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TAYLOR CALVIN B BANKSHARES INC

Form 10-K

March 10, 2006

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-K

Annual Report Pursuant to Section 13 or 15(d) of the Securities  
Exchange Act of 1934

For the fiscal year ended December 31, 2005

Commission File No. 000-50047

Calvin B. Taylor Bankshares, Inc.  
(Exact name of registrant as specified in its Charter)

Maryland (State of incorporation or organization)  
52-1948274 (I.R.S. Employer Identification No.)

24 North Main Street, Berlin, Maryland 21811  
(Address of principal executive offices, including zip code)

Registrant's telephone number, including area code: (410) 641-1700

Securities registered under Section 12(b) of the Act: None

Securities registered under Section 12(g) of the Act:  
Common Stock, par value \$1.00 per share

Indicate by check mark whether the registrant is a well-known seasoned issuer,  
as defined in Rule 405 of the Securities Act. Yes  No

Indicate by check mark whether the registrant is not required to file reports  
pursuant to Section 13 or Section 15(d) of the Act. Yes  No

Indicate by check mark whether the registrant has (1) filed all reports required  
to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934  
during the preceding 12 months (or for such shorter period that the registrant  
was required to file such reports), and (2) has been subject to such filing  
requirements for the past 90 days. Yes  No

Indicate by check mark if disclosure of delinquent filers in response to Item  
405 of Regulation S-K is not contained in this form, and will not be  
contained, to the best of the registrant's knowledge, in definitive proxy or  
information statements incorporated by reference in Part III of this Form  
10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an  
accelerated filer, or a non-accelerated filer. See definition of  
"accelerated filer and large accelerated filer" in Rule 12b-2 of the Exchange  
Act. Large accelerated filer   
Accelerated filer   
Non-accelerated filer

Indicate by check mark if the registrant is a shell company (as defined in Rule  
12b-2 of the Exchange Act). Yes  No

The aggregate market value of the Common Stock, all of which has voting rights,

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held by non-affiliates of the registrant on December 31, 2005, was \$97,956,200. This calculation is based upon the last price known to the registrant at which its Common Stock was sold as of the last business day of the registrant's most recently completed second fiscal quarter. As of June 30, 2005, the last known sale price was \$36.25 per share. There is not an active trading market for the Common Stock and it is not possible to identify precisely the market value of the Common Stock.

On February 15, 2006, 3,186,956 shares of the registrant's common stock were issued and outstanding.

### DOCUMENTS INCORPORATED BY REFERENCE

The Company's Proxy Statement for Annual Meeting of Shareholders to be held on May 17, 2006, is incorporated by reference in this Form 10-K in Part III, Item 10, Item 11, Item 12, Item 13, and Item 14.

This Report contains statements which constitute forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and the Securities Exchange Act of 1934. These statements appear in a number of places in this Report and include all statements regarding the intent, belief or current expectations of the Company, its directors, or its officers with respect to, among other things: (i) the Company's financing plans; (ii) trends affecting the Company's financial condition or results of operations; (iii) the Company's growth strategy and operating strategy; and (iv) the declaration and payment of dividends. Investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those projected in the forward-looking statements as a result of various factors discussed herein and those factors discussed in detail in the Company's filings with the Securities and Exchange Commission.

### PART I

#### Item 1. Business

##### General

Calvin B. Taylor Bankshares, Inc. (Company) was incorporated as a Maryland corporation on October 31, 1995. The Company owns all of the stock of Calvin B. Taylor Banking Company of Berlin, Maryland (Bank). The Bank is a commercial bank incorporated under the laws of the State of Maryland on December 17, 1907, with a main office located in Berlin, Maryland.

##### Location and Service Area

The Company, through the Bank, is engaged in a general commercial and retail banking business serving individuals, small- to medium-sized businesses, professional organizations, and governmental units. The Bank operates nine branches located throughout Worcester County, Maryland and one branch located in Sussex County, Delaware. The Bank draws most of its customer deposits and conducts most of its lending transactions within the communities in which these branches are located.

Much of the Bank's service area is located along the shores of the Atlantic Ocean and has grown as both a resort and a retirement community in recent years. The principal components of the economy are tourism and agriculture. Berlin has a strong component of health-care related businesses. The tourist businesses of Ocean City, Maryland and Bethany, Delaware and the health-care facilities in Berlin, Maryland (including Berlin Nursing Home and Atlantic General Hospital) are among the largest employers in the counties.

##### Banking Products and Services

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The Bank offers a full range of deposit services including checking, NOW, Money Market, and savings accounts, and time deposits including certificates of deposit. The transaction accounts and time certificates are tailored to the Bank's principal market areas at rates competitive to those offered in the area. In addition, the Bank offers certain retirement account services, such as Individual Retirements Accounts. All deposits are insured by the Federal Deposit Insurance Corporation (FDIC) up to the maximum amount allowed by law (generally, \$100,000 per depositor subject to aggregation rules). The Bank solicits these accounts from individuals, businesses, associations and organizations, and governmental authorities.

The Bank also offers a full range of short- to medium-term commercial and personal loans. Commercial loans include both secured and unsecured loans for working capital (including inventory and receivables), business expansion (including acquisition of real estate and improvements), and purchase of equipment and machinery. Consumer loans include secured and unsecured loans for financing automobiles, home improvements, education, and personal investments. The Bank originates commercial and residential mortgage loans and real estate construction and acquisition loans. These lending activities are subject to a variety of lending limits imposed by state and federal law. The Bank lends to directors and officers of the Company and the Bank under terms comparable to those offered to other borrowers entering into similar loan transactions. The Board of Directors approves all loans to officers and directors and reviews these loans every six months.

Other bank services include cash management services, 24-hour ATM's, debit cards, safe deposit boxes, travelers' checks, direct deposit of payroll and social security funds, and automatic drafts for various accounts. The Bank offers bank-by-phone and Internet banking services, including electronic bill-payment, to both commercial and retail customers. The Bank also offers non-deposit products including retail repurchase agreements and discount brokerage services through a correspondent bank.

### Competition

The Company and the Bank face strong competition in all areas of operations. The competition comes from entities operating in Worcester County, Maryland and Sussex County, Delaware and neighboring counties and includes branches of some of the largest banks in Maryland, Delaware, and Virginia. Its most direct competition for deposits historically has come from other commercial banks, savings banks, savings and loan associations, and credit unions operating in its service areas. The Bank also competes for deposits with money market mutual funds and corporate and government securities. The Bank competes for loans with the same banking entities, as well as mortgage banking companies and other institutional lenders. The competition for loans varies from time to time depending on certain factors. These factors include, among others, the general availability of lendable funds and credit, general and local economic conditions, current interest rate levels, conditions in the mortgage market, and other factors which are not readily predictable.

The Bank employs traditional marketing media including local newspapers and radio, to attract new customers. Bank officers, directors, and employees are active in numerous community organizations and participate in community-based events. These activities and referrals of satisfied customers result in new business.

### Employees

As of December 31, 2005, the Bank employed 96 full-time equivalent employees. The Company's operations are conducted through the Bank. Consequently, the Company does not have separate employees. None of the

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employees of the Bank are represented by any collective bargaining unit. The Bank considers its relations with its employees to be good.

### SUPERVISION AND REGULATION

The Company and the Bank are subject to state and federal banking laws and regulations which impose specific requirements or restrictions on, and provide for general regulatory oversight with respect to, virtually all aspects of operations. These laws and regulations are generally intended to protect depositors, not shareholders. The following is a summary of certain statutes, rules, and regulations affecting the Company and the Bank. To the extent that the following summary describes statutory or regulatory provisions, it is qualified in its entirety by reference to the particular statutory and regulatory provisions.

Proposed legislative changes and the policies of various regulatory authorities may affect the operations of the Company and the Bank and those effects may be material. The Company is unable to predict the nature or the extent of the effect on its business and earnings that fiscal or monetary policies, economic controls, or new federal or state legislation may have in the future.

#### The Company

##### Bank Holding Company Act of 1956

The Company is a bank holding company within the meaning of the federal Bank Holding Company Act of 1956 (BHCA). Under the BHCA, the Company is subject to periodic examination by the Federal Reserve and is required to file periodic reports of its operations and such additional information as the Federal Reserve may require. The Company's and the Bank's activities are limited to banking, managing or controlling banks, furnishing services to or performing services for its Subsidiary, or engaging in any other activity that the Federal Reserve determines to be so closely related to banking or managing and controlling banks as to be a proper incident thereto.

Investments, Control, and Activities. With certain limited exceptions, the BHCA requires a bank holding company to obtain the prior approval of the Federal Reserve before (i) acquiring substantially all the assets of any bank, (ii) acquiring direct or indirect ownership or control of any voting shares of any bank if after such acquisition it would own or control more than 5% of the voting shares of such bank (unless it already owns or controls the majority of such shares), or (iii) merging or consolidating with another bank holding company.

In addition, and subject to certain exceptions, the BHCA and the Change in Bank Control Act, together with regulations thereunder, require Federal Reserve approval (or, depending on the circumstances, no notice of disapproval) prior to any person or company acquiring "control" of a bank holding company, such as the Company. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the bank holding company. Because the Company's Common Stock is registered under the Securities Exchange Act of 1934, under Federal Reserve regulations, control will be rebuttably presumed to exist if a person acquires at least 10% of the outstanding shares of any class of voting securities of the Company. The regulations provide a procedure for challenge of the rebuttable control presumption.

Under the BHCA, the Company is generally prohibited from engaging in, or acquiring direct or indirect control of more than 5% of the voting shares of

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any company engaged in non-banking activities, unless the Federal Reserve, by order or regulation, has found those activities to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Source of Strength; Cross-Guarantee. Under Federal Reserve policy, the Company is expected to act as a source of financial strength to the Bank and to commit resources to support the Bank in circumstances in which the Company might not otherwise do so. The Federal Reserve may require a bank holding company to terminate an activity or relinquish control of a nonbank subsidiary if the Federal Reserve determines that such activity or control poses serious risk to the financial soundness or stability of a subsidiary bank. Further, federal bank regulatory authorities have discretion to require a bank holding company to divest itself of any bank or nonbank subsidiary if the agency determines that divestiture may aid the depository institution's financial condition. The Bank may be required to indemnify, or cross-guarantee, the FDIC against losses it incurs with respect to any other bank controlled by the Company, which in effect makes the Company's equity investments in healthy bank subsidiaries available to the FDIC to assist any failing or failed bank subsidiary of the Company.

### Gramm-Leach-Bliley Act

In November 1999, the Gramm-Leach-Bliley Act was signed into law. Among other things, the Act repeals the restriction, contained in the Glass-Steagall Act, on banks affiliating with securities firms. The Act permits bank holding companies to engage in a statutorily provided list of financial activities, including insurance and securities underwriting and agency activities, merchant banking, and insurance company portfolio investment activities. The Act also authorizes activities that are "complementary" to financial activities. The Act is intended to grant certain powers to community banks that larger institutions have accumulated on an ad hoc basis. The Act may have the result of increasing competition that the Company and the Bank face from larger institutions and other types of companies. In fact, it is not possible to predict the full effect that the Act will have on the Company and the Bank.

### Securities Exchange Act of 1934

The Company's common stock is registered with the Securities and Exchange Commission (SEC) under Section 12(g) of the Securities Exchange Act of 1934 (the Act). The Company is, therefore, subject to periodic and ad hoc information reporting, proxy solicitation rules, restrictions on insider trading, and other requirements of the Act.

### Sarbanes-Oxley Act

The Sarbanes-Oxley Act (SOX) of 2002 imposed additional disclosure requirements in the Company's reports filed with SEC. SOX defines new standards of independence for insiders, provides guidance for certain Board committees including the composition of those committees, and establishes corporate governance requirements.

### The Bank

General. The Bank operates as a state nonmember banking association incorporated under the laws of the State of Maryland. It is subject to examination by the FDIC and the state department of banking regulation for each state in which it has a branch. The States and FDIC regulate or monitor all areas of the Bank's operations, including security devices and procedures, adequacy of capitalization and loss reserves, loans, investments, borrowings, deposits, mergers, issuances of securities, payment of dividends, interest rates payable on deposits, interest rates or fees chargeable on loans,

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establishment of branches, corporate reorganizations, maintenance of books and records, and adequacy of staff training to carry on safe lending and deposit gathering practices. The FDIC requires the Bank to maintain certain capital ratios and imposes limitations on the Bank's aggregate investment in real estate, bank premises, and furniture and fixtures. The Bank is required by the FDIC to prepare quarterly reports on the Bank's financial condition.

Under provisions of the FDICIA, all insured institutions must undergo periodic on-site examination by the appropriate banking agency. The cost of examinations of insured depository institutions and any affiliates may be assessed by the agency against each institution or affiliate, as it deems necessary or appropriate. Insured institutions are required to submit annual reports to the FDIC and the appropriate agency (and state supervisor when applicable). FDICIA also directs the FDIC to develop with other appropriate agencies a method for insured depository institutions to provide supplemental disclosure of the estimated fair market value of assets and liabilities, to the extent feasible and practicable, in any balance sheet, financial statement, report of condition, or other report of any insured depository institution. FDICIA also requires the federal banking regulatory agencies to prescribe, by regulation, standards for all insured depository institutions and depository institution holding companies relating, among other things, to: (i) internal controls, information systems, and audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate risk exposure; and (v) asset quality.

Transactions With Affiliates and Insiders. The Bank is subject to Section 23A of the Federal Reserve Act, which places limits on the amount of loans or extensions of credit to, or investment in, or certain other transactions with, affiliates and on the amount of advances to third parties collateralized by the securities or obligations of affiliates. The aggregate of all covered transactions is limited in amount, as to any one affiliate, to 10% of the Bank's capital and surplus and, as to all affiliates combined, to 20% of the Bank's capital and surplus. In addition, each covered transaction must meet specific collateral requirements. The Bank is also subject to Section 23B of the Federal Reserve Act which, among other things, prohibits an institution from engaging in certain transactions with certain affiliates unless the transactions are on terms substantially the same, or at least as favorable to such institution or its subsidiaries, as those prevailing at the time for comparable transactions with nonaffiliated companies. The Bank is subject to certain restrictions on extensions of credit to executive officers, directors, certain principal shareholders, and their related interests. Such extensions of credit (i) must be made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with third parties, and (ii) must not involve more than the normal risk of repayment or present other unfavorable features.

Community Reinvestment Act. The Community Reinvestment Act requires that the Bank shall be evaluated by its primary federal regulator with respect to its record in meeting the credit needs of its local community, including low and moderate income neighborhoods, consistent with safe and sound operations. These factors are also considered in evaluating mergers, acquisitions, and applications to open a branch or facility. The Bank received a satisfactory rating in its most recent evaluation.

USA Patriot Act. In response to the terrorist attacks on September 11, 2001, Congress passed the Patriot Act. The Patriot Act requires that Banks prepare and retain additional records designed to assist the government in an effort to combat terrorism. The Act includes anti-money laundering and financial transparency provisions, and guidelines for verifying customer identification during account opening. The Act promotes cooperation between law enforcement, financial institutions, and financial regulators in identifying persons involved in illegal acts such as money laundering and terrorism.

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Other Regulations. Interest and certain other charges collected or contracted for by the Bank are subject to state and federal laws concerning interest rates. The Bank's loan operations are also subject to certain federal laws applicable to credit transactions, such as the federal Truth-In-Lending Act governing disclosures of credit terms to consumer borrowers, the Home Mortgage Disclosure Act of 1975 requiring financial institutions to provide information to enable the public and public officials to determine whether a financial institution is fulfilling its obligation to help meet the housing needs of the community it serves, the Equal Credit Opportunity Act prohibiting discrimination on the basis of race, creed, or other prohibited bases in extending credit, the Fair Credit Reporting Act of 1978 governing the use and provision of information to credit reporting agencies, the Fair Debt Collection Act governing the manner in which consumer debts may be collected by collection agencies, and the rules and regulations of the various federal agencies charged with the responsibility of implementing such federal laws. The deposit operations of the Bank are also subject to the Right to Financial Privacy Act which imposes a duty to maintain confidentiality of customers' financial records and prescribes procedures for complying with administrative subpoenas of financial records, and the Electronic Fund Transfers Act as implemented by the Federal Reserve Board's Regulation E which governs automatic deposits to and withdrawals from deposit accounts and customers' rights and liabilities arising from the use of automated teller machines and other electronic banking services.

### Deposit Insurance

The FDIC establishes rates for the payment of premiums by federally insured banks and thrifts for deposit insurance. Separate insurance funds are maintained for commercial banks (BIF) and thrifts (SAIF), with insurance premiums from the industry used to offset losses from insurance payouts when banks and thrifts fail. Since 1993, insured depository institutions like the Bank have paid for deposit insurance under a risk-based premium system. With BIF at its legally mandated reserve ratio, FDIC has set the premiums for well-capitalized banks at a level of \$.00 per \$100 of insured deposits. The BIF insurance assessment rate for the first semiannual assessment period of 2006 is proposed to remain at \$.00 to \$.27 per \$100 in deposits. In addition to the amount paid for deposit insurance, banks are assessed an additional amount to service the interest on the bond obligations of the Financial Corporation (FICO). Any increase in deposit insurance premiums for the Bank will increase the Bank's operating expenses, and there can be no assurance that such costs can be passed on to the Bank's customers.

