

PEOPLES FINANCIAL CORP /MS/  
Form 10-Q  
November 13, 2014

**SECURITIES AND EXCHANGE COMMISSION**

**Washington, D.C. 20549**

**FORM 10-Q**

**x QUARTERLY REPORT PURSUANT TO SECTION 13 or 15 (D) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**For the quarterly period ended September 30, 2014**

**or**

**.. TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (D) OF THE SECURITIES EXCHANGE  
ACT OF 1934**

**Commission File Number 001-12103**

**PEOPLES FINANCIAL CORPORATION**

**(Exact name of registrant as specified in its charter)**

**Mississippi  
(State or other jurisdiction of**

**64-0709834  
(I.R.S. Employer**

**incorporation or organization)**

**Identification No.)**

**Lameuse and Howard Avenues,**

**Biloxi, Mississippi**  
**(Address of principal executive offices)**

**39533**  
**(Zip Code)**

**(228) 435-5511**

**(Registrant's telephone number, including area code)**

Indicate by check mark whether the registrant (1) has 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 whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files.) Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer  (Do not check if a smaller reporting company)

Smaller reporting company

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

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the last practicable date. Peoples Financial Corporation has only one class of common stock authorized. At October 31, 2014, there were 15,000,000 shares of \$1 par value common stock authorized, with 5,123,186 shares issued and outstanding.

**Part 1 - Financial Information****Item 1: Financial Statements****Peoples Financial Corporation and Subsidiaries****Consolidated Statements of Condition****(in thousands except share data)**

	<b>September 30, 2014 (unaudited)</b>	<b>December 31, 2013 (audited)</b>
<b>Assets</b>		
Cash and due from banks	\$ 31,379	\$ 36,264
Federal funds sold	25,000	
Available for sale securities	263,045	275,440
Held to maturity securities, fair value of \$15,586 at September 30, 2014; \$10,686 at December 31, 2013	15,617	11,142
Other investments	3,026	3,262
Federal Home Loan Bank Stock, at cost	4,302	3,834
Loans	358,192	375,349
Less: Allowance for loan losses	11,010	8,934
Loans, net	347,182	366,415
Bank premises and equipment, net of accumulated depreciation	24,105	25,308
Other real estate	9,710	9,630
Accrued interest receivable	2,206	2,607
Cash surrender value of life insurance	17,896	17,456
Other assets	9,802	10,906
<b>Total assets</b>	<b>\$ 753,270</b>	<b>\$ 762,264</b>

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Condition (continued)**

(in thousands except share data)

	September 30, 2014 (unaudited)	December 31, 2013 (audited)
<b>Liabilities and Shareholders Equity</b>		
<b>Liabilities:</b>		
Deposits:		
Demand, non-interest bearing	\$ 134,954	\$ 107,117
Savings and demand, interest bearing	232,508	217,005
Time, \$100,000 or more	41,056	60,519
Other time deposits	41,186	43,917
Total deposits	449,704	428,558
Federal funds purchased and securities sold under agreements to repurchase	120,774	139,639
Borrowings from Federal Home Loan Bank	62,505	77,684
Employee and director benefit plans liabilities	13,497	12,725
Other liabilities	4,417	4,511
<b>Total liabilities</b>	<b>650,897</b>	<b>663,117</b>
<b>Shareholders Equity:</b>		
Common stock, \$1 par value, 15,000,000 shares authorized, 5,123,186 shares issued and outstanding at September 30, 2014 and December 31, 2013	5,123	5,123
Surplus	65,780	65,780
Undivided profits	32,862	34,259
Accumulated other comprehensive loss, net of tax	(1,392)	(6,015)
<b>Total shareholders equity</b>	<b>102,373</b>	<b>99,147</b>
<b>Total liabilities and shareholders equity</b>	<b>\$ 753,270</b>	<b>\$ 762,264</b>

See notes to consolidated financial statements.



## Peoples Financial Corporation and Subsidiaries

## Consolidated Statements of Operations

(in thousands except per share data)(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2014	2013	2014	2013
<b>Interest income:</b>				
Interest and fees on loans	\$ 3,867	\$ 4,217	\$ 12,284	\$ 12,995
<b>Interest and dividends on securities:</b>				
U.S. Treasuries	159	139	473	430
U.S. Government agencies	785	828	2,390	2,307
Mortgage-backed securities	234	228	720	458
States and political subdivisions	405	384	1,169	1,140
Other investments	12	6	16	12
Interest on federal funds sold	5	3	12	67
<b>Total interest income</b>	<b>5,467</b>	<b>5,805</b>	<b>17,064</b>	<b>17,409</b>
<b>Interest expense:</b>				
Deposits	482	293	965	928
Borrowings from Federal Home Loan Bank	66	43	172	124
Federal funds purchased and securities sold under agreements to repurchase	23	38	72	127
<b>Total interest expense</b>	<b>571</b>	<b>374</b>	<b>1,209</b>	<b>1,179</b>
<b>Net interest income</b>	<b>4,896</b>	<b>5,431</b>	<b>15,855</b>	<b>16,230</b>
<b>Provision for allowance for loan losses</b>	<b>3,541</b>	<b>542</b>	<b>4,615</b>	<b>4,619</b>
<b>Net interest income after provision for allowance for loan losses</b>	<b>\$ 1,355</b>	<b>\$ 4,889</b>	<b>\$ 11,240</b>	<b>\$ 11,611</b>

**Peoples Financial Corporation and Subsidiaries**  
**Consolidated Statements of Operations (continued)**  
(in thousands except per share data)(unaudited)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Non-interest income:</b>				
Trust department income and fees	\$ 391	\$ 368	\$ 1,108	\$ 1,062
Service charges on deposit accounts	1,437	1,618	4,656	4,649
Gain on sales and calls of securities		3		258
Income (loss) from other investments	(30)	36		45
Increase in cash surrender value of life insurance	115	121	360	364
Other income	166	160	452	460
<b>Total non-interest income</b>	<b>2,079</b>	<b>2,306</b>	<b>6,576</b>	<b>6,838</b>
<b>Non-interest expense:</b>				
Salaries and employee benefits	3,002	3,005	9,417	8,996
Net occupancy	600	544	1,867	1,780
Equipment rentals, depreciation and maintenance	748	722	2,321	2,164
FDIC assessments	259	162	799	607
Data processing	328	305	1,004	925
ATM expense	657	635	2,072	1,826
Other expense	893	1,041	2,799	2,742
<b>Total non-interest expense</b>	<b>6,487</b>	<b>6,414</b>	<b>20,279</b>	<b>19,040</b>
<b>Income (loss) before income tax benefit</b>	<b>(3,053)</b>	<b>781</b>	<b>(2,463)</b>	<b>(591)</b>
Income tax benefit	(1,254)	(105)	(1,578)	(936)
<b>Net income (loss)</b>	<b>\$ (1,799)</b>	<b>\$ 886</b>	<b>\$ (885)</b>	<b>\$ 345</b>
<b>Basic and diluted earnings (loss) per share</b>	<b>\$ (.35)</b>	<b>\$ .18</b>	<b>\$ (.17)</b>	<b>\$ .07</b>
<b>Dividends declared per share</b>	<b>\$</b>	<b>\$</b>	<b>\$ .10</b>	<b>\$</b>



See notes to consolidated financial statements.

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Comprehensive Income (Loss)**

(in thousands)(unaudited)

	<b>Three Months Ended</b>		<b>Nine Months Ended</b>	
	<b>September 30,</b>		<b>September 30,</b>	
	<b>2014</b>	<b>2013</b>	<b>2014</b>	<b>2013</b>
<b>Net income (loss)</b>	\$ (1,799)	\$ 886	\$ (885)	\$ 345
<b>Other comprehensive income (loss), net of tax:</b>				
Net unrealized gain (loss) on available for sale securities, net of tax of \$294 and \$981 for the three months ended September 30, 2014 and 2013, respectively, and \$2,382 and \$4,439 for the nine months ended September 30, 2014 and 2013, respectively	570	(1,904)	4,623	(8,617)
Reclassification adjustment for realized gains on available for sale securities called or sold, net of tax of \$1 for the three months ended September 30, 2013 and \$88 for the nine months ended September 30, 2013		(2)		(170)
<b>Total other comprehensive income (loss)</b>	570	(1,906)	4,623	(8,787)
<b>Total comprehensive income (loss)</b>	\$ (1,229)	\$ (1,020)	\$ 3,738	\$ (8,442)

See notes to consolidated financial statements.

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statement of Changes in Shareholders' Equity**

(in thousands except share and per share data)

	Number of Common Shares	Common Stock	Surplus	Accumulated		Total
				Undivided Profits	Other Comprehensive Loss	
<b>Balance, January 1, 2014</b>	5,123,186	\$ 5,123	\$ 65,780	\$ 34,259	\$ (6,015)	\$ 99,147
Net loss				(885)		(885)
Other comprehensive income, net of tax					4,623	4,623
Cash dividends (\$.10 per share)				(512)		(512)
<b>Balance, September 30, 2014</b>	5,123,186	\$ 5,123	\$ 65,780	\$ 32,862	\$ (1,392)	\$ 102,373

Note: Balances as of January 1, 2014 were audited.

See notes to consolidated financial statements.

