SOUTHERN

BANCSHARES

2016 Consolidated Financial Statements

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES

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DHG
DIXON HUGHES GOODMAN LLP

INDEPENDENT AUDITORS' REPORT

The Audit and Compliance Committee
Southern BancShares (N.C.), Inc.
Mount Olive, North Carolina

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Southern BancShares (N.C.), Inc. and subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income and comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditors' Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal 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. 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.

DIXON HUGHES GOODMAN LLP

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Southern BancShares (N.C.), Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Audit of Internal Control Over Financial Reporting

We also have audited, in accordance with attestation standards established by the American Institute of Certified Public Accountants, the Company's internal control over financial reporting as of December 31, 2016, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 27, 2017 expressed an unmodified opinion thereon.

Dixon Hughes Goodman LLP

Raleigh, North Carolina
March 27, 2017

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Dollars in Thousands Except Per Share Data)

	December 31, 2016	December 31, 2015
ASSETS		
Cash and cash equivalents:		
Cash and due from banks	$ 18,534	$ 23,644
Interest-bearing deposits with banks	42,236	203,076
Certificates of deposit with banks	77,418	60,333
Total cash and cash equivalents	138,188	287,053
Investment securities available for sale, at fair value (amortized cost of $713,233 and $579,412, respectively)	776,022	629,827
Loans held for sale	4,579	2,012
Loans and leases:		
Acquired loans	300,313	147,085
Non-acquired loans	1,188,739	1,003,752
Less allowance for loan and lease losses		
Acquired loans	(1,988)	(1,843)
Non-acquired loans	(14,803)	(12,811)
Net loans and leases	1,472,261	1,136,183
Premises and equipment, net	58,708	50,298
Accrued interest receivable	7,916	7,043
Stock in Federal Home Loan Bank of Atlanta	2,184	1,963
Other real estate owned:		
Covered under loss share agreements	95	11,692
Not covered under loss share agreements	1,705	1,097
FDIC receivable for loss share agreements	2,518	9,665
Goodwill	26,649	7,712
Intangible assets	7,440	5,407
Bank owned life insurance	5,830	-
Other assets	9,277	5,941
Total assets	$ 2,513,372	$2,155,893
LIABILITIES		
Deposits:		
Noninterest-bearing	$ 628,307	$ 487,412
Interest-bearing	1,492,396	1,314,839
Total deposits	2,120,703	1,802,251
Short-term borrowings	58,044	64,722
Long-term borrowings	40,836	40,836
FDIC true-up liability for loss share agreements	15,373	14,599
Other liabilities	23,012	17,054
Total liabilities	2,257,968	1,939,462
SHAREHOLDERS' EQUITY		
Preferred stock	1,840	1,851
Common stock, $5 par value; 158,485 shares authorized; 81,704 and 81,788 shares issued and outstanding at December 31, 2016 and 2015, respectively	409	409
Surplus	69,862	49,862
Retained earnings	151,923	140,816
Accumulated other comprehensive income	31,370	23,493
Total shareholders' equity	255,404	216,431
Total liabilities and shareholders' equity	$ 2,513,372	$2,155,893

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME
(Dollars in Thousands Except Per Share Data)

	Year Ended December 31, 2016	Year Ended December 31, 2015
Interest income:		
Loans and leases	$ 76,533	$ 67,679
Investment securities	13,077	11,020
Federal funds sold and deposits with banks	1,759	1,369
Total interest income	91,369	80,068
Interest expense:		
Deposits	2,425	2,924
Short-term borrowings	171	168
Long-term borrowings	2,551	2,513
Total interest expense	5,147	5,605
Net interest income	86,222	74,463
Provision (recovery) for loan and lease losses	3,770	(2,162)
Net interest income after provision (recovery) for loan and lease losses	82,452	76,625
Noninterest income:		
Service charges on deposit accounts	8,034	7,460
Other service charges and fees	4,378	3,952
Investment securities gains, net	2,203	4,685
Gain on sale of loans	739	643
Amortization on FDIC receivable for loss share agreements	(3,337)	(5,690)
Other FDIC receivable for loss share agreements expense	(1,089)	(2,243)
Loss on sale and writedowns of other real estate owned	(2,792)	(6,250)
Investment services revenue	1,272	1,400
Other	3,459	2,543
Total noninterest income	12,867	6,500
Noninterest expense:		
Personnel	39,801	39,637
Data processing	5,984	5,428
Occupancy	6,826	5,864
Furniture and equipment	5,057	5,128
FDIC assessments	1,248	1,636
Professional fees	2,406	3,554
Amortization of intangibles and mortgage servicing rights	2,158	1,242
Merger related expenses	3,028	357
Other	8,067	7,685
Total noninterest expense	74,575	70,531
Income before income taxes	20,744	12,594
Income taxes	7,385	4,738
Net income	13,359	7,856
Other comprehensive income (loss):		
Unrealized gains on investment securities available for sale:		
Unrealized gains (losses) arising during period on investment securities available for sale	14,577	(102)
Tax effect	(5,373)	38
Reclassification adjustment from security transactions	(2,203)	(4,685)
Tax effect	1,128	2,064
Net of tax amount	8,129	(2,685)
Pension obligation	(1,455)	513
Tax effect	532	(191)
Amortization of actuarial losses and prior service cost	1,193	1,932
Tax effect	(522)	(777)
Net of tax amount	(252)	1,477
Total other comprehensive income (loss)	7,877	(1,208)
Comprehensive income	$ 21,236	$ 6,648
Per share information:		
Net income available to common shareholders per common share, basic and diluted	$ 139.37	$ 82.92
Cash dividends declared on common shares	1.60	1.60
Weighted average common shares outstanding	81,774	81,788

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
(Dollars in Thousands Except Per Share Data)

	Preferred					Common		Retained	Accumulated Other Comprehensive	Total Shareholders'
	Series B	Series C	Series D	Series E	Series F	Stock	Surplus	Earnings	Income	Equity
BALANCE, DECEMBER 31, 2014	$ 1,361	$ 489	$ -	$ 1	$ -	$ 409	$ 49,862	$ 134,166	$ 24,701	$ 210,989
Net income	-	-	-	-	-	-	-	7,856	-	7,856
Cash dividends:										
Common stock	-	-	-	-	-	-	-	(131)	-	(131)
Preferred B	-	-	-	-	-	-	-	(245)	-	(245)
Preferred C	-	-	-	-	-	-	-	(33)	-	(33)
Preferred D	-	-	-	-	-	-	-	(718)	-	(718)
Preferred E	-	-	-	-	-	-	-	(79)	-	(79)
Other comprehensive loss	-	-	-	-	-	-	-	-	(1,208)	(1,208)
BALANCE, DECEMBER 31, 2015	1,361	489	-	1	-	409	49,862	140,816	23,493	216,431
Net income	-	-	-	-	-	-	-	13,359	-	13,359
Issuance of preferred stock series F	-	-	-	-	-	-	20,000	-		20,000
Purchase and retirement of stock	(11)	-	-	-	-	-	-	(158)	-	(169)
Cash dividends:									-	
Common stock	-	-	-	-	-	-	-	(132)	-	(132)
Preferred B	-	-	-	-	-	-	-	(244)	-	(244)
Preferred C	-	-	-	-	-	-	-	(33)	-	(33)
Preferred D	-	-	-	-	-	-	-	(678)	-	(678)
Preferred E	-	-	-	-	-	-	-	(79)	-	(79)
Preferred F	-	-	-	-	-	-	-	(928)	-	(928)
Other comprehensive income	-	-	-	-	-	-	-	-	7,877	7,877
BALANCE, DECEMBER 31, 2016	$ 1,350	$ 489	$ -	$ 1	$ -	$ 409	$ 69,862	$ 151,923	$ 31,370	$ 255,404

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Dollars in Thousands Except Per Share Data)

	Year Ended December 31, 2016	2015
OPERATING ACTIVITIES:		
Net income	$ 13,359	$ 7,856
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision (recovery) for loan and lease losses	3,770	(2,162)
Deferred income tax expense (benefit)	2,552	(940)
Gain on sales and issuer calls of securities	(2,203)	(4,685)
Loss (gain) on disposal of premises and equipment	517	(173)
Loss on charitable contributions of property	36	84
Valuation adjustments on property held for sale	138	34
Loss on sale and writedowns of other real estate owned	2,792	6,250
Gain on sale of loans	(739)	(643)
Net amortization on investments	3,834	2,436
Amortization on FDIC receivable for loss share agreements	3,337	5,690
Cash reimbursements on FDIC receivable for loss share agreements	4,860	11,159
Accretion on acquired loans	(17,798)	(20,965)
Amortization of intangibles and mortgage servicing rights	2,158	1,242
Depreciation	4,812	4,206
Proceeds from sales of loans held for sale	68,894	68,870
Origination of loans held for sale	(70,722)	(68,766)
Net increase in FDIC loss share receivable	(1,050)	(2,004)
Net increase in intangible assets	(581)	(748)
Net increase in accrued interest receivable	(873)	(973)
Net increase in bank owned life insurance	(160)	-
Net decrease (increase) in other assets	331	(1,533)
Net increase (decrease) in other liabilities	(3,162)	1,529
NET CASH PROVIDED BY OPERATING ACTIVITIES	14,102	5,764
INVESTING ACTIVITIES:		
Proceeds from maturities and issuer calls of investment securities available-for-sale	200,207	146,226
Proceeds from sales of investment securities available-for-sale	111,070	69,933
Purchases of investment securities available-for-sale	(414,078)	(305,955)
Net increase in loans and leases	(114,773)	(36,144)
Redemption of FHLB stock	674	38
Purchases of premises and equipment	(8,822)	(4,900)
Proceeds from sale of premises and equipment	28	1,278
Proceeds from the sale of other real estate owned	11,040	14,847
Net cash received in acquisition	6,921	-
NET CASH USED BY INVESTING ACTIVITIES	(207,733)	(114,677)
FINANCING ACTIVITIES:		
Net increase in noninterest-bearing demand deposits	33,109	28,978
Net increase (decrease) in interest-bearing deposits	17,325	(101,408)
Net repayments of short-term borrowed funds	(23,405)	(615)
Cash dividends paid	(2,094)	(1,206)
Proceeds from the issuance of preferred stock	20,000	-
Purchase and retirement of stock	(169)	-
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	44,766	(74,251)
NET DECREASE IN CASH AND CASH EQUIVALENTS	(148,865)	(183,164)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF YEAR	287,053	470,217
CASH AND CASH EQUIVALENTS AT THE END OF YEAR	$ 138,188	$ 287,053

SOUTHERN BANCSHARES (N.C.), INC. AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS (continued)
(Dollars in Thousands Except Per Share Data)

	Year Ended December 31, 2016	2015
SUPPLEMENTAL DISCLOSURES OF CASH PAID DURING THE YEAR FOR:		
Interest	$ 5,194	$ 5,756
Income taxes	3,854	7,405
SUPPLEMENTAL DISCLOSURES OF NONCASH FINANCING AND INVESTING ACTIVITIES:		
Unrealized gains (losses) on available-for-sale securities, net of tax	$ 8,129	$ (2,685)
Change in pension obligation, net of tax	(252)	1,477
Non-acquired foreclosed loans and leases transferred to other real estate	768	862
Acquired foreclosed loans and leases transferred to other real estate	2,075	10,040
Covered other real estate transferred to non-covered other real estate	1,230	-
Premises and equipment transferred to other assets	748	81
Reclassification from short-term borrowings to long-term borrowings	-	10,000
Acquisitions:		
Assets acquired (excluding goodwill)	$ 318,525	$ -
Liabilities assumed	287,591	-
Total consideration paid	49,871	-
Goodwill recorded	18,937	-

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

BancShares

Southern BancShares (N.C.), Inc. ("BancShares") is the holding company for Southern Bank and Trust Company ("Southern"), which operates 52 banking offices and 3 loan production offices in eastern North Carolina and 10 banking offices in southeastern Virginia.

Southern Bank Community Development, LLC, is a wholly owned subsidiary of BancShares for the construction or rehabilitation of low-to-moderate income residential or commercial properties primarily in the rural Eastern North Carolina markets served by Southern. Southern, which began operations January 29, 1901, has a wholly-owned subsidiary, Goshen, Inc., whose primary operations include holding certain investments. Southern also has a wholly owned subsidiary, Tuscarora Properties, LLC, that was created to hold, manage and ultimately dispose of select other real estate owned (“OREO”) properties. BancShares and Southern are headquartered in Mount Olive, North Carolina.

On September 23, 2011, Southern acquired certain assets and assumed certain liabilities of the former Bank of the Commonwealth (“BOC”), including its 10 subsidiaries through a Federal Deposit Insurance Corporation (“FDIC”) assisted transaction. All but two subsidiaries have been dissolved in prior years. BOC was the sole owner of WOV Properties, LLC and Ten Rivers Lots, LLC that were created to hold, manage and ultimately dispose of select OREO properties. It is anticipated that these two subsidiaries will remain active until all properties are liquidated. The financial position and operating results of any one of the acquired subsidiaries are not significant to BancShares as a whole and are not considered principal activities of BancShares at this time.

On July 1, 2013, Southern acquired all of the outstanding common and preferred stock of Heritage Bancshares, Inc. (“Heritage-NC”) of Lucama, North Carolina, the bank holding company for The Heritage Bank (“THB”), in a stock and cash transaction. Immediately following the merger, THB merged with and into Southern.

On February 1, 2016, Southern acquired all of the outstanding common stock of Heritage Bankshares, Inc. (“Heritage-VA”) of Norfolk, Virginia the bank holding company for Heritage Bank (“HB”), in an all cash transaction. Immediately following the merger, HB merged with and into Southern.

BancShares has no foreign operations and BancShares’ customers are principally located in eastern North Carolina and southeastern Virginia.

BancShares and Southern are subject to extensive federal and state banking laws and regulations. These laws and regulations focus on the protection of depositors, federal deposit insurance funds, and the banking system as a whole rather than the protection of security holders. Federal and state banking regulators possess broad powers to take supervisory actions as they deem appropriate. These supervisory actions may result in higher capital requirements, higher insurance premiums, increased expenses, reductions in fee income and limitations on activities that could have a materially adverse effect on our results of operations.

Principles of Consolidation

The consolidated financial statements include the accounts of BancShares and other entities in which BancShares has a controlling interest. All significant intercompany balances have been eliminated in consolidation.

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Basis of Financial Statement Presentation

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 liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The most significant estimates made by BancShares in the preparation of its consolidated financial statements are:

- Determination of the allowance for loan and lease losses
- Determination of other-than-temporary impairment for investment securities
- Determination of fair values of acquired assets and assumed liabilities
- Loss estimates related to loans and other real estate owned ("OREO") acquired which are covered under loss share agreements with the FDIC
- Determination of FDIC receivable for loss share agreements
- Determination of fair value estimates for OREO not covered under loss share agreements
- Goodwill impairment
- Pension plan assumptions
- Mortgage servicing rights
- Determination of FDIC true-up liability for loss share agreements
- Income taxes

Reclassifications

Certain prior year balances have been reclassified to conform to the current year presentation. Such reclassifications had no effect on net income or shareholders' equity as previously reported.

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits with banks, and certificates of deposit with banks. Overnight and federal funds are purchased and sold for one day periods.

Investment Securities

Accounting guidance requires BancShares to account for investments in debt and equity securities as either: held-to-maturity (reported at amortized cost), trading (reported at fair value with unrealized gains and losses included in earnings), or available-for-sale (reported at fair value with unrealized gains and losses excluded from earnings and reported, net of related income taxes, as a separate component of shareholders' equity). Securities available-for-sale consist of certain debt and marketable equity securities not classified as trading securities nor as securities held-to-maturity, and consist of securities which may be sold in response to changes in interest rates, prepayment risk, regulatory capital requirements and liquidity needs. BancShares does not have any trading or held-to-maturity securities as of December 31, 2016 and 2015. Unrealized losses on securities available-for-sale and held-to-maturity reflecting a decline in value judged to be other than temporary are charged to income in the consolidated statement of income.

Gains and losses on the sale and contribution of securities available-for-sale are determined using the specific-identification method. Premiums and discounts are amortized into income on a level yield basis until the investments mature or are called.

Investment securities are periodically evaluated to determine whether the investment is other than temporarily impaired. If an investment security is determined to be other than temporarily impaired, the security is written down to its fair value with an offsetting securities loss included in earnings.

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Loans Held for Sale

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Estimated fair value is determined on the basis of existing forward commitments or the current market value of similar loans. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. Loans held-for-sale are normally sold to investors with the best effort intent and ability to sell all loans as long as they meet the underwriting standards of the potential investor.

Loans and Leases

Non-acquired loans that are held for investment purposes are carried at the principal amount outstanding reduced by unearned income and an allowance for loan losses.

Acquired loans are recorded at fair value at the date of acquisition. The fair values of acquired credit-impaired loans accounted for in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC") Topic 310-30 are recorded net of a nonaccretable difference and, if appropriate, an accretable yield. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is the nonaccretable difference which is included as a reduction to the carrying amount of acquired FASB ASC Topic 310-30 loans.

Subsequent decreases to expected cash flows will generally result in recognition of an allowance by a charge to provision for loan and lease losses. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized in interest income over the remaining life of the loan when there is a reasonable expectation regarding the amount and timing of such cash flows. Subsequent increases in expected cash flows result in either a reversal of the provision for loan and lease losses to the extent of prior charges, or a reclassification of the difference from nonaccretable to accretable with a positive impact on the accretable yield.

Cash flow analyses are performed on acquired ASC 310-30 loans in order to determine the cash flows expected to be collected. Acquired credit-impaired loans that are accounted for in accordance with FASB ASC Topic 310-30, as well as acquired non-credit-impaired loans accounted for under ASC 310-20 are accruing interest under the accretion method and are thus not reported as nonaccrual. BancShares is accounting for substantially all acquired credit-impaired loans on a pool level basis with the exception of certain large or non-homogeneous loans.

Interest income on non-acquired loans is recognized in a manner that approximates the level yield method when related to the principal amount outstanding. Accrual of interest is discontinued on a loan when management believes the borrower's financial condition is such that collection of principal or interest is doubtful. Loans are returned to the accrual status when the factors indicating doubtful collectability cease to exist and the loan has performed in accordance with its terms for a demonstrated period of time. The past due status of loans is based on the contractual terms of the loan.

Management considers a non-acquired loan to be impaired when, based on current information or events, it is probable that a borrower will be unable to pay all amounts due according to the contractual terms of the loan agreement. Impaired loans are valued using either the discounted expected cash flow method or the collateral value. When the ultimate collectability of the non-acquired impaired loan's principal is doubtful, all cash receipts are applied to principal. Once the recorded principal balance has been reduced to zero, future cash receipts are applied to interest income, to the extent that any interest has been foregone. Future cash receipts are recorded as recoveries of any amounts previously charged-off.