### Dividends

The principal source of the Company's cash revenues comes from dividends received from the Bank. The amount of dividends that may be paid by the Bank to the Company depends on the Bank's earnings and capital position and is limited by federal and state laws, regulations, and policies. The Federal Reserve has stated that bank holding companies should refrain from or limit dividend increases or reduce or eliminate dividends under circumstances in which the bank holding company fails to meet minimum capital requirements or in which earnings are impaired.

The Company's ability to pay any cash dividends to its shareholders in the future will depend primarily on the Bank's ability to pay dividends to the Company. In order to pay dividends to the Company, the Bank must comply with the requirements of all applicable laws and regulations. Under Maryland law, the Bank must pay a cash dividend only from the following, after providing for due or accrued expenses, losses, interest, and taxes: (i) its undivided profits, or (ii) with the prior approval of the Department of Financial Regulation, its surplus in excess of 100% of its required capital stock. Under FDICIA, the Bank may not pay a dividend if, after paying the dividend, the Bank

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would be undercapitalized. See "Capital Regulations" below. See Item 5 for a discussion of dividends paid by the Bank in the past three years.

In addition to the availability of funds from the Bank, the future dividend policy of the Company is subject to the discretion of the Board of Directors and will depend upon a number of factors, including future earnings, financial condition, cash needs, and general business conditions. The amount of dividends that might be declared in the future presently cannot be estimated and it cannot be known whether such dividends would continue for future periods.

### Capital Regulations

The federal bank regulatory authorities have adopted risk-based capital guidelines for banks and bank holding companies that are designed to make regulatory capital requirements more sensitive to differences in risk profile among banks and bank holding companies, account for off-balance sheet exposure, and minimize disincentives for holding liquid assets. The resulting capital ratios represent qualifying capital as a percentage of total risk-weighted assets and off-balance sheet items. The guidelines are minimums, and the regulators have noted that banks and bank holding companies contemplating significant expansion programs should not allow expansion to diminish their capital ratios and should maintain ratios well in excess of the minimums.

Current guidelines require bank holding companies and federally regulated banks to maintain a minimum ratio of total capital to risk-based assets equal to 8%, of which at least 4% must be Tier 1 capital. Tier 1 capital includes common stockholders' equity before the unrealized gains and losses on securities available for sale, qualifying perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, but excludes goodwill and most other intangibles, and excludes the allowance for loan losses. Tier 2 capital includes the excess of any preferred stock not included in Tier 1 capital, mandatory convertible securities, hybrid capital instruments, subordinated debt and intermediate term-preferred stock, and general reserves for loan losses up to 1.25% of risk-weighted assets. Total capital is the sum of Tier 1 plus Tier 2 capital. The federal bank regulatory authorities have also implemented a leverage ratio, which is Tier 1 capital as a percentage of average total assets less intangibles, to be used as a supplement to the risk-based guidelines. The principal objective of the leverage ratio is to place a constraint on the maximum degree to which a bank holding company may leverage its equity capital base. The minimum required leverage ratio for top-rated institutions is 3%, but most institutions are required to maintain an additional cushion of at least 100 to 200 basis points.

FDICIA established a new capital-based regulatory scheme designed to promote early intervention for troubled banks and requires the FDIC to choose the least expensive resolution of bank failures. The new capital-based regulatory framework contains five categories for compliance with regulatory capital requirements, including "well capitalized," "adequately capitalized," "undercapitalized," "significantly undercapitalized," and "critically undercapitalized." To qualify as a "well capitalized" institution, a bank must have a leverage ratio of no less than 5%, a Tier 1 risk-based ratio of no less than 6%, and a total risk-based capital ratio of no less than 10%, and the bank must not be under any order or directive from the appropriate regulatory agency to meet and maintain a specific capital level. As of December 31, 2005, the Company and the Bank were qualified as "well capitalized." For further discussions, see "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation - Capital."

### Recent Legislative Developments

Periodically, the federal and state legislatures consider bills with respect to the regulation of financial institutions. Some of these



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proposals could significantly change the regulation of banks and the financial services industry. The Company cannot predict if such proposals will be adopted or the affect to the Company.

### Item 1B. Unresolved Staff Comments

The registrant, an accelerated filer, has not received comments from the Commission staff which remain unresolved at the time of this filing.

### Item 2. Properties

The Company has ten branch locations, all of which are owned by the Company or the Bank. The Bank leases the land on which the East Berlin branch is located. The locations are described as follows:

| Office                  | Location                                           | Square Footage |
|-------------------------|----------------------------------------------------|----------------|
| Main Office, Maryland   | 24 North Main Street, Berlin, Maryland 21811       | 24,229         |
| East Berlin Office      | 10524 Old Ocean City Blvd., Berlin, Maryland 21811 | 1,500          |
| 20th Street Office      | 100 20th Street, Ocean City, Maryland 21842        | 3,100          |
| Ocean Pines Office      | 11003 Cathell Road, Berlin, Maryland 21811         | 2,420          |
| Mid-Ocean City Office   | 9105 Coastal Highway, Ocean City, Maryland 21842   | 1,984          |
| North Ocean City Office | 14200 Coastal Highway, Ocean City, Maryland 21842  | 2,545          |
| West Ocean City Office  | 9923 Golf Course Road, Ocean City, Maryland 21842  | 2,496          |
| Pocomoke Office         | 2140 Old Snow Hill Road, Pocomoke, Maryland 21851  | 2,624          |
| Snow Hill Office        | 108 West Market Street, Snow Hill, Maryland 21863  | 3,773          |
| Ocean View, DE Office   | 50 Atlantic Avenue, Ocean View, Delaware 19970     | 4,900          |

The Berlin office is the centralized location for the Company and the Bank. Executive offices, loan processing, proof, bookkeeping, and the computer department are housed there. Most branches have a manager who also serves as a loan officer. All offices participate in normal day-to-day banking operations. The Company operates automated teller machines in all branches except the East Berlin office, and at one non-branch location in a local hospital.

### Item 3. Legal Proceedings

(a) There are no material pending legal proceedings to which the Company or the Bank or any of their properties are subject.

(b) No proceedings were terminated during the fourth quarter of the fiscal year covered by this report.

### Item 4. Submission of Matters to a Vote of Security Holders

There were no matters submitted to a vote of the shareholders of the Company during the fourth quarter of the fiscal year covered by this report.

## PART II

### Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities

The Company's Articles of Incorporation, as amended, authorize it to

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issue up to 10,000,000 shares of common stock.

As of February 15, 2006 there were approximately 1,016 stockholders of record and 3,186,956 shares of Common Stock issued and outstanding. There is no established public trading market in the stock, and there is no likelihood that a trading market will develop in the near future. Transactions in the common stock are infrequent and are frequently negotiated privately between the persons involved in those transactions.

All outstanding shares of common stock of the Company are entitled to share equally in dividends from funds legally available, when, as, and if declared by the Board of Directors. The Company paid or declared dividends of \$2.10 per share in 2005, \$.65 per share in 2004, and \$.60 per share in 2003. Included is a special cash dividend of \$1.40 per share in 2005, which is not expected to be an annual event.

The following table presents information about the Company's repurchase of its equity securities during the calendar quarter ended on the date of this Form 10-K.

| Period   | (a) Total Number<br>of shares | (b) Average<br>Price Paid<br>per Share | (c) Total Number of<br>Shares Purchased as<br>Part of a Publicly<br>Announced Program | (d) Maximum Number of<br>Shares that may yet<br>be Purchased Under<br>the Program |
|----------|-------------------------------|----------------------------------------|---------------------------------------------------------------------------------------|-----------------------------------------------------------------------------------|
| October  | -0-                           | N/A                                    | -0-                                                                                   | 300,026                                                                           |
| November | 100                           | \$ 36.00                               | 100                                                                                   | 299,926                                                                           |
| December | -0-                           | N/A                                    | -0-                                                                                   | 299,926                                                                           |
| Totals   | 100                           | \$ 36.00                               | 100                                                                                   | N/A                                                                               |

The Company publicly announced on August 14, 2003, that it would repurchase up to 10% of its outstanding equity stock at that time, which equated to a total of 324,000 common shares available for repurchase. There was no expiration date for this program. No other stock repurchase plan or program existed simultaneously, nor had any other plan or program expired during the period covered by this table. Common shares repurchased under this plan were retired.

As of January 1, 2005, this plan was renewed, by public announcement, making up to 10% of the Company's outstanding equity stock at that time, which equates to a total of 320,848 common shares, available for repurchase. This renewal continues into 2006. Common shares repurchased under this plan are retired.

### Item 6. Selected Financial Data

The following table presents selected financial data for the five years ended December 31, 2005.

|                | 2005                                              | 2004       | 2003       | 2002       | 2001       |
|----------------|---------------------------------------------------|------------|------------|------------|------------|
|                | (Dollars in thousands, except for per share data) |            |            |            |            |
| At Year End    |                                                   |            |            |            |            |
| Total assets   | \$ 389,075                                        | \$ 393,333 | \$ 386,486 | \$ 369,243 | \$ 336,825 |
| Total deposits | \$ 310,858                                        | \$ 319,772 | \$ 317,946 | \$ 301,495 | \$ 274,149 |

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|                                                                      |            |            |            |            |            |
|----------------------------------------------------------------------|------------|------------|------------|------------|------------|
| Total loans, net of unearned income<br>and allowance for loan losses | \$ 204,442 | \$ 161,510 | \$ 162,243 | \$ 161,825 | \$ 166,502 |
| Total stockholders' equity                                           | \$ 66,318  | \$ 66,698  | \$ 63,636  | \$ 60,015  | \$ 57,243  |
| For the Year                                                         |            |            |            |            |            |
| Net interest income                                                  | \$ 15,912  | \$ 13,698  | \$ 13,647  | \$ 13,741  | \$ 13,297  |
| Net income                                                           | \$ 6,798   | \$ 5,613   | \$ 5,540   | \$ 5,754   | \$ 5,414   |
| Per share data                                                       |            |            |            |            |            |
| Book value                                                           | \$ 20.81   | \$ 20.79   | \$ 19.71   | \$ 18.52   | \$ 17.67   |
| Net income                                                           | \$ 2.13    | \$ 1.74    | \$ 1.71    | \$ 1.78    | \$ 1.67    |
| Cash dividends declared                                              | \$ 2.10    | \$ .65     | \$ .60     | \$ 1.00    | \$ .37     |

### Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operation

The following discussion of the Company's financial condition and results of operations should be read in conjunction with the Company's financial statements and related notes and other statistical information included in this report.

#### Overview

Consolidated income of the Company is derived primarily from operations of the Bank. Net income for 2005 was \$6,797,638 compared to \$5,613,187 for 2004 and \$5,540,214 for 2003. The Company had a return on average equity of 10.01% and return on average assets of 1.71% for 2005, compared to returns on average equity of 8.64% and 8.97%, and returns on average assets of 1.42% and 1.45%, for 2004 and 2003, respectively.

#### Results of Operations

The Company's net income of \$6,797,638, or \$2.13 per share, for the year ended December 31, 2005, was an increase of \$1,184,451 or 21.10%, from the net income of \$5,613,187, or \$1.74 per share, for the year ended December 31, 2004. Contributing to this increase was a \$2,213,985 (16.16%) increase in net interest income. Noninterest revenue increased \$49,577 (2.83%) in 2005 compared to 2004, while noninterest expense increased \$351,211 (5.16%) during the same period.

The Company's net income of \$5,613,187, or \$1.74 per share, for the year ended December 31, 2004, was an increase of \$72,973 or 1.32%, from the net income of \$5,540,214, or \$1.71 per share, for the year ended December 31, 2003. Factors contributing to this increase included a \$50,572 increase in net interest income and a lower effective income tax rate that results from tax-favored revenue becoming a higher percentage of total revenue. Increases in noninterest revenues and noninterest expenses offset each other. Noninterest revenue increased \$185,961 (11.89%) in 2004 compared to 2003, while noninterest expense increased \$186,810 (2.82%) during the same period.

The Company's net income of \$1,703,943 or \$.53 per share, for the quarter ended December 31, 2005, was an increase of \$252,597, or 17.40%, from the net income of \$1,451,346 or \$.45 per share, for the quarter ended December 31, 2004. Increased net interest income, the primary reason for the increase, was due to growth in the Bank's loan portfolio and higher earnings rates on the Bank's investments. Deposit interest expense increased due to rate increases, but the effect on earnings was ameliorated by a reduction in the volume of time deposits.

The Company's net income of \$1,451,346 or \$.45 per share, for the quarter ended December 31, 2004, was an increase of \$142,802, or 10.91%, from the net

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income of \$1,308,544 or \$.40 per share, for the quarter ended December 31, 2003. Increased net interest income was the primary reason for the increase. As the Bank's time deposits continued to reprice downward, reflecting rate reductions from the previous year, the Bank enjoyed a widening interest spread. At the same time, the bank had seen a shift in interest-bearing deposits from higher rate time deposits to relatively lower rate NOW and Money Market accounts.

### Net Interest Income

The primary source of income for the Company is net interest income, which is the difference between revenue on interest-earning assets, such as investment securities and loans, and interest incurred on interest-bearing sources of funds, such as deposits and borrowings. The level of net interest income is determined primarily by the average balance of interest-earning assets and funding sources and the various rate spreads between the interest-earning assets and the Company's funding sources. Changes in net interest income from period to period result from increases or decreases in the volume of interest-earning assets and interest-bearing liabilities, and increases or decreases in the average rates earned and paid on such assets and liabilities. The volume of interest-earning assets and interest-bearing liabilities is affected by the ability to manage the earning-asset portfolio, which includes loans, and the availability of particular sources of funds, such as noninterest-bearing deposits.

The key performance measure for net interest income is the "net margin on interest-earning assets," or net interest income divided by average interest-earning assets. The Company's net interest margin for 2005 on a non-GAAP tax-equivalent basis, was 4.45%, compared to 3.88% and 3.96% for 2004 and 2003, respectively. Because most of the Bank's loans are written with a demand feature, the income of the Bank should not change dramatically as interest rates change. Management of the Company expects to maintain the net margin on interest-earning assets. The net margin may decline, however, if competition increases, loan demand decreases, or the cost of funds rises faster than the return on loans and securities. Although such expectations are based on management's judgment, actual results will depend on a number of factors that cannot be predicted with certainty, and fulfillment of management's expectations cannot be assured.

The following tables present information including average balances of interest-earning assets and interest-bearing liabilities, the amount of related interest income and interest expense, and the resulting yields by category of interest-earning asset and interest-bearing liability. In these tables, dividends and interest on tax-exempt securities and loans are reported on a fully taxable equivalent basis, which is a non-GAAP measure as defined in SEC Regulation G and Item 10 of SEC Regulation S-K. Management believes that these measures provide better yield comparability as a tool for managing net interest income.