**Peoples Financial Corporation and Subsidiaries**

**Consolidated Statements of Cash Flows**

(in thousands)(unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Cash flows from operating activities:</b>		
<b>Net income (loss)</b>	\$ (885)	\$ 345
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Depreciation	1,364	1,331
Provision for allowance for loan losses	4,615	4,619
Loss on sales of other real estate	80	59
Writedown of other real estate	219	46
Gain on sales of bank premises and equipment		(15)
Income from other investments		(45)
Gain on sales and calls of securities		(258)
Accretion of held to maturity securities	(2)	(2)
Change in accrued interest receivable	401	224
Increase in cash surrender value of life insurance	(360)	(364)
Change in other assets	964	756
Change in other liabilities	(1,562)	(1,393)
<b>Net cash provided by operating activities</b>	<b>\$ 4,834</b>	<b>\$ 5,303</b>

**Peoples Financial Corporation and Subsidiaries**  
**Consolidated Statements of Cash Flows (continued)**  
(in thousands) (unaudited)

	<b>Nine Months Ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Cash flows from investing activities:</b>		
Proceeds from maturities, sales and calls of available for sale securities	\$ 21,193	\$ 125,329
Proceeds from maturities of held to maturity securities	215	
Purchases of available for sale securities	(1,795)	(174,169)
Purchases of held to maturity securities	(4,688)	(4,670)
Purchases of Federal Home Loan Bank stock	(468)	(685)
Redemption of other investments	236	230
Proceeds from sales of bank premises and equipment		19
Proceeds from sales of other real estate	765	1,115
Insurance proceeds from casualty loss on other real estate		57
Loans, net change	13,474	29,186
Acquisition of bank premises and equipment	(161)	(806)
Investment in cash surrender value of life insurance	(80)	(77)
<b>Net cash provided by (used in) investing activities</b>	<b>28,691</b>	<b>(24,471)</b>
<b>Cash flows from financing activities:</b>		
Demand and savings deposits, net change	43,340	16,003
Time deposits, net change	(22,194)	(28,758)
Cash dividends	(512)	
Retirement of common stock		(181)
Borrowings from Federal Home Loan Bank	1,667,500	212,500
Repayments to Federal Home Loan Bank	(1,682,679)	(153,170)
Federal funds purchased and securities sold under agreements to repurchase, net change	(18,865)	(46,604)
<b>Net cash used in financing activities</b>	<b>(13,410)</b>	<b>(210)</b>
<b>Net decrease in cash and cash equivalents</b>	<b>20,115</b>	<b>(19,378)</b>

<b>Cash and cash equivalents, beginning of period</b>	36,264	54,020
<b>Cash and cash equivalents, end of period</b>	\$ 56,379	\$ 34,642

See notes to consolidated financial statements.

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PEOPLES FINANCIAL CORPORATION AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

For the Nine Months Ended September 30, 2014 and 2013

1. Basis of Presentation:

Peoples Financial Corporation (the Company) is a one-bank holding company headquartered in Biloxi, Mississippi. It has two operating subsidiaries, PFC Service Corp., an inactive company, and The Peoples Bank, Biloxi, Mississippi (the Bank). The Bank provides a full range of banking, financial and trust services to state, county and local government entities and individuals and small and commercial businesses operating in those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the Bank's three most outlying locations (the trade area).

The accompanying unaudited consolidated financial statements and notes thereto contain all adjustments, consisting only of normal recurring adjustments, necessary to present fairly, in accordance with accounting principles generally accepted in the United States of America (GAAP), the financial position of the Company and its subsidiaries as of September 30, 2014 and the results of their operations and their cash flows for the periods presented. The interim financial information should be read in conjunction with the annual consolidated financial statements and the notes thereto included in the Company's 2013 Annual Report and Form 10-K.

The results of operations for the quarter or nine months ended September 30, 2014, are not necessarily indicative of the results to be expected for the full year.

Use of Estimates - The preparation of financial statements in conformity with GAAP 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 consolidated financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from those estimates. Material estimates common to the banking industry that are particularly susceptible to significant change in the near term include, but are not limited to, the determination of the allowance for loan losses, the valuation of other real estate acquired in connection with foreclosure or in satisfaction of loans and valuation allowances associated with the realization of deferred tax assets, which are based on future taxable income.

Summary of Significant Accounting Policies - The accounting and reporting policies of the Company conform with GAAP and general practices within the banking industry. There have been no material changes or developments in the application of principles or in our evaluation of the accounting estimates and the underlying assumptions or methodologies that we believe to be Critical Accounting Policies as disclosed in our Form 10-K for the year ended December 31, 2013.

New Accounting Pronouncements - In April 2014, the Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) No. 2014-06, *Technical Corrections and Improvements Related to Glossary Terms*. This ASU added, deleted, corrected and modified terms in the Master Glossary of the Codification and was effective upon issuance. The adoption of this ASU did not have a material effect on the Company's financial position, results of operations or cash flows. In August 2014, the FASB issued ASU No. 2014-14, *Receivables - Troubled Debt*

*Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure.* This ASU requires that a mortgage loan be derecognized and a separate other receivable be recognized upon foreclosure if certain conditions are met. ASU No. 2014-14 is effective for annual periods and interim periods within those annual periods beginning after December 31, 2014. In August 2014, the FASB issued ASU No. 2014-15, *Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern.* This ASU defines management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 is effective for annual periods ending after December 31, 2016, and interim periods within annual periods beginning after December 14, 2016. The adoption of ASU 2014-14 and ASU 2014-15 is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

## 2. Earnings Per Share:

Per share data is based on the weighted average shares of common stock outstanding of 5,123,186 and 5,123,316 for the quarters ended September 30, 2014 and 2013, respectively, and 5,123,186 and 5,130,811 for the nine months ended September 30, 2014 and 2013, respectively.

## 3. Statements of Cash Flows:

The Company has defined cash and cash equivalents as cash and due from banks and federal funds sold. The Company paid \$1,209,501 and \$1,198,021 for the nine months ended September 30, 2014 and 2013, respectively, for interest on deposits and borrowings. Income tax payments of \$320,000 and \$810,000 were made during the nine months ended September 30, 2014 and 2013, respectively. Loans transferred to other real estate amounted to \$1,143,953 and \$3,695,825 during the nine months ended September 30, 2014 and 2013, respectively.



## 4. Investments:

The amortized cost and fair value of securities at September 30, 2014 and December 31, 2013, are as follows (in thousands):

September 30, 2014	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for sale securities:</b>				
<b>Debt securities:</b>				
U.S. Treasuries	\$ 37,669	\$ 146	\$ (537)	\$ 37,278
U.S. Government agencies	148,813	724	(5,462)	144,075
Mortgage-backed securities	46,400	423	(452)	46,371
States and political subdivisions	33,345	1,326		34,671
<b>Total debt securities</b>	<b>266,227</b>	<b>2,619</b>	<b>(6,451)</b>	<b>262,395</b>
Equity securities	650			650
<b>Total available for sale securities</b>	<b>\$ 266,877</b>	<b>\$ 2,619</b>	<b>\$ (6,451)</b>	<b>\$ 263,045</b>
<b>Held to maturity securities:</b>				
States and political subdivisions	\$ 15,617	\$ 73	\$ (104)	\$ 15,586
<b>Total held to maturity securities</b>	<b>\$ 15,617</b>	<b>\$ 73</b>	<b>\$ (104)</b>	<b>\$ 15,586</b>

December 31, 2013	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for sale securities:</b>				
<b>Debt securities:</b>				
U.S. Treasuries	\$ 44,636	\$ 54	\$ (1,042)	\$ 43,648
U.S. Government agencies	155,772	734	(10,701)	145,805
Mortgage-backed securities	51,454	141	(1,269)	50,326
States and political subdivisions	33,764	1,248	(1)	35,011
<b>Total debt securities</b>	<b>285,626</b>	<b>2,177</b>	<b>(13,013)</b>	<b>274,790</b>
Equity securities	650			650
<b>Total available for sale securities</b>	<b>\$ 286,276</b>	<b>\$ 2,177</b>	<b>\$ (13,013)</b>	<b>\$ 275,440</b>
<b>Held to maturity securities:</b>				
States and political subdivisions	\$ 11,142	\$ 13	\$ (469)	\$ 10,686
<b>Total held to maturity securities</b>	<b>\$ 11,142</b>	<b>\$ 13</b>	<b>\$ (469)</b>	<b>\$ 10,686</b>

The amortized cost and fair value of debt securities at September 30, 2014 (in thousands), by contractual maturity, are shown on the next page. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Amortized Cost	Fair Value
Available for sale securities:		
Due in one year or less	\$ 7,583	\$ 7,661
Due after one year through five years	66,926	67,065
Due after five years through ten years	58,613	58,927
Due after ten years	86,705	82,371
Mortgage-backed securities	46,400	46,371
Totals	\$ 266,227	\$ 262,395
Held to maturity securities:		
Due in one year or less	\$ 657	\$ 659
Due after one year through five years	3,638	3,655
Due after five years through ten years	5,875	5,896
Due after ten years	5,447	5,376
Totals	\$ 15,617	\$ 15,586

Available for sale and held to maturity securities with gross unrealized losses at September 30, 2014 and December 31, 2013, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows (in thousands):

	Less Than Twelve Months		Over Twelve Months		Total	
	Gross Unrealized		Gross Unrealized		Gross Unrealized	
	Fair Value	Losses	Fair Value	Losses	Fair Value	Losses
September 30, 2014:						
U.S. Treasuries	\$ 4,936	\$ 47	\$ 25,300	\$ 490	\$ 30,236	\$ 537
U.S. Government agencies	4,931	42	111,427	5,420	116,358	5,462
Mortgage-backed securities			28,317	452	28,317	452
States and political subdivisions	3,846	40	4,055	64	7,901	104
<b>TOTAL</b>	<b>\$ 13,713</b>	<b>\$ 129</b>	<b>\$ 169,099</b>	<b>\$ 6,426</b>	<b>\$ 182,812</b>	<b>\$ 6,555</b>
December 31, 2013:						
U.S. Treasuries	\$ 29,708	\$ 1,042	\$	\$	\$ 29,708	\$ 1,042
U.S. Government agencies	113,446	10,322	4,621	379	118,067	10,701
Mortgage-backed securities	44,269	1,269			44,269	1,269
States and political subdivisions	7,690	470			7,690	470
<b>TOTAL</b>	<b>\$ 195,113</b>	<b>\$ 13,103</b>	<b>\$ 4,621</b>	<b>\$ 379</b>	<b>\$ 199,734</b>	<b>\$ 13,482</b>

At September 30, 2014, 7 of the 10 securities issued by the U.S. Treasury, 23 of the 29 securities issued by U.S. Government agencies, 7 of the 13 mortgage-backed securities and 21 of the 157 securities issued by states and political subdivisions contained unrealized losses.