Southern provides an allowance for loan losses on non-acquired loans on a reserve basis and includes in operating expenses a provision for loan losses determined by management. The allowance is reduced by charge-offs and increased by subsequent recoveries. Management's periodic evaluation of the adequacy of the allowance is based on Southern's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect borrowers' experience, the estimated value of any underlying collateral, current economic conditions and other risk factors. Management believes it has established the allowance in accordance with accounting principles generally accepted in the United States of America and in consideration of the current economic environment. While management uses the best information available to make evaluations, future adjustments may be necessary.

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Loans and Leases (Continued)

In addition, various regulatory agencies, as an integral part of their examination process, periodically review Southern's allowance for loan losses and actual losses on OREO. Such agencies may require Southern to recognize adjustments to the allowance based on the examiners' judgments about information available to them at the time of their examinations.

Troubled Debt Restructurings ("TDRs")

Southern designates loan modifications as TDRs when, for economic or legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. Loans on nonaccrual status at the date of modification are initially classified as nonaccrual TDRs. Loans on accruing status at the date of modification are initially classified as accruing TDRs at the date of modification, if the note is reasonably assured of repayment and performance is in accordance with its modified terms. Such loans may be designated as nonaccrual loans subsequent to the modification date if reasonable doubt exists as to the collection of interest or principal under the restructuring agreement. Nonaccrual TDRs are returned to accruing status when there is economic substance to the restructuring, there is well documented credit evaluation of the borrower's financial condition, the remaining balance is reasonably assured of repayment in accordance with its modified terms, and the borrower has demonstrated sustained repayment performance in accordance with the modified terms for a reasonable period of time (generally a minimum of six months).

Premises and Equipment

Premises and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are computed using the straight-line method over the estimated lives of the assets, ranging from 15 to 39 years for buildings and improvements and 3 to 10 years for furniture and equipment.

Stock in Federal Home Loan Bank of Atlanta

Stock in Federal Home Loan Bank of Atlanta ("FHLB") is acquired for regulatory purposes. This security does not have a readily determinable fair value because its ownership is restricted and lacks a market for trading. As a result, this security is carried at cost and is periodically evaluated for impairment.

OREO Not Covered Under Loss Share Agreements

OREO not covered under loss share agreements acquired through, or in lieu of, foreclosure is held for sale and is stated at estimated fair market value of the property, less estimated disposal costs at time of foreclosure then lower of cost or net realizable value throughout the remaining life. At least annually, current appraisals are obtained for all OREO not covered under loss share agreements and carrying values are adjusted, if required, with a charge to current expenses for adjustments to reflect the current appraised values less the estimated cost to sell.

BancShares estimates fair value at the asset's fair market value less disposal costs using management's assumptions which are based on current market trends and historical losses for similar assets. Any excess of cost over the estimated fair market value at the time of foreclosure is charged to the allowance for loan and lease losses.

OREO Covered Under Loss Share Agreements

OREO covered under loss share agreements with the FDIC is reported exclusive of expected reimbursement cash flows from the FDIC. Subsequent downward adjustments to the estimated fair market value of OREO covered under loss share agreements result in a reduction of covered OREO, a charge to other noninterest expense and an increase in the FDIC receivable for the estimated amount to be reimbursed, with a corresponding amount recorded as an adjustment to other noninterest income. OREO is presented at the estimated fair market value that management expects to receive when the property is sold, net of related costs of disposal. Management uses appraisals of properties to determine fair values and applies additional discounts where appropriate for passage of time or, in certain cases, for subsequent events occurring after the appraisal date.

(Dollars in Thousands for Tabular Presentations)

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Goodwill and Intangible Assets

Intangible assets are composed primarily of goodwill, core deposit premiums and mortgage servicing rights. Core deposit premiums are generally amortized on an accelerated basis over a period of 5 to 10 years and the useful lives are periodically reviewed for reasonableness.

Mortgage servicing rights ("MSRs") represent the estimated value of the right to service mortgage loans for others. Capitalization of MSRs occurs when the underlying loans are sold. Capitalized MSRs are amortized into income over the projected servicing life of the underlying loans.

As of December 31, 2016, BancShares had goodwill and intangible assets totaling $34.1 million. Management evaluated BancShares' existing intangible assets and goodwill for impairment as of September 30, 2016. BancShares will continue to amortize the intangible assets with finite lives, totaling $7.4 million at December 31, 2016, which relate to acquisitions of core deposit intangibles and mortgage servicing rights. These intangible assets will continue to be amortized over their estimated useful lives. The amortization expense associated with intangible assets was $2.2 million and $1.2 million for the years ended December 31, 2016 and 2015, respectively.

Goodwill arising from acquisitions is not amortized but is reviewed for potential impairment at least annually or if events or circumstances indicate a potential impairment. An impairment loss is recorded to the extent that the carrying amount of goodwill exceeds its implied fair value. BancShares concluded that goodwill was not impaired as of December 31, 2016; however, future events impacting financial institutions could negatively impact BancShares' goodwill asset in the future.

The following is a summary of the gross carrying amounts, accumulated amortization and net carrying amounts of amortized intangible assets and the gross carrying amount of unamortized intangible assets as of December 31, 2016 and December 31, 2015:

	December 31, 2016		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortized intangible assets:			
Core deposits intangibles	$ 23,528	$ 19,460	$ 4,068
Mortgage servicing rights	9,119	5,747	3,372
Total	$ 32,647	$ 25,207	$ 7,440
Unamortized intangible assets:			
Goodwill	$ 26,649		

	December 31, 2015		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Amortized intangible assets:			
Core deposits intangibles	$ 19,918	$ 17,822	$ 2,096
Mortgage servicing rights	8,538	5,227	3,311
Total	$ 28,456	$ 23,049	$ 5,407
Unamortized intangible assets:			
Goodwill	$ 7,712		

Core deposit intangibles of $2.3 million were capitalized in 2011 as a result of the FDIC-assisted acquisition of certain liabilities of BOC. Core deposit intangibles of $2.9 million were capitalized in 2013 as a result of the acquisition of Heritage-NC. Core deposit intangibles of $3.6 million were capitalized in 2016 as a result of the acquisition of Heritage-VA. Related amortization for the acquisition recorded intangibles in 2016 and 2015 was $1.6 million and $760,000, respectively.

(Dollars in Thousands for Tabular Presentations)

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Goodwill and Intangible Assets (Continued)

At December 31, 2016, the scheduled amortization expense for intangible assets is as follows:

2017	$ 1,876
2018	1,574
2019	1,147
2020	702
2021	418
Thereafter	1,723
Total	$ 7,440

The actual amortization expense in future periods may be subject to change based on changes in the useful life of the assets, expectations for loan prepayments, future acquisitions and future loan sales.

Bank-Owned Life Insurance

The Company has purchased life insurance policies on certain current and past key employees and directors where the insurance policy benefits and ownership are retained by the employer. These policies are recorded at their cash surrender value. Income from these policies and changes in the net cash surrender value are recorded in non-interest income as earnings on bank-owned life insurance. The cash value accumulation is permanently tax deferred if the policy is held to the insured person’s death and certain other conditions are met.

Income Taxes

BancShares uses the asset and liability method to account for deferred income taxes. The objective of the asset and liability method is to establish deferred tax assets and liabilities for the temporary differences between the financial reporting basis and the income tax basis of BancShares’ assets and liabilities at enacted rates expected to be in effect when such amounts are realized or settled.

Recognition of deferred tax assets is based on management’s belief that it is “more likely than not” that the tax benefit associated with certain temporary differences will be realized. A valuation allowance is recorded for deferred tax assets when the “more likely than not” standard is not met.

Shareholders’ Equity

Common shareholders are entitled to one vote per share and Series B and C preferred shareholders are entitled to one vote for each 38 shares owned of a class. Dividends on BancShares’ common stock may be paid only after annual dividends of $.90 per share on both preferred series B and C shares have been paid, $1.36 per share on preferred series E shares, and after variable dividends, based on the current one month LIBOR rate plus a varying spread rate, not to exceed an annual rate of 12.24%, on series D and F preferred shares have been paid. Also see Note 14 – Related Parties. Holders of preferred series D and F shares have no right to vote, except with respect to such matters as to which voting by holders of preferred series D and F shares may be required by applicable law. When holders of preferred series D and F shares are entitled to vote, each such share will be entitled to one vote for each 38 shares held of record. Holders of preferred series E shares have no right to vote, except with respect to such matters as to which voting by holders of preferred series E shares may be required by applicable law. When holders of preferred series E shares are entitled to vote, each such share will be entitled to one vote for each share held of record.

(Dollars in Thousands for Tabular Presentations)

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Shareholders' Equity (Continued)

Share activity and other information for each of the preferred and common stock issues is presented below:

	Non-cumulative Preferred Series B	Non-cumulative Preferred Series C	Non-cumulative Preferred Series D	Non-cumulative Preferred Series E	Non-cumulative Preferred Series F	Common
December 31, 2014	272,181	36,923	21,375	57,798	-	81,788
Purchase and retirement	-	-	-	-	-	-
December 31, 2015	272,181	36,923	21,375	57,798	-	81,788
Issuance	-	-	-	-	20,000	-
Purchase and retirement	(2,192)	(56)	-	-	-	(84)
December 31, 2016	269,989	36,867	21,375	57,798	20,000	81,704
Shares authorized	408,228	43,631	39,750	79,680	20,000	158,485
Par value	None	None	None	None	None	$ 5.00
Liquidation value						
December 31, 2015	$ 2,722	$ 369	$ 21,375	$ 1,445	$ -	N/A
December 31, 2016	$ 2,700	$ 369	$ 21,375	$ 1,445	$ 20,000	N/A

Earnings per common share are computed by dividing income applicable to common shares by the weighted average number of common shares outstanding during the period. Income applicable to common shares represents net income reduced by dividends paid to preferred shareholders. BancShares has no potentially dilutive securities.

Earnings per common share are calculated based on the following amounts for the years ended December 31:

	2016	2015
Net income attributable to Bancshares	$ 13,359	$ 7,856
Less: preferred dividends	(1,962)	(1,075)
Net income applicable to common shares	$ 11,397	$ 6,781
Weighted average common shares outstanding during the period	81,774	81,788

Other Comprehensive Income

Other comprehensive income is defined as the change in equity during a period for non-owner transactions and comprises net income and other comprehensive income. Other comprehensive income includes revenues, expenses, gains, and losses that are excluded from earnings under current accounting standards. Components of other comprehensive income for BancShares consist of the unrealized gains and losses, net of taxes, in BancShares' available-for-sale securities portfolio and changes in the defined benefit pension plan obligation.

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Federally Assisted Acquisition of BOC

On September 23, 2011, Southern entered into an agreement with the FDIC, as Receiver, to purchase certain assets and assume certain liabilities of BOC of Norfolk, Virginia at a discount of $161.0 million with no deposit premium. BOC operated in Norfolk, Virginia, with 21 branch locations in southeastern Virginia and eastern North Carolina. The Purchase and Assumption Agreement with the FDIC includes loss share agreements on the covered loans and OREO purchased by BancShares which provides protection against losses to Southern. Loss share agreements between the FDIC and Southern (one for single family residential loans and related OREO with a term of 10 years and the other for commercial loans and related OREO with a term of 5 years) provide significant loss protection to Southern for substantially all acquired non-consumer loans and acquired OREO. Under the loss share agreements, the FDIC will pay Southern 80 percent of covered losses until reimbursement for such losses reaches $181.5 million; then 20 percent of covered losses for reimbursements from $181.5 million up to $279.2 million; and, finally, 80 percent of covered losses that result in reimbursements to Southern in excess of $279.2 million. Through December 31, 2016, the FDIC has reimbursed the Bank approximately $140.6 million in accordance with the provisions of the two loss share agreements. The commercial loss share agreement expired in September of 2016 and Southern is now subject to a three year trailing recovery period. Assets covered under the single family loss share agreement which expires in September of 2021 total $22.2 million.

The risks associated with covered loans are generally consistent with the risks identified for commercial and non-commercial loans and the classes of loans within those segments. An additional risk with respect to covered loans relates to the FDIC loss share agreements, specifically maintaining compliance with the agreements to be eligible to receive timely and full reimbursement from the FDIC for losses and related expenses that are believed to be covered by the loss share agreements. Further, these loans were underwritten by another institution with weaker lending standards. Therefore, there is a significant risk that the loans are not adequately supported by the paying capacity of the borrower or the values of underlying collateral at the time of origination.

The loss share agreement was terminated during the first quarter of 2017 as further discussed in Note 16.

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Business Combinations and Method for Accounting for Loans Acquired

Southern accounts for its acquisitions under FASB ASC Topic 805, *Business Combinations*, which requires the use of the acquisition method of accounting. All identifiable assets acquired, including loans, are recorded at fair value. No allowance for loan losses related to the acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding credit risk. Loans acquired are recorded at fair value in accordance with the fair value methodology prescribed in FASB ASC Topic 820, *Fair Value Measurements and Disclosures*, exclusive of the loss share agreements with the FDIC. The fair value estimates associated with the loans include estimates related to expected prepayments and the amount and timing of expected principal, interest and other cash flows.

Acquired credit-impaired loans are accounted for under the accounting guidance for loans and debt securities acquired with deteriorated credit quality, found in FASB ASC Topic 310-30, *Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality*, formerly American Institute of Certified Public Accountants ("AICPA") Statement of Position (SOP) 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, and initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loans. Loans acquired in business combinations with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered to be credit-impaired. Evidence of credit quality deterioration as of purchase dates may include information such as past-due and nonaccrual status, borrower credit scores and recent loan to value percentages. Southern considers expected prepayments and estimates the amount and timing of expected principal, interest and other cash flows for each loan or pool of loans meeting the criteria above, and determines the excess of the loan's scheduled contractual principal and contractual interest payments over all cash flows expected to be collected at acquisition as an amount that should not be accreted (nonaccretable difference). The remaining amount, representing the excess of the loan's or pool's cash flows expected to be collected over the fair value for the loan or pool of loans, is accreted into interest income over the remaining life of the loan or pool (accretable yield). In accordance with FASB ASC Topic 310-30, Southern aggregated acquired loans that have common risk characteristics into pools.

Loans acquired through business combinations that do not meet the specific criteria of FASB ASC Topic 310-30, but for which a discount is attributable at least in part to credit quality are generally accounted for under this guidance. As a result, related discounts are recognized subsequently through accretion based on the expected cash flow of the acquired loans. Certain acquired loans, such as lines of credit (consumer and commercial) and loans with no significant credit related discount are accounted for in accordance with FASB ASC Topic 310-20, where the discount is accreted through earnings based on contractual cash flows over the estimated life of the loan.

Subsequent to the acquisition date, increases in cash flows expected to be received in excess of Southern’s initial estimates are reclassified from nonaccretable difference to accretable yield and are accreted into interest income on a level-yield basis over the remaining life of the loan. Decreases in cash flows expected to be collected are recognized as impairment through the provision for loan losses. For acquired loans subject to a loss sharing agreement with the FDIC, the FDIC indemnification asset will be adjusted prospectively in a similar, consistent manner with increases and decreases in expected cash flows, except such adjustment is reflected over the shorter of the estimated life of the loans or the remaining contractual term of loss share agreements with the FDIC.

Probable and significant increases in cash flows (in a loan pool where an allowance for acquired loan losses was previously recorded) reduces the remaining allowance for acquired loan losses before recalculating the amount of accretable yield percentage for the loan pool in accordance with ASC 310-30. For covered loan pools, the reduction of the remaining allowance for acquired loan losses would be offset by the impact to the indemnification asset depending on the covered portfolio's loss share coverage.

(Dollars in Thousands for Tabular Presentations)

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Acquisition of Heritage Bankshares, Inc.

On February 1, 2016, Southern acquired all of the outstanding common stock of Heritage Bankshares, Inc. of Norfolk, Virginia, the bank holding company for Heritage Bank, in an all cash transaction. Heritage-VA common shareholders received $21.05 in cash for each share of stock owned. In total, the purchase price for Heritage-VA was $49.871 million in cash. This business combination expanded the Bank's market presence in southeastern Virginia.

The statement of net assets acquired and the resulting goodwill respective to our business combination with Heritage-VA are presented in the following table. As indicated in the explanatory notes that accompany the following table, the purchased assets, assumed liabilities and identifiable intangible assets were recorded at their respective acquisition date estimated fair values Results of operations for Heritage-VA prior to the acquisition date are not included in the income statement. To date no measurement period adjustments have been made to the original fair value estimates.

	February 1, 2016			
	As Recorded by Heritage-VA	Fair Value Adjustments		As Recorded by BancShares
ASSETS				
Cash and due from banks	$ 56,792	$ -		$ 56,792
Investment securities available for sale	29,885	2,804	a	32,689
Investment securities held to maturity	2,825	(2,825)	a	-
Loans	212,410	(2,290)	b	210,120
Premises and equipment	8,598	(2,905)	c	5,693
Stock in Federal Home Loan Bank of Atlanta	895	-		895
Stock in Federal Reserve Bank of Richmond	604	-		604
Bank owned life insurance	5,670	-		5,670
Goodwill	-	18,937		18,937
Core deposit intangible	-	3,610	d	3,610
Other assets	1,766	686	e	2,452
Total assets acquired	$ 319,445	$ 18,017		$ 337,462
LIABILITIES				
Noninterest-bearing	107,786	-		107,786
Interest-bearing	160,166	66	f	160,232
Total deposits	267,952	66		268,018
Short-term borrowings	16,727	-		16,727
Other liabilities	3,150	(304)	g	2,846
Total liabilities assumed	$ 287,829	$ (238)		$ 287,591
Excess of assets acquired over liabilities assumed	$ 31,616			$ 49,871
Aggregate fair value adjustments		$ 18,255		
FAIR VALUE OF CONSIDERATION TRANSFERRED				
Cash paid				$ 49,871

Explanation of fair value adjustments:

a - Adjustment reflects the reclass of securities held to maturity to available for sale plus the amount needed to adjust the carrying value of investments to their estimated fair value.

b - Adjustment reflects the fair value adjustments based on BancShares' evaluation of the acquired loan portfolio.

c - Adjustment reflects the estimated fair value of acquired premises and equipment.

d - Adjustment reflects the estimated value of the core deposit intangible.

e - Adjustment reflects the amount needed to adjust the carrying value of other assets to their estimated fair value. Included in the other assets is an adjustment to deferred tax assets totaling $692, which is related to deferred taxes on the other fair value adjustments.

f - Adjustment reflects the amount needed to adjust the carrying value of time deposits to their estimated fair value.

g - Adjustment reflects the amount needed to adjust the carrying value of other liabilities to their estimated fair value

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

FDIC Receivable and True-up Liability for Loss Share Agreements

The FDIC receivable for loss share agreements is measured separately from the related covered asset as it is not contractually embedded in the assets and is not transferable with the assets should Southern choose to dispose of them. Fair value was estimated at the acquisition date using projected cash flows related to the loss sharing agreements based on the expected reimbursements for losses and the applicable loss sharing percentages. These expected reimbursements do not include reimbursable amounts related to future covered expenditures. These cash flows were discounted to reflect the uncertainty of the timing and receipt of the loss sharing reimbursement from the FDIC. Southern will offset any recorded provision for loan losses related to acquired covered loans by recording an increase in the FDIC receivable by the increase in expected cash flow, which is the result of a decrease in expected cash flow of acquired loans. An increase in cash flows on acquired loans results in a decrease in cash flows on the FDIC receivable, which is recognized in the future as negative accretion through non-interest income over the shorter of the remaining life of the FDIC receivable or the underlying loans.