### Average Balances, Interest, and Yields (Dollars stated in thousands)

|                    | For the Year Ended<br>December 31, 2005 |          |       | For the Year Ended<br>December 31, 2004 |          |       | For the Year Ended<br>December 31, 2003 |          |       |
|--------------------|-----------------------------------------|----------|-------|-----------------------------------------|----------|-------|-----------------------------------------|----------|-------|
|                    | Average<br>Balance                      | Interest | Yield | Average<br>Balance                      | Interest | Yield | Average<br>Balance                      | Interest | Yield |
| <b>Assets</b>      |                                         |          |       |                                         |          |       |                                         |          |       |
| Federal funds sold | \$34,233                                | \$1,078  | 3.15% | \$41,762                                | \$ 547   | 1.31% | \$53,715                                | \$ 541   | 1.01% |
| Interest-bearing   |                                         |          |       |                                         |          |       |                                         |          |       |

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|                                                |           |          |       |           |          |       |           |          |       |
|------------------------------------------------|-----------|----------|-------|-----------|----------|-------|-----------|----------|-------|
| deposits                                       | 2,175     | 56       | 2.56% | 2,201     | 48       | 2.16% | 1,706     | 42       | 2.48% |
| Investment securities:                         |           |          |       |           |          |       |           |          |       |
| U. S. Treasury                                 | 105,456   | 2,881    | 2.73% | 116,537   | 2,443    | 2.10% | 99,711    | 2,411    | 2.42% |
| U. S. Government                               |           |          |       |           |          |       |           |          |       |
| Agency                                         | 19,666    | 525      | 2.67% | 18,844    | 503      | 2.67% | 18,172    | 531      | 2.92% |
| State and municipal                            | 16,618    | 388      | 2.34% | 19,004    | 407      | 2.14% | 12,119    | 332      | 2.74% |
| Other                                          | 1,882     | 90       | 4.80% | 1,786     | 79       | 4.43% | 1,600     | 70       | 4.40% |
| Total investment securities                    | 143,622   | 3,884    | 2.70% | 156,171   | 3,432    | 2.20% | 131,602   | 3,344    | 2.54% |
| Loans:                                         |           |          |       |           |          |       |           |          |       |
| Commercial                                     | 19,134    | 1,322    | 6.91% | 15,243    | 1,052    | 6.90% | 13,780    | 987      | 7.16% |
| Mortgage                                       | 165,415   | 11,485   | 6.94% | 146,121   | 10,289   | 7.04% | 150,491   | 10,879   | 7.23% |
| Consumer                                       | 2,083     | 178      | 8.53% | 2,305     | 201      | 8.73% | 3,108     | 284      | 9.15% |
| Total loans                                    | 186,632   | 12,985   | 6.96% | 163,669   | 11,542   | 7.05% | 167,379   | 12,150   | 7.26% |
| Allowance for loan losses                      | 2,193     |          |       | 2,188     |          |       | 2,185     |          |       |
| Total loans, net of allowance                  | 184,439   | 12,985   | 7.04% | 161,481   | 11,542   | 7.15% | 165,194   | 12,150   | 7.36% |
| Total interest-earning assets                  | 364,469   | \$18,003 | 4.94% | 361,615   | \$15,569 | 4.31% | 352,217   | \$16,077 | 4.56% |
| Noninterest-bearing cash                       | 19,946    |          |       | 19,705    |          |       | 19,091    |          |       |
| Premises and equipment                         | 6,757     |          |       | 6,968     |          |       | 6,567     |          |       |
| Other assets                                   | 6,194     |          |       | 6,428     |          |       | 3,220     |          |       |
| Total assets                                   | \$397,366 |          |       | \$394,716 |          |       | \$381,095 |          |       |
| Interest-bearing deposits                      |           |          |       |           |          |       |           |          |       |
| NOW                                            | \$67,452  | \$ 101   | 0.15% | \$ 64,537 | \$ 97    | 0.15% | \$ 61,800 | \$ 122   | 0.20% |
| Money market                                   | 50,537    | 218      | 0.43% | 49,733    | 198      | 0.40% | 50,141    | 305      | 0.61% |
| Savings                                        | 54,988    | 218      | 0.40% | 53,196    | 213      | 0.40% | 48,838    | 300      | 0.61% |
| Other time                                     | 63,710    | 1,202    | 1.89% | 72,621    | 1,028    | 1.42% | 77,668    | 1,384    | 1.78% |
| Total interest-bearing deposits                | 236,687   | 1,739    | 0.73% | 240,087   | 1,536    | 0.64% | 238,447   | 2,111    | 0.89% |
| Securities sold under agreements to repurchase | 6,325     | 22       | 0.34% | 5,021     | 8        | 0.17% | 4,135     | 10       | 0.24% |
| Borrowed funds                                 | 151       | 9        | 6.07% | 171       | 10       | 6.06% | 189       | 11       | 6.05% |
| Total interest-bearing liabilities             | 243,163   | 1,770    | 0.73% | 245,279   | 1,554    | 0.63% | 242,771   | 2,132    | 0.88% |
| Noninterest-bearing deposits                   | 85,526    | -        |       | 83,498    | -        |       | 75,898    | -        |       |
| Other liabilities                              | 328,689   | \$1,770  | 0.54% | 328,777   | \$1,554  | 0.47% | 318,669   | \$2,132  | 0.67% |
| Stockholders' equity                           | 750       |          |       | 990       |          |       | 651       |          |       |
| Total liabilities and stockholders' equity     | \$397,366 |          |       | \$394,716 |          |       | \$381,095 |          |       |
| Net interest spread                            |           |          | 4.21% |           |          | 3.68% |           |          | 3.68% |
| Net interest income                            | \$16,233  |          |       | \$14,015  |          |       | \$13,945  |          |       |
| Net margin on interest-earning assets          |           |          | 4.45% |           |          | 3.88% |           |          | 3.96% |
| Tax equivalent adjustment included in:         |           |          |       |           |          |       |           |          |       |
| Investment income                              | \$294     |          |       | \$286     |          |       | \$263     |          |       |
| Loan income                                    | \$ 27     |          |       | \$ 31     |          |       | \$ 35     |          |       |

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Analysis of Changes in Net  
Interest Income  
(Dollars stated in thousands)

|                              | Year ended December 31,<br>2005 compared with 2004<br>variance due to |       |        | Year ended December 31,<br>2004 compared with 2003<br>variance due to |       |        |
|------------------------------|-----------------------------------------------------------------------|-------|--------|-----------------------------------------------------------------------|-------|--------|
|                              | Total                                                                 | Rate  | Volume | Total                                                                 | Rate  | Volume |
| Earning assets               |                                                                       |       |        |                                                                       |       |        |
| Federal funds sold           | 531                                                                   | 630   | (99)   | 6                                                                     | 126   | (120)  |
| Interest-bearing deposits    | 8                                                                     | 9     | (1)    | 6                                                                     | (6)   | 12     |
| Investment securities:       |                                                                       |       |        |                                                                       |       |        |
| U. S. Treasury               | 438                                                                   | 670   | (232)  | 32                                                                    | (375) | 407    |
| U. S. Government Agency      | 22                                                                    | -     | 22     | (28)                                                                  | (48)  | 20     |
| State and municipals         | (19)                                                                  | 32    | (51)   | 75                                                                    | (114) | 189    |
| Other                        | 11                                                                    | 7     | 4      | 9                                                                     | 1     | 8      |
| Loans:                       |                                                                       |       |        |                                                                       |       |        |
| Commercial                   | 270                                                                   | 1     | 269    | 65                                                                    | (40)  | 105    |
| Mortgage                     | 1,196                                                                 | (163) | 1,359  | (590)                                                                 | (274) | (316)  |
| Consumer                     | (23)                                                                  | (4)   | (19)   | (83)                                                                  | (10)  | (73)   |
| Total interest revenue       | 2,434                                                                 | 1,182 | 1,252  | (508)                                                                 | (740) | 232    |
| Interest-bearing liabilities |                                                                       |       |        |                                                                       |       |        |
| NOW                          | 4                                                                     | -     | 4      | (24)                                                                  | (28)  | 4      |
| Money market                 | 20                                                                    | 17    | 3      | (107)                                                                 | (105) | (2)    |
| Savings                      | 5                                                                     | (2)   | 7      | (88)                                                                  | (111) | 23     |
| Other time deposits          | 174                                                                   | 300   | (126)  | (356)                                                                 | (266) | (90)   |
| Other borrowed funds         | 13                                                                    | 12    | 1      | (3)                                                                   | (18)  | 15     |
| Total interest expense       | 216                                                                   | 327   | (111)  | (578)                                                                 | (528) | (50)   |
| Net interest income          | 2,218                                                                 | 855   | 1,363  | 70                                                                    | (212) | 282    |

In the preceding table, the variance that is both rate and volume related is reported with the rate variance.

Composition of Loan Portfolio

Because loans are expected to produce higher yields than investment securities and other interest-earning assets (assuming that loan losses are not excessive), the absolute volume of loans and the volume as a percentage of total earning assets is an important determinant of net interest margin. Average loans, net of the allowance for loan losses, were \$184,438,751, \$161,481,136, and \$165,194,000 during 2005, 2004, and 2003, respectively, which constituted 50.60%, 44.66%, and 46.90% of average interest-earning assets for the periods. The Company's loan to deposit ratio was 65.77%, 50.51%, and 51.03% at December 31, 2005, 2004, and 2003, respectively. Average loans to average deposits were 57.24%, 49.90%, and 52.55% for 2005, 2004, and 2003. The increase in the loan to deposit ratio from 2004 to 2005 is attributable to 14.22% growth in the average loan portfolio due to the Bank's lending rates becoming more competitive in the recent rising rate environment, accompanied by a .42% reduction in average deposits during 2005.

The Company extends loans primarily to customers located in and near Worcester County, Maryland and Sussex County, Delaware. There are no industry

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concentrations in the Company's loan portfolio. The Company does, however, have a substantial portion of its loans in real estate and performance will be influenced by the real estate market in the region.

The following table sets forth the composition of the Company's loan portfolio as of December 31, 2005, 2004, and 2003, respectively.

| Composition of the Loan Portfolio |               |               |               |
|-----------------------------------|---------------|---------------|---------------|
|                                   | 2005          | 2004          | 2003          |
| Commercial                        | \$ 21,461,593 | \$ 14,007,430 | \$ 13,199,879 |
| Real estate                       | 170,277,344   | 141,029,581   | 134,492,195   |
| Construction                      | 12,678,430    | 6,640,665     | 14,107,588    |
| Consumer                          | 2,215,299     | 2,010,407     | 2,630,623     |
| Total loans                       | 206,632,666   | 163,688,083   | 164,430,285   |
| Less allowance for<br>loan losses | 2,190,709     | 2,177,926     | 2,187,277     |
| Net loans                         | \$204,441,957 | \$161,510,157 | \$162,243,008 |

The following table sets forth the maturity distribution, classified according to sensitivity to changes in interest rates, for selected components of the Company's loan portfolio as of December 31, 2005.

| Loan Maturity Schedule and Sensitivity<br>to Changes in Interest Rates |                     |                                   |                    |               |
|------------------------------------------------------------------------|---------------------|-----------------------------------|--------------------|---------------|
| December 31, 2005                                                      |                     |                                   |                    |               |
|                                                                        | One year<br>or less | Over one<br>through<br>five years | Over five<br>years | Total         |
| Commercial                                                             | \$ 19,160,984       | \$ 1,755,046                      | \$ 545,563         | \$ 21,461,593 |
| Real estate                                                            | 169,501,508         | 173,327                           | 602,509            | 170,277,344   |
| Construction                                                           | 12,678,430          | -                                 | -                  | 12,678,430    |
| Consumer                                                               | 1,185,879           | 921,567                           | 107,853            | 2,215,299     |
| Total                                                                  | \$202,526,801       | \$ 2,849,940                      | \$ 1,255,925       | \$206,632,666 |
| Fixed interest rate                                                    | \$ 1,185,879        | \$ 2,849,940                      | \$ 1,255,925       | \$ 5,291,744  |
| Variable interest<br>rate (or demand)                                  | 201,340,922         | -                                 | -                  | 201,340,922   |
| Total                                                                  | \$202,526,801       | \$ 2,849,940                      | \$ 1,255,925       | \$206,632,666 |

As of December 31, 2005, \$201,340,922 or 97.44%, of the total loans were either variable rate loans or loans written on demand.

The Company has the following commitments, lines of credit, and letters of credit outstanding as of December 31, 2005, 2004, and 2003, respectively.

|                    | 2005          | 2004         | 2003          |
|--------------------|---------------|--------------|---------------|
| Construction loans | \$ 21,845,161 | \$ 7,294,592 | \$ 10,495,735 |

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|                           |               |               |               |
|---------------------------|---------------|---------------|---------------|
| Other loan commitments    | 24,252,637    | 21,276,025    | 15,036,346    |
| Standby letters of credit | 1,272,000     | 1,535,210     | 2,957,508     |
| Total                     | \$ 47,369,798 | \$ 30,105,827 | \$ 28,489,589 |

Loan commitments are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments may have interest fixed at current rates, fixed expiration dates, and may require the payment of a fee. Letters of credit are commitments issued to guarantee the performance of a customer to a third party. Loan commitments and letters of credit are made on the same terms, including collateral, as outstanding loans. The Company's exposure to credit loss in the event of nonperformance by the borrower is represented by the contract amount of the commitment.

### Loan Quality

The allowance for loan losses represents an allowance for potential losses in the loan portfolio. The adequacy of the allowance for loan losses is evaluated periodically based on a review of all significant loans, with a particular emphasis on non-accruing, past due, and other loans that management believes require attention. The determination of the allowance rests upon management's judgment about factors affecting loan quality and assumptions about the economy. Management considers the year-end allowance appropriate and adequate to cover possible losses in the loan portfolio; however, management's judgment is based upon a number of assumptions about future events, which are believed to be reasonable, but which may or may not prove valid. Thus, there can be no assurance that charge-offs in future periods will not exceed the allowance for loan loss or that additional increases in the loan loss allowance will not be required. The Company has a history of low loan charge-offs.

For significant problem loans, management's review consists of evaluation of the financial strengths of the borrowers and guarantors, the related collateral, and the effects of economic conditions. The overall evaluation of the adequacy of the total allowance for loan losses is based on an analysis of historical loan loss ratios, loan charge-offs, delinquency trends, and previous collection experience, along with an assessment of the effects of external economic conditions. It is the Company's policy to evaluate loan portfolio risk for the purpose of establishing an adequate allowance. The allowance may be increased for reserves for specific loans identified as substandard during management's loan review. Generally, the Company will not require a negative provision to reduce the allowance as a result of either net recoveries or a decrease in loans.

The provision for loan losses is a charge to earnings in the current period to replenish the allowance and maintain it at a level management has determined to be adequate. As of December 31, 2005, the allowance for loan losses was 1.06% of outstanding loans. As of December 31, 2004, and 2003 the allowance for loan losses was 1.33% of outstanding loans.

No provision for loan losses was made in 2005, 2004 or 2003 due to low levels of delinquencies.

The following table presents the allocation of the Allowance for Loan Losses to major categories of loans as of December 31 2005, 2004, and 2003, respectively.

|                                             |      |      |
|---------------------------------------------|------|------|
| Allocation of the Allowance for Loan Losses |      |      |
| 2005                                        | 2004 | 2003 |



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|              |    |           |    |           |    |           |
|--------------|----|-----------|----|-----------|----|-----------|
| Commercial   | \$ | 223,411   | \$ | 220,460   | \$ | 163,059   |
| Real estate  |    | 911,257   |    | 805,287   |    | 798,290   |
| Construction |    | 63,392    |    | 33,203    |    | 70,538    |
| Consumer     |    | 65,748    |    | 78,948    |    | 81,845    |
| General      |    | 926,901   |    | 1,040,028 |    | 1,073,545 |
| Total        | \$ | 2,190,709 | \$ | 2,177,926 | \$ | 2,187,277 |

The following table sets forth the composition of the Company's loan portfolio stated as percentages as of December 31, 2005, 2004, and 2003, respectively.

| Composition of the Loan Portfolio Stated as Percentages |          |          |          |
|---------------------------------------------------------|----------|----------|----------|
|                                                         | 2005     | 2004     | 2003     |
| Commercial                                              | 10.39 %  | 8.56 %   | 8.03 %   |
| Real estate                                             | 82.41 %  | 86.16 %  | 81.79 %  |
| Construction                                            | 6.13 %   | 4.05 %   | 8.58 %   |
| Consumer                                                | 1.07 %   | 1.23 %   | 1.60 %   |
| Total loans                                             | 100.00 % | 100.00 % | 100.00 % |

| Allowance for Loan Losses                                     |             |             |             |
|---------------------------------------------------------------|-------------|-------------|-------------|
|                                                               | 2005        | 2004        | 2003        |
| Balance at beginning of year                                  | \$2,177,926 | \$2,187,277 | \$2,181,135 |
| Loan losses:                                                  |             |             |             |
| Commercial                                                    | -           | -           | -           |
| Mortgages                                                     | -           | -           | -           |
| Consumer                                                      | 8,131       | 13,874      | 3,423       |
| Total loan losses                                             | 8,131       | 13,874      | 3,423       |
| Recoveries on loans previously charged off:                   |             |             |             |
| Commercial                                                    | -           | 2,577       | 533         |
| Mortgages                                                     | 15,263      | -           | -           |
| Consumer                                                      | 5,651       | 1,946       | 9,032       |
| Total loan recoveries                                         | 20,914      | 4,523       | 9,565       |
| Net loan losses (recoveries)                                  | (12,783)    | 9,351       | (6,142)     |
| Provision for loan losses charged to expense                  | -           | -           | -           |
| Balance at end of year                                        | \$2,190,709 | \$2,177,926 | \$2,187,277 |
| <br>                                                          |             |             |             |
| Allowance for loan losses to loans outstanding at end of year | 1.06%       | 1.33%       | 1.33%       |
| Net charge-offs to average loans                              | 0.00%       | 0.00%       | 0.00%       |

As a result of management's ongoing review of the loan portfolio, loans are classified as nonaccrual when it is not reasonable to expect collection of interest under the original terms. These loans are classified as nonaccrual even though the presence of collateral or the borrower's financial strength may be sufficient to provide for ultimate repayment. Interest on nonaccrual loans is recognized only when received. A delinquent loan is generally placed in nonaccrual status when it becomes 90 days or more past due. When a loan is placed in nonaccrual status, all interest that has been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest income. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. The Company had no nonaccrual loans at December 31, 2005, 2004 or 2003. Amounts

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past due 90 days or more, and still accruing interest at December 31, 2005, 2004, and 2003, were \$131,717, \$391,676, and \$315,395, respectively.

When real estate acquired by foreclosure and held for sale is included with nonperforming loans, the result comprises nonperforming assets. There were no nonperforming assets at December 31, 2005, 2004, or 2003. Loans are classified as impaired when the collection of contractual obligations, including principal and interest, is doubtful. Management has identified no significant impaired loans as of December 31, 2005, 2004, or 2003.

### Liquidity and Interest Rate Sensitivity

The primary objective of asset/liability management is to ensure the steady growth of the Company's primary source of earnings, net interest income. Net interest income can fluctuate with significant interest rate movements. To lessen the impact of these margin swings, the balance sheet should be structured so that repricing opportunities exist for both assets and liabilities in roughly equivalent amounts at approximately the same time intervals. Imbalances in these repricing opportunities at any point in time constitute interest rate sensitivity.