Management evaluates securities for other-than-temporary impairment on a monthly basis. In performing this evaluation, the length of time and the extent to which the fair value has been less than cost, the fact that the Company's securities are primarily issued by U.S. Treasury and U.S. Government Agencies and the cause of the decline in value are considered. In addition, the Company does not intend to sell and it is not more likely than not that it will be required to sell these securities before maturity. While some available for sale securities have been sold for liquidity purposes or for gains, the Company has traditionally held its securities, including those classified as available for sale, until maturity. As a result of the evaluation of these securities, the Company has determined that the unrealized losses summarized in the tables above are not deemed to be other-than-temporary.

Securities with a fair value of \$212,315,955 and \$262,830,011 at September 30, 2014 and December 31, 2013, respectively, were pledged to secure public deposits, federal funds purchased and other balances required by law.

Proceeds from the sale of available for sale debt securities were \$26,075,225 for the nine months ended September 30, 2013. Available for sale debt securities were sold for a realized gain of \$257,997. There were no sales of available for sale securities in 2014.

#### 5. Loans:

The composition of the loan portfolio at September 30, 2014 and December 31, 2013, is as follows (in thousands):

	September 30, 2014	December 31, 2013
Gaming	\$ 23,747	\$ 29,570
Residential and land development	16,873	19,403
Real estate, construction	39,976	44,987
Real estate, mortgage	242,128	237,158
Commercial and industrial	26,049	35,007
Other	9,419	9,224
Total	\$ 358,192	\$ 375,349

The age analysis of the loan portfolio, segregated by class of loans, as of September 30, 2014 and December 31, 2013, is as follows (in thousands):

	Number of Days Past Due			Total Past Due	Current	Total Loans	Loans Past Due Greater Than 90 Days & Still Accruing
	30 - 59	60 - 89	Greater Than 90				
September 30, 2014:							
Gaming	\$	\$	\$ 591	\$ 591	\$ 23,156	\$ 23,747	\$
Residential and land development			11,440	11,440	5,433	16,873	
Real estate, construction	1,596	755	1,303	3,654	36,322	39,976	81
Real estate, mortgage	8,381	11,666	4,003	24,050	218,078	242,128	1,197
Commercial and industrial	878	1,061	216	2,155	23,894	26,049	
Other	177	63		240	9,179	9,419	
<b>Total</b>	<b>\$ 11,032</b>	<b>\$ 13,545</b>	<b>\$ 17,553</b>	<b>\$ 42,130</b>	<b>\$ 316,062</b>	<b>\$ 358,192</b>	<b>\$ 1,278</b>
December 31, 2013:							
Gaming	\$	\$	\$	\$	\$ 29,570	\$ 29,570	\$
Residential and land development	51		13,572	13,623	5,780	19,403	
Real estate, construction	3,846		9,452	13,298	31,689	44,987	146
Real estate, mortgage	6,910	2,684	5,134	14,728	222,430	237,158	505
Commercial and industrial	1,192			1,192	33,815	35,007	
Other	227	5		232	8,992	9,224	
<b>Total</b>	<b>\$ 12,226</b>	<b>\$ 2,689</b>	<b>\$ 28,158</b>	<b>\$ 43,073</b>	<b>\$ 332,276</b>	<b>\$ 375,349</b>	<b>\$ 651</b>

The Company monitors the credit quality of its loan portfolio through the use of a loan grading system. A score of 1 to 5 is assigned to the loan on factors including repayment ability, trends in net worth and/or financial condition of the borrower and guarantors, employment stability, management ability, loan to value fluctuations, the type and structure of the loan, conformity of the loan to bank policy and payment performance. Based on the total score, a loan grade of A - F is applied. A grade of A will generally be applied to loans for customers that are well known to the Company and that have excellent sources of repayment. A grade of B will generally be applied to loans for customers that have excellent sources of repayment which have no identifiable risk of collection. A grade of C will generally be applied to loans for customers that have adequate sources of repayment which have little identifiable risk of collection. Loans with a grade of C may be placed on the watch list if weaknesses are not resolved which could result in potential loss or for other circumstances that require monitoring. A grade of D will generally be applied to loans for customers that are inadequately protected by current sound net worth, paying capacity of the borrower, or pledged collateral. Loans with a grade of D have unsatisfactory characteristics such as cash flow deficiencies, bankruptcy filing by the borrower or dependence on the sale of collateral for the primary source of repayment, causing more than acceptable levels of risk. Loans 60 to 89 days past due receive a grade of D. A grade of E will generally be applied to loans for customers with weaknesses inherent in the D classification and in which collection or liquidation in full is questionable. In addition, on a monthly basis the Company determines which loans are 90 days or more past due and assigns a grade of E to

them. A grade of F is applied to loans which are considered uncollectible and of such little value that their continuance in an active bank is not warranted. Loans with this grade are charged off, even though partial or full recovery may be possible in the future.

An analysis of the loan portfolio by loan grade, segregated by class of loans, as of September 30, 2014 and December 31, 2013, is as follows (in thousands):

	Loans With A Grade Of:					Total
	A or B	C	D	E	F	
<b>September 30, 2014:</b>						
Gaming	\$ 23,156	\$	\$	\$ 591	\$	\$ 23,747
Residential and land development	4,004	1,401	28	11,440		16,873
Real estate, construction	33,069	729	3,813	2,365		39,976
Real estate, mortgage	202,585	4,025	17,396	18,122		242,128
Commercial and industrial	23,232	25	2,735	57		26,049
Other	9,377	9	31	2		9,419
<b>Total</b>	<b>\$ 295,423</b>	<b>\$ 6,189</b>	<b>\$ 24,003</b>	<b>\$ 32,577</b>	<b>\$</b>	<b>\$ 358,192</b>
<b>December 31, 2013:</b>						
Gaming	\$ 23,975	\$ 2,500	\$	\$ 3,095	\$	\$ 29,570
Residential and land development	4,236	1,544	51	13,572		19,403
Real estate, construction	38,808	781	2,220	3,178		44,987
Real estate, mortgage	204,569	4,495	17,852	10,242		237,158
Commercial and industrial	31,902	682	2,402	21		35,007
Other	9,131	24	50	19		9,224
<b>Total</b>	<b>\$ 312,621</b>	<b>\$ 10,026</b>	<b>\$ 22,575</b>	<b>\$ 30,127</b>	<b>\$</b>	<b>\$ 375,349</b>



A loan may be impaired but not on nonaccrual status when the loan is well secured and in the process of collection. Total loans on nonaccrual as of September 30, 2014 and December 31, 2013, are as follows (in thousands):

	September 30, 2014	December 31, 2013
Gaming	\$ 591	\$ 1,223
Residential and land development	11,440	13,572
Real estate, construction	1,772	2,588
Real estate, mortgage	18,768	8,788
Commercial and industrial	880	
Total	\$ 33,451	\$ 26,171

The Company has modified certain loans by granting interest rate concessions to these customers. These loans are in compliance with their modified terms, are currently accruing and the Company has classified them as troubled debt restructurings. Troubled debt restructurings as of September 30, 2014 and December 31, 2013 were as follows (in thousands except for number of contracts):

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Related Allowance
September 30, 2014:				
Real estate, construction	2	\$ 856	\$ 856	\$ 267
Real estate, mortgage	5	1,820	1,820	190
Total	7	\$ 2,676	\$ 2,676	\$ 457
December 31, 2013:				
Real estate, construction	2	\$ 891	\$ 891	\$ 270
Real estate, mortgage	6	10,012	10,012	994
Commercial and industrial	1	678	678	
Total	9	\$ 11,581	\$ 11,581	\$ 1,264

During September 2014, two loans which had been classified as troubled debt restructurings at December 31, 2013 became in default of their modified terms and were placed on nonaccrual. These loans included one loan that was included in the real estate mortgage segment with a balance of \$8,169,179 and one loan that was included in the commercial and industrial segment with a balance of \$677,901 as of December 31, 2013.

Impaired loans, which include loans classified as nonaccrual and troubled debt restructurings, segregated by class of loans, as of September 30, 2014 and December 31, 2013, are as follows (in thousands):

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>September 30, 2014:</b>					
With no related allowance recorded:					
Residential and land development	\$ 19,625	\$ 10,425	\$	\$ 12,158	\$
Real estate, construction	2,090	2,090		1,774	25
Real estate, mortgage	12,185	11,585		9,563	27
Commercial and industrial	880	880		680	15
<b>Total</b>	<b>34,780</b>	<b>24,980</b>		<b>24,175</b>	<b>67</b>
With a related allowance recorded:					
Gaming	1,691	591	166	941	
Residential and land development	2,119	1,015	177	1,016	
Real estate, construction	538	538	291	567	11
Real estate, mortgage	9,003	9,003	4,312	8,965	202
<b>Total</b>	<b>13,351</b>	<b>11,147</b>	<b>4,946</b>	<b>11,489</b>	<b>213</b>
Total by class of loans:					
Gaming	1,691	591	166	941	
Residential and land development	21,744	11,440	177	13,174	
Real estate, construction	2,628	2,628	291	2,341	36
Real estate, mortgage	21,188	20,588	4,312	18,528	229
Commercial and industrial	880	880		680	15
<b>Total</b>	<b>\$ 48,131</b>	<b>\$ 36,127</b>	<b>\$ 4,946</b>	<b>\$ 35,664</b>	<b>\$ 280</b>