The FDIC true-up liability for loss share agreements relates to contingent payments that may be owed to the FDIC at the termination of the loss share agreement. The contingent payment is due to the FDIC if actual cumulative losses on acquired covered assets are lower than the cumulative losses originally estimated by the FDIC at the time of acquisition. The contingent liability is calculated by discounting estimated future payments and is reported in the Consolidated Balance Sheets as an FDIC true-up liability for loss share agreements. The ultimate settlement amount of the contingent payment is dependent upon the performance of the underlying covered assets, the passage of time and actual claims submitted to the FDIC. Southern terminated the agreement with the FDIC in March of 2017 as further discussed in Note 16 to the consolidated financial statements.

Southern incurs expenses related to the assets indemnified by the FDIC and pursuant to the loss share agreement certain costs are reimbursable by the FDIC and are included in quarterly claims made by Southern. The estimates of reimbursements are netted against Other FDIC receivable for loss share agreements expense in the Consolidated Statements of Income and Comprehensive Income.

Recent Accounting Pronouncements

The following is a summary of recent authoritative pronouncements that could impact the accounting, reporting, and/or disclosure of financial information by BancShares.

In May 2014, the FASB issued Accounting Standards Update No. 2014-09, *Revenue from Contracts with Customers* ("ASU 2014-09"). This guidance will supersede most of the existing revenue recognition requirements in accounting principles generally accepted in the United States (“GAAP”) and will require entities to recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. The new standard also requires significantly expanded disclosures regarding the qualitative and quantitative information of an entity’s nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. During 2015, the FASB amended this update to defer the effective date by one year. The pronouncement is effective for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period and is to be applied retrospectively. We are currently evaluating the impact the pronouncement will have on our consolidated financial statements and related disclosures.

In February 2015 FASB issued Accounting Standards Update No. 2015-02, *Consolidation (Topic 810): Amendments to the Consolidation Analysis (Topic 860)* (“ASU 2015-02”). The ASU changes the guidance with respect to the analysis that a reporting entity must perform to determine whether it should consolidate certain types of legal entities. The amendments include: (1) modifying the evaluation of limited partnerships and similar legal entities, (2) amending when fees paid to a decision maker should be included in the variable interest entity analysis, (3) amending the related party relationship guidance, and (4) providing a scope exception from the consolidation guidance for reporting entities with interests in certain investment funds. The ASU is effective for interim and annual reporting periods beginning after December 15, 2015. The adoption of this guidance did not have a material impact on our consolidated financial statements.

(Dollars in Thousands for Tabular Presentations)

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Recent Accounting Pronouncements (Continued)

In September 2015, the FASB issued Accounting Standards Update No. 2015-16: *Business Combinations (Topic 805): Simplifying the Accounting for Measurement Period Adjustments* ("ASU 2015-16"). The new guidance requires acquirers to recognize adjustments to provisional amounts (that are identified during the measurement period) in the reporting period in which the adjustment amounts are determined. The new guidance also requires such amounts to be disclosed in the consolidated financial statements. The amendments in this update should be applied prospectively to adjustments to provisional amounts that occur after the effective date of this update with earlier application permitted for financial statements that have not been issued. We adopted the guidance effective in the first quarter of 2016 and it did not impact our consolidated financial statements.

In January 2016, the FASB issued Accounting Standards Update 2016-01: *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ("ASU 2016-01"). The new guidance addresses certain aspects of recognition, measurement, presentation and disclosure. The amendments in this update (1) require equity investments to be measured at fair value with changes in fair value recognized in net income; (2) simplify the impairment assessment of equity investments without readily determinable fair value; (3) require public business entities to use exit prices, rather than entry prices, when measuring fair value of financial instruments for disclosure purposes; (4) require separate presentation of financial assets and financial liabilities by measurement category and form of financial assets on the balance sheet or the accompanying notes to the financial statements; (5) eliminate the requirement to disclose the method(s) and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet; (6) require separate presentation in other comprehensive income of the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; and (7) state that a valuation allowance on deferred tax assets related to available-for-sale securities should be evaluated in combination with other deferred tax assets. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The ASU only permits early adoption of the instrument-specific credit risk provision. We expect the adoption of the ASU to have a material impact on our consolidated financial statements. We will adopt the ASU during the first quarter of 2018 with a cumulative-effect adjustment from accumulated other comprehensive income to retained earnings as of the beginning of the year of adoption. The cumulative-effect adjustment will be impacted by the equity securities portfolio composition and valuation at the date of adoption. If the ASU had been effective for the years ended December 31, 2016 and 2015 BancShares pro-forma net income would have been as follows:

	2016	2015
Current net income	$ 13,359	$ 7,856
Change in fair value of equity investments, net of tax	12,526	(421)
Pro-forma net income after application of ASU 2016-01	$ 25,885	$ 7,435

In February 2016, the FASB issued Accounting Standards Update 2016-02, *Leases (Topic 842)* ("ASU 2016-02"). The ASU was issued in order to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous GAAP. The ASU requires that a lessee should recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term on the balance sheet. The ASU is effective for interim and annual periods beginning after December 15, 2018, using a modified retrospective approach, and early adoption is permitted. The Company is currently evaluating the impact the pronouncement will have on its consolidated financial statements.

In June 2016, the FASB issued Accounting Standards Update 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* ("ASU 2016-03"). This ASU eliminates the delayed recognition of the full amount of credit losses until the loss was probable of occurring and instead will reflect an entity's current estimate of all expected credit losses. The amendments in this ASU broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The ASU does not specify a method for measuring expected credit losses and allows an entity to apply methods that reasonably reflect its expectations of the credit loss estimate based on the entity's size, complexity and risk profile. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2020. The Company is currently evaluating the effect that implementation of the new standard will have on its consolidated financial statements.

(Dollars in Thousands for Tabular Presentations)

Note 1. Nature of Operations and Summary of Significant Accounting Policies (Continued)

Recent Accounting Pronouncements (Continued)

Although it is likely that further regulatory actions will arise as the Federal government attempts to address the economic situation, management is not aware of any further recommendations by regulatory authorities that, if implemented, would have or would be reasonably likely to have a material effect on liquidity, capital ratios or results of operations.

From time to time the FASB issues exposure drafts for proposed statements of financial accounting standards. Such exposure drafts are subject to comment from the public, to revisions by the FASB and to final issuance by the FASB as statements of financial accounting standards. Management considers the effect of the proposed statements on the consolidated financial statements of BancShares and monitors the status of changes to and proposed effective dates of exposure drafts.

Note 2. Investment Securities

The amortized cost and estimated fair values of investment securities at December 31 were as follows:

	2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasuries and government-sponsored entities debt*	$ 121,179	$ 132	$ (1,915)	$ 119,396
Corporate debt securities	11,943	590	(176)	12,357
Marketable equity securities	16,600	68,087	-	84,687
Obligations of states and political subdivisions	33,992	315	(549)	33,758
Residential government-sponsored mortgage-backed securities	529,519	1,247	(4,942)	525,824
TOTAL	$ 713,233	$ 70,371	$ (7,582)	$ 776,022

	2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Treasuries and government-sponsored entities debt*	$ 158,968	$ 427	$ (204)	$ 159,191
Corporate debt securities	6,847	683	(37)	7,493
Marketable equity securities	16,808	48,771	-	65,579
Obligations of states and political subdivisions	21,897	535	-	22,432
Residential government-sponsored mortgage-backed securities	374,892	1,481	(1,241)	375,132
TOTAL	$ 579,412	$ 51,897	$ (1,482)	$ 629,827

* - Government-sponsored entities debt consists of debt securities offered by Federal Home Loan Mortgage Corporation, Federal National Mortgage Corporation, Federal Home Loan Bank, and Federal Farm Credit Banks.

(Dollars in Thousands for Tabular Presentations)

Note 2. Investment Securities (Continued)

Securities with a carrying value of $248.1 million, $71.5 million, and $52.3 million were pledged at December 31, 2016 to secure public deposits, short-term borrowings, and long-term borrowings, respectively.

During the year ended December 31, 2011, BancShares acquired corporate debt securities with warrants attached that provide for the acquisition of up to 7,600 shares of common stock of the issuer. These warrants, which were non-detachable, expired as worthless on June 29, 2016.

Included in the following tables are all investments with unrealized loss positions. Securities with unrealized losses in which other-than-temporary impairment has been recognized are further discussed below.

Temporarily impaired securities at December 31 were as follows:

	2016					
	Less Than 12 Months		12 Months or Longer		Total	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
U.S. Treasuries and government-sponsored entities debt	$ 1,901	$ 84,760	$ 14	$ 7,507	1,915	$ 92,267
Corporate debt securities	161	2,828	15	1,046	176	3,874
Obligations of states and political subdivisions	549	12,694	-	-	549	12,694
Residential government-sponsored mortgage-backed securities	3,366	182,897	1,576	158,039	4,942	340,936
Total temporarily impaired securities	$ 5,977	$ 283,179	$ 1,605	$ 166,592	$ 7,582	$ 449,771

	2015					
	Less Than 12 Months		12 Months or Longer		Total	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
U.S. Treasuries and government-sponsored entities debt	$ 29	$ 5,975	$ 175	$ 40,986	$ 204	$ 46,961
Corporate debt securities	-	-	37	1,037	37	1,037
Residential government-sponsored mortgage-backed securities	1,131	206,506	110	8,020	1,241	214,526
Total temporarily impaired securities	$ 1,160	$ 212,481	$ 322	$ 50,043	$ 1,482	$ 262,524

The above securities' losses were considered temporary losses at December 31, 2016 principally resulting from the increase in rates toward the end of 2016 and 2015. There were one hundred thirty five and sixty seven securities in an unrealized loss position at December 31, 2016 and 2015, respectively including twenty four and eight U.S. Treasuries and government-sponsored entities debt, two and one corporate debt securities, twenty and zero obligations of states and political subdivisions, eighty nine and fifty eight residential government-sponsored mortgage-backed securities, respectively. The unrealized losses are not likely to reverse unless and until market interest rates decline to the levels that existed when the securities were purchased or until the security matures or is called by the issuer. Since none of the unrealized losses relate to the marketability of the securities or the issuer's ability to honor redemption obligations, none of the securities are deemed to be other than temporarily impaired. As of December 31, 2016, there was no intent to sell any of the securities classified as available-for-sale. Furthermore, it is not likely that BancShares will have to sell any such securities before a recovery of the carrying value.

(Dollars in Thousands for Tabular Presentations)

Note 2. Investment Securities (Continued)

The amortized cost and estimated fair value of debt securities at December 31, 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Securities available-for-sale:		
U.S. Treasuries and government-sponsored entities debt		
Due in one year or less	$ 14,487	$ 14,518
Due after one year through five years	76,902	75,978
Due after five years through ten years	29,790	28,900
	121,179	119,396
Corporate debt securities		
Due in one year or less	4,497	4,580
Due after one year through five years	2,742	2,741
Due after five years through ten years	4,669	4,550
Due after ten years	35	486
	11,943	12,357
Obligations of states and political subdivisions		
Due after one year through five years	9,781	9,896
Due after five years through ten years	3,600	3,661
Due after ten years	20,611	20,201
	33,992	33,758
Residential government-sponsored mortgage-backed securities	529,519	525,824
Marketable equity securities	16,600	84,687
Total	$ 713,233	$ 776,022

Sales of securities available-for-sale having a cost basis of $54.3 million and $65.2 million in 2016 and 2015, respectively, resulted in gross realized gains of $3.8 million and $4.7 million for 2016 and 2015, respectively. The proceeds from such sales were $58.1 million and $69.9 million for the years ended December 31, 2016 and 2015, respectively. Sales of securities available-for-sale in 2016 having a cost basis of $54.6 million resulted in gross realized losses of $1.6 million. The proceeds from such sales were $53.0 million.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses

The following is a summary of non-acquired loans:

	December 31, 2016	December 31, 2015
Non-acquired loans		
Commercial:		
Construction and land development	$ 35,347	$ 41,574
Agricultural	176,703	170,925
Commercial mortgage	480,973	376,960
Commercial and industrial	116,122	98,669
Lease financing	1,496	1,883
Other	14,724	13,855
Non-commercial		
Residential mortgage	228,905	186,708
Revolving mortgage (HELOCS)	84,498	70,703
Construction and land development	27,318	20,124
Consumer	22,653	22,351
Total non-acquired loans	$ 1,188,739	$ 1,003,752
Loans held for sale (excluded from total loans)	$ 4,579	$ 2,012
Loans serviced for others (excluded from total loans)	$ 506,469	$ 521,851

Net deferred revenues included within the respective balances for each loan type presented above total $348,000 and $399,000 at December 31, 2016 and 2015, respectively.

Total loans to directors, executive officers and related individuals and organizations were $365,000 and $751,000 at December 31, 2016 and 2015, respectively. During 2016, there were $324,000 of advances of these loans made to this group, and repayments totaling $710,000. There were no restructured or nonaccrual loans to directors, executive officers or related individuals and organizations. All extensions of credit to such persons have been made in the ordinary course of business.

Each portfolio segment and the classes within those segments are subject to risks that could have an adverse impact on the credit quality of the loan and lease portfolio. Management has identified the most significant risks as described below which are generally similar among the segments and classes. While the list is not exhaustive, it provides a description of the risks that management has determined are the most significant.

Commercial loans and leases

Each commercial loan or lease is underwritten based primarily upon the customer’s ability to generate the required cash flow to service the debt in accordance with the contractual terms and conditions of the loan agreement. A complete understanding of the borrower’s businesses including the experience and background of the principals is obtained prior to approval. To the extent that the loan or lease is secured by collateral, which is true for the majority of commercial loans and leases, the likely value of the collateral and what level of strength the collateral brings to the transaction is evaluated. To the extent that the principals or other parties provide personal guarantees, the relative financial strength and liquidity of each guarantor is assessed. Common risks to each class of commercial loans include general economic conditions within the markets BancShares serves, as well as risks that are specific to each transaction including demand for products and services, personal events such as disability or change in marital status, and reductions in the value of collateral.

Note 3. Loans and Allowance for Loan Losses (Continued)

In addition to these common risks for the majority of commercial loans and leases, additional risks are inherent in certain classes of commercial loans and leases, as follows:

Construction and land development
Construction and land development loans are highly dependent on the supply and demand for commercial real estate in the markets served by BancShares as well as the demand for newly constructed residential homes and lots that customers are developing. Continuing deterioration in demand could result in significant decreases in the underlying collateral values and make repayment of the outstanding loans more difficult for customers.

Agricultural, commercial mortgage, commercial and industrial and commercial leases
Agricultural, commercial mortgage, commercial and industrial loans and commercial leases are primarily dependent on the ability of borrowers to achieve business results consistent with those projected at loan origination resulting in cash flow sufficient to service the debt. To the extent that a customer's business results are significantly unfavorable versus the original projections, the ability for the loan to be serviced on a basis consistent with the contractual terms may be at risk. The performance of agricultural loans is highly dependent on favorable weather, reasonable costs for seed and fertilizer, and the ability to successfully market the product at a profitable margin. The demand for these products is also dependent on macroeconomic conditions that are beyond the control of the borrower. While these loans and leases are generally secured by real property, personal property, or business assets such as inventory or accounts receivable, it is possible that the liquidation of the collateral will not fully satisfy the obligation.

Commercial other
Commercial other loans consist primarily of loans to municipalities and not for profit organizations, such as volunteer fire departments. Commercial other loans are dependent on the municipality or not for profit entity's ability to generate adequate cash flows to service the loan, primarily through tax revenues, fee revenues, federal and state grants, and donations by local citizens. As such, deterioration in the general economy could impact a borrower's ability to repay the loan due to declines in a municipality's tax base, available federal and state grants, and citizen's ability to provide donations. These loans are primarily secured by equipment used by the municipality or not for profit entity.

Non-commercial loans
Each non-commercial loan is underwritten based primarily upon the customer's ability to generate the required cash flow to service the debt in accordance with the contractual terms and conditions of the loan agreement. A complete understanding of the borrower's financial situation is obtained prior to loan approval. To the extent that the loan is secured by collateral we also evaluate the likely value of that collateral. Common risks to each class of non-commercial loans include risks that are not specific to individual transactions such as general economic conditions within the markets BancShares serves, particularly unemployment and potential declines in real estate values. Personal events such as disability or change in marital status also add risk to non-commercial loans.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

In addition to these common risks for the majority of non-commercial loans, additional risks are inherent in certain classes of non-commercial loans, as follows:

Home Equity Line of Credit ("HELOC")
HELOC loans are often secured by second liens on residential real estate, thereby making such loans particularly susceptible to declining collateral values. A substantial decline in collateral value could render a second lien position to be effectively unsecured. Additional risks include lien perfection inaccuracies and disputes with first lien holders that may further weaken the collateral position. Further, the open-end structure of these loans creates the risk that customers may draw on the lines in excess of the collateral value if there have been significant declines since origination.

Consumer
The consumer loan portfolio includes loans secured by personal property such as automobiles, marketable securities, other titled recreational vehicles including boats and motorcycles, as well as unsecured consumer debt. The value of underlying collateral within this class is especially volatile due to potential rapid depreciation in values since the date of loan origination in excess of principal repayment.

Residential mortgage and non-commercial construction and land development
Residential mortgage and non-commercial construction and land development loans are made to individuals and are typically secured by 1-4 family residential property, undeveloped land, and partially developed land in anticipation of pending construction of a personal residence. Significant and rapid declines in real estate values can result in residential mortgage loan borrowers having debt levels in excess of the current market value of the collateral. Such a decline in values has led to unprecedented levels of foreclosures and losses within the banking industry. Non-commercial construction and land development projects can experience delays in completion and cost overruns that exceed the borrower's financial ability to complete the project. Such cost overruns can routinely result in foreclosure of partially completed and unmarketable collateral.

Acquired loans
The risks associated with acquired loans are generally consistent with the risks identified for commercial and non-commercial loans and the classes of loans within those segments. Further, these loans were underwritten by another institution with weaker lending standards. Therefore, there is a significant risk that the loans are not adequately supported by the paying capacity of the borrower or the values of underlying collateral at the time of origination.

During 2016 and 2015, provision (recovery) for loan and lease losses on acquired loans totaled $932,000 and ($2.7) million, respectively.