Liquidity represents the ability to provide steady sources of funds for loan commitments and investment activities, as well as to provide sufficient funds to cover deposit withdrawals and payment of debt and operating obligations. These funds can be obtained by converting assets to cash or by attracting new deposits. Average liquid assets (cash and amounts due from banks, interest-bearing deposits in other banks, federal funds sold, and investment securities) were 62.06% of average deposits for 2005, compared to 67.94% and 65.57% for 2004 and 2003, respectively.

As of December 31, 2005, \$74,014,166, or 64.16% of the investment debt securities mature in one year or less. Funds invested in federal funds sold provide liquidity so the Bank does not need a large portfolio of securities classified as "available-for-sale." Other sources of liquidity include letters of credit, overnight federal funds, and reverse repurchase agreements available from correspondent banks. The total lines and letters of credit available from correspondent banks were \$19,000,000 as of December 31, 2005, 2004 and 2003.

Interest rate sensitivity refers to the responsiveness of interest-bearing assets and liabilities to changes in market interest rates. The rate-sensitive position, or gap, is the difference in the volume of rate-sensitive assets and liabilities at a given time interval. The general objective of gap management is to actively manage rate-sensitive assets and liabilities to reduce the impact of interest rate fluctuations on the net interest margin. Management generally attempts to maintain a balance between rate-sensitive assets and liabilities as the exposure period is lengthened to minimize the overall interest rate risk to the Company.

Interest rate sensitivity may be controlled on either side of the balance sheet. On the asset side, management exercises some control over maturities. Also, loans are written to provide repricing opportunities on fixed rate notes. The Company's investment portfolio, including federal funds sold, provides the most flexible and fastest control over rate sensitivity since it can generally be restructured more quickly than the loan portfolio.

On the liability side, deposit products are structured to offer incentives to attain the maturity distribution desired. Competitive factors sometimes make control over deposits more difficult and, therefore, less effective as an interest rate sensitivity management tool.

The asset mix of the balance sheet is continually evaluated in terms of several variables: yield, credit quality, appropriate funding sources, and

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liquidity. Management of the liability mix of the balance sheet focuses on expanding the various funding sources.

As of December 31, 2005, the Company was asset-sensitive for all time horizons. For asset-sensitive institutions, if interest rates should decrease, the net interest margins should decline. Since all interest rates and yields do not adjust at the same velocity, the gap is only a general indicator of rate sensitivity.

### Interest Sensitivity Analysis December 31, 2005

|                                                 | Within<br>three<br>months | After three<br>but within<br>twelve<br>months | After one<br>but within<br>five years | After<br>five years | T                    |
|-------------------------------------------------|---------------------------|-----------------------------------------------|---------------------------------------|---------------------|----------------------|
| <b>Assets</b>                                   |                           |                                               |                                       |                     |                      |
| <b>Earning assets</b>                           |                           |                                               |                                       |                     |                      |
| Federal funds sold                              | \$ 26,296,780             | \$ -                                          | \$ -                                  | \$ -                | \$ 26,296,780        |
| Interest-bearing deposits                       | 59,025                    | 1,342,019                                     | 791,687                               | -                   | 2,192,731            |
| Investment debt securities                      | 14,264,994                | 59,749,172                                    | 38,761,137                            | 2,587,187           | 115,362,490          |
| Loans                                           | 201,528,965               | 997,836                                       | 2,851,798                             | 1,254,067           | 206,632,696          |
| <b>Total earning asset</b>                      | <b>\$242,149,764</b>      | <b>\$ 62,089,027</b>                          | <b>\$ 42,404,622</b>                  | <b>\$ 3,841,254</b> | <b>\$350,484,699</b> |
| <b>Liabilities</b>                              |                           |                                               |                                       |                     |                      |
| <b>Interest-bearing deposits</b>                |                           |                                               |                                       |                     |                      |
| NOW                                             | \$ 62,601,973             | \$ -                                          | \$ -                                  | \$ -                | \$ 62,601,973        |
| Money market                                    | 46,464,340                | -                                             | -                                     | -                   | 46,464,340           |
| Savings                                         | 51,648,088                | -                                             | -                                     | -                   | 51,648,088           |
| Certificates                                    |                           |                                               |                                       |                     |                      |
| \$100,000 and over                              | 5,801,641                 | 8,192,604                                     | 3,883,981                             | -                   | 17,878,226           |
| Certificates under \$100,000                    | 14,258,095                | 19,991,677                                    | 9,779,075                             | -                   | 44,028,847           |
| Securities sold under agreements to repurchase  | 6,149,263                 | -                                             | -                                     | -                   | 6,149,263            |
| Note payable                                    | 5,214                     | 16,118                                        | 99,320                                | 21,417              | 142,079              |
| <b>Total interest-bearing liabilities</b>       | <b>\$186,928,614</b>      | <b>\$ 28,200,399</b>                          | <b>\$ 13,762,376</b>                  | <b>\$ 21,417</b>    | <b>\$228,912,837</b> |
| Period gap                                      | \$ 55,221,150             | \$ 33,888,628                                 | \$ 28,642,246                         | \$ 3,819,837        | \$121,571,861        |
| Cumulative gap                                  | \$ 55,221,150             | \$ 89,109,778                                 | \$117,752,024                         | \$121,571,861       |                      |
| Ratio of cumulative gap to total earning assets | 15.76%                    | 25.42%                                        | 33.60%                                | 34.69%              |                      |

### Investment Securities Maturity Distribution and Yields

| December 31, 2005 |       | December 31, 2004 |       | December 31, 2003 |       |
|-------------------|-------|-------------------|-------|-------------------|-------|
| Amount            | Yield | Amount            | Yield | Amount            | Yield |

U. S. Treasury

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|                                    |               |       |               |       |               |       |
|------------------------------------|---------------|-------|---------------|-------|---------------|-------|
| One year or less                   | \$ 57,192,124 | 2.66% | \$ 58,255,488 | 1.71% | \$ 68,496,088 | 0.97% |
| Over one through                   |               |       |               |       |               |       |
| five years                         | 27,462,872    | 3.48% | 58,361,766    | 2.57% | 51,965,421    | 1.74% |
| Over ten years                     | 2,587,187     | 7.28% | 2,554,687     | 7.28% | 2,559,062     | 7.28% |
| Total U.S. Treasury securities     | 87,242,183    | 3.05% | 119,171,941   | 2.25% | 123,020,571   | 1.43% |
|                                    |               |       |               |       |               |       |
| U.S. Government Agencies           |               |       |               |       |               |       |
| One year or less                   | 9,999,514     | 2.31% | 3,250,000     | 2.20% | 2,000,810     | 4.65% |
| Over one through                   |               |       |               |       |               |       |
| five years                         | 7,746,483     | 3.13% | 16,741,938    | 2.61% | 15,000,000    | 2.31% |
| Total U. S. Government Agencies    | 17,745,997    | 2.67% | 19,991,938    | 2.55% | 17,000,810    | 2.59% |
|                                    |               |       |               |       |               |       |
| State, county, and municipal       |               |       |               |       |               |       |
| One year or less                   | 6,822,528     | 1.59% | 11,399,926    | 1.34% | 6,395,697     | 1.72% |
| Over one through                   |               |       |               |       |               |       |
| five years                         | 3,551,782     | 2.32% | 8,121,361     | 1.60% | 9,830,041     | 1.35% |
| Total state, county, and municipal | 10,374,310    | 1.84% | 19,521,287    | 1.45% | 16,225,738    | 1.49% |
|                                    |               |       |               |       |               |       |
| Total debt securities              |               |       |               |       |               |       |
|                                    |               |       |               |       |               |       |
| One year or less                   | 74,014,166    | 2.51% | 72,905,414    | 1.67% | 76,892,595    | 1.13% |
| Over one through                   |               |       |               |       |               |       |
| five years                         | 38,761,137    | 3.30% | 83,225,065    | 2.48% | 76,795,462    | 1.80% |
| Over ten years                     | 2,587,187     | 7.28% | 2,554,687     | 7.28% | 2,559,062     | 7.28% |
| Total debt securities              | 115,362,490   | 2.89% | 158,685,166   | 2.19% | 156,247,119   | 1.56% |
|                                    |               |       |               |       |               |       |
| Equity securities                  | 3,721,950     | 2.95% | 3,265,566     | 2.72% | 2,685,158     | 2.70% |
|                                    |               |       |               |       |               |       |
| Total securities                   | \$119,084,440 | 2.89% | \$161,950,732 | 2.20% | \$158,932,277 | 1.58% |

### Deposits and Other Interest-Bearing Liabilities

Average interest-bearing liabilities decreased \$2,115,262, or .86%, from \$245,279,167 in 2004, to \$243,163,905 in 2005. Average interest-bearing deposits decreased \$3,399,683, or 1.42%, from \$240,087,443 in 2004 to \$236,687,760 in 2005, while average noninterest-bearing demand deposits increased \$2,027,298, or 2.43% from \$83,499,032 in 2004 to \$85,526,330 in 2005. At December 31, 2005, total deposits were \$310,857,607, compared to \$319,772,358 at December 31, 2004, a decrease of 2.79%. Management believes that decreasing deposit volume is indicative of a return by investors to non-deposit investment products and strong competition for deposits in the local market. Management monitors deposit volume decreases closely and implements counter-measures as needed, including but not limited to rate increases on existing products and the development of new products.

Average interest-bearing liabilities increased \$2,507,550, or 1.03%, to \$245,279,167 in 2004, from \$242,771,617 in 2003. Average interest-bearing deposits increased \$1,640,081, or .69%, to \$240,087,443 in 2004 from \$238,447,362 in 2003, while average noninterest-bearing demand deposits increased \$7,600,593, or 10.01% to \$83,499,032 in 2004 from \$75,898,439 in 2003. At December 31, 2004, total deposits were \$319,772,358, compared to \$317,946,053 at December 31, 2003, an increase of .57%. These rates of increase have slowed significantly from the rates at which deposits have grown since mid-2001. Management attributes the growth of deposits in recent years to investors' discomfort with a depressed and volatile stock market, and a resultant flight

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to the safety of insured deposits.

The following table sets forth the deposits of the Company by category as of December 31, 2005, 2004, and 2003, respectively.

|                                       | 2005          |                        | December 31,<br>2004 |                        | 2003          |             |
|---------------------------------------|---------------|------------------------|----------------------|------------------------|---------------|-------------|
|                                       | Amount        | Percent of<br>deposits | Amount               | Percent of<br>deposits | Amount        | Per<br>dep. |
| Demand deposit accounts               | \$ 88,236,133 | 28.39%                 | \$ 78,542,414        | 24.56%                 | \$ 75,601,460 | 23.         |
| NOW accounts                          | 62,601,973    | 20.14%                 | 68,892,269           | 21.55%                 | 63,400,879    | 19.         |
| Money market                          | 46,464,340    | 14.95%                 | 49,362,532           | 15.44%                 | 50,168,501    | 15.         |
| Savings accounts                      | 51,648,088    | 16.61%                 | 53,667,019           | 16.78%                 | 51,495,252    | 16.         |
| Time deposits less than<br>\$100,000  | 44,028,847    | 14.16%                 | 50,683,867           | 15.85%                 | 57,242,198    | 18.         |
| Time deposits of \$100,000<br>or more | 17,878,226    | 5.75%                  | 18,624,257           | 5.82%                  | 20,037,763    | 6.          |
| Total deposits                        | \$310,857,607 | 100.00%                | \$319,772,358        | 100.00%                | \$317,946,053 | 100.        |

Core deposits, which exclude certificates of deposit of \$100,000 or more, provide a relatively stable funding source for the Company's loan portfolio and other earning assets. The Company's core deposits decreased \$8,168,720 during 2005. Management attributes this decrease to more aggressive competition for time deposits in the rising rate environment of 2005, and to the reversal of the some of the prior years' migration of funds from the stock market into insured deposits. The Company's core deposits increased \$3,239,811 and \$12,254,910 during 2004, and 2003, respectively. Management believes that this increase was largely attributable to a migration of funds from the stock market into insured deposits.

Deposits, and particularly core deposits, have been the Company's primary source of funding and have enabled the Company to meet both its short-term and long-term liquidity needs. Management anticipates that while such deposits will continue to be the Company's primary source of funding in the future, continued reductions in deposit levels, if coupled with growth in the Company's loan portfolio, could require periodic borrowing of funds. In this event, it is likely that Management would purchase overnight federal funds as needed.

The maturity distribution of the Company's time deposits over \$100,000 at December 31, 2005, is shown in the following table.

### Maturities of Certificates of Deposit and Other Time Deposits of \$100,000 or More

|                                                    | December 31, 2005      |                                      |                                          |                        |            |
|----------------------------------------------------|------------------------|--------------------------------------|------------------------------------------|------------------------|------------|
|                                                    | Within three<br>months | After three<br>through<br>six months | After six<br>through<br>Twelve<br>months | After twelve<br>Months | Total      |
| Certificates of<br>deposit of<br>\$100,000 or more | \$ 5,801,641           | \$ 2,547,291                         | \$ 5,645,313                             | \$ 3,883,981           | \$ 17,878, |

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Large certificate of deposit customers tend to be extremely sensitive to interest rate levels, making these deposits less reliable sources of funding for liquidity planning purposes than core deposits. Some financial institutions partially fund their balance sheets using large certificates of deposit obtained through brokers. These brokered deposits are generally expensive and are unreliable as long-term funding sources. Accordingly, the Company does not accept brokered deposits.

### Noninterest revenue

Noninterest revenue for 2005 increased \$49,577, or 2.83% from the previous year. Of this, \$49,710, representing a 15.40% line item increase, is attributable to revenues from ATM and VISA debit card usage.

Noninterest revenue for 2004 increased \$185,961, or 11.89% from the previous year. Included is a \$160,771 increase in cash surrender value of bank owned life insurance policies with a face value of \$4,000,000, which were purchased by the Bank in August 2003. A second significant increase occurred in ATM and debit card revenues, which were up \$46,742 (16.94%) from 2003 due to increased usage.

The following table presents the principal components of noninterest revenue for the years ended December 31, 2005, 2004, and 2003, respectively.

|                                     | Noninterest revenue |             |             |
|-------------------------------------|---------------------|-------------|-------------|
|                                     | 2005                | 2004        | 2003        |
| Service charges on deposit accounts | \$1,053,443         | \$1,050,504 | \$1,028,306 |
| ATM and debit card revenue          | 372,426             | 322,716     | 275,974     |
| Miscellaneous revenue               | 373,505             | 376,577     | 259,556     |
| Total noninterest revenue           | \$1,799,374         | \$1,749,797 | \$1,563,836 |

|                                                             |       |       |       |
|-------------------------------------------------------------|-------|-------|-------|
| Noninterest revenue as a percentage of average total assets | 0.45% | 0.44% | 0.41% |
|-------------------------------------------------------------|-------|-------|-------|

### Noninterest Expense

Noninterest expense increased \$351,211, or 5.16%, from 2004 to 2005. Increased personnel costs of \$194,255 include a \$37,487 increase in expense related to the Bank's employee retirement plan and the accrual of a 10-year commitment, valued at \$107,409, to provide long-term care insurance to the Chairman of the Board. Occupancy expense increased \$46,860 due to routine increases in costs of utilities, real property taxes, and insurance, in addition to several significant repairs. Furniture and equipment expense are down \$60,766, of which \$26,769 is reduced depreciation expense, and \$21,944 is lower cost of service contracts and repairs. Other operating expense increased \$170,862, including a \$29,452 increase in telephone and network telecommunications.

Noninterest expense increased \$186,810, or 2.82%, from 2003 to 2004. Increased personnel costs of \$75,864 include a \$50,132 increase in the cost of group insurance. Occupancy expense increased due to increased depreciation and real property taxes related to the Bank's Berlin office expansion completed late in 2003. Cost related to ATM and debit cards rose \$30,999 due to increased usage. The revenues net of expenses related to ATM and debit card usage, increased \$15,743 from 2003 to 2004.

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The following table presents the principal components of noninterest expense for the years ended December 31, 2005, 2004, and 2003, respectively.

|                                                                | 2005        | 2004        | 2003        |
|----------------------------------------------------------------|-------------|-------------|-------------|
| Salaries and employee benefits                                 | \$4,097,533 | \$3,903,278 | \$3,827,414 |
| Occupancy expense                                              | 640,335     | 593,475     | 536,269     |
| Furniture and equipment expense                                | 490,955     | 551,721     | 542,433     |
| Advertising                                                    | 147,541     | 145,583     | 152,358     |
| Armored car service                                            | 76,068      | 60,829      | 67,517      |
| ATM and debit card                                             | 234,732     | 232,353     | 201,354     |
| Business and product development                               | 78,399      | 70,720      | 66,480      |
| Computer software amortization                                 | 121,982     | 117,191     | 91,736      |
| Computer software maintenance                                  | 101,875     | 82,514      | 97,570      |
| Courier service                                                | 105,148     | 103,922     | 93,457      |
| Deposit insurance                                              | 42,098      | 45,403      | 46,975      |
| Director fees                                                  | 99,900      | 89,375      | 84,240      |
| Dues, donations, and subscriptions                             | 94,385      | 81,328      | 80,842      |
| Liability insurance                                            | 40,380      | 41,556      | 47,160      |
| Postage                                                        | 179,462     | 169,569     | 168,083     |
| Professional fees                                              | 65,090      | 22,745      | 37,551      |
| Stationery and supplies                                        | 111,593     | 135,269     | 125,593     |
| Telephone                                                      | 152,464     | 123,012     | 117,602     |
| Miscellaneous                                                  | 279,742     | 238,628     | 237,027     |
| Total noninterest expense                                      | \$7,159,682 | \$6,808,471 | \$6,621,661 |
| <br>                                                           |             |             |             |
| Noninterest expense as a percentage<br>of average total assets | 1.80%       | 1.73%       | 1.75%       |

### Capital

Under the capital guidelines of the Federal Reserve Board and the FDIC, the Company and the Bank are currently required to maintain a minimum risk-based total capital ratio of 8%, with at least 4% being Tier 1 capital. Tier 1 capital consists of common stockholders' equity, qualifying perpetual preferred stock, and minority interests in equity accounts of consolidated subsidiaries, less certain intangibles. In addition, the Company and the Bank must maintain a minimum Tier 1 leverage ratio (Tier 1 capital to total assets) of at least 3%, but this minimum ratio is increased by 100 to 200 basis points for other than the highest-rated institutions.