	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2013:					
With no related allowance recorded:					
Residential and land development	\$ 4,425	\$ 4,425	\$	\$ 4,465	\$
Real estate, construction	2,294	2,294		2,054	26
Real estate, mortgage	9,722	9,123		9,097	26
Commercial and industrial	678	678		689	24
<b>Total</b>	<b>17,119</b>	<b>16,520</b>		<b>16,305</b>	<b>76</b>
With a related allowance recorded:					
Gaming	1,698	1,223	626	1,316	
Residential and land development	17,576	9,147	471	15,909	
Real estate, construction	1,185	1,185	337	1,239	23
Real estate, mortgage	9,677	9,677	1,110	8,801	306
<b>Total</b>	<b>30,136</b>	<b>21,232</b>	<b>2,544</b>	<b>27,265</b>	<b>329</b>
Total by class of loans:					
Gaming	1,698	1,223	626	1,316	
Residential and land development	22,001	13,572	471	20,374	
Real estate, construction	3,479	3,479	337	3,293	49
Real estate, mortgage	19,399	18,800	1,110	17,898	332
Commercial and industrial	678	678		689	24
<b>Total</b>	<b>\$ 47,255</b>	<b>\$ 37,752</b>	<b>\$ 2,544</b>	<b>\$ 43,570</b>	<b>\$ 405</b>

## 6. Allowance for Loan Losses:

Transactions in the allowance for loan losses for the quarters and nine months ended September 30, 2014 and 2013, and the balances of loans, individually and collectively evaluated for impairment, as of September 30, 2014 and 2013, are as follows (in thousands):

	Gaming	Residential and Land Development	Real Estate, Construction	Real Estate, Mortgage	Commercial and Industrial	Other	Total
For the Nine Months Ended							
September 30, 2014:							
Allowance for Loan Losses:							
Beginning Balance	\$ 977	\$ 776	\$ 695	\$ 5,553	\$ 632	\$ 301	\$ 8,934
Charge-offs	(701)	(1,875)	(108)	(163)	(9)	(176)	(3,032)
Recoveries	261			147	18	67	493
Provision	12	1,550	73	2,975	(98)	103	4,615
Ending Balance	\$ 549	\$ 451	\$ 660	\$ 8,512	\$ 543	\$ 295	\$ 11,010

## For the Quarter Ended

September 30, 2014:

## Allowance for Loan Losses:

Beginning Balance	\$ 355	\$ 705	\$ 686	\$ 6,749	\$ 653	\$ 286	\$ 9,434
Charge-offs	(75)	(1,875)	(104)	(127)	(3)	(60)	(2,244)
Recoveries	171			66	4	38	279
Provision	98	1,621	78	1,824	(111)	31	3,541
Ending Balance	\$ 549	\$ 451	\$ 660	\$ 8,512	\$ 543	\$ 295	\$ 11,010

## Allowance for loan losses,

September 30, 2014:

Ending balance: individually evaluated for impairment	\$ 166	\$ 177	\$ 563	\$ 5,102	\$ 293	\$ 2	\$ 6,303
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Ending balance: collectively evaluated for impairment	\$ 383	\$ 274	\$ 97	\$ 3,410	\$ 250	\$ 293	\$ 4,707
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## Total Loans, September 30,

2014:

Ending balance: individually evaluated for impairment	\$ 591	\$ 11,467	\$ 6,179	\$ 35,518	\$ 2,792	\$ 33	\$ 56,580
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Ending balance: collectively evaluated for impairment	\$ 23,156	\$ 5,406	\$ 33,797	\$ 206,610	\$ 23,257	\$ 9,386	\$ 301,612
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	Gaming Development	Residential and Land	Real Estate,	Real Estate, Mortgage	Commercial and Industrial	Other	Total
<b>For the Nine Months Ended September 30, 2013:</b>							
<b>Allowance for Loan Losses:</b>							
Beginning Balance	\$ 1,541	\$ 200	\$ 967	\$ 5,273	\$ 593	\$ 283	\$ 8,857
Charge-offs	(474)		(947)	(623)	(21)	(173)	(2,238)
Recoveries	65	67	79	150	24	73	458
Provision	(143)	3,068	586	999	4	105	4,619
Ending Balance	\$ 989	\$ 3,335	\$ 685	\$ 5,799	\$ 600	\$ 288	\$ 11,696
<b>For the Quarter Ended September 30, 2013:</b>							
<b>Allowance for Loan Losses:</b>							
Beginning Balance	\$ 986	\$ 3,343	\$ 1,330	\$ 5,588	\$ 627	\$ 276	\$ 12,150
Charge-offs			(900)	(342)	(21)	(43)	(1,306)
Recoveries	65		79	148	2	16	310
Provision	(62)	(8)	176	405	(8)	39	542
Ending Balance	\$ 989	\$ 3,335	\$ 685	\$ 5,799	\$ 600	\$ 288	\$ 11,696
<b>Allowance for loan losses, September 30, 2013:</b>							
Ending balance: individually evaluated for impairment	\$ 626	\$ 3,149	\$ 651	\$ 2,128	\$ 330	\$ 33	\$ 6,917
Ending balance: collectively evaluated for impairment	\$ 363	\$ 186	\$ 34	\$ 3,671	\$ 270	\$ 255	\$ 4,779
<b>Total Loans, September 30, 2013:</b>							
Ending balance: individually evaluated for impairment	\$ 13,888	\$ 20,974	\$ 5,570	\$ 28,693	\$ 2,505	\$ 80	\$ 71,710
Ending balance: collectively evaluated for impairment	\$ 28,679	\$ 5,836	\$ 39,035	\$ 210,327	\$ 32,359	\$ 8,476	\$ 324,712

#### 7. Deposits:

At September 30, 2014, time deposits of \$100,000 or more include brokered deposits of \$5,000,000, which mature in 2017.

#### 8. Fair Value Measurements and Disclosures:

The Company utilizes fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. Available for sale securities are recorded at fair value on a recurring basis.

Additionally, from time to time, the Company may be required to record other assets at fair value on a non-recurring basis, such as impaired loans and ORE. These non-recurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets. Additionally, the Company is required to

disclose, but not record, the fair value of other financial instruments.

#### Fair Value Hierarchy

The Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

These levels are:

Level 1 - Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 - Valuation is based upon quoted market prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 - Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

Following is a description of valuation methodologies used to determine the fair value of financial assets and liabilities.

#### Cash and Due from Banks

The carrying amount shown as cash and due from banks approximates fair value.

#### Federal Funds Sold

The carrying amount shown as federal funds sold approximates fair value.

#### Available for Sale Securities

The fair value of available for sale securities is based on quoted market prices. The Company's available for sale securities are reported at their estimated fair value, which is determined utilizing several sources. The primary source is Interactive Data Corporation, which utilizes pricing models that vary based on asset class and include available trade, bid and other market information and whose methodology includes broker quotes, proprietary models and vast descriptive databases. The other source for determining fair value is matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark securities. All of the Company's available for sale securities are Level 2 assets.

#### Held to Maturity Securities

The fair value of held to maturity securities is based on quoted market prices.

#### Other Investments

The carrying amount shown as other investments approximates fair value.

#### Federal Home Loan Bank Stock

The carrying amount shown as Federal Home Loan Bank Stock approximates fair value.

#### Loans



The fair value of fixed rate loans is estimated by discounting the future cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings for the remaining maturities. The cash flows considered in computing the fair value of such loans are segmented into categories relating to the nature of the contract and collateral based on contractual principal

maturities. Appropriate adjustments are made to reflect probable credit losses. Cash flows have not been adjusted for such factors as prepayment risk or the effect of the maturity of balloon notes. The fair value of floating rate loans is estimated to be its carrying value. At each reporting period, the Company determines which loans are impaired. Accordingly, the Company's impaired loans are reported at their estimated fair value on a non-recurring basis. An allowance for each impaired loan, which are generally collateral-dependent, is calculated based on the fair value of its collateral. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by Management. If the recorded investment in the impaired loan exceeds the measure of fair value of the collateral, a valuation allowance is recorded as a component of the allowance for loan losses. Impaired loans are non-recurring Level 3 assets.

#### Other Real Estate

In the course of lending operations, Management may determine that it is necessary to foreclose on the related collateral. Other real estate acquired through foreclosure is carried at fair value, less estimated costs to sell. The fair value of the collateral is based on appraisals performed by third-party valuation specialists. Factors including the assumptions and techniques utilized by the appraiser are considered by Management. If the current appraisal is more than one year old and/or the loan balance is more than \$200,000, a new appraisal is obtained. Otherwise, the Bank's in-house property evaluator and Management will determine the fair value of the collateral, based on comparable sales, market conditions, Management's plans for disposition and other estimates of fair value obtained from principally independent sources, adjusted for estimated selling costs. Other real estate is a non-recurring Level 3 asset.

#### Cash Surrender Value of Life Insurance

The carrying amount of cash surrender value of bank-owned life insurance approximates fair value.

#### Deposits

The fair value of non-interest bearing demand and interest bearing savings and demand deposits is the amount reported in the financial statements. The fair value of time deposits is estimated by discounting the cash flows using current rates of time deposits with similar remaining maturities. The cash flows considered in computing the fair value of such deposits are based on contractual maturities, since approximately 98% of time deposits provide for automatic renewal at current interest rates.

#### Federal Funds Purchased and Securities Sold under Agreements to Repurchase

The carrying amount shown as federal funds purchased and securities sold under agreements to repurchase approximates fair value.

#### Borrowings from Federal Home Loan Bank

The fair value of Federal Home Loan Bank ( FHLB ) fixed rate borrowings is estimated using discounted cash flows based on current incremental borrowing rates for similar types of borrowing arrangements. The fair value of FHLB variable rate borrowings is estimated to be its carrying value.