In accordance with FASB guidance on accounting for acquired loans with deteriorated credit quality, BancShares aggregated the majority of acquired loans that have common risk characteristics into pools of loan categories as described in the tables that follow. Certain loans with unique characteristics or larger balances that did not conform to the pools are accounted for individually. These loans are identified as "Loans individually accounted for under FASB ASC Topic 310-30" in the tables that follow. The collectability of these loans is influenced by the continued stabilization of the local real estate market combined with borrower strength. The carrying value which is net of specific reserves of $382,000 and $347,000 in 2016 and 2015, respectively and classification of these loans are as follows:

	December 31, 2016	December 31, 2015
Loans individually accounted for under FASB ASC Topic 310-30		
Non-farm, non-residential	$ 4,637	$ 4,192
1-4 family residential property	3,415	1,848
Commercial and industrial	1,591	2,484
1-4 family residential construction	40	68
Construction and land development	1,869	1,008
Other	48	86
Total loans individually accounted for under FASB ASC Topic 310-30	$ 11,600	$ 9,686

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

Southern's acquired loan portfolio is comprised of the following balances net of related discount:

	Covered Under Loss Share Agreements	Not Covered Under Loss Share Agreements	Total
December 31,2016			
FASB ASC Topic 310-30 acquired loans:			
Commercial performing	$ -	$ 886	$ 886
Commercial non performing	-	540	540
Consumer performing	15	335	350
Consumer non performing	-	969	969
Construction & development performing	-	1,702	1,702
Construction & development non performing	-	1,232	1,232
Consumer real estate performing	2,992	8,882	11,874
Consumer real estate non performing	1,106	4,031	5,137
Commercial real estate performing short term amortizing	-	561	561
Commercial real estate non performing short term amortizing	-	2,230	2,230
Commercial real estate performing long term amortizing	-	6,815	6,815
Commercial real estate non performing long term amortizing	-	19,212	19,212
Commercial real estate non performing interest only	-	-	-
HELOCs	4,556	-	4,556
Loans individually accounted for under FASB ASC Topic 310-30	-	11,982	11,982
Total FASB ASC Topic 310-30 acquired loans	8,669	59,377	68,046
FASB ASC Topic 310-20 acquired loans	6,894	225,373	232,267
Total Acquired Loans:	$ 15,563	$ 284,750	$ 300,313
Less allowance for loan losses	-	(1,988)	(1,988)
Acquired loans, net	$ 15,563	$ 282,762	$ 298,325

	Covered Under Loss Share Agreements	Not Covered Under Loss Share Agreements	Total
December 31,2015			
FASB ASC Topic 310-30 acquired loans:			
Commercial performing	$ 1,112	$ -	$ 1,112
Commercial non performing	148	-	148
Consumer performing	53	471	524
Consumer non performing	214	875	1,089
Construction & development performing	1,750	-	1,750
Construction & development non performing	3,225	-	3,225
Consumer real estate performing	14,412	-	14,412
Consumer real estate non performing	6,260	-	6,260
Commercial real estate performing short term amortizing	1,312	-	1,312
Commercial real estate non performing short term amortizing	2,958	-	2,958
Commercial real estate performing long term amortizing	9,320	-	9,320
Commercial real estate non performing long term amortizing	19,968	-	19,968
Commercial real estate non performing interest only	1,131	-	1,131
HELOCs	6,780	-	6,780
Loans individually accounted for under FASB ASC Topic 310-30	3,937	6,096	10,033
Total FASB ASC Topic 310-30 acquired loans	72,580	7,442	80,022
FASB ASC Topic 310-20 acquired loans	9,505	57,558	67,063
Total Acquired Loans:	$ 82,085	$ 65,000	$ 147,085
Less allowance for loan losses	(1,133)	(710)	(1,843)
Acquired loans, net	$ 80,952	$ 64,290	$ 145,242

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

Contractual loan payments receivable, estimates of amounts not expected to be collected, other fair value adjustments and the resulting fair values of FASB ASC Topic 310-30 acquired loans at the acquisition date for Heritage-VA (February 1, 2016) are as follows:

	February 1, 2016 FASB ASC Topic 310-30 Loans
Contractual principal and interest	$ 5,190
Nonaccretable difference	412
Cash-flows expected to be collected	4,778
Accretable yield	837
Carrying value	$ 3,941

The table above excludes $206.0 million ($208.9 million in contractual principal less a $2.9 million fair value adjustment) in acquired loans at fair value as of the acquisition date that are accounted for under FASB ASC Topic 310-20. These loans did not display signs of credit deterioration at the date of acquisition and the entire discount will be accreted into income.

The total contractual principal balance for acquired loans was $345.3 million at December 31, 2016 and $207.2 million at December 31, 2015.

The following are changes in the carrying value of acquired loans during the years ended December 31, 2016 and 2015.

	FASB ASC Topic 310-30
Balance at December 31, 2014	$ 132,748
Reductions for payments, foreclosures, and draws net of accretion	(57,137)
Change in the allowance for loan losses on loans	2,588
Balance at December 31, 2015	78,199
Fair value of Heritage-VA acquired loans	3,941
Reductions for payments, foreclosures, and draws net of accretion	(15,918)
Change in the allowance for loan losses on loans	517
Balance at December 31, 2016	$ 66,739

The total outstanding balance, which includes contractual principal and interest owed at the end of the reporting period, for loans accounted for under FASC ASC Topic 310-30 was $109.3 million and $137.3 million at December 31, 2016 and 2015, respectively.

The table above excludes $232.3 million ($336.0 million in fair value of acquired loans at acquisition date and $103.7 million in net decreases for payments, draws, and accretion) in acquired loans at carrying value as of December 31, 2016 that are accounted for under FASB ASC Topic 310-20. The table above excludes $67.1 million ($130.0 million in fair value of acquired loans at acquisition date and $62.9 million in net decreases for payments, draws, and accretion) in acquired loans at carrying value as of December 31, 2015 that are accounted for under FASB ASC Topic 310-20. At December 31, 2016 and 2015 there was an allowance for loan loss in the amount of $682,000 and $20,000, respectively which related to FASB ASC Topic 310-20 loans.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following are changes in the carrying amount of accretable yield for loans accounted for under FASC ASC Topic 310-30:

	Years Ended December 31, 2016	Years Ended December 31, 2015
Balance at beginning of period	$ 71,126	$ 98,566
Addition from Heritage-VA acquisition	837	-
Interest income	(17,798)	(20,965)
Reclass of nonaccretable difference due to improvement in expected cash flows	6,021	14,459
Other changes, net	(1,081)	(20,934)
Balance at end of period	$ 59,105	$ 71,126

The allowance for loan losses is based upon estimates made by management. We maintain an allowance for loan losses at a level that we believe is appropriate to cover estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of our loan portfolio. Arriving at the allowance involves a high degree of management judgment and results in a range of estimated losses. We regularly evaluate the adequacy of the allowance through our internal risk rating system, outside credit review, and regulatory agency examinations to assess the quality of the loan portfolio and identify problem loans. The evaluation process also includes our analysis of current economic conditions, composition of the loan portfolio, past due and nonaccrual loans, concentrations of credit, lending policies and procedures, and historical loan loss experience. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on, among other factors, changes in economic conditions in our markets. In addition, regulatory agencies, as an integral part of their examination process, periodically review our allowances for losses on loans. These agencies may require management to recognize additions to the allowances based on their judgments about information available to them at the time of their examination. Because of these and other factors, it is possible that the allowances for losses on loans may change. The provision for loan losses is charged to expense in an amount necessary to maintain the allowance at an appropriate level.

The allowance for loan losses on non-acquired loans consists of general and specific reserves. The general reserves are determined by applying loss percentages to the portfolio that are based on historical loss experience for each class of loans and management's evaluation and "risk grading" of the loan portfolio. Additionally, the general economic and business conditions affecting key lending areas, credit quality trends, collateral values, loan volumes and concentrations, seasoning of the loan portfolio, the findings of internal and external credit reviews and results from external bank regulatory examinations are included in this evaluation. Currently, these adjustments are applied to the non-acquired loan portfolio when estimating the level of reserve required. The specific reserves are determined on a loan-by-loan basis based on management's evaluation of our exposure for each credit, given the current payment status of the loan and the value of any underlying collateral. These are loans classified by management as doubtful or substandard. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. Loans that are determined to be impaired are provided a specific reserve, if necessary, and are excluded from the calculation of the general reserves.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

In determining the acquisition date fair value of purchased loans, and in subsequent accounting, Southern generally aggregates purchased loans into pools of loans with common risk characteristics. Expected cash flows at the acquisition date in excess of the fair value of loans are recorded as interest income over the life of the loans using a level yield method if the timing and amount of the future cash flows of the pool is reasonably estimable. Subsequent to the acquisition date, increases in cash flows over those expected at the acquisition date reduce previously recorded allowance for loan losses and any remaining portion are reclassified from the nonaccretable difference to accretable yield and recognized as interest income prospectively. Decreases in expected cash flows after the acquisition date are recognized by recording an allowance for loan losses. Management analyzes the acquired loan pools and loans not accounted for in pools using various assessments of risk to determine an expected loss. The expected loss is derived based upon a loss given default based upon the collateral type and/or detailed review by loan officers and the probability of default that is determined based upon historical data at the loan level. Trends are reviewed in terms of accrual status, past due status, and weighted-average grade of the loans within each of the accounting pools. In addition, the relationship between the change in the unpaid principal balance and change in the mark is assessed to correlate the directional consistency of the expected loss for each pool. Offsetting the impact of the provision established for acquired loans covered under FDIC loss share agreements, the receivable from the FDIC is adjusted to reflect the indemnified portion of the post-acquisition exposure with a corresponding credit to the provision for loan losses.

An aggregated analysis of changes in allowance for loan losses is as follows

	Non-acquired Loans	Acquired Loans	Total
Balance at December 31, 2014	$ 12,676	$ 4,411	$ 17,087
Loans charged-off	(928)	(567)	(1,495)
Recoveries of loans previously charged off	483	741	1,224
Net charge-offs	(445)	174	(271)
Provision (recovery) for loan losses	580	(2,742)	(2,162)
Balance at December 31, 2015	12,811	1,843	14,654
Loans charged-off	(1,330)	(1,100)	(2,430)
Recoveries of loans previously charged off	484	313	797
Net charge-offs	(846)	(787)	(1,633)
Provision for loan losses	2,838	932	3,770
Balance at December 31, 2016	$ 14,803	$ 1,988	$ 16,791

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following tables present a disaggregated analysis of activity in the allowance for loan losses and loan balances for non-acquired loans:

	As of and for the Year Ended December 31, 2016						
Allowances for loan losses:	Commercial Loans	Consumer Loans	Mortgage Loans	Revolving Credit	Leases	Demand Overdrafts	Total
December 31, 2015	$ 9,024	$ 1,428	$ 666	$ 1,518	$ 17	$ 158	$ 12,811
Charge offs	(837)	(75)	(43)	(130)	-	(245)	(1,330)
Recoveries	203	71	66	78	-	66	484
Provision charged to operating expense	3,304	(374)	(151)	(153)	(2)	214	2,838
December 31, 2016	$ 11,694	$ 1,050	$ 538	$ 1,313	$ 15	$ 193	$ 14,803
Allowance for loans and leases individually evaluated for impairment	$ 186	$ 38	$ -	$ -	$ -	$ -	$ 224
Allowance for loans and leases collectively evaluated for impairment	$ 11,508	$ 1,012	$ 538	$ 1,313	$ 15	$ 193	$ 14,579
Loans and leases:							
Ending balance:	$ 823,869	$ 200,206	$ 78,202	$ 84,498	$ 1,496	$ 468	$ 1,188,739
Ending balance: individually evaluated for impairment	$ 6,525	$ 1,731	$ 577	$ 135	$ -	$ -	$ 8,968
Ending balance: collectively evaluated for impairment	$ 817,344	$ 198,475	$ 77,625	$ 84,363	$ 1,496	$ 468	$ 1,179,771

	As of and for the Year Ended December 31, 2015						
Allowances for loan losses:	Commercial Loans	Consumer Loans	Mortgage Loans	Revolving Credit	Leases	Demand Overdrafts	Total
December 31, 2014	$ 9,220	$ 1,474	$ 451	$ 1,301	$ 30	$ 200	$ 12,676
Charge offs	(232)	(230)	(68)	(186)	-	(212)	(928)
Recoveries	159	109	19	136	-	60	483
Provision charged to operating expense	(123)	75	264	267	(13)	110	580
December 31, 2015	$ 9,024	$ 1,428	$ 666	$ 1,518	$ 17	$ 158	$ 12,811
Allowance for loans and leases individually evaluated for impairment	$ 262	$ 39	$ -	$ -	$ -	$ -	$ 301
Allowance for loans and leases collectively evaluated for impairment	$ 8,762	$ 1,389	$ 666	$ 1,518	$ 17	$ 157	$ 12,509
Loans and leases:							
Ending balance:	$ 701,983	$ 173,884	$ 55,013	$ 70,703	$ 1,883	$ 286	$ 1,003,752
Ending balance: individually evaluated for impairment	$ 7,115	$ 1,695	$ 731	$ 209	$ -	$ -	$ 9,750
Ending balance: collectively evaluated for impairment	$ 694,868	$ 172,189	$ 54,282	$ 70,494	$ 1,883	$ 286	$ 994,002

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following tables present a disaggregated analysis of activity in the allowance for loan losses and loan balances for acquired loans.

Allowances for loan losses:	Commercial Performing	Commercial Non Performing	Consumer Performing	Consumer Non Performing	Construction and Development Performing	Construction and Development Non Performing	Consumer Real Estate Performing	Consumer Real Estate Non Performing	Commercial Real Estate Performing ST Amortizing
December 31, 2015	$ -	$ -	$ 1	$ 601	$ -	$ -	$ 1	$ -	$ -
Charge offs	-	-	-	-	-	-	-	-	-
Recoveries	-	-	-	-	-	-	-	-	-
Provision charged to operating expense	-	-	(1)	4	-	-	318	-	-
December 31, 2016	$ -	$ -	$ -	$ 605	$ -	$ -	$ 319	$ -	$ -
Allowance for loans and leases individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Allowance for loans and leases collectively evaluated for impairment	$ -	$ -	$ -	$ 605	$ -	$ -	$ 319	$ -	$ -
Loan and lease balances:									
Ending balance	$ 886	$ 540	$ 350	$ 969	$ 1,702	$ 1,232	$ 11,874	$ 5,137	$ 561
Ending balance individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance collectively evaluated for impairment	$ 886	$ 540	$ 350	$ 969	$ 1,702	$ 1,232	$ 11,874	$ 5,137	$ 561
December 31, 2014	$ -	$ 302	$ 1	$ 697	$ -	$ 692	$ 388	$ 1	$ -
Charge offs	-	-	-	(33)	-	-	(16)	-	(6)
Recoveries	-	-	-	-	-	100	2	37	-
Provision charged to operating expense	-	(302)	-	(63)	-	(792)	(373)	(38)	6
December 31, 2015	$ -	$ -	$ 1	$ 601	$ -	$ -	$ 1	$ -	$ -
Allowance for loans and leases individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Allowance for loans and leases collectively evaluated for impairment	$ -	$ -	$ 1	$ 601	$ -	$ -	$ 1	$ -	$ -
Loan and lease balances:									
Ending balance	$ 1,112	$ 148	$ 524	$ 1,089	$ 1,750	$ 3,225	$ 14,412	$ 6,260	$ 1,312
Ending balance individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Ending balance collectively evaluated for impairment	$ 1,112	$ 148	$ 524	$ 1,089	$ 1,750	$ 3,225	$ 14,412	$ 6,260	$ 1,312

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

Allowances for loan losses:	Commercial Real Estate Non Performing ST Amortizing	Commercial Real Estate Performing LT Amortizing	Commercial Real Estate Non Performing LT Amortizing	Commercial Real Estate Non Performing Interest Only	HELOCS	Loans Individually Accounted For Under FASB ASC Topic 310-30	FASB ASC Topic 310-20 Loans	Total Loans
December 31, 2015	$ -	$ -	$ -	$ 873	$ -	$ 347	$ 20	$ 1,843
Charge offs	-	-	-	(944)	-	(41)	(115)	(1,100)
Recoveries	-	-	-	-	-	-	313	313
Provision charged to operating expense	-	-	-	71	-	76	464	932
December 31, 2016	$ -	$ -	$ -	$ -	$ -	$ 382	$ 682	$ 1,988
Allowance for loans and leases individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ 382	$ 14	$ 396
Allowance for loans and leases collectively evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ -	$ 668	$ 1,592
Loan and lease balances:								
Ending balance	$ 2,230	$ 6,815	$ 19,212	$ -	$ 4,556	$ 11,982	$ 232,267	$ 300,313
Ending balance individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ 11,982	$ 636	$ 12,618
Ending balance collectively evaluated for impairment	$ 2,230	$ 6,815	$ 19,212	$ -	$ 4,556	$ -	$ 231,631	$ 287,695
December 31, 2014	$ 5	$ -	$ -	$ 1,549	$ -	$ 776	$ -	$ 4,411
Charge offs	-	-	-	(45)	-	(187)	(280)	(567)
Recoveries	(3)	-	5	7	-	224	369	741
Provision charged to operating expense	(2)	-	(5)	(638)	-	(466)	(69)	(2,742)
December 31, 2015	$ -	$ -	$ -	$ 873	$ -	$ 347	$ 20	$ 1,843
Allowance for loans and leases individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ 347	$ 19	$ 366
Allowance for loans and leases collectively evaluated for impairment	$ -	$ -	$ -	$ 873	$ -	$ -	$ 1	$ 1,477
Loan and lease balances:								
Ending balance	$ 2,958	$ 9,320	$ 19,968	$ 1,131	$ 6,780	$ 10,033	$ 67,063	$ 147,085
Ending balance individually evaluated for impairment	$ -	$ -	$ -	$ -	$ -	$ 10,033	$ 237	$ 10,270
Ending balance collectively evaluated for impairment	$ 2,958	$ 9,320	$ 19,968	$ 1,131	$ 6,780	$ -	$ 66,826	$ 136,815

Note 3. Loans and Allowance for Loan Losses (Continued)

Loans and leases are closely monitored by management for changes in quality. This monitoring includes assessing the appropriateness of the credit quality indicator in relation to the risk of the loan or lease. Southern utilizes a risk rating matrix to assign a risk rating to each of its loans and leases. A description of the general characteristics of risk ratings is as follows:

- Superior - This grade includes loans to borrowers with excellent credit quality. These borrowers have exceptionally high net worth and cash flows to service existing debt and most have a significant or long term deposit relationship with Southern. If secured, the collateral for these loans is readily marketable and consists of savings accounts, life insurance assignments, etc.

- Above average - This grade includes loans to borrowers of adequate credit quality, adequate sufficient net worth and cash flows to service existing debt. Borrowers in this grade have an existing long term deposit relationship with Southern and have made a reasonable investment in the loan. If secured, collateral for these loans is reasonably marketable such as listed stocks and bonds.

- Average - This grade includes loans to borrowers of acceptable credit quality and risk. Such borrowers have maintained an existing deposit relationship with Southern, but not for the time periods of those included in the above grades of average and superior. These borrowers also have sufficient net worth and cash flows to service existing debt, but not to the level of those included in grades above average and superior. There has been reasonable investment in the loan by the borrower.

- Below average - This grade includes loans to borrowers with credit history that reflects delinquencies with justifiable explanation or no credit history. Typically these borrowers do not have a deposit relationship with Southern and/or have made an insignificant investment in the loan. Included in this grade are loans to borrowers with marginal cash flows and net worth or who reside outside of the trade area. Also, loans for which repayment is dependent upon sales in unproven or unstable markets fall into this grade.