At December 31, 2005, the Company and the Bank were well-capitalized, exceeding all minimum requirements, as set forth in the following table.

|                                 | Analysis of Capital     |       |                           | Required<br>minimums |
|---------------------------------|-------------------------|-------|---------------------------|----------------------|
|                                 | Consolidated<br>Company | Bank  | To be well<br>capitalized |                      |
| 2005                            |                         |       |                           |                      |
| Total risk-based capital ratio  | 35.2%                   | 32.9% | 10.0%                     | 8.0%                 |
| Tier I risk-based capital ratio | 33.5%                   | 31.7% | 6.0%                      | 4.0%                 |
| Tier I leverage ratio           | 16.2%                   | 15.4% | 5.0%                      | 4.0%                 |

2004

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|                                 |       |       |       |      |
|---------------------------------|-------|-------|-------|------|
| Total risk-based capital ratio  | 43.3% | 41.3% | 10.0% | 8.0% |
| Tier I risk-based capital ratio | 41.7% | 40.1% | 6.0%  | 4.0% |
| Tier I leverage ratio           | 16.0% | 15.3% | 5.0%  | 4.0% |
| 2003                            |       |       |       |      |
| Total risk-based capital ratio  | 39.1% | 37.1% | 10.0% | 8.0% |
| Tier I risk-based capital ratio | 37.6% | 35.9% | 6.0%  | 4.0% |
| Tier I leverage ratio           | 16.0% | 14.9% | 5.0%  | 4.0% |

### Website Access to SEC Reports

The Bank maintains an Internet website at [www.taylorbank.com](http://www.taylorbank.com). The Company's periodic SEC reports, including annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K, are accessible through this website. Access to these filings is free of charge. The reports are available as soon as practicable after they are filed electronically with the SEC.

### Accounting Rule Changes

The following accounting pronouncements have been approved by the Financial Accounting Standards Board but not become effective as of December 31, 2005. These pronouncements would apply to the Company if the Company or the Bank entered into an applicable activity.

FASB Statement No. 154, Accounting Changes and Error Corrections replaces APB Opinion No. 20 Accounting Changes and FASB Statement No. 3 Reporting Accounting Changes in Interim Financial Statements—An Amendment of APB Opinion No. 28. FASB Statement No. 154 changes the requirements for the accounting for and reporting of a change in accounting principle. It applies to all voluntary changes in accounting principle. It establishes retrospective application as the required method for reporting a change in accounting principle and the reporting of a correction of an error. The Statement is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005.

FASB Statement No. 153, Exchanges of Nonmonetary Assets an Amendment of APB Opinion No. 29, eliminates the exception to fair value for exchanges of similar productive assets that was provided in APB Opinion No. 29.

FASB Statement No. 152, Accounting for Real Estate Time-Sharing Transactions, amends FASB Statement No. 66 Accounting for Sales of Real Estate to reference the financial accounting and reporting guidance for real estate time-sharing transactions that is provided in AICPA Statement of Position 04-2, Accounting for Real Estate Time Sharing Transactions. This Statement also amends FASB Statement No. 67, Accounting for Costs and Initial Rental Operations of Real Estate Projects, to state that the guidance for (a) incidental operations and (b) costs incurred to sell real estate projects does not apply to real estate time-sharing transactions.

FASB Statement No. 123R, Share Based Payment, revises FASB Statement No. 123, Accounting for Stock-Based Compensation and supersedes Accounting Principles Board (APB) Opinion No. 25, Accounting for Stock Issued to Employees, and its related implementation guidance. Statement 123R establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. Statement 123R requires entities to recognize the cost of employee services received in exchange for awards of equity instruments based on the grant-date fair value of those awards. As such, it eliminated the alternative provided by Statement 123 that such costs could be



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measured either by using fair value or by using Opinion 25's intrinsic value method of accounting which generally did not result in the recognition of compensation costs as a result of the grant of stock options to employees. In addition, Statement 123R amends FASB Statement No. 95, Statement of Cash Flows, to require that excess tax benefits be reported as a financing cash inflow rather than as a reduction of taxes paid. Statement 123R becomes effective as of the first interim or annual reporting period that begins after December 15, 2005.

AICPA Statement of Position No. 03-3, Accounting for Certain Loans or Debt Securities Acquired in a Transfer, prohibits the carrying over of valuation allowances in loans and securities acquired in a transfer. At transfer, the assets are to be recorded at the total cash flows expected to be collected. The SOP is effective for loans acquired in fiscal years beginning after December 15, 2004.

The accounting policies adopted by management are consistent with accounting principles generally accepted in the United States of America and are consistent with those followed by peer Banks.

### Item 7A. Quantitative and Qualitative Disclosures About Market Risk

#### Impact of Inflation

Unlike most industrial companies, the assets and liabilities of financial institutions such as the Company and the Bank are primarily monetary in nature. Therefore, interest rates have a more significant effect on the Company's performance than do the effects of changes in the general rate of inflation and change in prices. In addition, interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services. As discussed previously, management seeks to manage the relationships between interest sensitive assets and liabilities in order to protect against wide interest rate fluctuations, including those resulting from inflation. See "Liquidity and Interest Rate Sensitivity" above.

### Item 8. Financial Statements and Supplementary Data

In response to this Item, the information included on pages 1 through 21 of the Company's Annual Report to Shareholders for the year ended December 31, 2005, is incorporated herein by reference.

## PART III

### Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosures

There have been no changes in or disagreements with accountants on accounting or financial disclosure during the fiscal year covered by this report.

### Item 9A. Controls and Procedures

#### Evaluation of disclosure controls and procedures

Disclosure Controls and procedures are designed and maintained by the Company to ensure that information required to be disclosed in the Company's publicly filed reports is recorded, processed, summarized and reported in a timely manner. Such information must be available to management, including the Chief Executive Officer (CEO) and Treasurer, to allow them to make timely decisions about required disclosures. Even a well-designed and maintained control system can provide only reasonable, not absolute, assurance that its objectives are achieved. Inherent limitations in any system of controls include

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flawed judgment, errors, omissions, or intentional circumvention of controls.

The Company's management, including the CEO and Treasurer, performed an evaluation of the effectiveness of the design and operation of the Company's disclosure controls and procedures as of December 31, 2005. Based on that evaluation, the Company's management, including the CEO and Treasurer, has concluded that the Company's disclosure controls and procedures are effective. The projection of an evaluation of controls to future periods is subject to the risk that procedures may become inadequate due to changes in conditions including the degree of compliance with procedures.

### Internal Control Over Financial Reporting

#### Management Report on Internal Control over Financial Reporting

Calvin B. Taylor Bankshares, Inc. maintains a system of internal control over financial reporting, which is designed to provide reasonable assurance to the Company's management and board of directors regarding the preparation of reliable published financial statements. The system includes an organizational structure and division of responsibility, established policies and procedures including a code of conduct to foster a strong ethical climate, and the careful selection, training and development of our staff. The system contains self-monitoring mechanisms, and an internal auditor monitors the operation of the internal control system and reports findings and recommendations to management and the board of directors. Corrective actions are taken to address control deficiencies and other opportunities for improving the system as they are identified. The board, operating through its audit committee, which is composed entirely of directors who are not officers or employees of the Company, provides oversight to the financial reporting process.

There are inherent limitations in the effectiveness of any system of internal controls, including the possibility of human error and the circumvention or overriding of controls. Accordingly, even an effective internal control system can provide only reasonable assurance with respect to financial statement preparation. Furthermore, the effectiveness of an internal control system may vary over time and with circumstances.

The Company assessed its internal control system as of December 31, 2005 in relation to criteria for effective internal control over financial reporting as described in "Internal Control - Integrated Framework," issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on its assessment, the Company believes that, as of December 31, 2005, its system of internal control over financial reporting met those criteria.

Calvin B. Taylor Bankshares, Inc.

/s/ Raymond M. Thompson  
by Raymond M. Thompson., Chief Executive Officer March 8, 2006  
Date

/s/ Jennifer G. Hawkins  
by Jennifer G. Hawkins, Treasurer March 8, 2006  
Date

Attestation Report of the Registered Public Accounting Firm

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Calvin B. Taylor Bankshares, Inc.  
Berlin, Maryland

We have audited management's assessment, included in the accompanying Management Report on Internal Control Over Financial Reporting, that Calvin B. Taylor Bankshares, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005, based on criteria established

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in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company's management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management's assessment and an opinion on the effectiveness of the Company's internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management's assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management's assessment that Calvin B. Taylor Bankshares, Inc. and Subsidiary maintained effective internal control over financial reporting as of December 31, 2005, is fairly stated, in all material respects, based on criteria established in "Internal Control - Integrated Framework" issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Also, in our opinion, Calvin B. Taylor Bankshares, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

We have audited, in accordance with the standards of the Public Company Accounting Oversight Board in the United States of America, the consolidated balance sheets and the related consolidated statements of income, changes in stockholders' equity and cash flows of Calvin B. Taylor Bankshares, Inc. and Subsidiary, and our report dated January 31, 2006, expressed an unqualified opinion.

/s/ Rowles & Company, LLP

Baltimore, Maryland  
January 31, 2006

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### Changes in Internal Controls

During the quarter ended on the date of this report, there were no significant changes in the Company's internal controls over financial reporting that have had or are reasonably likely to have a material affect on the Company's internal control over financial reporting. As of December 31, 2005, the Company's management, including the CEO and Treasurer, has concluded that the Company's internal controls over financial reporting are effective.

### Audit Committee and Financial Expert

The Board of Directors has adopted a written Audit Policy, which serves as a charter for the Audit Committee. The Audit Committee is comprised of seven independent directors, including Chairman James R. Bergey, Jr. who serves as the financial expert. The Audit Committee is scheduled to meet quarterly and held four meetings in 2005.

### Item 10. Directors and Executive Officers of the Registrant

In response to this item, the information included in the Company's Proxy Statement for Annual Meeting of Shareholders To Be Held on May 17, 2006, is incorporated herein by reference.

### Item 11. Executive Compensation

In response to this item, the information included in the Company's Proxy Statement for Annual Meeting of Shareholders To Be Held on May 17, 2006, is incorporated herein by reference.

### Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.

In response to this item, the information included in the Company's Proxy Statement for Annual Meeting of Shareholders To Be Held on May 17, 2006, is incorporated herein by reference.

### Item 13. Certain Relationships and Related Transactions

In response to this item, the information included in the Company's Proxy Statement for Annual Meeting of Shareholders To Be Held on May 17, 2006, is incorporated herein by reference.

### Item 14. Principal Accounting Fees and Services

In response to this item, the information included in the Company's Proxy Statement for Annual Meeting of Shareholders To Be Held on May 17, 2006, is incorporated herein by reference.

## PART IV

### Item 15. Exhibits, Financial Statement Schedules

#### (a) Exhibits

- 3.1 Articles of Incorporation of the Company, incorporated by reference to Exhibit 3.1 of Registration Statement Form S-4, File No. 33-99762.
- 3.2 Bylaws of the Company, incorporated by reference to Exhibit 3.2 of

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Registration Statement Form S-4, File No. 33-99762.

13 Annual Report to Shareholders for the year ended December 31, 2005.

### SIGNATURES

Pursuant to the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CALVIN B. TAYLOR BANKSHARES, INC.  
(Registrant)

Date: March 8, 2006 By: /s/ Raymond M. Thompson  
Raymond M. Thompson  
Chief Executive Officer

Date: March 8, 2006 By: /s/ Jennifer G. Hawkins  
Jennifer G. Hawkins  
Treasurer / Principal Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: March 8, 2006 By: /s/ James R. Bergey, Jr.  
James R. Bergey, Jr., Director

Date: March 8, 2006 By: /s/ John H. Burbage, Jr.  
John H. Burbage, Jr., Director

Date: March 8, 2006 By: /s/ Reese F. Cropper, Jr.  
Reese F. Cropper, Jr.  
Chairman of the Board of Directors

Date: March 8, 2006 By: /s/ Reese F. Cropper, III  
Reese F. Cropper, III, Director

Date: March 8, 2006 By: /s/ Hale Harrison  
Hale Harrison, Director

Date: March 8, 2006 By: /s/ Gerald T. Mason  
Gerald T. Mason, Director

Date: March 8, 2006 By: /s/ William H. Mitchell  
William H. Mitchell,  
Vice President and Director

Date: March 8, 2006 By: /s/ Joseph E. Moore  
Joseph E. Moore, Director

Date: March 8, 2006 By: /s/ Michael L. Quillin  
Michael L. Quillin, Sr., Director

Date: March 8, 2006 By: /s/ D. Bruce Rogers  
D. Bruce Rogers, Director

Date: March 8, 2006 By: /s/ Raymond M. Thompson  
Raymond M. Thompson, Director  
President and Chief Executive Officer









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FOR THE YEAR ENDED DECEMBER 31, 2005

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary

Financial Statements

December 31, 2005

Calvin B. Taylor Bankshares, Inc.  
and Subsidiary

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Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders  
Calvin B. Taylor Bankshares, Inc.  
Berlin, Maryland

We have audited the accompanying consolidated balance sheets of Calvin B. Taylor Bankshares, Inc. and Subsidiary (the Company) as of December 31, 2005, 2004, and 2003 and the related consolidated statements of income, changes in stockholders' equity, and cash flows for each of the three years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Calvin B. Taylor Bankshares, Inc. and Subsidiary as of December 31, 2005, 2004, and 2003, and the results of its operations and its cash flows for each of the three years then ended, in conformity with accounting principles generally accepted in the United States of America.

We have also audited, in accordance with standards of the Public Company Accounting Oversight Board in the United States of America, the effectiveness of the Company's internal control over financial reporting as of December 31, 2005, based on criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated January 31, 2006, expressed an unqualified opinion on management's assessment of internal control over financial reporting and an unqualified opinion on the effectiveness of internal control over financial reporting.