The balances of available for sale securities, which are the only assets measured at fair value on a recurring basis, by level within the fair value hierarchy and by investment type, as of September 30, 2014 and December 31, 2013 are as follows (in thousands):

	Total	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
<b>September 30, 2014:</b>				
U.S. Treasuries	\$ 37,278	\$	\$ 37,278	\$
U.S. Government agencies	144,075		144,075	
Mortgage-backed securities	46,371		46,371	
States and political subdivisions	34,671		34,671	
Equity securities	650		650	
<b>Total</b>	<b>\$ 263,045</b>	<b>\$</b>	<b>\$ 263,045</b>	<b>\$</b>
<b>December 31, 2013:</b>				
U.S. Treasuries	\$ 43,648	\$	\$ 43,648	\$
U.S. Government agencies	145,805		145,805	
Mortgage-backed securities	50,326		50,326	
States and political subdivisions	35,011		35,011	
Equity securities	650		650	
<b>Total</b>	<b>\$ 275,440</b>	<b>\$</b>	<b>\$ 275,440</b>	<b>\$</b>

Impaired loans, which are measured at fair value on a non-recurring basis, by level within the fair value hierarchy as of September 30, 2014 and December 31, 2013 are as follows (in thousands):

	Total	Fair Value Measurements Using		
		Level 1	Level 2	Level 3
September 30, 2014	\$ 12,346	\$	\$	\$ 12,346
December 31, 2013	18,831			18,831

The following table presents a summary of changes in the fair value of impaired loans which are measured using level 3 inputs (in thousands):

	For the Nine Months Ended September 30, 2014	For the Year Ended December 31, 2013
Balance, beginning of period	\$ 18,831	\$ 16,030

Additions to impaired loans and troubled debt restructurings	212	17,424
Principal payments, charge-offs and transfers to other real estate	(4,297)	(15,153)
Change in allowance for loan losses on impaired loans	(2,400)	530
Balance, end of period	\$ 12,346	\$ 18,831

Other real estate, which is measured at fair value on a non-recurring basis, by level within the fair value hierarchy as of September 30, 2014 and December 31, 2013 are as follows (in thousands):

	Total	Fair Value Measurements Using		Level 3
		Level 1	Level 2	
September 30, 2014	\$ 9,710	\$	\$	\$ 9,710
December 31, 2013	9,630			9,630

The following table presents a summary of changes in the fair value of other real estate which is measured using level 3 inputs (in thousands):

	For the Nine Months Ended September 30, 2014	For the Year Ended December 31, 2013
Balance, beginning of period	\$ 9,630	\$ 7,008
Loans transferred to ORE	1,144	4,537
Sales	(845)	(1,188)
Writedowns	(219)	(670)
Insurance proceeds for casualty loss		(57)
Balance, end of period	\$ 9,710	\$ 9,630

The carrying value and estimated fair value of assets and liabilities, by level within the fair value hierarchy, at September 30, 2014 and December 31, 2013, are as follows (in thousands):

	Carrying Amount	Fair Value Measurements Using			Total
		Level 1	Level 2	Level 3	
<b>September 30, 2014:</b>					
<b>Financial Assets:</b>					
Cash and due from banks	\$ 31,379	\$ 31,379	\$	\$	\$ 31,379
Federal funds sold	25,000	25,000			25,000
Available for sale securities	263,045		263,045		263,045
Held to maturity securities	15,617		15,586		15,586
Other investments	3,025	3,025			3,025
Federal Home Loan Bank stock	4,302		4,302		4,302
Loans, net	347,182			348,610	348,610
Other real estate	9,710			9,710	9,710
Cash surrender value of life insurance	17,896			17,896	17,896
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
Non-interest bearing	134,954	134,954			134,954
Interest bearing	314,750			315,920	315,920
Federal funds purchased and securities sold under agreements to repurchase	120,774	120,774			120,774
Borrowings from Federal Home Loan Bank	62,505		63,377		63,377
<b>December 31, 2013:</b>					
<b>Financial Assets:</b>					
Cash and due from banks	\$ 36,264	\$ 36,264	\$	\$	\$ 36,264
Available for sale securities	257,440		275,440		275,440
Held to maturity securities	11,142		10,686		10,686
Other investments	3,262	3,262			3,262
Federal Home Loan Bank stock	3,834		3,834		3,834
Loans, net	366,415			369,117	369,117
Other real estate	9,630			9,630	9,630
Cash surrender value of life insurance	17,456			17,456	17,456
<b>Financial Liabilities:</b>					
<b>Deposits:</b>					
Non-interest bearing	107,117	107,117			107,117
Interest bearing	321,441			322,535	322,535
Federal funds purchased and securities sold under agreements to repurchase	139,639	139,639			139,639
Borrowings from Federal Home Loan Bank	77,684		79,051		79,051

9. Reclassifications:

Certain reclassifications, which had no effect on prior year net income, have been made to prior period statements to conform to current year presentation.



## Item 2: Management's Discussion and Analysis of Financial Condition and Results of Operations

### GENERAL

The Company is a one-bank holding company headquartered in Biloxi, Mississippi. It has two operating subsidiaries, PFC Service Corp., an inactive company, and The Peoples Bank, Biloxi, Mississippi (the Bank). The Bank provides a full range of banking, financial and trust services to state, county and local government entities and individuals and small and commercial businesses operating in those portions of Mississippi, Louisiana and Alabama which are within a fifty mile radius of the Waveland, Wiggins and Gautier branches, the Bank's three most outlying locations (the trade area).

The following presents Management's discussion and analysis of the consolidated financial condition and results of operations of Peoples Financial Corporation and Subsidiaries. These comments should be considered in combination with the Consolidated Financial Statements and Notes to Consolidated Financial Statements included in this report on Form 10-Q and the Consolidated Financial Statements, Notes to Consolidated Financial Statements and Management's Discussion and Analysis included in the Company's Form 10-K for the year ended December 31, 2013.

### Forward-Looking Information

Congress passed the Private Securities Litigation Act of 1995 in an effort to encourage corporations to provide information about a company's anticipated future financial performance. This act provides a safe harbor for such disclosure which protects the companies from unwarranted litigation if actual results are different from management expectations. This report contains forward-looking statements and reflects industry conditions, company performance and financial results. These forward-looking statements are subject to a number of factors and uncertainties which could cause the Company's actual results and experience to differ from the anticipated results and expectations expressed in such forward-looking statements. Such factors and uncertainties include, but are not limited to: changes in interest rates and market prices, changes in local economic and business conditions, increased competition for deposits and loans, a deviation in actual experience from the underlying assumptions used to determine and establish the allowance for loan losses, changes in the availability of funds resulting from reduced liquidity, changes in government regulations and acts of terrorism, weather or other events beyond the Company's control.

### New Accounting Pronouncements

In April 2014, the Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2014-06, *Technical Corrections and Improvements Related to Glossary Terms*. This ASU added, deleted, corrected and modified terms in the Master Glossary of the Codification and was effective upon issuance. The adoption of this ASU did not have a material effect on the Company's financial position, results of operations or cash flows.

In August 2014, the FASB issued ASU No. 2014-14, *Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Classification of Certain Government-Guaranteed Mortgage Loans upon Foreclosure*. This ASU requires that a mortgage loan be derecognized and a separate other



receivable be recognized upon foreclosure if certain conditions are met. ASU No. 2014-14 is effective for annual periods and interim periods within those annual periods beginning after December 31, 2014. The adoption of this ASU is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

In August 2014, the FASB issued ASU No. 2014-15, *Presentation of Financial Statements - Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern*. This ASU defines management's responsibility to evaluate whether there is substantial doubt about an organization's ability to continue as a going concern and to provide related footnote disclosures. ASU 2014-15 is effective for annual periods ending after December 31, 2016, and interim periods within annual periods beginning after December 14, 2016. The adoption of this ASU is not expected to have a material effect on the Company's financial position, results of operations or cash flows.

### **Critical Accounting Policies**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires Management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. The Company evaluates these estimates and assumptions on an on-going basis using historical experience and other factors, including the current economic environment. We adjust such estimates and assumptions when facts and circumstances dictate. Certain critical accounting policies affect the more significant estimates and assumptions used in the preparation of the consolidated financial statements.

#### **Allowance for loan losses:**

The Company's most critical accounting policy relates to its allowance for loan losses (ALL), which reflects the estimated losses resulting from the inability of its borrowers to make loan payments. The ALL is established and maintained at an amount sufficient to cover the estimated loss associated with the loan portfolio of the Company as of the date of the financial statements. Credit losses arise not only from credit risk, but also from other risks inherent in the lending process including, but not limited to, collateral risk, operation risk, concentration risk and economic risk. As such, all related risks of lending are considered when assessing the adequacy of the ALL. On a quarterly basis, Management estimates the probable level of losses to determine whether the allowance is adequate to absorb reasonably foreseeable, anticipated losses in the existing portfolio based on our past loan loss experience, known and inherent risk in the portfolio, adverse situations that may affect the borrowers' ability to repay and the estimated value of any underlying collateral and current economic conditions. Management believes that the ALL is adequate and appropriate for all periods presented in these financial statements. If there was a deterioration of any of the factors considered by Management in evaluating the ALL, the estimate of loss would be updated, and additional provisions for loan losses may be required. The analysis divides the portfolio into two segments: a pool analysis of loans based upon a five year average loss history which is updated on a quarterly basis and which may be adjusted by qualitative factors by loan type and a specific reserve analysis for those loans considered impaired under GAAP. All credit relationships with an outstanding balance of \$100,000 or greater that are included in Management's loan watch list are

individually reviewed for impairment. All losses are charged to the ALL when the loss actually occurs or when a determination is made that a loss is likely to occur; recoveries are credited to the ALL at the time of receipt.

**Other Real Estate:**

Other real estate ( ORE ) includes real estate acquired through foreclosure. Each other real estate property is carried at fair value, less estimated costs to sell. Fair value is principally based on appraisals performed by third-party valuation specialists. If Management determines that the fair value of a property has decreased subsequent to foreclosure, the Company records a write down which is included in noninterest expense.