- Special mention - This grade is for loans which are "especially mentioned" in accordance with regulatory guidelines. This grade includes loans on management's "watchlist". This grade includes loans for which repayment terms exceed policy or with no significant principal reduction in the past 12 months, are in an industry that is deteriorating, or that repayment is based upon the sale of collateral, guarantors, or government guarantees. Also included are real estate under construction for speculative purposes and the borrower does not have a long history of sales. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation.

- Substandard - This grade includes loans on management's "watchlist". Substandard loans are inadequately protected by the current sound 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. These loans are characterized by the distinct possibility that Southern will sustain some loss if the deficiency is not corrected.

- Doubtful - Loans classified as "doubtful" have all the weaknesses inherent in those classified as "substandard" with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions, and values, highly questionable and improbable.

- Loss - Loans 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 it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be affected in the future. Included in this category are loans that are covered under loss share agreements with the FDIC which have been partial charge-offs based on the terms of the loss share agreements.

- Ungradable - This represents loans that are HELOC and other consumer type loans with relatively small balances for which risk ratings are not assigned.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following presents the credit risk profile by risk grade for non-acquired loans:

	As of December 31, 2016								
	Superior	Above average	Average	Below average	Special mention	Substandard	Doubtful	Loss	Totals
Construction and land development	$ -	$ -	$ 28,143	$ 6,475	$ 643	$ 86	$ -	$ -	$ 35,347
Agricultural loans	-	148	143,232	30,607	1,806	910	-	-	176,703
Commercial mortgage	-	82	397,800	77,802	1,463	3,826	-	-	480,973
Commercial and industrial	2	70	91,143	24,144	411	352	-	-	116,122
Commercial lease financing	-	103	1,240	153	-	-	-	-	1,496
Commercial other	-	-	14,088	636	-	-	-	-	14,724
Non commercial residential mortgage	-	332	195,920	26,054	2,358	4,241	-	-	228,905
HELOC	21	1,219	76,878	5,724	354	302	-	-	84,498
Non construction land and development	-	6	26,306	892	-	114	-	-	27,318
Consumer	9	157	19,522	2,811	124	30	-	-	22,653
Totals	$ 32	$ 2,117	$ 994,272	$ 175,298	$ 7,159	$ 9,861	$ -	$ -	$ 1,188,739

	As of December 31, 2015								
	Superior	Above average	Average	Below average	Special mention	Substandard	Doubtful	Loss	Totals
Construction and land development	$ -	$ -	$ 33,441	$ 7,137	$ 794	$ 202	$ -	$ -	$ 41,574
Agricultural loans	303	1,060	143,758	20,237	5,010	557	-	-	170,925
Commercial mortgage	-	148	317,266	54,787	2,157	2,602	-	-	376,960
Commercial and industrial	2	2,327	78,052	16,954	993	341	-	-	98,669
Commercial lease financing	-	464	1,224	195	-	-	-	-	1,883
Commercial other	-	-	13,114	741	-	-	-	-	13,855
Non commercial residential mortgage	-	55,808	107,253	18,115	2,228	3,304	-	-	186,708
HELOC	28	1,526	63,844	4,623	303	379	-	-	70,703
Non construction land and development	196	34	18,694	1,103	13	84	-	-	20,124
Consumer	9	213	19,197	2,751	114	67	-	-	22,351
Totals	$ 538	$ 61,580	$ 795,843	$ 126,643	$ 11,612	$ 7,536	$ -	$ -	$ 1,003,752

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following table presents the credit risk profile by risk grade of covered acquired loans, net of the related discount.

	As of December 31, 2016									
Covered Loans	Superior	Above average	Average	Below average	Special mention	Sub-standard	Doubtful	Loss	Ungradable	Total
Commercial performing	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial non-performing	-	-	-	-	-	-	-	-	-	-
Consumer performing	-	-	15	-	-	-	-	-	-	15
Consumer non-performing	-	-	-	-	-	-	-	-	-	-
Construction and development performing	-	-	-	-	-	-	-	-	-	-
Construction and development non-performing	-	-	-	-	-	-	-	-	-	-
Consumer real estate performing	-	-	604	1,874	199	67	17	231	-	2,992
Consumer real estate non-performing	-	-	-	77	60	646	7	316	-	1,106
Commercial real estate performing ST amortizing	-	-	-	-	-	-	-	-	-	-
Commercial real estate non-performing ST amortizing	-	-	-	-	-	-	-	-	-	-
Commercial real estate performing LT amortizing	-	-	-	-	-	-	-	-	-	-
Commercial real estate non-performing LT amortizing	-	-	-	-	-	-	-	-	-	-
Commercial real estate interest only	-	-	-	-	-	-	-	-	-	-
HELOCs	-	-	-	4,472	-	-	84	-	-	4,556
Loans individually accounted for under FASB ASC Topic 310-30	-	-	-	-	-	-	-	-	-	-
FASB ASC Topic 310-20 acquired loans	-	-	36	6,509	49	103	171	26	-	6,894
Total Loans	$ -	$ -	$ 655	$ 12,932	$ 308	$ 816	$ 279	$ 573	$ -	$ 15,563

	As of December 31, 2015									
Covered Loans	Superior	Above average	Average	Below average	Special mention	Sub-standard	Doubtful	Loss	Ungradable	Total
Commercial performing	$ -	$ -	$ 483	$ 511	$ 118	$ -	$ -	$ -	$ -	$ 1,112
Commercial non-performing	-	-	5	46	50	22	7	18	-	148
Consumer performing	-	-	49	4	-	-	-	-	-	53
Consumer non-performing	-	-	-	-	27	-	187	-	-	214
Construction and development performing	-	-	350	1,400	-	-	-	-	-	1,750
Construction and development non-performing	-	-	-	1,280	21	715	-	1,209	-	3,225
Consumer real estate performing	-	-	2,554	8,876	2,441	79	15	447	-	14,412
Consumer real estate non-performing	-	-	-	2,473	1,019	1,078	193	1,497	-	6,260
Commercial real estate performing ST amortizing	-	-	343	889	80	-	-	-	-	1,312
Commercial real estate non-performing ST amortizing	-	-	-	152	523	19	13	2,251	-	2,958
Commercial real estate performing LT amortizing	-	-	3,559	4,723	665	196	-	177	-	9,320
Commercial real estate non-performing LT amortizing	-	-	-	8,661	4,796	2,327	2,625	1,559	-	19,968
Commercial real estate interest only	-	-	-	-	-	-	-	1,131	-	1,131
HELOCs	-	-	-	6,636	-	-	142	2	-	6,780
Loans individually accounted for under FASB ASC Topic 310-30	-	-	-	666	1,425	1,846	-	-	-	3,937
FASB ASC Topic 310-20 acquired loans	-	-	92	9,040	42	154	138	39	-	9,505
Total Loans	$ -	$ -	$ 7,435	$ 45,357	$ 11,207	$ 6,436	$ 3,320	$ 8,330	$ -	$ 82,085

Note 3. Loans and Allowance for Loan Losses (Continued)

(Dollars in Thousands for Tabular Presentations)

The following table presents the credit risk profile by risk grade of non-covered acquired loans, net of the related discount.

Non-Covered Loans	Superior	Above average	Average	Below average	Special mention	Substandard	Doubtful	Loss	Ungradable	Total
	As of December 31, 2016									
Commercial performing	$ -	$ -	$ 436	$ 350	$ 100	$ -	$ -	$ -	$ -	$ 886
Commercial non-performing	-	-	-	365	71	104	-	-	-	540
Consumer performing	-	-	236	99	-	-	-	-	-	335
Consumer non-performing	-	-	-	-	528	441	-	-	-	969
Construction and development performing	-	-	286	1,416	-	-	-	-	-	1,702
Construction and development non-performing	-	-	-	792	-	440	-	-	-	1,232
Consumer real estate performing	-	-	448	6,167	656	1,611	-	-	-	8,882
Consumer real estate non-performing	-	-	-	2,388	490	1,153	-	-	-	4,031
Commercial real estate performing ST amortization	-	-	-	523	38	-	-	-	-	561
Commercial real estate non-performing ST amortization	-	-	-	196	69	1,933	-	32	-	2,230
Commercial real estate performing LT amortization	-	-	1,982	3,861	625	347	-	-	-	6,815
Commercial real estate non-performing LT amortization	-	-	-	10,123	3,439	5,650	-	-	-	19,212
Commercial real estate interest only	-	-	-	-	-	-	-	-	-	-
HELOCs	-	-	-	-	-	-	-	-	-	-
Loans individually accounted for under FASB ASC Topic 310-30	-	-	2,450	781	3,573	5,178	-	-	-	11,982
FASB ASC Topic 310-20 acquired loans	52	38	197,061	26,369	1,414	439	-	-	-	225,373
Total Loans	$ 52	$ 38	$ 202,899	$ 53,430	$ 11,003	$ 17,296	$ -	$ 32	$ -	$ 284,750

Non-Covered Loans	Superior	Above	Average	Below	Special	Substandard	Doubtful	Loss	Ungradable	Total
	As of December 31, 2015									
Commercial performing	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Commercial non-performing	-	-	-	-	-	-	-	-	-	-
Consumer performing	-	-	326	145	-	-	-	-	-	471
Consumer non-performing	-	-	-	-	588	287	-	-	-	875
Construction and development performing	-	-	-	-	-	-	-	-	-	-
Construction and development non-performing	-	-	-	-	-	-	-	-	-	-
Consumer real estate performing	-	-	-	-	-	-	-	-	-	-
Consumer real estate non-performing	-	-	-	-	-	-	-	-	-	-
Commercial real estate performing ST amortization	-	-	-	-	-	-	-	-	-	-
Commercial real estate non-performing ST amortization	-	-	-	-	-	-	-	-	-	-
Commercial real estate performing LT amortization	-	-	-	-	-	-	-	-	-	-
Commercial real estate non-performing LT amortization	-	-	-	-	-	-	-	-	-	-
Commercial real estate interest only	-	-	-	-	-	-	-	-	-	-
HELOCs	-	-	-	-	-	-	-	-	-	-
Loans individually accounted for under FASB ASC Topic 310-30	-	-	74	639	2,623	2,760	-	-	-	6,096
FASB ASC Topic 310-20 acquired loans	117	208	36,899	18,751	1,228	355	-	-	-	57,558
Total Loans	$ 117	$ 208	$ 37,299	$ 19,535	$ 4,439	$ 3,402	$ -	$ -	$ -	$ 65,000

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The risk grading of acquired loans is determined utilizing a loan's contractual balance, while the amount recorded in the financial statements and reflected above is the carrying value. In an FDIC-assisted acquisition, covered acquired loans are initially recorded at their fair value, including a credit discount due to the high concentration of substandard and doubtful loans. In addition to the credit discount and the allowance for loan losses on covered acquired loans, Bancshares' risk of loss is mitigated by the FDIC loss share arrangement.

The following is a summary of information pertaining to impaired non-acquired and acquired loans accounted for under FASB ASC Topic 310-20:

	For the year ended December 31, 2016				
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
Non-Acquired:					
Commercial:					
Construction and land development loans	$ 1,085	$ 86	$ 817	$ 903	$ 117
Agricultural	1,479	1,219	112	1,331	5
Commercial mortgage	4,619	1,885	295	2,180	22
Commercial and industrial	95	67	25	92	1
Non-commercial:					
Residential mortgage	4,767	3,504	599	4,103	56
Revolving mortgage	168	135	-	135	-
Construction and land development	65	56	-	56	-
Consumer	193	-	193	193	23
Total Non-Acquired	12,471	6,952	2,041	8,993	224
Acquired:					
FASB ASC Topic 310-20 acquired loans	711	538	97	636	14
Total Acquired	711	538	97	636	14
Total Impaired loans	$ 13,182	$ 7,490	$ 2,138	$ 9,629	$ 238

	For the year ended December 31, 2015				
	Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
Non-Acquired:					
Commercial:					
Construction and land development loans	$ 1,241	$ 196	$ 840	$ 1,036	$ 107
Agricultural	1,194	1,054	119	1,173	6
Commercial mortgage	5,453	2,361	776	3,137	37
Commercial and industrial	45	3	38	41	38
Non-commercial:					
Residential mortgage	4,291	3,069	691	3,760	89
Revolving mortgage	247	210	-	210	-
Construction and land development	227	224	-	224	-
Consumer	218	11	197	208	24
Total Non-Acquired	12,916	7,128	2,661	9,789	301
Acquired:					
FASB ASC Topic 310-20 acquired loans	295	133	104	237	19
Total Acquired	295	133	104	237	19
Total Impaired loans	$ 13,211	$ 7,261	$ 2,765	$ 10,026	$ 320

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following table summarizes the average investment in impaired loans, non-acquired and acquired loans accounted for under FASB ASC Topic 310-20, and interest income recognized on these loans:

	Years Ended December 31,			
	2016		2015	
	Average Investment in Impaired Loans	Interest Income Recognized	Average Investment in Impaired Loans	Interest Income Recognized
Non-Acquired				
Commercial:				
Construction and land development	$ 953	$ 36	$ 1,338	$ 55
Agricultural	1,195	36	1,109	38
Commercial mortgage	2,511	32	3,756	85
Commercial and industrial	61	1	37	-
Non-commercial:				
Residential mortgage	4,071	109	4,582	79
Revolving mortgage (HELOCS)	165	2	244	4
Construction and land development	75	1	193	9
Consumer	199	5	237	4
Total Non-Acquired	9,230	222	11,496	274
Acquired:				
FASB ASC Topic 310-20 acquired loans	433	-	441	-
Total Acquired	433	-	441	-
Totals	$ 9,663	$ 222	$ 11,937	$ 274

The amount of foregone interest on non-acquired and acquired loans accounted for under FASB ASC Topic 310-20 at December 31, 2016 and 2015 was not material for the periods presented.

The following is a summary of information pertaining to non-acquired loans and acquired loans accounted for under FASB ASC Topic 310-20 that are on non-accrual, including restructured loans:

	December 31,	
	2016	2015
Commercial:		
Construction and land development	$ 21	$ 140
Agricultural	630	250
Commercial mortgage	1,703	2,157
Commercial and industrial	42	41
Non-commercial:		
Residential mortgage	2,631	2,197
Revolving mortgage	109	146
Construction and land development	56	66
Consumer	-	11
Total Non-Acquired	5,192	5,008
Acquired:		
FASB ASC Topic 310-20 acquired loans	636	237
Total Acquired	636	237
Totals	$ 5,828	$ 5,245

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

An aging analysis of past due loans, segregated by class for non-acquired loans, was as follows:

	As of December 31, 2016						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment Greater Than 90 Days and Accruing
Commercial:							
Construction and land development	$ 130	$ -	$ 15	$ 145	$ 35,202	$ 35,347	$ -
Agriculture	58	-	280	338	176,365	176,703	-
Commercial mortgage	1,051	248	285	1,584	479,389	480,973	-
Commercial and industrial	64	51	17	132	115,990	116,122	-
Lease financing	-	-	-	-	1,496	1,496	-
Other	-	-	-	-	14,724	14,724	-
Non-commercial:							
Residential mortgage	687	71	683	1,441	227,464	228,905	-
Revolving mortgage	183	-	19	202	84,296	84,498	-
Construction and land development	138	14	-	152	27,166	27,318	-
Consumer	150	-	-	150	22,503	22,653	-
Totals	$ 2,461	$ 384	$ 1,299	$ 4,144	$ 1,184,595	$ 1,188,739	$ -

	As of December 31, 2015						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans	Recorded Investment Greater Than 90 Days and Accruing
Commercial:							
Construction and land development	$ 233	$ -	$ 111	$ 344	$ 41,230	$ 41,574	$ -
Agriculture	378	-	97	475	170,450	170,925	-
Commercial mortgage	370	77	248	695	376,265	376,960	-
Commercial and industrial	528	-	-	528	98,141	98,669	-
Lease financing	-	-	-	-	1,883	1,883	-
Other	-	-	-	-	13,855	13,855	-
Non-commercial:							
Residential mortgage	1,237	87	352	1,676	185,032	186,708	-
Revolving mortgage	224	56	20	300	70,403	70,703	-
Construction and land development	-	17	46	63	20,061	20,124	-
Consumer	184	-	4	188	22,163	22,351	4
Totals	$ 3,154	$ 237	$ 878	$ 4,269	$ 999,483	$ 1,003,752	$ 4

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

An aging analysis of past due loans, segregated by class for loans covered by loss share agreements acquired loans, was as follows:

	As of December 31, 2016					
Covered loans:	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans
FASB ASC Topic 310-30 acquired loans:						
Commercial performing	$ -	$ -	$ -	$ -	$ -	$ -
Commercial non-performing	-	-	-	-	-	-
Consumer performing	-	-	-	-	15	15
Consumer non-performing	-	-	-	-	-	-
Construction and development performing	-	-	-	-	-	-
Construction and development non-performing	-	-	-	-	-	-
Consumer real estate performing	-	167	-	167	2,825	2,992
Consumer real estate non-performing	81	-	56	137	969	1,106
Commercial real estate performing ST amortizing	-	-	-	-	-	-
Commercial real estate non-performing ST amortizing	-	-	-	-	-	-
Commercial real estate performing LT amortizing	-	-	-	-	-	-
Commercial real estate non-performing LT amortizing	-	-	-	-	-	-
Commercial real estate interest only	-	-	-	-	-	-
HELOCs	177	-	19	196	4,360	4,556
Loans individually accounted for under FASB ASC Topic 310-30	-	-	-	-	-	-
Total FASB ASC Topic 310-30 acquired loans	258	167	75	500	8,169	8,669
FASB ASC Topic 310-20 acquired loans	188	-	123	311	6,583	6,894
Totals	$ 446	$ 167	$ 198	$ 811	$ 14,752	$ 15,563

	As of December 31, 2015					
Covered loans:	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans
FASB ASC Topic 310-30 acquired loans:						
Commercial performing	$ 39	$ -	$ -	$ 39	$ 1,073	$ 1,112
Commercial non-performing	-	-	-	-	148	148
Consumer performing	-	-	-	-	53	53
Consumer non-performing	-	187	-	187	27	214
Construction and development performing	46	-	-	46	1,704	1,750
Construction and development non-performing	-	-	1,209	1,209	2,016	3,225
Consumer real estate performing	387	215	224	826	13,586	14,412
Consumer real estate non-performing	42	8	518	568	5,692	6,260
Commercial real estate performing ST amortizing	-	-	-	-	1,312	1,312
Commercial real estate non-performing ST amortizing	-	-	591	591	2,367	2,958
Commercial real estate performing LT amortizing	-	-	-	-	9,320	9,320
Commercial real estate non-performing LT amortizing	-	506	3,782	4,288	15,680	19,968
Commercial real estate interest only	-	-	1,131	1,131	-	1,131
HELOCs	57	-	81	138	6,642	6,780
Loans individually accounted for under FASB ASC Topic 310-30	-	-	-	-	3,937	3,937
Total FASB ASC Topic 310-30 acquired loans	571	916	7,536	9,023	63,557	72,580
FASB ASC Topic 310-20 acquired loans	14	9	32	55	9,450	9,505
Totals	$ 585	$ 925	$ 7,568	$ 9,078	$ 73,007	$ 82,085