/s/ Rowles & Company, LLP

Baltimore, Maryland  
January 31, 2006

### Calvin B. Taylor Bankshares, Inc. and Subsidiary Consolidated Balance Sheets

|                                                                                                                             | 2005          | December 31,<br>2004 | 2003          |
|-----------------------------------------------------------------------------------------------------------------------------|---------------|----------------------|---------------|
| <b>Assets</b>                                                                                                               |               |                      |               |
| Cash and due from banks                                                                                                     | \$ 24,069,790 | \$ 21,901,546        | \$ 20,482,866 |
| Federal funds sold                                                                                                          | 26,296,780    | 32,692,233           | 29,525,781    |
| Interest-bearing deposits                                                                                                   | 2,192,731     | 2,161,496            | 2,281,337     |
| Investment securities<br>available for sale                                                                                 | 6,505,278     | 5,921,287            | 9,265,471     |
| Investment securities held<br>to maturity (approximate fair<br>value of \$111,306,528,<br>\$155,107,698, and \$150,075,210) | 112,579,162   | 156,029,445          | 149,666,806   |
| Loans, less allowance for loan                                                                                              |               |                      |               |

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|                                                        |               |               |               |
|--------------------------------------------------------|---------------|---------------|---------------|
| losses of \$2,190,709,<br>\$2,177,926, and \$2,187,277 | 204,441,957   | 161,510,157   | 162,243,008   |
| Premises and equipment                                 | 6,664,051     | 6,891,238     | 7,064,970     |
| Accrued interest receivable                            | 1,504,945     | 1,415,775     | 1,344,613     |
| Computer software                                      | 228,014       | 322,209       | 265,961       |
| Bank owned life insurance                              | 4,367,744     | 4,214,806     | 4,054,035     |
| Other assets                                           | 224,172       | 272,790       | 291,553       |
|                                                        | \$389,074,624 | \$393,332,982 | \$386,486,401 |

Liabilities and Stockholders' Equity

|                                                   |               |               |               |
|---------------------------------------------------|---------------|---------------|---------------|
| Deposits                                          |               |               |               |
| Noninterest-bearing                               | \$ 88,236,133 | \$ 78,542,414 | \$ 75,601,460 |
| Interest-bearing                                  | 222,621,474   | 241,229,944   | 242,344,593   |
|                                                   | 310,857,607   | 319,772,358   | 317,946,053   |
| Securities sold under<br>agreements to repurchase | 6,149,263     | 5,933,466     | 4,113,154     |
| Dividend payable                                  | 4,462,578     | -             | -             |
| Accrued interest payable                          | 177,357       | 116,502       | 145,044       |
| Note payable                                      | 142,069       | 162,161       | 181,087       |
| Deferred income taxes                             | 635,336       | 549,070       | 355,632       |
| Other liabilities                                 | 332,030       | 101,857       | 109,399       |
|                                                   | 322,756,240   | 326,635,414   | 322,850,369   |

Stockholders' equity

|                                                                                                                                                                                                                                       |               |               |               |
|---------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|---------------|---------------|---------------|
| Common stock, par value \$1 per<br>share; authorized 10,000,000<br>shares; issued and outstanding<br>3,187,556 shares at December 31,<br>2005, 3,208,478 shares at<br>December 31, 2004, and 3,227,966<br>shares at December 31, 2003 | 3,187,556     | 3,208,478     | 3,227,966     |
| Additional paid-in capital                                                                                                                                                                                                            | 15,454,735    | 16,187,005    | 16,869,085    |
| Retained earnings                                                                                                                                                                                                                     | 46,021,128    | 45,917,427    | 42,391,363    |
|                                                                                                                                                                                                                                       | 64,663,419    | 65,312,910    | 62,488,414    |
| Accumulated other<br>comprehensive income                                                                                                                                                                                             | 1,654,965     | 1,384,658     | 1,147,618     |
|                                                                                                                                                                                                                                       | 66,318,384    | 66,697,568    | 63,636,032    |
|                                                                                                                                                                                                                                       | \$389,074,624 | \$393,332,982 | \$386,486,401 |

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

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Consolidated Statements of Income

|                                                    |                          |               |               |
|----------------------------------------------------|--------------------------|---------------|---------------|
|                                                    | Years Ended December 31, |               |               |
|                                                    | 2005                     | 2004          | 2003          |
| Interest and dividend revenue                      |                          |               |               |
| Loans, including fees                              | \$ 12,957,693            | \$ 11,512,125 | \$ 12,115,447 |
| U. S. Treasury and government<br>agency securities | 3,267,544                | 2,822,526     | 2,817,600     |
| State and municipal securities                     | 267,243                  | 273,712       | 219,806       |
| Federal funds sold                                 | 1,077,571                | 547,226       | 540,804       |
| Interest-bearing deposits                          | 55,674                   | 47,574        | 42,363        |

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|                                                     |              |              |              |
|-----------------------------------------------------|--------------|--------------|--------------|
| Equity securities                                   | 55,494       | 8,592        | 43,227       |
| Total interest and dividend revenue                 | 17,681,219   | 15,251,755   | 15,779,247   |
| Interest expense                                    |              |              |              |
| Deposits                                            | 1,738,647    | 1,535,171    | 2,110,465    |
| Borrowings                                          | 30,726       | 18,723       | 21,493       |
| Total interest expense                              | 1,769,373    | 1,553,894    | 2,131,958    |
| Net interest income                                 | 15,911,846   | 13,697,861   | 13,647,289   |
| Provision for loan losses                           | -            | -            | -            |
| Net interest income after provision for loan losses | 15,911,846   | 13,697,861   | 13,647,289   |
| Noninterest revenue                                 |              |              |              |
| Service charges on deposit accounts                 | 1,053,443    | 1,050,504    | 1,028,306    |
| ATM and debit card revenue                          | 372,426      | 322,716      | 275,974      |
| Miscellaneous revenue                               | 373,505      | 376,577      | 259,556      |
| Total noninterest revenue                           | 1,799,374    | 1,749,797    | 1,563,836    |
| Noninterest expenses                                |              |              |              |
| Salaries                                            | 3,173,430    | 3,136,220    | 3,092,919    |
| Employee benefits                                   | 924,103      | 767,058      | 734,495      |
| Occupancy                                           | 640,335      | 593,475      | 536,269      |
| Furniture and equipment                             | 490,955      | 551,721      | 542,433      |
| Other operating                                     | 1,930,859    | 1,759,997    | 1,715,545    |
| Total noninterest expenses                          | 7,159,682    | 6,808,471    | 6,621,661    |
| Income before income taxes                          | 10,551,538   | 8,639,187    | 8,589,464    |
| Income taxes                                        | 3,753,900    | 3,026,000    | 3,049,250    |
| Net income                                          | \$ 6,797,638 | \$ 5,613,187 | \$ 5,540,214 |
| Earnings per common share                           |              |              |              |
| - basic and diluted                                 | \$2.13       | \$1.74       | \$1.71       |

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

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Consolidated Statements of Changes in Stockholders' Equity

|                                                                                              | Common stock<br>Shares | Common stock<br>Par value | Additional<br>Paid-in capital | Retained<br>earnings | Accumulated<br>other<br>comprehensive<br>income | Compr<br>i |
|----------------------------------------------------------------------------------------------|------------------------|---------------------------|-------------------------------|----------------------|-------------------------------------------------|------------|
| Balance, December 31, 2002                                                                   | 3,240,000              | \$3,240,000               | \$17,290,000                  | \$38,788,018         | \$697,268                                       |            |
| Net income                                                                                   | -                      | -                         | -                             | 5,540,214            | -                                               | \$5,       |
| Unrealized gain on investment securities available for sale net of income taxes of \$239,066 | -                      | -                         | -                             | -                    | 450,350                                         |            |

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|                                                                                                          |           |             |              |              |             |      |
|----------------------------------------------------------------------------------------------------------|-----------|-------------|--------------|--------------|-------------|------|
| Comprehensive income                                                                                     |           |             |              |              |             | \$5, |
| Common shares repurchased                                                                                | (12,034)  | (12,034)    | (420,915)    | -            | -           |      |
| Cash dividend,<br>\$.60 per share                                                                        | -         | -           | -            | (1,936,869)  | -           |      |
| Balance, December 31, 2003                                                                               | 3,227,966 | 3,227,966   | 16,869,085   | 42,391,363   | 1,147,618   |      |
| Net income                                                                                               | -         | -           | -            | 5,613,187    | -           | \$5, |
| Unrealized gain on<br>investment securities<br>available for sale<br>net of income taxes<br>of \$151,226 | -         | -           | -            | -            | 237,040     |      |
| Comprehensive income                                                                                     |           |             |              |              |             | \$5, |
| Common shares repurchased                                                                                | (19,488)  | (19,488)    | (682,080)    | -            | -           |      |
| Cash dividend,<br>\$.65 per share                                                                        | -         | -           | -            | (2,087,123)  | -           |      |
| Balance, December 31, 2004                                                                               | 3,208,478 | 3,208,478   | 16,187,005   | 45,917,427   | 1,384,658   |      |
| Net income                                                                                               | -         | -           | -            | 6,797,638    | -           | \$6, |
| Unrealized gain on<br>investment securities<br>available for sale<br>net of income taxes<br>of \$168,016 | -         | -           | -            | -            | 270,307     |      |
| Comprehensive income                                                                                     |           |             |              |              |             | \$7, |
| Common shares repurchased                                                                                | (20,922)  | (20,922)    | (732,270)    | -            | -           |      |
| Cash dividend,<br>\$2.10 per share                                                                       | -         | -           | -            | (6,693,937)  | -           |      |
| Balance, December 31, 2005                                                                               | 3,187,556 | \$3,187,556 | \$15,454,735 | \$46,021,128 | \$1,654,965 |      |

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

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Consolidated Statements of Cash Flows

|                                                             | Years Ended December 31, |               |               |
|-------------------------------------------------------------|--------------------------|---------------|---------------|
|                                                             | 2005                     | 2004          | 2003          |
| Cash flows from operating activities                        |                          |               |               |
| Interest received                                           | \$ 17,301,217            | \$ 15,076,687 | \$ 15,761,248 |
| Fees and commissions received                               | 1,720,362                | 1,640,852     | 1,507,872     |
| Interest paid                                               | (1,708,517)              | (1,582,435)   | (2,230,381)   |
| Cash paid to suppliers<br>and employees                     | (6,418,778)              | (6,149,693)   | (6,026,828)   |
| Income taxes paid                                           | (3,738,920)              | (3,013,895)   | (3,232,338)   |
|                                                             | 7,155,364                | 5,971,516     | 5,779,573     |
| Cash flows from investing activities                        |                          |               |               |
| Certificates of deposits<br>purchased, net of maturities    | (1,934)                  | (567)         | (699,000)     |
| Proceeds from maturity of<br>investments available for sale | -                        | 4,000,000     | -             |

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|                                                                         |              |               |               |
|-------------------------------------------------------------------------|--------------|---------------|---------------|
| Purchase of investments available for sale                              | (45,379)     | (264,504)     | (182,500)     |
| Proceeds from maturities of investments held to maturity                | 89,345,000   | 102,010,000   | 107,310,000   |
| Purchase of investments held to maturity                                | (45,704,174) | (108,272,336) | (145,709,919) |
| Loans made, net of principal collected                                  | (42,931,800) | 732,851       | (418,331)     |
| Purchases of and deposits on premises, equipment, and computer software | (311,387)    | (551,236)     | (1,941,071)   |
| Purchase of bank owned life insurance                                   | -            | -             | (4,000,000)   |
|                                                                         | 350,326      | (2,345,792)   | (45,640,821)  |
| Cash flows from financing activities                                    |              |               |               |
| Net increase (decrease) in                                              |              |               |               |
| Time deposits                                                           | (7,401,051)  | (9,431,045)   | (1,459,208)   |
| Other deposits                                                          | (1,513,700)  | 11,257,350    | 17,909,795    |
| Securities sold under agreements to repurchase                          | 215,797      | 1,820,312     | 84,054        |
| Payments on note payable                                                | (20,093)     | (18,926)      | (17,825)      |
| Common shares repurchased                                               | (753,192)    | (701,568)     | (432,949)     |
| Dividends paid                                                          | (2,231,359)  | (2,087,123)   | (1,936,869)   |
|                                                                         | (11,703,598) | 839,000       | 14,146,998    |
| Net increase (decrease) in cash and cash equivalents                    | (4,197,908)  | 4,464,724     | (25,714,250)  |
| Cash and cash equivalents at beginning of year                          | 54,623,503   | 50,158,779    | 75,873,029    |
| Cash and cash equivalents at end of year                                | \$50,425,595 | \$54,623,503  | \$50,158,779  |

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

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Consolidated Statements of Cash Flows  
(Continued)

Years Ended December 31,

|                                                                                  | 2005         | 2004         | 2003         |
|----------------------------------------------------------------------------------|--------------|--------------|--------------|
| Reconciliation of net income to net cash provided by operating activities        |              |              |              |
| Net income                                                                       | \$ 6,797,638 | \$ 5,613,187 | \$ 5,540,214 |
| Adjustments to reconcile net income to net cash provided by operating activities |              |              |              |
| Depreciation and amortization                                                    | 630,606      | 656,293      | 633,383      |
| Provision for loan losses                                                        | -            | -            | -            |
| Deferred income taxes                                                            | (81,749)     | 42,212       | 46,409       |
| Amortization of premiums and accretion of discounts, net                         | (290,831)    | (103,350)    | (78,972)     |

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|                                                     |              |              |              |
|-----------------------------------------------------|--------------|--------------|--------------|
| (Gain) loss on disposition of assets                | 2,163        | 12,427       | 5,902        |
| Decrease (increase) in                              |              |              |              |
| Accrued interest receivable                         | (80,917)     | (71,162)     | 60,974       |
| Cash surrender value of bank owned life insurance   | (152,938)    | (160,771)    | (54,035)     |
| Other assets                                        | 48,618       | 18,763       | (185,549)    |
| Increase (decrease) in                              |              |              |              |
| Accrued interest payable                            | 60,855       | (28,542)     | (98,424)     |
| Accrued income taxes                                | 88,474       | (30,107)     | -            |
| Other liabilities                                   | 133,445      | 22,566       | (90,329)     |
|                                                     | \$ 7,155,364 | \$ 5,971,516 | \$ 5,779,573 |
| Composition of cash and cash equivalents            |              |              |              |
| Cash and due from banks                             | \$24,069,790 | \$21,901,546 | \$20,482,866 |
| Federal funds sold                                  | 26,296,780   | 32,692,233   | 29,525,781   |
| Interest-bearing deposits, except for time deposits | 59,025       | 29,724       | 150,132      |
|                                                     | \$50,425,595 | \$54,623,503 | \$50,158,779 |

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

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Notes to Consolidated Financial Statements

### 1. Summary of Significant Accounting Policies

Calvin B. Taylor Bankshares, Inc. is a bank holding company. Its subsidiary, Calvin B. Taylor Banking Company, is a financial institution operating primarily in Worcester County, Maryland and Sussex County, Delaware.

The accounting and reporting policies reflected in the financial statements conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions may affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

#### Principles of consolidation

The consolidated financial statements of Calvin B. Taylor Bankshares, Inc. include the accounts of its wholly owned subsidiary, Calvin B. Taylor Banking Company. All significant intercompany balances and transactions have been eliminated in consolidation.

#### Cash equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold and interest-bearing deposits except for time deposits. Federal funds are purchased and sold for one-day periods.

#### Investment securities

As securities are purchased, management determines if the securities should be classified as held to maturity or available for sale.



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Securities which management has the intent and ability to hold to maturity are recorded at amortized cost which is cost adjusted for amortization of premiums and accretion of discounts to maturity. Securities classified as available-for-sale are recorded at fair value.

Gains and losses on disposal are determined using the specific-identification method.

### Loans and allowance for loan losses

Loans are stated at face value less the allowance for loan losses. Interest on loans is credited to income based on the principal amounts outstanding. The accrual of interest is discontinued when any portion of the principal or interest is ninety days past due and collateral is insufficient to discharge the debt in full.

The allowance for loan losses is maintained at a level deemed appropriate by management to provide adequately for known and inherent risks in the loan portfolio. The minimum range of the allowance for loan losses is calculated by applying risk-weighted percentages to loans based on their delinquency and underlying collateral. The portion of the allowance that is a result of geographic and industry concentrations and current economic conditions is not allocated to specific loans. At December 31, 2005, the allowance included approximately \$926,900 that was not allocated to specific loans.

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Notes to Consolidated Financial Statements

### 1. Summary of Significant Accounting Policies (Continued)

#### Loans and allowance for loan losses (continued)

If the current economy or real estate market were to suffer a severe downturn, the estimate for uncollectible accounts would need to be increased. Loans that are deemed to be uncollectible are charged off and deducted from the allowance. The provision for loan losses and recoveries on loans previously charged off are added to the allowance.

Loans are considered impaired when, based on current information, management considers it unlikely that collection of principal and interest payments will be made according to contractual terms. Generally, loans are not reviewed for impairment until the accrual of interest has been discontinued.

#### Premises and equipment

Premises and equipment are recorded at cost less accumulated depreciation. Depreciation is computed under both straight-line and accelerated methods over the estimated useful lives of the assets.

#### Computer software

The Company amortizes software costs over their useful lives using the straight-line method.

#### Bank owned life insurance

The Company records increases in cash surrender value of bank owned life insurance as current period income based on projections provided by the underwriting company.

#### Advertising

Advertising costs are expensed as incurred.

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### Income taxes

The provision for income taxes includes taxes payable for the current year and deferred income taxes. Deferred income taxes are provided for the temporary differences between financial and taxable income. Tax expense and tax benefits are allocated to the Bank and Company based on their proportional share of taxable income.

### Per share data

Earnings per common share are determined by dividing net income by the weighted average number of common shares outstanding for the period, which was 3,194,669, 3,219,116, and 3,235,767 for the years ended December 31, 2005, 2004, and 2003, respectively.

### 2. Cash and Due From Banks

The Company normally carries balances with other banks that exceed the federally insured limit. The average balances carried in excess of the limit, including unsecured federal funds sold to the same banks, were \$34,580,755 for 2005, \$42,076,235 for 2004, and \$53,869,724 for 2003.

Banks are required to carry noninterest-bearing cash reserves at specified percentages of deposit balances. The Company's normal amount of cash on hand and on deposit with other banks is sufficient to satisfy the reserve requirements.