**Employee Benefit Plans:**

Employee benefit plan liabilities and pension costs are determined utilizing actuarially determined present value calculations. The valuation of the benefit obligation and net periodic expense is considered critical, as it requires Management and its actuaries to make estimates regarding the amount and timing of expected cash outflows including assumptions about mortality, expected service periods and the rate of compensation increases.

**Income Taxes:**

GAAP requires the asset and liability approach for financial accounting and reporting for deferred income taxes. We use the asset and liability method of accounting for deferred income taxes and provide deferred income taxes for all significant income tax temporary differences. As part of the process of preparing our consolidated financial statements, the Company is required to estimate our income taxes in each of the jurisdictions in which we operate. This process involves estimating our actual current tax exposure together with assessing temporary differences resulting from differing treatment of items, such as the provision for loan losses, for tax and financial reporting purposes. These differences result in deferred tax assets and liabilities that are included in our consolidated statement of condition. We must also assess the likelihood that our deferred tax assets will be recovered from future taxable income, and to the extent we believe that recovery is not likely, we must establish a valuation allowance. Significant management judgment is required in determining our provision for income taxes, our deferred tax assets and liabilities and any valuation allowance recorded against our net deferred tax assets. To the extent the Company establishes a valuation allowance or adjusts this allowance in a period, we must include an expense within the tax provisions in the consolidated statement of income.

**OVERVIEW**

The Company is a community bank serving the financial and trust needs of its customers in its trade area of south Mississippi, southeast Louisiana and southwest Alabama. Maintaining a strong core deposit base and providing commercial and real estate lending in our trade area are the traditional focuses of the Company. Growth has largely been achieved through de novo branching activity, and it is expected that these strategies will continue to be emphasized in the future.

The Company incurred a net loss of \$1,799,000 for the third quarter of 2014 compared with net income of \$886,000 for the third quarter of 2013 and a net loss of \$885,000 for the first three quarters of 2014 compared with net income of \$345,000 for the first three quarters of 2013. Results

in 2014 were directly related to the large provision for the allowance for loan losses recorded in the third quarter of 2014. Management updated its evaluation of collateral relating to two loans during the third quarter of 2014 as a result of receiving new appraisals. These new evaluations resulted in additional loan loss provisions for these two credits. The provision for the allowance for loan losses was \$3,541,000 and \$4,615,000 for the third quarter and first three quarters of 2014, respectively, compared with \$542,000 and \$4,619,000, respectively, for the third quarter and first three quarters of 2013.

Managing the net interest margin in the Company's highly competitive market and in context of larger economic conditions has been very challenging and will continue to be so for the foreseeable future. The yield on average loans has increased as average nonaccrual loans have decreased significantly in 2014 as compared with 2013. The Company extended durations on its investments during 2013 in order to increase yield, which can be seen from the improved yield on average available for sale securities.

Monitoring asset quality, estimating potential losses in our loan portfolio and addressing non-performing loans continue to be emphasized during these difficult economic times, as the local and national economy continues to negatively impact collateral values and borrowers' ability to repay their loans. The Company is working diligently to address and reduce its non-performing assets. The Company's nonaccrual loans totaled \$33,451,000 and \$26,171,000 at September 30, 2014 and December 31, 2013, respectively. Most of these loans are collateral-dependent, and the Company has rigorously evaluated the value of its collateral to determine potential losses.

Non-interest income decreased \$227,000 and \$262,000 for the three and nine months ended September 30, 2014 as compared with 2013 results. Service charges on deposit accounts decreased \$181,000 for the three months ended September 30, 2014. Results for the nine months ended September 30, 2013 included gains on sales of securities of \$258,000, while there were no sales in 2014.

Non-interest expense increased \$73,000 and \$1,239,000 for the three and nine months ended September 30, 2014 as compared with 2013 results. This increase for the three months ended September 30, 2014 was the result of increases in net occupancy expense of \$56,000 and FDIC assessments of \$97,000, while other expenses decreased \$148,000 as compared with 2013. This increase for the nine months ended September 30, 2014 was the result of increases in salaries and employee benefits of \$421,000, equipment rentals, depreciation and maintenance of \$157,000, FDIC assessments of \$192,000, and ATM expenses of \$246,000 as compared with 2013.

Total assets at September 30, 2014 decreased \$8,994,000 as compared with December 31, 2013. Loans decreased \$17,157,000 at September 30, 2014 as compared with December 31, 2013, as principal payments, maturities, charge-offs and foreclosures on existing loans exceeded new loans. Federal funds sold were \$25,000,000 at September 30, 2014 in the management of the Company's liquidity position.

## RESULTS OF OPERATIONS

### Net Interest Income

Net interest income, the amount by which interest income on loans, investments and other interest earning assets exceeds interest expense on deposits and other borrowed funds, is the single largest component of the Company's income. Management's objective is to provide the largest possible amount of income while balancing interest rate, credit, liquidity and capital risk. Changes in the volume and mix of interest earning assets and interest-bearing liabilities combined with changes in market rates of interest directly affect net interest income.

#### Quarter Ended September 30, 2014 as Compared with Quarter Ended September 30, 2013

The Company's average interest earning assets decreased approximately \$56,762,000, or 8%, from approximately \$711,253,000 for the third quarter of 2013 to approximately \$654,491,000 for the third quarter of 2014. Average loans decreased as loan demand has been weak in the Company's trade area and the volume of maturities and pay-offs, particularly in the gaming portfolio, have been significant.

The average yield on earning assets increased by 9 basis points, from 3.38% for the third quarter of 2013 to 3.47% for the third quarter of 2014. The yield on average loans increased from 4.21% in 2013 to 4.33% in 2014 as a result of the reduction in average nonaccrual loans. Average nonaccrual loans decreased from approximately \$47,632,000 in 2013 to approximately \$29,180,000 in 2014.

Average interest bearing liabilities decreased approximately \$54,781,000, or 10%, from approximately \$564,722,000 for the third quarter of 2013 to approximately \$509,941,000 for the third quarter of 2014. Average time deposits decreased primarily as customers have moved their accounts to transaction deposits and brokered deposits matured in 2013. Average federal funds purchased and securities sold under agreements to repurchase, which only included non-deposit accounts, decreased \$76,901,000 as these customers reallocate their balances periodically. Average borrowings from the Federal Home Loan Bank increased \$66,165,000 due to the liquidity needs of the bank subsidiary.

The average rate paid on interest bearing liabilities for the third quarter of 2013 was .26% as compared with .45% for the third quarter of 2014. This increase was due to an immaterial interest expense adjustment of \$231,000 on time deposits. The average rate paid on time deposits would have been .27% in 2014 without this adjustment.

The Company's net interest margin on a tax-equivalent basis, which is net interest income as a percentage of average earning assets, was 3.12% for the quarter ended September 30, 2014, down 5 basis points from 3.17% for the quarter ended September 30, 2013. The net interest margin on tax-equivalent basis would have been 3.26% without the interest adjustment on time deposits.

#### Nine Months Ended September 30, 2014 as Compared with Nine Months Ended September 30, 2013

The Company's average interest earning assets decreased approximately \$79,567,000, or 11%, from approximately \$740,290,000 for the first three quarters of 2013 to approximately \$660,723,000 for the first three quarters of 2014. Average loans decreased as loan demand has been weak in the Company's trade area and the volume of maturities and pay-offs, particularly in the gaming portfolio, have been significant. Average federal funds sold also decreased based on the liquidity position of the bank subsidiary.



The average yield on earning assets increased by 33 basis points, from 3.24% for the first three quarters of 2013 to 3.57% for the first three quarters of 2014. The yield on average loans increased from 4.22% for the first three quarters of 2013 to 4.49% for the first three quarters of 2014 as a result of the reduction in average nonaccrual loans. Average nonaccrual loans decreased from approximately \$49,743,000 in 2013 to approximately \$29,811,000 in 2014. The yield on average taxable available for sale securities increased from 1.73% for the first three quarters of 2013 to 2.01% for the first three quarters of 2014 as a result of the Company's strategy of extending the duration of new investments. Future security purchases may be of shorter duration in anticipation of rising rates in the future.

Average interest bearing liabilities decreased approximately \$72,094,000, or 12%, from approximately \$590,582,000 for the first three quarters of 2013 to approximately \$518,488,000 for the first three quarters of 2014. Average time deposits decreased primarily as \$24,000,000 in brokered deposits matured during 2013. Average federal funds purchased and securities sold under agreements to repurchase, which only included non-deposit accounts, decreased \$66,607,000 as these customers reallocate their balances periodically. Average borrowings from the Federal Home Loan Bank increased \$50,460,000 due to the liquidity needs of the bank subsidiary.

The average rate paid on interest bearing liabilities increased 4 basis points, from .27% for the first three quarters of 2013 to .31% for the first three quarters of 2014.

The Company's net interest margin on a tax-equivalent basis, which is net interest income as a percentage of average earning assets, was 3.32% for the first three quarters of 2014, up 29 basis points from 3.03% for the first three quarters 2013.

The tables below analyze the changes in tax-equivalent net interest income for the quarters ended September 30, 2014 and 2013 and the nine months ended September 30, 2014 and 2013.