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

An aging analysis of past due loans, segregated by class for non-covered acquired loans, was as follows:

	December 31, 2016					
Non-covered loans:	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans
FASB ASC Topic 310-30 acquired loans:						
Commercial performing	$ -	$ -	$ -	$ -	$ 886	$ 886
Commercial non-performing	-	-	-	-	540	540
Consumer performing	-	-	-	-	335	335
Consumer non-performing	-	-	178	178	791	969
Construction and development performing	-	-	-	-	1,702	1,702
Construction and development non-performing	-	-	-	-	1,232	1,232
Consumer real estate performing	197	-	121	318	8,564	8,882
Consumer real estate non-performing	-	-	-	-	4,031	4,031
Commercial real estate performing ST amortizing	-	-	-	-	561	561
Commercial real estate non-performing ST amortizing	-	43	-	43	2,187	2,230
Commercial real estate performing LT amortizing	-	-	-	-	6,815	6,815
Commercial real estate non-performing LT amortizing	-	-	1,725	1,725	17,487	19,212
HELOCs	-	-	-	-	-	-
Commercial real estate interest only	-	-	-	-	-	-
Loans accounted for individually under FASB ASC Topic 310-30	-	-	-	-	11,982	11,982
Total FASB ASC Topic 310-30 acquired loans	197	43	2,024	2,264	57,113	59,377
FASB ASC Topic 310-20 acquired loans	93	263	281	637	224,736	225,373
Totals	$ 290	$ 306	$ 2,305	2,901	$ 281,849	$ 284,750

	December 31, 2015					
Non-covered loans:	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days Past Due	Total Past Due	Current	Total Loans
FASB ASC Topic 310-30 acquired loans:						
Commercial performing	$ -	$ -	$ -	$ -	$ -	$ -
Commercial non-performing	-	-	-	-	-	-
Consumer performing	-	-	-	-	471	471
Consumer non-performing	-	-	-	-	875	875
Construction and development performing	-	-	-	-	-	-
Construction and development non-performing	-	-	-	-	-	-
Consumer real estate performing	-	-	-	-	-	-
Consumer real estate non-performing	-	-	-	-	-	-
Commercial real estate performing ST amortizing	-	-	-	-	-	-
Commercial real estate non-performing ST amortizing	-	-	-	-	-	-
Commercial real estate performing LT amortizing	-	-	-	-	-	-
Commercial real estate non-performing LT amortizing	-	-	-	-	-	-
HELOCs	-	-	-	-	-	-
Commercial real estate interest only	-	-	-	-	-	-
Loans accounted for individually under FASB ASC Topic 310-30	83	-	39	122	5,974	6,096
Total FASB ASC Topic 310-30 acquired loans	83	-	39	122	7,320	7,442
FASB ASC Topic 310-20 acquired loans	117	10	-	127	57,431	57,558
Totals	$ 200	$ 10	$ 39	249	$ 64,751	$ 65,000

In the course of resolving delinquent loans, the Bank may choose to restructure the contractual terms of certain loans. A troubled debt restructuring is a restructuring of a loan in which a concession is granted to a borrower experiencing financial difficulty. A loan is accounted for as a troubled debt restructured loan (“TDR”) if BancShares, for reasons related to the borrower's financial difficulties, grants a concession to the borrower that it would not otherwise grant. A TDR typically involves a modification of terms such as a reduction of the interest rate below the current market rate for a loan with similar risk characteristics or the waiving of certain financial loan covenants without corresponding offsetting compensation or additional support. BancShares measures the impairment loss of a TDR using the methodology for individually impaired loans. In accordance with FASB ASC Topic 310-30, a loan is not considered a TDR at the date of acquisition but may be classified as such if a modification is made subsequent to the acquisition.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following table presents a breakdown of the types of concessions made by loan class for the non-acquired loans that were modified as TDR's during 2016 and 2015. For the twelve month period ended December 31, 2016 and 2015, the recorded investment in TDR's prior to modification was not materially impacted by the modification. Commitments to lend additional funds to TDR borrowers at December 31, 2016 and 2015 were not considered material.

	Years Ended December 31,					
	2016			2015		
	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of Loans	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Below market interest rates:	-	$ -	$ -	-	$ -	$ -
Totals interest rate modifications	-	$ -	$ -	-	$ -	$ -
Extended payment terms:						
Commercial:						
Construction and land development	-	$ -	$ -	$ -	$ -	$ -
Agricultural	-	-	-	3	175	170
Commercial mortgage	2	418	415	-	-	-
Commercial and industrial	1	50	50	1	7	7
Non-commercial:						
Residential mortgage	4	270	267	3	481	487
Revolving mortgage	-	-	-	-	-	-
Construction and land development	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total term modifications	7	$ 738	$ 732	7	$ 663	$ 664
Forgiveness of principal:	-	$ -	$ -	-	$ -	$ -
Total forgiveness of principal	-	$ -	$ -	-	$ -	$ -
Total restructured loans	7	$ 738	$ 732	7	$ 663	$ 664

Southern had $5.7 million and $6.8 million of non-acquired loans considered TDR's at December 31, 2016 and 2015, respectively. Included in TDR's are non-acquired loans totaling $2.0 million and $2.1 million at December 31, 2016 and 2015, respectively, which were also classified as nonaccrual loans. These loans were modified to extend maturity dates or permit interest only terms for a defined period of time with no material effect on interest income recognition.

These troubled debt restructurings are evaluated on an individual basis along with all other troubled debt restructurings based on underlying collateral value if asset dependent or the present value of future cash flows. In the event that there is a shortfall in the value of the collateral securing these loans or the present value of future cash flows the calculated impairment is reserved for in the allowance for loan losses.

(Dollars in Thousands for Tabular Presentations)

Note 3. Loans and Allowance for Loan Losses (Continued)

The following table presents non-acquired loans that were modified as troubled debt restructurings during the 12 months indicated for which there was a payment default. A payment default is defined as a loan that is past due more than 30 days.

	December 31, 2015		December 31, 2015	
	Number of Loans	Recorded Investment	Number of Loans	Recorded Investment
Non-Acquired:				
Below market interest rates:	-	$ -	-	$ -
Totals interest rate modifications	-	$ -	-	$ -
Extended payment terms:				
Commercial:				
Construction and land development	-	$ -	-	$ -
Agricultural	-	-	2	50
Commercial mortgage	1	165	-	-
Commercial and industrial	-	-	-	-
Non-commercial:				
Residential mortgage	3	225	3	479
Revolving mortgage	-	-	-	-
Construction and land development	-	-	-	-
Consumer	-	-	-	-
Total term modifications	4	$ 390	5	$ 529
Forgiveness of principal:	-	$ -	-	$ -
Total forgiveness of principal	-	$ -	-	$ -
Total restructured loans	4	$ 390	5	$ 529

These troubled debt restructurings are evaluated on an individual basis along with all other troubled debt restructurings based on underlying collateral value. In the event that there is a shortfall in the value of the collateral securing these loans, the calculated impairment is included in the allowance for loan losses.

At December 31, 2016 and 2015, BancShares had $1.4 million and $5.1 million, respectively, of foreclosed residential real estate property in OREO. The recorded investment in consumer mortgage loans collateralized by residential real estate property in the process of foreclosure totaled $502,000 and $602,000 at December 31, 2016 and December 31, 2015, respectively.

Note 4. FDIC Receivable (True-up Liability) for Loss Share Agreements

The following table provides changes in the net FDIC true-up liability for loss share agreements:

	Years Ended December 31,	
	2016	2015
Balance at beginning of period	$ (4,934)	$ 9,911
Increase (decrease) in expected losses on loans	(2,138)	(6,485)
Additional losses on OREO	1,704	4,998
Reimbursable expenses net of rents received	710	3,491
Amortization of discounts and premiums, net	(3,337)	(5,690)
Reimbursements from FDIC	(4,860)	(11,159)
Balance at end of period	$ (12,855)	$ (4,934)

The net payable is presented on the balance sheet as follows:

	December 31,	
	2016	2015
FDIC Receivable for loss share agreements	$ 2,518	$ 9,665
FDIC true-up liability for loss share agreements	15,373	14,599
Balance at end of period	$ (12,855)	$ (4,934)

(Dollars in Thousands for Tabular Presentations)

Note 4. FDIC Receivable (True-up Liability) for Loss Share Agreements (Continued)

The FDIC indemnification asset is measured separately from the related covered assets. At December 31, 2016, the projected cash flows related to the FDIC indemnification asset for losses on assets acquired were approximately $4.0 million less than the current carrying value. This amount is being recognized as negative accretion (in non interest income) over the shorter of the underlying asset's remaining life or remaining term of the loss share agreements.

Reducing the FDIC receivable for loss share agreements is an expected true up with the FDIC related to the BOC acquisition. This amount is determined each reporting period and at December 31, 2016, the net present value was estimated to be approximately $15.4 million at the end of the loss share agreement (in five years). The actual payment will be determined at the end of the loss sharing agreement term for the FDIC-assisted acquisitions and is based on the negative bid, expected losses, intrinsic loss estimate, and assets covered under loss share.

In March of 2017 Southern entered into an agreement with the FDIC to terminate the loss share agreements as further discussed in Note 16.

Note 5. Premises and Equipment

The components of premises and equipment were as follows:

	December 31, 2016	December 31, 2015
Land	$ 17,431	$ 14,698
Buildings and improvements	58,097	49,568
Furniture and equipment	20,738	18,398
Construction-in-progress	2,194	3,999
	98,460	86,663
Less: accumulated depreciation	(39,752)	(36,365)
Balance at the end of the year	$ 58,708	$ 50,298

Depreciation and amortization amounts of $4.8 million and $4.2 million in 2016 and 2015, respectively, are included in occupancy and furniture and equipment expenses. Construction-in-progress represents facilities currently undergoing renovations.

Premises and Equipment Lease Commitments

BancShares leases certain premises and equipment under various lease agreements that provide for payment of property taxes, insurance and maintenance costs. Operating leases frequently provide for one or more renewal options on the same basis as current rental terms. However, certain leases require increased rentals under cost of living escalation clauses. Some leases also provide purchase options.

Future minimum rental commitments for non-cancellable operating leases with initial or remaining terms of one or more years consisted of the following at December 31, 2016:

For the Year Ending December 31:	
2017	$ 966
2018	812
2019	456
2020	218
2021	181
Thereafter	41
Total future minimum payments	$ 2,674

Rent expense for all operating leases totaled $1.2 million and $764,000 for the years ended December 31, 2016 and 2015, respectively.

(Dollars in Thousands for Tabular Presentations)

Note 5. Premises and Equipment (Continued)

In 2015 Southern disposed of a facility for a net gain of $223,000 and leased it back until construction of a new building could be completed. The net gain was deferred and is being amortized over the two year lease term of the building sold. The amount included in other income was $107,000 and $90,000 in 2016 and 2015, respectively. The Bank had several former bank branch facilities which were being marketed and were written down to the lower of cost or estimated net realizable value resulting in a write-down of approximately $158,000 and $586,000 in 2016 and 2015, respectively. The remaining net realizable value of those facilities in the amount of $817,000 and $270,000 was reclassified out of Property and Equipment and is included in Other Assets as of December 31, 2016 and 2015, respectively.

Note 6. Income Taxes

Allocation of federal and state income taxes between current and deferred portions for the years ended December 31 is as follows:

	2016	2015
Current:		
Federal	$ 4,357	$ 5,202
State	476	476
Total	$ 4,833	$ 5,678
Deferred:		
Federal	$ 2,307	$ (998)
State	245	58
Total	$ 2,552	$ (940)
Total tax expense	$ 7,385	$ 4,738

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense included in the consolidated statements of income and comprehensive income is as follows:

	2016	2015
Tax at statutory federal rate	$ 7,261	$ 4,450
State income tax, net of federal benefit	469	347
Tax exempt income	(418)	(290)
Merger expenses	43	70
Dividends received deduction	(114)	(97)
Other	144	258
Total	$ 7,385	$ 4,738

(Dollars in Thousands for Tabular Presentations)

Note 6. Income Taxes (Continued)

The components of the net deferred tax liability, included in other liabilities, are as follows:

	December 31, 2016	December 31, 2015
Deferred tax assets:		
Allowance for loan losses	$ 6,871	$ 7,840
Pension liability	4,762	4,752
Deferred compensation	1,286	932
Gain on FDIC-assisted transaction, deferred for tax purposes	9,299	6,961
Other	2,617	1,706
Total deferred tax assets	24,835	22,191
Deferred tax liabilities:		
Depreciation	(1,636)	(1,509)
Intangibles	(3,895)	(2,405)
Pension funding commitment	(5,422)	(3,662)
Unrealized gains on investments available-for-sale	(23,143)	(18,898)
Other	(2,306)	(1,679)
Total deferred tax liabilities	(36,402)	(28,153)
Net deferred tax liability	$ (11,567)	$ (5,962)

The Company adjusted its net deferred tax liability as a result of reduction in the North Carolina corporate income tax rates that were enacted July 23, 2013, and became effective January 1, 2015 and January 1, 2016. The lower corporate income tax rate resulted in a reduction in the deferred tax liability in 2016 and 2015 and an increase in current period income tax benefit for the years ended December 31, 2016 and 2015, respectively.

BancShares has invested in Qualified Affordable Housing Projects in the amount of $2.5 million. The current investment balance net of amortized tax benefits is $1.9 million and is shown on the balance sheet in other assets. BancShares also has commitments, which are shown in other liabilities on the balance sheet, to provide additional capital calls in the amount of $1.9 million. It is anticipated that these additional commitment amounts will be paid within the next four years.

Tax positions must meet a recognition threshold of more-likely-than-not in order for the benefit of those tax positions to be recognized in BancShares' consolidated financial statements. BancShares has determined that it does not have any material unrecognized tax benefits or obligations as of December 31, 2016. Interest and penalties related to income tax assessments, if any, are reflected in income tax expense in the accompanying consolidated statements of income and comprehensive income. Fiscal years ending on or after December 31, 2012 remain subject to examination by federal and state tax authorities.

Note 7. Deposits

Deposits at December 31 are summarized as follows:

	2016	2015
Demand	$ 628,307	$ 487,412
Time	329,666	377,700
Money market accounts	664,137	483,433
Checking with interest	340,968	315,241
Savings	157,625	138,465
Total deposits	$ 2,120,703	$ 1,802,251

(Dollars in Thousands for Tabular Presentations)

Note 7. Deposits (Continued)

Total time deposits with a denomination of $250,000 or more were $38.4 million and $48.7 million at December 31, 2016 and 2015, respectively.

At December 31, 2016, the scheduled maturities of all time deposits were:

2017	$	296,867
2018		13,498
2019		4,181
2020		4,740
2021		6,964
Thereafter		3,416
Total time deposits	$	329,666

Note 8. Short and Long-Term Borrowings

Short-term Borrowings

	2016	2015
Repurchase agreements	$ 58,044	$ 64,722

For the years ended December 31, 2016 and 2015, average short-term borrowings outstanding totaled $63.8 million and $72.1 million, respectively, with weighted average rates of 0.27% and 0.41% as of December 31, 2016 and 2015, respectively.

We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and secure long-term funding needs. Repurchase agreements are transactions whereby we offer to sell to a counterparty an undivided interest in an eligible security at an agreed upon purchase price, and which obligates BancShares to repurchase the security on an agreed upon date at an agreed upon repurchase price plus interest at an agreed upon rate. Securities sold under agreements to repurchase are recorded at the amount of cash received in connection with the transaction and are reflected as short-term borrowings on the Consolidated Balance Sheets.

We monitor collateral levels on a continuous basis and maintain records of each transaction specifically describing the applicable security and the counterparty's fractional interest in that security, and we segregate the security from its general assets in accordance with regulations governing custodial holdings of securities. The primary risk with our repurchase agreements is market risk associated with the investments securing the transactions, as we may be required to provide additional collateral based on fair value changes of the underlying investments. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agents.

At December 31, 2016 and 2015, investment securities with a carrying value of $71.5 million and $68.5 million, respectively were pledged for repurchase agreements. The securities collateralizing the repurchase agreements have been delivered to a third party custodian for safekeeping.

The remaining contractual maturity of the securities sold under agreements to repurchase by class of collateral pledged included in short-term borrowings as of December 31, 2016 and 2015 is as follows:

	Overnight and Continuous	
	2016	2015
U.S. Treasuries and government-sponsored entities debt	$ 16,227	$ 28,452
Residential government-sponsored mortgage-backed securities	55,312	40,068
TOTAL	$ 71,539	$ 68,520

(Dollars in Thousands for Tabular Presentations)

Note 8. Short and Long-Term Borrowings (Continued)

Long-term Borrowings

Long-term borrowings at December 31 were:

	2016	2015
Junior subordinated debentures	$ 23,711	$ 23,711
Subordinated debt	7,125	7,125
Other borrowing	10,000	10,000
Total long-term borrowings	$ 40,836	$ 40,836

The $23.7 million junior subordinated debentures payable to Southern Capital Trust II (the "Trust"), qualify as Tier 1 Capital for BancShares, bear interest at 6.95% and mature in 2035. The Trust is a grantor trust established by BancShares for the purpose of issuing trust preferred securities. The obligations of the Company with respect to the issuance of the capital securities constitute a full and unconditional guarantee by the Company of the Trusts' obligations with respect to the capital securities. BancShares may, at any time, redeem the junior subordinated debentures long-term borrowings in whole or in part. The Trust is not consolidated with BancShares. Accordingly, BancShares does not report the securities issued by Southern Capital Trust II as liabilities, and instead reports as liabilities the junior subordinated debentures issued by BancShares and held by the Trust. However, BancShares has fully and unconditionally guaranteed the repayment of the trust preferred securities. These trust preferred securities currently qualify as Tier 1 capital for regulatory capital requirements of BancShares.

Subordinated debt in the amount of $8.8 million was issued September 21, 2011 to assist in the acquisition of BOC. The subordinated debt pays interest quarterly at the annual rate, reset monthly, at the 1 month LIBOR plus 824 basis points through November 30, 2013, but no more than 15.72% and at the rate, reset monthly, of the 1 month LIBOR plus 1,045 basis points after November 30, 2013 through maturity, but no more than 15.72%. In February of 2016 the subordinated debt interest rate was modified to equal 3 month LIBOR plus 1035.33 basis points not to exceed 15.72%. The interest rate at December 31, 2016 and 2015 was 11.17% and 10.81%, respectively. The subordinated debt matures on September 21, 2026 and can be prepaid any time after September 30, 2012. See also Note 14 Related Parties regarding the issuance of the subordinated debt.

The other borrowing of $10.0 million from a commercial bank was used to help fund the retirement of common stock during December of 2012. The note is secured by a first priority secured interest in marketable equity securities with a December 31, 2015 carrying value of $52.3. The note was renewed in November of 2015 for an additional three years at a rate of 1 month LIBOR (0.72% and 0.36% at December 31, 2016 and 2015, respectively) plus 112.5 basis points. The interest rate at December 31, 2016 and 2015 was 1.84% and 1.48%, respectively.