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Calvin B. Taylor Bankshares, Inc.  
and Subsidiary  
Notes to Consolidated Financial Statements

### 3. Investment Securities

Investment securities are summarized as follows:

|                           | Amortized<br>cost | Unrealized<br>gains | Unrealized<br>losses | Fair<br>value |
|---------------------------|-------------------|---------------------|----------------------|---------------|
| December 31, 2005         |                   |                     |                      |               |
| Available for sale        |                   |                     |                      |               |
| U.S. Treasury             | \$ 1,995,197      | \$ 591,990          | \$ -                 | \$ 2,587,187  |
| State and municipal       | 200,000           | -                   | 3,859                | 196,141       |
| Equity                    | 1,658,091         | 2,063,859           | -                    | 3,721,950     |
|                           | \$ 3,853,288      | \$ 2,655,849        | \$ 3,859             | \$ 6,505,278  |
| Held to maturity          |                   |                     |                      |               |
| U.S. Treasury             | \$ 84,654,996     | \$ -                | \$ 890,971           | \$ 83,764,025 |
| U.S. Government<br>agency | 17,745,997        | -                   | 282,502              | 17,463,495    |
| State and<br>municipal    | 10,178,169        | -                   | 99,161               | 10,079,008    |
|                           | \$112,579,162     | \$ -                | \$1,272,634          | \$111,306,528 |
| December 31, 2004         |                   |                     |                      |               |
| Available for sale        |                   |                     |                      |               |
| U.S. Treasury             | \$ 1,994,909      | \$ 559,778          | \$ -                 | \$ 2,554,687  |
| State and municipal       | 100,000           | 1,034               | -                    | 101,034       |
| Equity                    | 1,612,712         | 1,653,106           | 252                  | 3,265,566     |

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|                        |               |              |            |               |
|------------------------|---------------|--------------|------------|---------------|
|                        | \$ 3,707,621  | \$ 2,213,918 | \$ 252     | \$ 5,921,287  |
| Held to maturity       |               |              |            |               |
| U.S. Treasury          | \$116,617,254 | \$ 3,267     | \$ 602,820 | \$116,017,701 |
| U.S. Government agency | 19,991,938    | 1,615        | 216,549    | 19,777,004    |
| State and municipal    | 19,420,253    | 982          | 108,242    | 19,312,993    |
|                        | \$156,029,445 | \$ 5,864     | \$ 927,611 | \$155,107,698 |
| December 31, 2003      |               |              |            |               |
| Available for sale     |               |              |            |               |
| U.S. Treasury          | \$ 5,991,862  | \$ 588,451   | \$ -       | \$ 6,580,313  |
| Equity                 | 1,448,208     | 1,236,950    | -          | 2,685,158     |
|                        | \$ 7,440,070  | \$ 1,825,401 | \$ -       | \$ 9,265,471  |
| Held to maturity       |               |              |            |               |
| U.S. Treasury          | \$116,440,258 | \$ 416,411   | \$ 34,334  | \$116,822,335 |
| U.S. Government agency | 17,000,810    | 69,385       | 60,879     | 17,009,316    |
| State and municipal    | 16,225,738    | 34,016       | 16,195     | 16,243,559    |
|                        | \$149,666,806 | \$ 519,812   | \$ 111,408 | \$150,075,210 |

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3. Investment Securities (Continued)

The table below shows the gross unrealized losses and fair value of securities that are in an unrealized loss position as of December 31, 2005, aggregated by length of time that individual securities have been in a continuous unrealized loss position.

|                         | Less than 12 months |                 | 12 months or more |                 | Total         |                 |
|-------------------------|---------------------|-----------------|-------------------|-----------------|---------------|-----------------|
|                         | Fair value          | Unrealized loss | Fair value        | Unrealized loss | Fair value    | Unrealized loss |
| U. S. Treasury          | \$26,731,015        | \$ 199,773      | \$56,783,203      | \$ 691,198      | \$ 83,514,218 | \$ 890,971      |
| U. S. Government Agency | 990,942             | 9,058           | 16,472,553        | 273,444         | 17,463,495    | 282,502         |
| State and municipal     | 2,060,529           | 24,368          | 7,962,363         | 78,652          | 10,022,892    | 103,020         |
|                         | \$29,782,486        | \$ 233,199      | \$81,218,119      | \$1,043,294     | \$111,000,605 | \$ 1,276,493    |

The debt securities for which an unrealized loss is recorded are issues of the United States Treasury, Federal Home Loan Bank (a U. S. government agency), and general obligations of states and municipalities. The Company has the ability and the intent to hold the securities until they are called or mature at face value. Fluctuations in fair value reflect market conditions, and are not indicative of an other-than-temporary impairment of the investment.

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The amortized cost and estimated fair value of debt securities, by contractual maturity and the amount of pledged securities, follow. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

|                                         | December 31, 2005 |               | December 31, 2004 |               | December 31, 2003 |               |
|-----------------------------------------|-------------------|---------------|-------------------|---------------|-------------------|---------------|
|                                         | Amortized<br>cost | Fair<br>value | Amortized<br>cost | Fair<br>value | Amortized<br>cost | Fair<br>value |
| Available for sale                      |                   |               |                   |               |                   |               |
| Within one year                         | \$ -              | \$ -          | \$ -              | \$ -          | \$ 3,997,243      | \$ 4,021,251  |
| After one year<br>through five<br>years | 200,000           | 196,141       | 100,000           | 101,034       | -                 | -             |
| After ten years                         | 1,995,197         | 2,587,187     | 1,994,909         | 2,554,687     | 1,994,619         | 2,559,062     |
|                                         | \$ 2,195,197      | \$ 2,783,328  | \$ 2,094,909      | \$ 2,655,721  | \$ 5,991,862      | \$ 6,580,313  |
| Held to maturity due                    |                   |               |                   |               |                   |               |
| Within one year                         | \$74,014,166      | \$73,304,862  | \$72,905,414      | \$72,619,263  | \$72,871,344      | \$73,184,592  |
| After one year<br>through five<br>years | 38,564,996        | 38,001,666    | 83,124,031        | 82,488,435    | 76,795,462        | 76,890,618    |
|                                         | \$112,579,162     | \$111,306,528 | \$156,029,445     | \$155,107,698 | \$149,666,806     | \$150,075,210 |
| Pledged securities                      | \$26,980,663      | \$26,656,250  | \$27,289,502      | \$27,610,734  | \$21,790,367      | \$21,870,641  |

Investments are pledged to secure deposits of federal and local governments. Pledged securities also serve as collateral for securities sold under agreements to repurchase.

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Calvin B. Taylor Bankshares, Inc.  
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#### 4. Lines of Credit

The Company has available lines of credit, including overnight federal funds, reverse repurchase agreements and letters of credit, totaling \$19,000,000 as of December 31, 2005, 2004, and 2003.

#### 5. Loans and Allowance for Loan Losses

Major classifications of loans are as follows:

|              | 2005          | 2004          | 2003          |
|--------------|---------------|---------------|---------------|
| Commerical   | \$ 21,461,593 | \$ 14,007,430 | \$ 13,199,879 |
| Real estate  | 170,277,344   | 141,029,581   | 134,492,195   |
| Construction | 12,678,430    | 6,640,665     | 14,107,588    |
| Consumer     | 2,215,299     | 2,010,407     | 2,630,623     |
|              | 206,632,666   | 163,688,083   | 164,430,285   |

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|                           |               |               |               |
|---------------------------|---------------|---------------|---------------|
| Allowance for loan losses | 2,190,709     | 2,177,926     | 2,187,277     |
| Loans, net                | \$204,441,957 | \$161,510,157 | \$162,243,008 |

The rate repricing distribution of the loan portfolio follows:

|                        |               |               |               |
|------------------------|---------------|---------------|---------------|
| Immediately            | \$201,175,220 | \$159,522,150 | \$160,730,764 |
| Within one year        | 1,351,581     | 1,240,935     | 1,405,338     |
| Over one to five years | 2,849,940     | 2,107,774     | 2,031,134     |
| Over five years        | 1,255,925     | 817,224       | 263,049       |
|                        | \$206,632,666 | \$163,688,083 | \$164,430,285 |

The Company makes loans to customers located primarily in the Delmarva region. Although the loan portfolio is diversified, its performance will be influenced by the economy of the region.

Transactions in the allowance for loan losses were as follows:

|                                 | 2005         | 2004         | 2003         |
|---------------------------------|--------------|--------------|--------------|
| Beginning balance               | \$ 2,177,926 | \$ 2,187,277 | \$ 2,181,135 |
| Provision charged to operations | -            | -            | -            |
| Recoveries                      | 20,914       | 4,523        | 9,565        |
|                                 | 2,198,840    | 2,191,800    | 2,190,700    |
| Loans charged off               | 8,131        | 13,874       | 3,423        |
| Ending balance                  | \$ 2,190,709 | \$ 2,177,926 | \$ 2,187,277 |

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### 5. Loans and Allowance for Loan Losses (Continued)

Amounts past due 90 days or more, and still accruing interest at December 31, are as follows:

|             | 2005       | 2004       | 2003       |
|-------------|------------|------------|------------|
| Commercial  | \$ 11,443  | \$ 151,063 | \$ 55,795  |
| Real estate | 119,741    | 200,278    | 251,658    |
| Consumer    | 533        | 40,335     | 7,942      |
|             | \$ 131,717 | \$ 391,676 | \$ 315,395 |

Management has identified no impaired loans at December 31, 2005, 2004, and 2003. There were no nonaccrual loans at December 31, 2005, 2004 or 2003.

### 6. Loan Commitments

Loan commitments are agreements to lend to customers as long as there is no violation of any conditions of the contracts. Loan commitments generally have interest at current market rates, fixed expiration dates, and may require payment of a fee. Letters of credit are commitments issued to guarantee the

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performance of a customer to a third party.

Loan commitments and letters of credit are made on the same terms, including collateral, as outstanding loans. The Company's exposure to loan loss in the event of nonperformance by the borrower is represented by the contract amount of the commitment.

Outstanding loan commitments, lines of credit, and letters of credit at December 31, are as follows:

|                                      | 2005          | 2004          | 2003          |
|--------------------------------------|---------------|---------------|---------------|
| Loan commitments and lines of credit |               |               |               |
| Construction and land development    | \$ 21,845,161 | \$ 7,294,592  | \$ 10,495,735 |
| Other                                | 24,252,637    | 21,276,025    | 15,036,346    |
|                                      | \$ 46,097,798 | \$ 28,570,617 | \$ 25,532,081 |
| Standby letters of credit            | \$ 1,272,000  | \$ 1,535,210  | \$ 2,957,508  |

### 7. Lease Commitments

The Company leases the land on which the Route 50 branch in East Berlin is located. The lease obligation, which expires August 31, 2009, requires payments as follows:

| Period | Minimum rentals |
|--------|-----------------|
| 2006   | \$ 15,000       |
| 2007   | 15,000          |
| 2008   | 15,000          |
| 2009   | 10,000          |
|        | \$ 55,000       |

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Calvin B. Taylor Bankshares, Inc.  
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### 8. Premises and Equipment

A summary of premises and equipment and the related depreciation is as follows:

|                            | Estimated useful life | 2005         | 2004         | 2003         |
|----------------------------|-----------------------|--------------|--------------|--------------|
| Land                       |                       | \$ 2,092,717 | \$ 2,076,097 | \$ 1,893,946 |
| Premises                   | 5 - 50 years          | 6,449,630    | 6,400,025    | 6,423,636    |
| Furniture and equipment    | 5 - 40 years          | 3,517,505    | 3,473,775    | 3,446,813    |
|                            |                       | 12,059,852   | 11,949,897   | 11,764,395   |
| Accumulated depreciation   |                       | 5,395,801    | 5,058,659    | 4,699,425    |
| Net premises and equipment |                       | \$ 6,664,051 | \$ 6,891,238 | \$ 7,064,970 |

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Depreciation expense \$ 508,624 \$ 539,102 \$ 541,647

9. Interest-bearing Deposits

Major classifications of interest-bearing deposits are as follows:

|                                                  | 2005          | 2004          | 2003          |
|--------------------------------------------------|---------------|---------------|---------------|
| NOW                                              | \$ 62,601,973 | \$ 68,892,269 | \$ 63,400,879 |
| Money market                                     | 46,464,340    | 49,362,532    | 50,168,501    |
| Savings                                          | 51,648,088    | 53,667,019    | 51,495,252    |
| Other time, including<br>certificates of deposit | 61,907,073    | 69,308,124    | 77,279,961    |
|                                                  | \$222,621,474 | \$241,229,944 | \$242,344,593 |

The rate repricing distribution of other time deposits follows:

|                                     |               |               |               |
|-------------------------------------|---------------|---------------|---------------|
| Three months or less                | \$ 20,059,735 | \$ 22,567,632 | \$ 26,832,009 |
| Over three through twelve<br>months | 28,184,281    | 34,055,564    | 35,832,764    |
| Over one through two years          | 13,663,057    | 12,684,928    | 14,615,188    |
|                                     | \$ 61,907,073 | \$ 69,308,124 | \$ 77,279,961 |

Included in other time deposits are certificates of deposit of \$100,000 or more as follows:

|                    |               |               |               |
|--------------------|---------------|---------------|---------------|
| Amount outstanding | \$ 17,878,226 | \$ 18,624,257 | \$ 20,037,763 |
| Interest expense   | \$ 337,314    | \$ 276,074    | \$ 324,822    |

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Calvin B. Taylor Bankshares, Inc.  
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10. Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase represent overnight borrowings from customers. The government agency securities that collateralize these agreements are owned by the Company but maintained in the custody of an unaffiliated bank designated by the Company. Additional information follows:

|                                                                | 2005         | 2004         | 2003         |
|----------------------------------------------------------------|--------------|--------------|--------------|
| Maximum month-end amount outstanding                           | \$ 8,720,287 | \$ 7,617,275 | \$ 6,542,540 |
| Average amount outstanding                                     | \$ 6,324,760 | \$ 5,020,784 | \$ 4,134,892 |
| Average rate paid during the year                              | .34%         | .17%         | .24%         |
| Investment securities underlying the<br>agreements at year end |              |              |              |
| Carrying value                                                 | \$18,986,750 | \$21,991,519 | \$16,993,472 |
| Estimated fair value                                           | \$18,805,000 | \$21,839,000 | \$17,051,000 |

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### 11. Note Payable

In 1999, the Company purchased real estate in Berlin, financing 100% of the purchase price. In 2003, an operations center was constructed on this site. This 6% unsecured note has a final maturity of September, 2011. The note requires principal payments as follows:

|      |           |
|------|-----------|
| 2006 | \$ 21,332 |
| 2007 | 22,647    |
| 2008 | 24,044    |
| 2009 | 25,527    |
| 2010 | 27,102    |
| 2011 | 21,417    |
|      | \$142,069 |

### 12. Profit Sharing Plan

In 1999, the Company adopted a defined contribution profit sharing plan under Section 401(k) of the Internal Revenue Code. The plan covers substantially all of the employees and allows discretionary Company contributions. Annually, the Board of Directors approves a discretionary contribution in addition to matching 50% of employee contributions to a maximum of 6% of the employee wages.

The total cost of the profit sharing plan for 2005, 2004, and 2003, was \$186,657, \$149,171, and \$170,395, respectively.

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### 13. Noninterest Expenses

The components of noninterest other operating expenses follow:

|                                         | 2005        | 2004        | 2003        |
|-----------------------------------------|-------------|-------------|-------------|
| Advertising                             | \$ 147,541  | \$ 145,583  | \$ 152,358  |
| Armored car service                     | 76,068      | 60,829      | 67,517      |
| ATM and debit card                      | 234,732     | 232,353     | 201,354     |
| Business and product development        | 78,399      | 70,720      | 66,480      |
| Computer software amortization          | 121,982     | 117,191     | 91,736      |
| Computer software maintenance contracts | 101,875     | 82,514      | 97,570      |
| Courier service                         | 105,148     | 103,922     | 93,457      |
| Deposit insurance                       | 42,098      | 45,403      | 46,975      |
| Director fees                           | 99,900      | 89,375      | 84,240      |
| Dues, donations, and subscriptions      | 94,385      | 81,328      | 80,842      |
| Liability insurance                     | 40,380      | 41,556      | 47,160      |
| Postage                                 | 179,462     | 169,569     | 168,083     |
| Professional fees                       | 65,090      | 22,745      | 37,551      |
| Stationery and supplies                 | 111,593     | 135,269     | 125,593     |
| Telephone                               | 152,464     | 123,012     | 117,602     |
| Miscellaneous                           | 279,742     | 238,628     | 237,027     |
|                                         | \$1,930,859 | \$1,759,997 | \$1,715,545 |



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### 14. Related Party Transactions

The executive officers and directors of the Company enter into loan transactions with the Bank in the ordinary course of business. The terms of these transactions are similar to the terms provided to other borrowers entering into similar loan transactions. Executive officers and directors make deposits in the Bank, and invest in uninsured non-deposit investment products. They receive the same rates and terms on insured deposit accounts and securities sold under agreements to repurchase as other customers with similar accounts.

| Related party loan activity                     | 2005          | 2004         | 2003          |
|-------------------------------------------------|---------------|--------------|---------------|
| Beginning balance                               | \$ 6,207,252  | \$ 9,156,940 | \$ 11,133,959 |
| Advances                                        | 23,755,489    | 9,146,486    | 8,550,318     |
|                                                 | 29,962,741    | 18,303,426   | 19,684,277    |
| Repayments                                      | 7,741,845     | 12,096,074   | 10,527,337    |
| Other decreases                                 | -             | 100          | -             |
| Ending balance                                  | \$ 22,220,896 | \$ 6,207,252 | \$ 9,156,940  |
| <br>Deposit and non-deposit investment balances |               |              |               |
|                                                 | \$ 6,670,094  | \$13,833,657 | \$ 9,466,866  |

The Company obtains legal services from a law firm in which one of the principal attorneys is also a member of the Board of Directors. Fees charged for these services are at similar rates charged by unrelated law firms for similar legal work. Amounts paid to this related party totaled \$13,438, and \$3,490 during the years ended December 31, 2005, and 2003, respectively. There were no payments to this related party during 2004.