## Analysis of Average Balances, Interest Earned/Paid and Yield

(In Thousands)

	Three Months Ended September 30, 2014			Three Months Ended September 30, 2013		
	Average Balance	Interest Earned/Paid	Rate	Average Balance	Interest Earned/Paid	Rate
Loans (2)(3)	\$ 356,980	\$ 3,868	4.33%	\$ 400,355	\$ 4,217	4.21%
Federal funds sold	9,083	5	0.22%	7,805	3	0.15%
<b>HTM:</b>						
Non taxable (1)	13,427	116	3.46%	11,788	97	3.29%
<b>AFS:</b>						
Taxable	234,779	1,178	2.01%	253,553	1,195	1.89%
Non taxable (1)	35,437	498	5.62%	35,905	485	5.40%
Other	4,785	12	1.00%	1,847	6	1.30%
<b>Total</b>	<b>\$ 654,491</b>	<b>\$ 5,677</b>	<b>3.47%</b>	<b>\$ 711,253</b>	<b>\$ 6,003</b>	<b>3.38%</b>
<b>Savings &amp; interest-bearing</b>						
DDA	\$ 227,304	\$ 42	0.07%	\$ 237,141	\$ 42	0.07%
Time deposits	86,529	440	2.03%	120,737	251	0.83%
Federal funds purchased	112,031	23	0.08%	188,932	38	0.08%
FHLB advances	84,077	66	0.31%	17,912	43	0.96%
<b>Total</b>	<b>\$ 509,941</b>	<b>\$ 571</b>	<b>0.45%</b>	<b>\$ 564,722</b>	<b>\$ 374</b>	<b>0.26%</b>
<b>Net tax-equivalent spread</b>			<b>3.02%</b>	<b>3.11%</b>		
<b>Net tax-equivalent margin on earning assets</b>			<b>3.12%</b>	<b>3.17%</b>		

(1) All interest earned is reported on a taxable equivalent basis using a tax rate of 34% in 2014 and 2013.

(2) Loan fees of \$193 and \$104 for 2014 and 2013, respectively, are included in these figures.

(3) Includes nonaccrual loans.

## Analysis of Average Balances, Interest Earned/Paid and Yield

(In Thousands)

	Nine Months Ended September 30, 2014			Nine Months Ended September 30, 2013		
	Average Balance	Interest Earned/Paid	Rate	Average Balance	Interest Earned/Paid	Rate
Loans (2)(3)	\$ 364,427	\$ 12,284	4.49%	\$ 410,921	\$ 12,995	4.22%
Federal funds sold	6,753	12	0.24%	34,371	67	0.26%
<b>HTM:</b>						
Non taxable (1)	12,786	334	3.48%	9,412	259	3.67%
<b>AFS:</b>						
Taxable	237,569	3,583	2.01%	246,918	3,195	1.73%
Non taxable (1)	35,023	1,438	5.47%	36,955	1,468	5.30%
Other	4,165	16	0.51%	1,713	12	0.93%
<b>Total</b>	<b>\$ 660,723</b>	<b>\$ 17,667</b>	<b>3.57%</b>	<b>\$ 740,290</b>	<b>\$ 17,996</b>	<b>3.24%</b>
<b>Savings &amp; interest-bearing</b>						
DDA	\$ 232,981	\$ 130	0.07%	\$ 253,401	\$ 139	0.07%
Time deposits	93,081	835	1.20%	128,608	789	0.82%
Federal funds purchased	130,721	72	0.07%	197,328	127	0.09%
FHLB advances	61,705	172	0.37%	11,245	124	1.47%
<b>Total</b>	<b>\$ 518,488</b>	<b>\$ 1,209</b>	<b>0.31%</b>	<b>\$ 590,582</b>	<b>\$ 1,179</b>	<b>0.27%</b>
<b>Net tax-equivalent spread</b>			<b>3.25%</b>	<b>2.97%</b>		
<b>Net tax-equivalent margin on earning assets</b>			<b>3.32%</b>	<b>3.03%</b>		

(1) All interest earned is reported on a taxable equivalent basis using a tax rate of 34% in 2014 and 2013.

(2) Loan fees of \$449 and \$350 for 2014 and 2013, respectively, are included in these figures.

(3) Includes nonaccrual loans.



## Analysis of Changes in Interest Income and Interest Expense

(In Thousands)

	For the Quarter Ended			
	September 30, 2014	compared with September 30, 2013		
	Volume	Rate	Rate/Volume	Total
<b>Interest earned on:</b>				
Loans	\$ (457)	\$ 121	\$ (13)	\$ (349)
Federal funds sold	1	1		2
<b>Held to maturity securities:</b>				
Non taxable	13	5	1	19
<b>Available for sale securities:</b>				
Taxable	(88)	77	(6)	(17)
Non taxable	(6)	20	(1)	13
Other	10	(1)	(3)	6
<b>Total</b>	<b>\$ (527)</b>	<b>\$ 223</b>	<b>\$ (22)</b>	<b>\$ (326)</b>
<b>Interest paid on:</b>				
Savings & interest-bearing DDA	\$ (2)	\$ 2	\$	\$
Time deposits	(71)	363	(103)	189
Federal funds purchased	(15)	1	(1)	(15)
FHLB advances	159	(29)	(107)	23
<b>Total</b>	<b>\$ 71</b>	<b>\$ 337</b>	<b>\$ (211)</b>	<b>\$ 197</b>

## Analysis of Changes in Interest Income and Interest Expense

(In Thousands)

	For the Nine Months Ended September 30, 2014 compared with September 30, 2013			
	Volume	Rate	Rate/ Volume	Total
<b>Interest earned on:</b>				
Loans	\$ (1,470)	\$ 855	\$ (96)	\$ (711)
Federal funds sold	(54)	(6)	5	(55)
<b>Held to maturity securities:</b>				
Non taxable	93	(13)	(5)	75
<b>Available for sale securities:</b>				
Taxable	(121)	529	(20)	388
Non taxable	(77)	49	(2)	(30)
Other	17	(5)	(8)	4
<b>Total</b>	<b>\$ (1,612)</b>	<b>\$ 1,409</b>	<b>\$ (126)</b>	<b>\$ (329)</b>
<b>Interest paid on:</b>				
Savings & interest-bearing DDA	\$ (11)	\$ 2	\$	\$ (9)
Time deposits	(218)	365	(101)	46
Federal funds purchased	(43)	(18)	6	(55)
FHLB advances	556	(93)	(415)	48
<b>Total</b>	<b>\$ 284</b>	<b>\$ 256</b>	<b>\$ (510)</b>	<b>\$ 30</b>

**Provision for Loan Losses**

In the normal course of business, the Company assumes risk in extending credit to its customers. This credit risk is managed through compliance with the loan policy, which is approved by the Board of Directors. The policy establishes guidelines relating to underwriting standards, including but not limited to financial analysis, collateral valuation, lending limits, pricing considerations and loan grading. The Company's Loan Review and Special Assets Departments play key roles in monitoring the loan portfolio and managing problem loans. New loans and, on a periodic basis, existing loans are reviewed to evaluate compliance with the loan policy. Loan customers in concentrated industries such as gaming and hotel/motel, as well as the exposure for out of area; residential and land development; construction and commercial real estate loans; and their direct and indirect impact on its operations are evaluated on a monthly basis. Loan delinquencies and deposit overdrafts are closely monitored in order to identify developing problems as early as possible. Lenders experienced in workout scenarios consult with loan officers and customers to address non-performing loans. A watch list of credits which pose a potential loss to the Company is

prepared based on the loan grading system. This list forms the foundation of the Company's allowance for loan loss computation.

Management relies on its guidelines and existing methodology to monitor the performance of its loan portfolio and identify and estimate potential losses based on the best available information. The potential effect resulting from the economic downturn on a national and local level, the decline in real estate values and actual losses incurred by the Company were key factors in our analysis. Much of the Company's loan portfolio is collateral-dependent, requiring careful consideration of changes in the value of the collateral.

The Company's on-going, systematic evaluation resulted in the Company recording a provision for loan losses of \$3,541,000 and \$542,000 for the third quarters of 2014 and 2013, respectively, and \$4,615,000 and \$4,619,000 for the first three quarters of 2014 and 2013, respectively. As a result of receiving new appraisals during the third quarter of 2014, the Company updated the evaluation of the collateral value relating to two previously impaired loans. An additional loan loss provision of \$1,700,000 was recorded for one out-of-area residential development loan. An additional loan loss provision of \$2,100,000 was recorded for one commercial real estate loan secured by a hotel in our trade area. During the second quarter of 2013, the Company recorded a loan loss provision of \$3,000,000 on the out-of-area residential development loan. The allowance for loan losses as a percentage of loans was 3.07% and 2.38% at September 30, 2014 and December 31, 2013, respectively. The Company's analysis includes evaluating the current values of collateral securing all nonaccrual loans. Even though nonaccrual loans were \$33,451,000 and \$26,171,000 at September 30, 2014 and December 31, 2013, respectively, specific reserves of only \$4,489,000 and \$1,280,000, respectively, have been allocated to these loans as collateral values appear sufficient to cover loan losses or the loan balances have been charged down to their realizable value. The Company believes that its allowance for loan losses is appropriate as of September 30, 2014.

The allowance for loan losses is an estimate, and as such, events may occur in the future which may affect its accuracy. The Company anticipates that it is possible that additional information will be gathered in future quarters which may require an adjustment to the allowance for loan losses. Management will continue to closely monitor its portfolio and take such action as it deems appropriate to accurately report its financial condition and results of operations.

### **Non-interest income**

#### Quarter Ended September 30, 2014 as Compared with Quarter Ended September 30, 2013

Non-interest income decreased \$227,000 for the third quarter of 2014 as compared with the third quarter of 2013. Trust department income and fees increased while service charges on deposit accounts and income from other investments decreased in 2014 as compared with 2013.

Trust department income and fees increased \$23,000 in 2014 as compared with 2013 as a result of the increase in market value, on which fees are based, of personal trust accounts.

Service charges on deposit accounts decreased by \$181,000 during the third quarter of 2014 as compared with the third quarter of 2013. ATM fee income decreased \$182,000 as the Company's off-site ATMs at a casino transferred to another vendor during 2014.

The Company realized a loss from operations of its investment in a low income housing partnership in 2014 as compared with income from operations in 2013 as a result of decreased occupancy.