Total long-term borrowing averaged $40.8 million and $31.8 million for 2016 and 2015, respectively and the average cost was 6.24% and 7.45% for 2016 and 2015, respectively.

Note 9. Retirement Plans

Southern has a noncontributory, defined benefit pension plan which covers a substantial number of full-time employees. Southern discontinued offering benefits under the defined benefit plan to employees hired after June 30, 2012. Employees hired who met eligibility requirements on or before June 30, 2012 were allowed the option of continued participation in the defined benefit plan and the existing 401(k) plan or enrollment in an enhanced 401(k) plan, discussed further below. Employees who elected to enroll in the enhanced plan discontinued the accrual of additional years of service under the defined benefit plan. Under the plan, retirement benefits are based on years of service and average earnings. The plan's assets consist primarily of investments in listed common stocks and fixed income securities. It is Southern's policy to determine the service cost and projected benefit obligation using the Projected Unit Credit Cost method.

(Dollars in Thousands for Tabular Presentations)

Note 9. Retirement Plans (Continued)

The following sets forth pertinent information regarding the projected benefit obligation of the pension plan for the periods indicated:

	2016	2015
Projected benefit obligation, beginning of year	$ 71,999	$ 74,519
Service cost	2,038	2,317
Interest cost	3,179	3,057
Actuarial (gain) loss	1,699	(5,379)
Benefits paid	(2,873)	(2,515)
Projected benefit obligation, end of year	$ 76,042	$ 71,999

The accumulated benefit obligation for the pension plan at the end of 2016 and 2015 was $66.4 million and $62.5 million, respectively.

Southern uses a measurement date of December 31 for its pension plan.

The weighted average assumptions used to determine benefit obligations, at the end of the year were as follows:

	2016	2015
Discount rate	4.15%	4.40%
Rate of compensation increase	4.00%	4.00%

The change in pension plan assets is as follows:

	2016	2015
Fair value of plan assets, beginning of year	$ 69,069	$ 69,144
Actual return on plan assets	4,371	(813)
Employer contribution	7,283	3,253
Benefits paid	(2,873)	(2,515)
Fair value of plan assets, end of year	$ 77,850	$ 69,069

Employer contributions and benefits paid in the above table include only those amounts contributed directly to, or paid directly from, plan assets.

	2016	2015
Funded status, end of year		
Fair value of plan assets	$ 77,850	$ 69,069
Projected benefit obligation	(76,042)	(71,999)
Funded status	1,808	(2,930)
Amounts not yet recognized:		
Unrecognized net loss	-	-
Net amount recognized	$ 1,808	$ (2,930)

	2016	2015
Amounts recognized in the statement of financial position consist of:		
Noncurrent asset	$ 1,808	$ -
Noncurrent liability	$ -	$ (2,930)
Amounts recognized in accumulated other comprehensive income, excluding income taxes, consist of:		
Net actuarial loss	$ 13,038	$ 12,776
Prior service cost	-	-
Accumulated other comprehensive income	$ 13,038	$ 12,776

(Dollars in Thousands for Tabular Presentations)

Note 9. Retirement Plans (Continued)

The following table discloses the components of periodic benefit cost related to the pension plan for the years ended December 31, 2016 and 2015:

	2016	2015
Service cost	$ 2,038	$ 2,317
Interest cost	3,179	3,057
Expected return on plan assets	(4,127)	(4,053)
Amortization of net actuarial loss	1,193	1,932
Net periodic benefit cost	$ 2,283	$ 3,253

Investment decisions regarding the plan's assets seek to achieve a favorable annual return through a diversified portfolio that will provide needed capital appreciation and cash flow to allow both current and future benefit obligations to be paid. The target asset mix may change if the objectives for the plan's assets or risk tolerance change or if a major shift occurs in the expected long-term risk and reward characteristics of one or more asset classes.

The asset allocation for Southern's pension plan at the end of 2016 and 2015, and the target allocation for 2017, by asset category, follows:

Asset category	Target Allocation for 2017	Percentage of Plan Assets at December 31, 2016	2015
Equity securities	45%	49%	65%
Debt securities	33%	39%	33%
Other investments	20%	7%	0%
Cash and cash equivalents	2%	5%	2%
Total	100%	100%	100%

The expected long term rate of return on the plan assets was 6.50% and 7.00% in 2016 and 2015, respectively. Southern's investment strategy calls for earning an adequate return on assets while not exposing the assets to unnecessary risk. The plan's assets are invested in marketable, fixed rate U. S. Government and corporate securities and marketable equity securities. In 2016 the plan's committee did not modify the target allocation of the plan's assets from the stated targets of the previous year. This was determined after careful deliberation and review of historic returns in these two categories of investments.

(Dollars in Thousands for Tabular Presentations)

Note 9. Retirement Plans (Continued)

The fair values of pension plan assets at December 31, 2016 and 2015, by asset category are as follows:

Asset Category	Market Value as of December 31,	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Target Allocation	Actual % of Plan Assets
2016						
Money market fund	$ 4,299	$ -	$ 4,299	$ -	3%	6%
Other investments	4,255	4,255	-	-	0%	5%
Equity securities:					59%	53%
Individual equities	17,180	17,170	10	-		
Mutual funds	20,553	20,553	-	-		
Exchange traded funds	3,828	3,828	-	-		
Debt securities:					38%	41%
Bonds	24,766	9,561	15,205	-		
Exchange traded funds	815	815	-	-		
Mutual funds	2,154	2,154	-	-		
Total pension assets	$ 77,850	$ 58,336	$ 19,514	$ -	100%	100%
2015						
Money market fund	$ 1,104	$ -	$ 1,104	$ -	3%	2%
Equity securities:					58%	65%
Individual equities	37,367	37,346	21	-		
Mutual funds	7,419	7,419	-	-		
Debt securities:					39%	33%
Bonds	19,748	5,021	14,727	-		
Mutual funds	3,431	3,431	-			
Total pension assets	$ 69,069	$ 53,217	$ 15,852	$ -	100%	100%

In 2016, the Company made the decision to increase the 2015 employer contributions by $2.0 million as allowed by accounting guidance ASC 960 specific for pension plans. The subsequent contribution had no impact to balances presented as of and for the year ended December 31, 2015 for the Company. Following are estimated payments to pension plan participants in the indicated periods:

Employer Contributions	
2017 (expected) to plan trust	$ 132
Expected Benefit Payments	
2017	$ 2,866
2018	3,071
2019	3,228
2020	3,376
2021	3,522
2022 - 2026	20,018

(Dollars in Thousands for Tabular Presentations)

Note 9. Retirement Plans (Continued)

The weighted-average assumptions used to determine the net periodic benefit cost for the years ended December 31, 2016 and 2015 are as follows:

	2016	2015
Discount rate	4.15%	4.05%
Rate of compensation increase	4.00%	4.00%
Expected return on plan assets	6.50%	7.00%

The discount rate above reflects the discount in effect at January 1 of the plan year. The estimated actuarial loss that will be amortized from accumulated other comprehensive income into net periodic benefit cost in 2017 is $1.1 million. There is no prior service cost expected to be amortized into the net periodic benefit cost in 2017.

Employees hired before July 1, 2012 are also eligible to participate in a 401(k) plan through deferral of portions of their salary. Based on the employee's contribution, BancShares will match up to 100% of the first 3% of the participant's contributions and 50% of the next 3%. In addition BancShares also offers an enhanced 401(k) plan for certain employees. BancShares will match 100% of the first 6% of the participant's contributions. In addition BancShares may make discretionary contributions. BancShares made participating contributions of $1.2 million and $1.1 million during 2016 and 2015, respectively.

Note 10. Regulatory Requirements and Restrictions

BancShares is subject to regulations with respect to certain risk-based capital ratios. These risk-based capital ratios measure the relationship of capital to a combination of balance sheet and off-balance sheet risks. The values of both balance sheet and off-balance sheet items are adjusted based on the rules to reflect categorical credit risk. In addition to the risk-based capital ratios, the regulatory agencies have also established a leverage ratio for assessing capital adequacy. The leverage ratio is equal to Tier 1 capital divided by total consolidated on-balance sheet assets (minus amounts deducted from Tier 1 capital). The leverage ratio does not involve assigning risk weights to assets.

In July 2013, the Federal Reserve announced its approval of a final rule to implement the regulatory capital reforms developed by the Basel Committee on Banking Supervision ("Basel III"), among other changes required by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The new rules became effective January 1, 2015, subject to a phase-in period for certain aspects of the new rules.

As applied to BancShares and Southern, the new rules include a new minimum ratio of common equity Tier 1 capital ("CET1") to risk-weighted assets of 4.5%. The new rules also raise the minimum required ratio of Tier 1 capital to risk-weighted assets from 4% to 6%. The minimum required leverage ratio under the new rules is 4%. The minimum required total capital to risk-weighted assets ratio remains at 8% under the new rules.

In order to avoid restrictions on capital distributions and discretionary bonus payments to executives, under the new rules a covered banking organization will also be required to maintain a "capital conservation buffer" in addition to its minimum risk-based capital requirements. This buffer will be required to consist solely of common equity Tier 1, and the buffer will apply to all three risk-based measurements (CET1, Tier 1 capital and total capital). The capital conservation buffer, which is 0.625% at December 31, 2016, is being phased in incrementally over time and will be fully effective on January 1, 2019, and will ultimately consist of an additional amount of Tier 1 common equity equal to 2.5% of risk-weighted assets.

Southern is also subject to the regulatory framework for prompt corrective action, which identifies five capital categories for insured depository institutions (well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized) and is based on specified thresholds for each of the three risk-based regulatory capital ratios (CET1, Tier 1 capital and total capital) and for the leverage ratio.

Note 10. Regulatory Requirements and Restrictions (Continued)

The following table presents actual and required capital ratios as of December 31, 2016 for BancShares and Southern under the Basel III capital rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2016 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

	Actual		Minimum capital required - Basel III phase-in schedule		Minimum capital required - Basel III fully phased-in		Required to be considered well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)					
December 31, 2016:								
Common equity Tier 1 to risk-weighted assets:								
BancShares	$ 153,690	8.339%	$ 94,455	5.125%	$ 129,012	7.000%	$ 119,797	6.500%
Southern	216,765	12.248%	90,702	5.125%	123,886	7.000%	115,037	6.500%
Tier 1 capital to risk-weighted assets								
BancShares	220,909	11.987%	122,092	6.625%	156,647	8.500%	147,432	8.000%
Southern	216,765	12.248%	117,249	6.625%	150,433	8.500%	141,584	8.000%
Total capital to risk-weighted assets								
BancShares	275,465	14.947%	158,954	8.625%	193,509	10.500%	184,295	10.000%
Southern	242,050	13.676%	152,653	8.625%	185,838	10.500%	176,989	10.000%
Tier 1 capital to average assets (leverage ratio):								
BancShares	220,909	9.016%	98,008	4.000%	98,008	4.000%	122,509	5.000%
Southern	216,765	8.867%	97,785	4.000%	97,785	4.000%	122,231	5.000%

	Actual		Minimum capital required - Basel III phase-in schedule		Minimum capital required - Basel III fully phased-in		Required to be considered well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(Dollars in thousands)					
December 31, 2015:								
Common equity Tier 1 to risk-weighted assets:								
BancShares	$ 161,419	12.280%	$ 59,152	4.500%	$ 92,014	7.000%	$ 85,442	6.500%
Southern	203,373	16.160%	56,632	4.500%	88,095	7.000%	81,802	6.500%
Tier 1 capital to risk-weighted assets								
BancShares	209,089	15.900%	78,902	6.000%	111,777	8.500%	105,202	8.000%
Southern	203,373	16.160%	75,510	6.000%	106,972	8.500%	100,680	8.000%
Total capital to risk-weighted assets								
BancShares	252,746	19.220%	105,201	8.000%	138,077	10.500%	131,502	10.000%
Southern	223,485	17.760%	100,669	8.000%	132,128	10.500%	125,836	10.000%
Tier 1 capital to average assets (leverage ratio):								
BancShares	209,089	9.560%	87,485	4.000%	87,485	4.000%	109,356	5.000%
Southern	203,373	9.320%	87,285	4.000%	87,285	4.000%	109,106	5.000%

Note 10. Regulatory Requirements and Restrictions (Continued)

The primary source of funds for the dividends paid by BancShares to its shareholders is dividends received from its banking subsidiary. Southern is restricted as to dividend payout by state laws applicable to banks and may pay dividends only out of retained earnings. Should at any time its surplus be less than 50% of its paid-in capital stock, Southern may not declare a dividend until it has transferred from retained earnings to surplus 25% of its undivided profits or any lesser percentage that may be required to restore its surplus to an amount equal to 50% of its paid-in capital stock. Additionally, dividends paid by Southern may be limited by the need to retain sufficient earnings to satisfy minimum capital requirements imposed by the FDIC. Dividends on BancShares' common shares may be paid only after dividends on preferred series B, C, D, E and F shares have been paid. Common share dividends are based upon BancShares' profitability and are paid at the discretion of the Board of Directors.

Management does not expect any of the foregoing restrictions to materially limit its ability to pay dividends comparable to those paid in the past. At December 31, 2016, BancShares' investment in Southern was restricted to an amount equal to the level of regulatory capital that could be transferred from Southern without obtaining prior regulatory approval.

Note 11. Commitments, Contingencies and Concentration of Credit Risk

In the normal course of business there are various commitments and contingent liabilities outstanding, such as guarantees, commitments to extend credit, etc., which are not reflected in the accompanying financial statements. Southern is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates. These financial instruments include commitments to extend credit, standby letters of credit and undisbursed advances on customer lines of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheet.

Southern is exposed to credit loss for the contractual notional amount of commitments to extend credit and standby letters of credit in the event of nonperformance by the other party to the financial instrument. Southern uses the same credit policies in making these commitments and conditional obligations as it does for on-balance-sheet instruments.

Commitments to extend credit and undisbursed advances on customer lines of 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 commitments expire without being drawn, the total commitment amounts do not necessarily represent future cash requirements. Southern evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by Southern, upon extension of credit is based on management's credit evaluation of the borrower. Collateral held varies but may include trade accounts receivable, property, plant, and equipment and income-producing commercial properties.

Standby letters of credit are commitments issued by Southern to guarantee the performance of a customer to a third party. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The maximum potential amount of undiscounted future payments related to standby letters of credit at December 31, 2016 is $5.6 million. At December 31, 2016, BancShares considered this amount to be immaterial and has recorded no liability for the current carrying amount of the obligation to perform as a guarantor and no liability is considered necessary. Substantially all standby letters of credit are secured by real estate and/or guaranteed by third parties in the event BancShares had to advance funds to fulfill the guarantee.

Outstanding commitments to lend at December 31, 2016 and December 31, 2015 were $395.2 million and $281.9 million and include undisbursed advances on customer lines of credit of $123.2 million and $101.7 million, respectively. Outstanding standby letters of credit and commitments to lend at December 31, 2016 generally expire within one year, whereas commitments associated with undisbursed advances on customer lines of credit at December 31, 2016 generally expire within one to five years.

Non-recourse commitments to sell loans amounted to $16.0 million and $10.7 million at December 31, 2016 and 2015, respectively. BancShares utilized investor commitments to protect its mortgage loans held for sale from interest rate risk from the time of origination to the time of sale. These commitments are accounted for at fair market value. Unfunded residential mortgage loan commitments for loans to be sold are also accounted for at fair market value. These fair market value adjustments were insignificant as of and for the years ended December 31, 2016 and 2015.

Southern is also committed to leases for banking facilities. See Note 5 – Premises and Equipment for lease commitments at December 31, 2016.

BancShares does not have any special purpose entities or other similar forms of off-balance sheet financing arrangements other than the trust preferred securities discussed in Note 8.

(Dollars in Thousands for Tabular Presentations)

Note 11. Commitments, Contingencies and Concentration of Credit Risk (Continued)

Southern grants agribusiness, commercial and consumer loans to customers primarily in eastern North Carolina and southeastern Virginia. As a result of the FDIC-assisted acquisition of BOC, FDIC covered loans were acquired outside of the primary North Carolina and Virginia markets.

BancShares is also involved in various legal actions arising in the normal course of business. Management is of the opinion that the outcome of such actions will not have a material adverse effect on the consolidated financial condition of BancShares.

Note 12. Parent Company Financial Statements

Presented below are the condensed balance sheets (parent company only) of Southern BancShares (N.C.), Inc. as of December 31, 2016 and 2015 and condensed statements of income and cash flows for the years then ended.

CONDENSED BALANCE SHEETS

	December 31, 2016	December 31, 2015
ASSETS		
Cash	$ 23,441	$ 26,374
Investment securities available-for-sale	60,005	47,640
Loans receivable	-	2,200
Other assets	6,274	5,248
Investment in subsidiaries	243,436	210,701
Total assets	$ 333,156	$ 292,163
LIABILITIES AND SHAREHOLDERS' EQUITY		
Accrued liabilites	$ 17,769	$ 13,797
Notes payable	59,983	61,935
Total liabilities	77,752	75,732
Shareholders' equity	255,404	216,431
Total liabilities and shareholders' equity	$ 333,156	$ 292,163

CONDENSED STATEMENTS OF INCOME

	Year Ended December 31, 2016	Year Ended December 31, 2015
Interest and dividend income	$ 617	$ 497
Dividends from bank subsidiary	32,696	3,767
Securities gains	3,034	2,722
Total income	36,347	6,986
Interest expense	3,258	2,594
Other expense	560	654
Income before equity in undistributed income of subsidiaries	32,529	3,738
Equity in undistributed income of subsidiaries	(19,170)	4,118
Net income	13,359	7,856
Dividends on preferred stock	1,962	1,075
Net income available to common shareholders	$ 11,397	$ 6,781

(Dollars in Thousands for Tabular Presentations)

Note 12. Parent Company Financial Statements (Continued)

CONDENSED STATEMENTS OF CASH FLOWS

	Year Ended December 31, 2016	Year Ended December 31, 2015
OPERATING ACTIVITIES:		
Net income	$ 13,359	$ 7,856
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in undistributed net income of subsidiaries	19,170	(4,168)
Gains on sales and issuer calls of securities	(3,034)	(2,722)
Loss on charitable contribution of stock	36	-
Increase in other assets	(1,466)	(131)
Increase in accrued liabilities	21	764
NET CASH PROVIDED BY OPERATING ACTIVITIES	28,086	1,599
INVESTING ACTIVITIES:		
Proceeds from sales, maturities and issuer calls of securities	3,206	4,300
Net cash paid in acquisition	(49,760)	-
Net increase in loans and leases	(250)	(2,200)
NET CASH PROVIDED (USED) BY INVESTING ACTIVITIES	(46,804)	2,100
FINANCING ACTIVITIES:		
Repayment of borrowed funds	(1,952)	-
Dividends paid	(2,094)	(1,205)
Issuance of preferred stock	20,000	-
Purchase and retirement or redemption of stock	(169)	-
NET CASH PROVIDED (USED) BY FINANCING ACTIVITIES	15,785	(1,205)
NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(2,933)	2,494
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF YEAR	26,374	23,880
CASH AND CASH EQUIVALENTS AT THE END OF YEAR	$ 23,441	$ 26,374
SUPPLEMENTAL DISCLOSURES OF CASH PAID DURING THE YEAR FOR:		
Interest	$ 3,258	$ 2,594
SUPPLEMENTAL DISCLOSURES OF NONCASH INVESTING ACTIVITIES:		
Elimination of loan to Heritage-VA in acquisition	$ 2,450	$ -

Note 13. Fair Value of Financial Instruments

The following methods and assumptions were used to estimate the fair value of each class of financial instrument:

Cash and Due from Banks, Interest–bearing Deposits with Banks, Certificates of Deposit with Banks and Accrued Interest Receivable

The carrying amounts for cash and due from banks, interest-bearing deposits with banks, certificates of deposits with banks and accrued interest receivable are equal to their fair values due to the short term nature of these financial instruments.