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### 15. Income Taxes

The components of income tax expense are as follows:

|          | 2005        | 2004        | 2003        |
|----------|-------------|-------------|-------------|
| Current  |             |             |             |
| Federal  | \$3,339,742 | \$2,597,535 | \$2,613,587 |
| State    | 495,907     | 386,253     | 389,254     |
|          | 3,835,649   | 2,983,788   | 3,002,841   |
| Deferred | (81,749)    | 42,212      | 46,409      |
|          | \$3,753,900 | \$3,026,000 | \$3,049,250 |

The components of the deferred taxes are as follows:

|                           |            |          |            |
|---------------------------|------------|----------|------------|
| Provision for loan losses | \$ (4,774) | \$ 5,820 | \$ (2,372) |
| Nonaccrual loan interest  | -          | -        | 43         |
| Depreciation              | (42,854)   | 30,862   | 47,512     |

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|                                                         |             |           |           |
|---------------------------------------------------------|-------------|-----------|-----------|
| Discount accretion                                      | 3,113       | 5,367     | (128)     |
| Employee benefit                                        | (37,234)    | -         | -         |
| Net operating loss carryforward<br>for state income tax | -           | 163       | (163)     |
| Organization costs                                      | -           | -         | 1,517     |
|                                                         | \$ (81,749) | \$ 42,212 | \$ 46,409 |

The components of the net deferred tax liability are as follows:

|                                                            |              |              |              |
|------------------------------------------------------------|--------------|--------------|--------------|
| Deferred tax assets                                        |              |              |              |
| Allowance for loan losses                                  | \$ 602,449   | \$ 597,675   | \$ 603,495   |
| Employee benefit                                           | 37,234       | -            | -            |
| Net operating loss<br>carryforward for state<br>income tax | -            | -            | 163          |
|                                                            | 639,683      | 597,675      | 603,658      |
| Deferred tax liabilities                                   |              |              |              |
| Depreciation                                               | 256,119      | 298,974      | 268,112      |
| Discount accretion                                         | 21,875       | 18,762       | 13,395       |
| Unrealized gain on securities<br>available for sale        | 997,025      | 829,009      | 677,783      |
|                                                            | 1,275,019    | 1,146,745    | 959,290      |
| Net deferred tax liability                                 | \$ (635,336) | \$ (549,070) | \$ (355,632) |

A reconciliation of the provision for taxes on income from the statutory federal income tax rates to the effective income tax rates follows:

|                                                         |       |       |       |
|---------------------------------------------------------|-------|-------|-------|
| Statutory federal income tax rate                       | 34.0% | 34.0% | 34.0% |
| Increase (decrease) in tax rate<br>resulting from       |       |       |       |
| Tax-exempt income                                       | (1.5) | (2.0) | (1.5) |
| State income taxes net of federal<br>income tax benefit | 3.1   | 3.0   | 3.0   |
|                                                         | 35.6% | 35.0% | 35.5% |

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16. Fair Value of Financial Instruments

The estimated fair values of the Company's financial instruments are summarized below. The fair values of a significant portion of these financial instruments are estimates derived using present value techniques prescribed by the Financial Accounting Standards Board and may not be indicative of the net realizable or liquidation values. The calculation of estimated fair values is based on market conditions at a specific point in time and may not reflect current or future fair values.

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|                           | December 31, 2005 |               | December 31, 2004 |               | December 31, 2003 |               |
|---------------------------|-------------------|---------------|-------------------|---------------|-------------------|---------------|
|                           | Carrying amount   | Fair value    | Carrying amount   | Fair value    | Carrying amount   | Fair value    |
| Financial assets          |                   |               |                   |               |                   |               |
| Cash and due from banks   | \$ 24,069,790     | \$ 24,305,510 | \$ 21,901,546     | \$ 22,074,622 | \$ 20,482,866     | \$ 20,632,954 |
| Interest-bearing deposits | 2,192,731         | 2,149,957     | 2,161,496         | 2,163,186     | 2,281,337         | 2,305,344     |
| Investment securities     | 119,084,440       | 117,811,806   | 161,950,732       | 161,028,985   | 158,932,277       | 159,340,681   |
| Loans, net                | 204,441,957       | 204,438,718   | 161,510,157       | 161,534,247   | 162,243,008       | 162,289,522   |
| Financial liabilities     |                   |               |                   |               |                   |               |
| Interest-bearing deposits | \$222,621,474     | \$222,335,613 | \$241,229,944     | \$241,284,245 | \$242,344,593     | \$242,471,838 |
| Note payable              | 142,069           | 137,990       | 162,161           | 158,414       | 181,087           | 176,288       |

The fair value of federal funds sold, noninterest-bearing deposits, and securities sold under agreements to repurchase equals their carrying value.

The fair value of silver coin included with cash is determined based on quoted market prices.

The fair value of interest-bearing deposits with other financial institutions is estimated based on quoted interest rates for certificates of deposit with similar remaining terms.

The fair values of equity securities are determined using market quotations. The fair values of debt securities, which are provided by an independent third party, are estimated using a matrix that considers yield to maturity, credit quality, and marketability.

The fair value of fixed-rate loans is estimated to be the present value of scheduled payments discounted using interest rates currently in effect for loans of the same class and term. The fair value of variable-rate loans, including loans with a demand feature, is estimated to equal the carrying amount. The valuation of loans is adjusted for possible loan losses.

The fair value of interest-bearing checking, savings, and money market deposit accounts is equal to the carrying amount. The fair value of fixed-rate time deposits is estimated based on interest rates currently offered for deposits of similar remaining maturities.

It is not practicable to estimate the fair value of outstanding loan commitments, unused lines, and letters of credit.

17. Capital Standards

The Federal Reserve Board and the Federal Deposit Insurance Corporation have adopted risk-based capital standards for banking organizations. These

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standards require ratios of capital to assets for minimum capital adequacy and to be classified as well capitalized under prompt corrective action provisions. The capital ratios and minimum capital adequacy requirements of the Company and the Bank are as follows:

| (in thousands)                        | Company<br>Actual |       | Bank<br>Actual |       | To be well<br>capitalized<br>Ratio | Minimum<br>adequacy<br>Ratio |
|---------------------------------------|-------------------|-------|----------------|-------|------------------------------------|------------------------------|
|                                       | Amount            | Ratio | Amount         | Ratio |                                    |                              |
| December 31, 2005                     |                   |       |                |       |                                    |                              |
| Total risk-based capital              |                   |       |                |       |                                    |                              |
| (to risk weighted assets)             | \$67,783          | 35.2% | \$62,749       | 32.9% | 10.0%                              | 8.0%                         |
| Tier 1 capital                        |                   |       |                |       |                                    |                              |
| (to risk-weighted assets)             | \$64,663          | 33.5% | \$60,558       | 31.7% | 6.0%                               | 4.0%                         |
| Tier 1 capital                        |                   |       |                |       |                                    |                              |
| (to average fourth<br>quarter assets) | \$64,663          | 16.2% | \$60,558       | 15.4% | 5.0%                               | 4.0%                         |
| December 31, 2004                     |                   |       |                |       |                                    |                              |
| Total risk-based capital              |                   |       |                |       |                                    |                              |
| (to risk weighted assets)             | \$67,862          | 43.3% | \$63,174       | 41.3% | 10.0%                              | 8.0%                         |
| Tier 1 capital                        |                   |       |                |       |                                    |                              |
| (to risk-weighted assets)             | \$65,313          | 41.7% | \$61,260       | 40.1% | 6.0%                               | 4.0%                         |
| Tier 1 capital                        |                   |       |                |       |                                    |                              |
| (to average fourth<br>quarter assets) | \$65,313          | 16.0% | \$61,260       | 15.3% | 5.0%                               | 4.0%                         |
| December 31, 2003                     |                   |       |                |       |                                    |                              |
| Total risk-based capital              |                   |       |                |       |                                    |                              |
| (to risk weighted assets)             | \$65,082          | 39.1% | \$60,447       | 37.1% | 10.0%                              | 8.0%                         |
| Tier 1 capital                        |                   |       |                |       |                                    |                              |
| (to risk-weighted assets)             | \$62,488          | 37.6% | \$58,410       | 35.9% | 6.0%                               | 4.0%                         |
| Tier 1 capital                        |                   |       |                |       |                                    |                              |
| (to average fourth<br>quarter assets) | \$62,488          | 16.0% | \$58,410       | 14.9% | 5.0%                               | 4.0%                         |

Tier 1 capital consists of common stock, additional paid-in capital, and retained earnings. Total risk-based capital includes a limited amount of the allowance for loan losses. In calculating risk-weighted assets, specific risk percentages are applied to each category of asset and off-balance sheet items.

Failure to meet the capital requirements could affect the Company's ability to pay dividends and accept deposits, and may significantly affect the operations of the Company.

In the most recent regulatory report, the Company was determined to be well capitalized. Management has no plans that should change the classification of the capital adequacy.

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Balance Sheets

|                                            | December 31,  |               |               |
|--------------------------------------------|---------------|---------------|---------------|
|                                            | 2005          | 2004          | 2003          |
| Assets                                     |               |               |               |
| Cash and due from banks                    | \$ 18,212     | \$ 10,651     | \$ 52,244     |
| Interest-bearing deposits                  | 561,527       | 530,291       | 650,132       |
| Investment securities available for sale   | 3,721,949     | 3,265,566     | 2,685,158     |
| Investment securities held to maturity     | 502,064       | 503,156       | 499,692       |
| Investment in subsidiary bank              | 60,945,846    | 61,630,473    | 58,798,328    |
| Premises and equipment                     | 1,281,065     | 1,311,740     | 1,342,696     |
| Other assets                               | 4,467,685     | 77,742        | 163,001       |
| Total assets                               | \$ 71,498,348 | \$ 67,329,619 | \$ 64,191,251 |
| Liabilities and Stockholders' Equity       |               |               |               |
| Dividend payable                           | \$ 4,462,578  | \$ -          | \$ -          |
| Deferred income taxes                      | 709,207       | 552,841       | 393,950       |
| Other liabilities                          | 8,179         | 79,210        | 161,269       |
|                                            | 5,179,964     | 632,051       | 555,219       |
| Stockholders' equity                       |               |               |               |
| Common stock                               | 3,187,556     | 3,208,478     | 3,227,966     |
| Additional paid-in capital                 | 15,454,735    | 16,187,005    | 16,869,085    |
| Retained earnings                          | 46,021,128    | 45,917,427    | 42,391,363    |
| Accumulated other comprehensive income     | 1,654,965     | 1,384,658     | 1,147,618     |
| Total stockholders' equity                 | 66,318,384    | 66,697,568    | 63,636,032    |
| Total liabilities and stockholders' equity | \$ 71,498,348 | \$ 67,329,619 | \$ 64,191,251 |

Statements of Income  
Years Ended December 31,

|                                              | 2005         | 2004         | 2003         |
|----------------------------------------------|--------------|--------------|--------------|
| Interest revenue                             | \$ 24,671    | \$ 19,480    | \$ 12,678    |
| Dividend revenue                             | 55,518       | 48,676       | 43,227       |
| Dividends from subsidiary                    | 2,984,551    | 2,721,640    | 2,936,869    |
| Equity in undistributed income of subsidiary | 3,759,919    | 2,850,387    | 2,562,464    |
| Rental income and other fees                 | -            | -            | 2,028        |
|                                              | 6,824,659    | 5,640,183    | 5,557,266    |
| Expenses                                     |              |              |              |
| Occupancy                                    | 2,087        | 3,251        | 3,777        |
| Furniture and equipment                      | -            | -            | 1,167        |
| Other                                        | 21,034       | 22,745       | 20,272       |
|                                              | 23,121       | 25,996       | 25,216       |
| Income before income taxes                   | 6,801,538    | 5,614,187    | 5,532,050    |
| Income taxes (benefit)                       | 3,900        | 1,000        | (8,164)      |
| Net income                                   | \$ 6,797,638 | \$ 5,613,187 | \$ 5,540,214 |

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## and Subsidiary Notes to Consolidated Financial Statements

### 18. Parent Company Financial Information (Continued)

| Statements of Cash Flows                                                           | Years Ended December 31, |              |              |
|------------------------------------------------------------------------------------|--------------------------|--------------|--------------|
|                                                                                    | 2005                     | 2004         | 2003         |
| Cash flows from operating activities                                               |                          |              |              |
| Interest and dividends received                                                    | \$ 3,065,338             | \$ 2,789,328 | \$ 2,992,141 |
| Rental payments and fees received                                                  | 33,619                   | 33,600       | 35,629       |
| Cash paid for operating expenses                                                   | (26,047)                 | (28,639)     | (26,197)     |
| Income taxes refunded (paid)                                                       | (4,194)                  | 1,310        | (100,483)    |
|                                                                                    | 3,068,716                | 2,795,599    | 2,901,090    |
| Cash flows from investing activities                                               |                          |              |              |
| Certificates of deposit purchased,<br>net of maturities                            | (1,923)                  | (564)        | (500,000)    |
| Purchase of investments available<br>for sale                                      | (45,379)                 | (164,504)    | (182,500)    |
| Proceeds from maturities of investments<br>held to maturity                        | -                        | 500,000      | -            |
| Purchase of investments held to maturity                                           | -                        | (503,842)    | -            |
|                                                                                    | (47,302)                 | (168,910)    | (682,500)    |
| Cash flows from financing activities                                               |                          |              |              |
| Common shares repurchased                                                          | (753,192)                | (701,568)    | (432,949)    |
| Dividends paid                                                                     | (2,231,359)              | (2,087,123)  | (1,936,869)  |
|                                                                                    | (2,984,551)              | (2,788,691)  | (2,369,818)  |
| Net increase (decrease) in cash                                                    | 36,863                   | (162,002)    | (151,228)    |
| Cash at beginning of year                                                          | 40,374                   | 202,376      | 353,604      |
| Cash at end of year                                                                | \$ 77,237                | \$ 40,374    | \$ 202,376   |
| Reconciliation of net income to net cash<br>provided by operating activities       |                          |              |              |
| Net income                                                                         | \$ 6,797,638             | \$ 5,613,187 | \$ 5,540,214 |
| Adjustments to reconcile net income<br>to net cash used in operating<br>activities |                          |              |              |
| Undistributed net income of<br>subsidiary                                          | (3,759,919)              | (2,850,387)  | (2,562,464)  |
| Amortization of premiums and<br>accretion of discounts                             | 1,092                    | 21           | (462)        |
| Depreciation                                                                       | 30,675                   | 30,957       | 32,619       |
| Decrease (increase) in other<br>assets                                             | (4,389,943)              | 85,259       | (159,371)    |
| Increase (decrease) in Deferred<br>income taxes and other<br>liabilities           | 4,389,173                | (83,438)     | 50,554       |
|                                                                                    | \$ 3,068,716             | \$ 2,795,599 | \$ 2,901,090 |
| Composition of cash and cash equivalents                                           |                          |              |              |
| Cash and due from banks                                                            | \$ 18,212                | \$ 10,650    | \$ 52,244    |
| Interest-bearing deposits, except<br>for time deposits                             | 59,025                   | 29,724       | 150,132      |
|                                                                                    | \$ 77,237                | \$ 40,374    | \$ 202,376   |

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Calvin B. Taylor Bankshares, Inc.  
And Subsidiary  
Notes to Consolidated Financial Statements

19. Quarterly Results of Operations (Unaudited)

|                               | December 31, | September 30, | Three months ended<br>June 30, | March 31,   |
|-------------------------------|--------------|---------------|--------------------------------|-------------|
| 2005                          |              |               |                                |             |
| Interest and dividend revenue | \$4,793,757  | \$4,656,566   | \$4,289,745                    | \$3,941,151 |
| Interest expense              | 560,574      | 458,851       | 388,934                        | 361,014     |
| Net interest income           | 4,233,183    | 4,197,715     | 3,900,811                      | 3,580,137   |
| Provision for loan losses     | -            | -             | -                              | -           |
| Net income                    | 1,703,943    | 1,905,371     | 1,687,865                      | 1,500,459   |
| Comprehensive income          | 1,686,643    | 1,883,824     | 1,900,312                      | 1,597,166   |
| Earnings per share            | \$0.53       | \$0.60        | \$0.53                         | \$0.47      |
| 2004                          |              |               |                                |             |
| Interest and dividend revenue | \$3,954,857  | \$3,820,243   | \$3,733,533                    | \$3,743,122 |
| Interest expense              | 384,375      | 382,761       | 384,221                        | 402,537     |
| Net interest income           | 3,570,482    | 3,437,482     | 3,349,312                      | 3,340,585   |
| Provision for loan losses     | -            | -             | -                              | -           |
| Net income                    | 1,451,346    | 1,447,964     | 1,371,093                      | 1,342,784   |
| Comprehensive income          | 1,564,420    | 1,663,271     | 1,235,704                      | 1,386,832   |
| Earnings per share            | \$0.45       | \$0.45        | \$0.43                         | \$0.42      |
| 2003                          |              |               |                                |             |
| Interest and dividend revenue | \$3,826,749  | \$3,934,534   | \$4,024,543                    | \$3,993,421 |
| Interest expense              | 435,526      | 473,779       | 559,096                        | 663,557     |
| Net interest income           | 3,391,223    | 3,460,755     | 3,465,447                      | 3,329,864   |
| Provision for loan losses     | -            | -             | -                              | -           |
| Net income                    | 1,308,544    | 1,429,125     | 1,450,040                      | 1,352,505   |
| Comprehensive income          | 1,372,451    | 1,288,388     | 1,994,551                      | 1,335,174   |
| Earnings per share            | \$0.40       | \$0.44        | \$0.45                         | \$0.42      |

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