Investment Securities

Fair values of investment securities are based on quoted market prices. If a quoted market price is not available, fair value is estimated using quoted market prices for similar securities.

Loans Held for Sale

Fair value for loans held for sale is generally based on market prices for loans with similar characteristics or external valuations.

Loans

For variable-rate loans that are performing, fair values are based on carrying values. The fair values of fixed rate loans that are performing are estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The fair value of nonperforming loans is based on the book value of each loan, less an applicable reserve for credit losses. This reserve for credit losses is determined on a loan-by-loan basis for nonperforming assets based on one or a combination of the following: external appraisals, internal assessments using available market information and specific borrower information, or discounted cash flow analysis. However, the values derived likely do not represent exit prices due to weaker than state average economic conditions in our primary markets. Therefore, a liquidity discount of approximately 2.5% was subtracted to reflect the illiquidity of loans and our economically weaker markets at both December 31, 2016 and December 31, 2015.

FDIC Receivable for Loss Share Agreements and FDIC True-up Liability for Loss Share Agreements

The fair value is estimated based on discounted future cash flows using current discount rates.

Stock in FHLB

The carrying amount for FHLB stock is equal to the fair value due to the redemption provisions of the FHLB and no ready market for such stock.

Deposits

The fair value of demand deposits, savings accounts and money market deposits is the amount payable on demand at year end. The fair value of certificates of deposit is estimated by discounting the future cash flows using the current rates paid for similar deposits.

Short-term Borrowings and Accrued Interest Payable

The carrying amounts for short-term borrowings and accrued interest payable are equal to the fair values due to the short-term nature of these financial instruments.

Long-term Borrowings

The fair value of long-term borrowings reflects discounting future cash flows using the current interest rates for similar maturities.

Commitments

Southern's commitments to extend credit have no carrying value and are generally at variable rates and/or have relatively short terms to expiration. Accordingly, these financial instruments are deemed to have no material fair value.

(Dollars in Thousands for Tabular Presentations)

Note 13. Fair Value of Financial Instruments (Continued)

The estimated fair values of BancShares' financial instruments at December 31 are as follows:

	2016		2015	
	Carrying Amount	Estimated Fair Value	Carrying Amount	Estimated Fair Value
Financial assets:				
Cash and due from banks	$ 18,534	$ 18,534	$ 23,644	$ 23,644
Interest-bearing deposits with banks	42,236	42,236	203,076	203,076
Certificates of deposits with banks	77,418	77,418	60,333	60,333
Investment securities available-for-sale	776,022	776,022	629,827	629,827
Loans held for sale	4,579	4,579	2,012	2,037
Loans and leases, net of allowance	1,472,261	1,463,951	1,136,183	1,182,528
FDIC receivable for loss share agreements	2,518	463	9,665	8,596
Stock in FHLB	2,184	2,184	1,963	1,963
Accrued interest receivable	7,916	7,916	7,043	7,043
Financial liabilities:				
Deposits	$ 2,120,703	$ 2,010,137	$ 1,802,251	$ 1,734,482
Short-term borrowings	58,044	58,044	64,722	64,722
Long-term borrowings	40,836	43,968	40,836	44,069
FDIC true-up liability for loss share agreements	15,373	15,373	14,599	14,599
Accrued interest payable	112	112	160	160

Limitations on Fair Value Assumptions

Fair value estimates are made by management at specific points in time based on relevant information about the financial instrument and the market. These estimates do not reflect any premium or discount that could result from offering for sale at one time BancShares' entire holdings of a particular financial instrument nor are potential taxes and other expenses that would be incurred in an actual sale considered. Because no market exists for a significant portion of BancShares' financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments and other factors. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and th erefore cannot be determined with precision. Changes in assumptions and/or the methodology used could significantly affect the estimates disclosed. Similarly, the fair values disclosed could vary significantly from amounts realized in actual transactions.

Fair value estimates are based on existing on- and off-balance sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. For example, BancShares has premises and equipment which are not considered financial instruments. Accordingly, the value of these assets has not been incorporated into the fair value estimates. In addition, tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of the estimates.

BancShares reports fair value on a recurring basis for certain financial instruments, most notably for available-for-sale investment securities and certain derivative instruments. BancShares may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis. These include assets that are measured at the lower of cost or market that were recognized at fair value which was below cost at the end of the period. Assets subject to nonrecurring use of fair value measurements could include impaired loans, loans held for sale, goodwill, and OREO.

(Dollars in Thousands for Tabular Presentations)

Note 13. Fair Value of Financial Instruments (Continued)

BancShares groups financial assets and financial liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

Level 1 – Valuations for assets and liabilities traded in active exchange markets, such as the New York Stock Exchange. Level 1 also includes U.S. Treasury, other U.S. government and agency mortgage-backed securities that are traded by dealers or brokers in active markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 – Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party services for similar or comparable assets or liabilities.

Level 3 – Valuations for assets and liabilities that are derived from other valuation methodologies, including option pricing models, discounted cash flow models and similar techniques, and not based on market exchange, dealer, or brokered traded transactions. Level 3 valuations incorporate certain assumptions and projections in determining the fair value assigned to such assets or liabilities.

Securities available for sale are valued on a recurring basis at quoted market prices where available. If quoted market prices are not available, fair values are based on quoted market prices of comparable securities. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, or U.S. Treasury securities and mortgage backed securities by government sponsored entities that are traded by dealers or brokers in active over-the-counter markets and money market funds. Level 2 securities include obligations of states and political subdivisions and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets given that there is an absence of observable inputs for these and similar securities in the debt markets. For these securities, a present value approach that maximizes the use of relevant observable inputs and minimizes the use of unobservable inputs provides representative fair values, and therefore, has been used rather than a market valuation approach. This income valuation approach requires numerous steps in determining fair value. These steps include estimating credit quality of the collateral, generating asset defaults, forecasting cash flows for underlying collateral, and determining losses given default assumptions.

BancShares is allowed to make an irrevocable election to measure certain financial instruments at fair value. The changes in fair value from one reporting period to the next period must be reported in the income statement with additional disclosures to identify the effect on net income. BancShares continued to account for securities available-for-sale at fair value as reported in prior years. BancShares has no derivative activity. Securities available-for-sale are reported on a recurring basis.

Fair Value Measurements at December 31:

	Market Value	Quoted Prices in Active Markets for Identical (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2016				
U.S. Treasuries and government sponsored entities debt	$ 119,396	$ 119,396	$ -	$ -
Corporate debt securities	12,357	-	11,365	992
Marketable equity securities	84,687	84,687	-	-
Obligations of states and political subdivisions	33,758	-	29,191	4,567
Residential government-sponsored mortgage-backed securities	525,824	-	525,824	-
Total	$ 776,022	$ 204,083	$ 566,380	$ 5,559

(Dollars in Thousands for Tabular Presentations)

Note 13. Fair Value of Financial Instruments (Continued)

	Market Value	Quoted Prices in Active Markets for Identical (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2015				
U.S. Treasuries and government sponsored entities debt	$ 159,191	$ 159,191	$ -	$ -
Corporate debt securities	7,493	-	6,491	1,002
Marketable equity securities	65,579	65,579	-	-
Obligations of states and political subdivisions	22,432	-	17,536	4,896
Residential government-sponsored mortgage-backed securities	375,132	-	375,132	-
Total	$ 629,827	$ 224,770	$ 399,159	$ 5,898

For those investment securities available-for-sale with fair values that are determined by reliance on significant unobservable inputs, the following table identifies the factors causing the change in fair values for the years ended December 31, 2016 and 2015:

Description	Investment Securities Available-For-Sale With Fair Values Based on Significant Unobservable Inputs
Beginning balance, January 1, 2015	$ 10,301
Total gains (losses) realized or unrealized:	
Included in earnings	(4)
Included in other comprehensive income	(86)
Maturities and calls, net	(4,313)
Ending balance, December 31, 2015	5,898
Total gains (losses) realized or unrealized:	
Included in earnings	(4)
Included in other comprehensive income	(22)
Maturities and calls, net	(313)
Ending balance, December 31, 2016	$ 5,559

As previously discussed, loans are considered impaired when it is determined to be probable that all amounts due under the contractual terms of the loan will not be collected when due. Loans considered individually impaired are evaluated and a specific allowance is established, if required, based on the most appropriate of the three measurement methods: present value of expected future cash flows, fair value of collateral, or the observable market price of a loan method. A specific allowance is required if the fair value of the expected repayments or the collateral is less than the recorded investment in the loan. At December 31, 2016 $2.1 million of impaired loans required a specific allowance of $238,000 and $1.9 million of impaired loans had partial charge-offs for a total of $3.8 million of impaired loans measured at fair value. At December 31, 2015 $2.7 million of impaired loans required a specific allowance of $321,000 and $1.5 million of impaired loans had partial charge-offs for a total of $3.9 million of impaired loans measured at fair value. The methods used to determine the fair value of these loans were considered Level 3.

(Dollars in Thousands for Tabular Presentations)

Note 13. Fair Value of Financial Instruments (Continued)

OREO is measured and reported at fair value using Level 3 inputs for valuations based on non-observable criteria. At December 31, 2016 and 2015, OREO not covered under loss share agreements totaled $1.7 million and $1.1 million, respectively all of which was valued using Level 3 inputs. At December 31, 2016 and 2015, OREO covered under loss share agreements totaled $95,000 and $11.7 million, respectively, all of which was valued using Level 3 inputs.

At December 31, 2016 and December 31, 2015, BancShares had certain impaired loans and OREO that are measured at fair value on a nonrecurring basis. The significant unobservable input used in the fair value measurement of BancShares' impaired loans and OREO range between 6 - 15% discount from appraisals for expected liquidation and sales costs.

The tables below present the balances of assets and liabilities measured at fair value on a nonrecurring basis.

	Market Value	(Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
2016				
Impaired loans	$ 3,791	$ -	$ -	$ 3,791
OREO - covered under loss share agreements	95	-	-	95
OREO - not covered under loss share agreements	1,705	-	-	1,705
2015				
Impaired loans	$ 3,933	$ -	$ -	$ 3,933
OREO - covered under loss share agreements	11,692	-	-	11,692
OREO - not covered under loss share agreements	1,097	-	-	1,097

Certain assets are carried at fair value on a nonrecurring basis. Loans held for sale are carried at the lower of aggregate cost or fair value and are therefore carried at fair value only when fair value is less than the asset cost. The values of loans held for sale are based on prices observed for similar pools of loans. There have been no fair value adjustments recorded for loans held for sale at December 31, 2016 and 2015. No financial liabilities were carried at fair value on a nonrecurring basis as of December 31, 2016 or December 31, 2015.

Note 14. Related Parties

First Citizens BancShares, Inc. has an executive officer who is also a significant shareholder and director of BancShares. At December 31, 2016 the officer beneficially owned 8,937 shares, or 10.94%, of BancShares' outstanding common stock. In addition, another director who is related to the aforementioned director beneficially owns 9,318 shares, or 11.40%, of BancShares' outstanding common stock and 946 shares, or 0.35%, of BancShares' outstanding Series B preferred stock.

The Series D preferred stock is non-cumulative, non-voting and redeemable after September 30, 2012. Dividends on the Series D preferred stock are payable at the rate of the 1 month LIBOR plus 210 basis points through November 30, 2013 but no more than 12.24% and at the rate of the 1 month LIBOR plus 317 basis points after November 30, 2013 but no more than 12.24%.

To complete the FDIC-assisted acquisition of BOC, BancShares issued subordinated debt to the same Director that purchased the Series D preferred stock discussed above. The Director currently owns $1.0 million or 14.28% of the current outstanding balance. The terms of the subordinated debt are described in Note 8.

In January of 2016 the Series D preferred stock and the subordinated debt securities were transferred to a limited liability company owned by the two related party directors and other related shareholders. In addition, in January of 2016 the Series F preferred stock was also issued to the limited liability company.

Note 14. Related Parties (Continued)

BancShares has entered into various service contracts with First Citizens BancShares, Inc. and its subsidiary, First-Citizens Bank and Trust Company (collectively "First Citizens"). The following table lists the various charges paid to First Citizens during the years ended December 31:

	2016	2015
Data and item processing	$ 218	$ 259
Consulting fees	-	30
Trustee for employee benefit plans	323	304
Total	$ 541	$ 593

Data and item processing expenses include various processing services and courier services. Forms, supplies and equipment includes branch data processing customer service equipment replacements and additions. During 2013 the Company moved most of its data processing services to another provider. The payment for these services should continue to decrease in the ensuing years as the reliance on First Citizens lessens. BancShares also has a correspondent relationship with First Citizens. Correspondent account balances with First Citizens included in cash and due from banks totaled $607,000 and $802,000 at December 31, 2016 and 2015, respectively. In addition, at December 31, 2016 and 2015 BancShares had $576,000 and $783,000, respectively of loan participations bought from First Citizens and loan participations sold of $4.4 million as of December 31, 2016.

BancShares was also related through common ownership with First Citizens Bancorporation, Inc. ("Bancorporation") in that the aforementioned significant shareholder of BancShares and certain of their related parties were also significant shareholders of Bancorporation. In December 2011, BancShares contracted Bancorporation to provide accounting services beginning in January 2012 for a three year term related to the loss share accounting for the loans acquired in the FDIC-assisted acquisition of BOC on September 23, 2011. The contractual payments include one-time advance fees of $420,000 and monthly fees of $15,000. This contract was modified in 2012 and $75,000 of the advance fees were returned to BancShares. On October 1, 2014 First Citizens acquired Bancorporation, assumed the agreement and notified BancShares that the agreement would be terminated on April 30, 2015.

BancShares also owns stock in First Citizens as follows:

	2016			2015		
	Number of shares	Amortized Cost	Fair Value	Number of shares	Amortized Cost	Fair Value
			($ in thousands)			
First Citizens						
Class A	216,963	$ 15,690	$ 77,022	229,463	$ 15,862	$ 59,240
Class B	22,619	532	6,786	22,619	532	5,479
Total	239,582	$ 16,222	$ 83,808	252,082	$ 16,394	$ 64,719

BancShares is also related through common ownership with Fidelity BancShares NC, Inc., ("Fidelity") in that the aforementioned significant shareholder of BancShares and certain of their related parties are also significant shareholders of Fidelity. At December 31, 2016 and 2015 BancShares had $7.9 million and $3.7 million, respectively in loan participations sold to Fidelity. Fidelity has also contracted with BancShares for BancShares to service, on Fidelity's behalf, $166,000 and $620,000 of Fidelity's mortgage loans at December 31, 2016 and 2015, respectively.

(Dollars in Thousands for Tabular Presentations)

Note 15. Accumulated Other Comprehensive Income

Accumulated other comprehensive income included the following as of December 31:

	2016			2015		
	Accumulated other comprehensive income (loss)	Deferred tax benefit (expense)	Accumulated other comprehensive income (loss) net of tax	Accumulated other comprehensive income (loss)	Deferred tax benefit (expense)	Accumulated other comprehensive income (loss) net of tax
Unrealized gains on investment securities available for sale	$ 62,789	$ (23,143)	$ 39,646	$ 50,415	$ (18,898)	$ 31,517
Funded status of defined benefit plan	(13,038)	4,762	$ (8,276)	(12,776)	4,752	$ (8,024)
Total	49,751	(18,381)	31,370	37,639	(14,146)	23,493

	Unrealized gains and losses on available-for-sale securities	Defined benefit pension plans	Total
Balance at January 1, 2015	$ 34,202	$ (9,501)	$ 24,701
Other comprehensive income (loss) before reclassifications	(64)	322	258
Amounts reclassified from accumulated other comprehensive income (loss)	(2,621)	1,155	(1,466)
Net current period other comprehensive income (loss)	(2,685)	1,477	(1,208)
Balance at December 31, 2015	31,517	(8,024)	23,493
Other comprehensive income (loss) before reclassifications	9,204	(923)	8,281
Amounts reclassified from accumulated other comprehensive income (loss)	(1,075)	671	(404)
Net current period other comprehensive income (loss)	8,129	(252)	7,877
Balance at December 31, 2016	$ 39,646	$ (8,276)	$ 31,370

(Dollars in Thousands for Tabular Presentations)

Note 15. Accumulated Other Comprehensive Income (Continued)

The following table represents the amounts reclassified from accumulated other comprehensive income and the line items affected in the statement where net income is presented for the twelve months ended December 31, 2016 and December 31, 2015:

	Year ended December 31, 2016	
Details about accumulated other comprehensive income	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented
Unrealized gains and losses on available-for-sale securities	$ (2,203)	Investment securities gains, net
	1,128	Income taxes
	$ (1,075)	Net income
Amortization of defined benefit plan		
Actuarial losses	$ 1,193	Personnel
	(522)	Income taxes
	$ 671	Net income
Total reclassifications for the period	$ (404)	

	Year ended December 31, 2015	
Details about accumulated other comprehensive income	Amount reclassified from accumulated other comprehensive income	Affected line item in the statement where net income is presented
Unrealized gains and losses on available-for-sale securities	$ 4,685	Investment securities gains, net
	(2,064)	Income taxes
	$ 2,621	Net income
Amortization of defined benefit plan		
Actuarial losses	$ (1,932)	Personnel
	777	Income taxes
	$ (1,155)	Net income
Total reclassifications for the period	$ 1,466	

Note 16. Subsequent Events

Management has evaluated subsequent events through March 27, 2017, the date the consolidated statements were available to be issued. During the first quarter of 2017, we entered into an agreement with the FDIC and paid $17.3 million to terminate the loss share agreement for BOC resulting in a one-time pre-tax charge of $4.1 million, or $2.6 million after tax. Approximately $3.7 million of the one-time charge was related to amortization on the FDIC receivable scheduled to be recognized during future quarters with the remainder of the one-time charge primarily consisting of our payment to the FDIC to eliminate all rights and obligations between Southern and the FDIC under the loss share agreements and settle outstanding claims for reimbursement between the parties. All rights and obligations of the parties under the FDIC loss share agreements, including the clawback provisions and the settlement of historic loss share expense reimbursement claims, were eliminated under the early termination agreement. All future charge-offs, recoveries, gains, losses and expenses related to assets previously covered by FDIC loss share will now be recognized entirely by us since the FDIC will no longer be sharing in such charge-offs, recoveries, gains, losses and expenses.