Nine Months Ended September 30, 2014 as Compared with Nine Months Ended September 30, 2013

Non-interest income decreased \$262,000 for the first three quarters of 2014 as compared with the first three quarters of 2013. Trust department income accounts increased and income from other investments decreased in 2014 as compared with 2013. During the first three quarters of 2013, the Company realized gains from sales and calls of securities while there were no sales or calls in 2014.

Trust department income and fees increased \$46,000 in 2014 as compared with 2013 as a result of the increase in market value, on which fees are based, of personal trust accounts.

The Company realized no income from operations of its investment in a low income housing partnership in 2014 as compared with income from operations in 2013 as a result of decreased occupancy.

**Non-interest expense**

Quarter Ended September 30, 2014 as Compared with Quarter Ended September 30, 2013

Total non-interest expense increased \$73,000 for the third quarter of 2014 as compared with the third quarter of 2013. Net occupancy increased \$56,000; equipment rentals, depreciation and maintenance increased \$26,000; FDIC assessments increased \$97,000; data processing expenses increased \$23,000; ATM expense increased \$22,000 and other expenses decreased \$148,000 for the third quarter of 2014 as compared with the third quarter of 2013.

The increase in net occupancy was primarily the result of increased insurance costs during 2014.

The increase in equipment rentals, depreciation and maintenance expense was primarily the result of servicing costs associated with bank-wide hardware and software conversions during 2014.

FDIC assessment costs in 2013 included a refund of prepaid assessments which results in 2013 expense being lower than 2014 expense.

Data processing costs increased in 2014 as compared with 2013 as result of additional costs associated with bank-wide hardware and software conversions.

ATM expenses increased in 2014 as a result of increased ATM activity in the current year.

Other expenses decreased in 2014 as 2013's results included costs incurred to produce a new advertising campaign and the Company's legal fees decreased in 2014 as compared with 2013.

Nine Months Ended September 30, 2014 as Compared with Nine Months Ended September 30, 2013

Total non-interest expense increased \$1,239,000 for the first three quarters of 2014 as compared with the first three quarters of 2013. Salaries and employee benefits increased \$421,000; equipment rentals, depreciation and maintenance increased \$157,000; FDIC assessments increased \$192,000; data processing expenses increased \$79,000 and ATM expense increased \$246,000 for the first three quarters of 2014 as compared with the first three quarters of 2013.



The increase in salaries and employee benefits was primarily the result of an increase in salaries and increase in costs relating to the deferred compensation plans. Salaries increased \$170,000 in the first three quarters of 2014 as compared with the first three quarters of 2013 due to merit raises. Costs associated with the Company's deferred compensation plans increased \$204,000 as a result of a change in the discount rate utilized to compute the related liabilities.

The increase in equipment rentals, depreciation and maintenance expense was primarily the result of servicing costs associated with bank-wide hardware and software conversions during 2014.

FDIC assessment costs in 2013 included a refund of prepaid assessments which results in 2013 expense being lower than 2014 expense.

Data processing costs increased in 2014 as compared with 2013 as result of additional costs associated with bank-wide hardware and software conversions.

ATM expenses increased in 2014 as a result of increased ATM activity in the current year.

### Income Taxes (Benefit)

Income taxes have been impacted by non-taxable income and federal tax credits during the quarters and nine months ended September 30, 2014 and 2013, as follows (in thousands except rate):

	Quarters Ended September 30,			
	2014		2013	
	Tax	Rate	Tax	Rate
Taxes at statutory rate	\$ (1,038)	(34)	\$ 265	34
Increase (decrease) resulting from:				
Tax-exempt interest income	(142)	(5)	(249)	(32)
Income from BOLI	(39)	(1)	(42)	(5)
Federal tax credits	(75)	(2)	(74)	(9)
Other	40	1	(5)	(1)
Total income taxes (benefit)	\$ (1,254)	(41)	\$ (105)	(13)

	Nine Months Ended September 30,			
	2014		2013	
	Tax	Rate	Tax	Rate
Taxes at statutory rate	\$ (837)	(34)	\$ (201)	(34)
Increase (decrease) resulting from:				
Tax-exempt interest income	(402)	(16)	(395)	(66)
Income from BOLI	(122)	(5)	(124)	(21)
Federal tax credits	(223)	(10)	(222)	(38)
Other	6	1	6	1
<b>Total income taxes (benefit)</b>	<b>\$ (1,578)</b>	<b>(64)</b>	<b>\$ (936)</b>	<b>(158)</b>

## FINANCIAL CONDITION

Cash and due from banks decreased \$4,885,000 at September 30, 2014, compared with December 31, 2013 in the management of the bank subsidiary's liquidity position.

Federal funds sold totaled \$25,000,000 at September 30, 2014 as a result of the bank subsidiary's liquidity position.

Loans decreased \$17,157,000 at September 30, 2014 compared with December 31, 2013, as principal payments, maturities, charge-offs and foreclosures on existing loans exceeded new loans.

Other real estate ( ORE ) increased \$80,000 at September 30, 2014 as compared with December 31, 2013. Loans totaling \$1,144,000 were transferred into ORE while \$845,000 was sold for a loss of \$80,000 and writedowns of ORE to fair value were \$219,000 during the first nine months of 2014.

Other assets decreased \$1,104,000 at September 30, 2014 as compared with December 31, 2013 primarily as the Company received an income tax refund of \$1,215,000.

Total deposits increased \$21,146,000 at September 30, 2014, as compared with December 31, 2013. Typically, significant increases or decreases in total deposits and/or significant fluctuations among the different types of deposits from quarter to quarter are anticipated by Management as customers in the casino industry and county and municipal entities reallocate their resources periodically.

Federal funds purchased and securities sold under agreements to repurchase decreased \$18,865,000 at September 30, 2014 as compared with December 31, 2013 as several county and municipal entities reallocated their balances from a non-deposit account during 2014.

Borrowings from the Federal Home Loan Bank decreased \$15,179,000 at September 30, 2014 as compared with December 31, 2013 based on the liquidity needs of the bank subsidiary.

Employee and director benefit plans liabilities increased \$772,000 at September 30, 2014 as compared with December 31, 2013 due to deferred compensation benefits earned by officers and directors during 2014.



**SHAREHOLDERS EQUITY AND CAPITAL ADEQUACY**

Strength, security and stability have been the hallmark of the Company since its founding in 1985 and of its bank subsidiary since its founding in 1896. A strong capital foundation is fundamental to the continuing prosperity of the Company and the security of its customers and shareholders.

The Company and the Bank are subject to regulatory capital adequacy requirements imposed by the federal banking agencies. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, specific capital guidelines that involve quantitative measures of the bank subsidiary's assets and certain off-balance sheet items, adjusted for credit risk, as calculated under regulatory accounting practices must be met. The risk-based capital standards currently in effect are designed to make regulatory capital requirements more sensitive to differences in risk profiles among bank holding companies and banks and to account for off-balance sheet exposure. Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios of Total and Tier 1 capital to risk-weighted assets, and Tier 1 capital to average assets.

As of September 30, 2014, the most recent notification from the Federal Deposit Insurance Corporation categorized the bank subsidiary as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the bank subsidiary must have a Total risk-based capital ratio of 10.00% or greater, a Tier 1 risk-based capital ratio of 6.00% or greater and a Leverage capital ratio of 5.00% or greater. There are no conditions or events since that notification that Management believes have changed the bank subsidiary's category.

The actual capital amounts and ratios and required minimum capital amounts and ratios for the Company as of September 30, 2014 and December 31, 2013, are as follows (in thousands):

	<b>Actual</b>		<b>For Capital Adequacy Purposes</b>	
	<b>Amount</b>	<b>Ratio</b>	<b>Amount</b>	<b>Ratio</b>
<b>September 30, 2014:</b>				
Total Capital (to Risk Weighted Assets)	\$ 109,580	23.20%	\$ 37,792	8.00%
Tier 1 Capital (to Risk Weighted Assets)	103,612	21.93%	18,896	4.00%
Tier 1 Capital (to Average Assets)	103,612	13.89%	29,842	4.00%
<b>December 31, 2013:</b>				
Total Capital (to Risk Weighted Assets)	\$ 111,141	22.79%	\$ 39,022	8.00%
Tier 1 Capital (to Risk Weighted Assets)	105,009	21.54%	19,511	4.00%
Tier 1 Capital (to Average Assets)	105,009	13.48%	31,170	4.00%

The actual capital amounts and ratios and required minimum capital amounts and ratios for the Bank as of September 30, 2014 and December 31, 2013, are as follows (in thousands):

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
September 30, 2014:						
Total Capital (to Risk Weighted Assets)	\$ 105,879	22.44%	\$ 37,743	8.00%	\$ 47,179	10.00%
Tier 1 Capital (to Risk Weighted Assets)	99,918	21.18%	18,872	4.00%	28,307	6.00%
Tier 1 Capital (to Average Assets)	99,918	13.56%	29,473	4.00%	36,842	5.00%
December 31, 2013:						
Total Capital (to Risk Weighted Assets)	\$ 106,870	21.94%	\$ 38,968	8.00%	\$ 48,711	10.00%
Tier 1 Capital (to Risk Weighted Assets)	100,746	20.69%	19,484	4.00%	29,227	6.00%
Tier 1 Capital (to Average Assets)	100,746	13.02%	30,958	4.00%	38,697	5.00%

In addition to monitoring its risk-based capital ratios, the Company also determines the primary capital ratio on a quarterly basis. This ratio was 14.77% at September 30, 2014, which is well above the regulatory minimum of 6.00%. Management continues to emphasize the importance of maintaining the appropriate capital levels of the Company and has established the goal of maintaining its primary capital ratio at 8.00%, which is the minimum requirement for classification as being well-capitalized by the banking regulatory authorities.

## LIQUIDITY

Liquidity represents the Company's ability to adequately provide funds to satisfy demands from depositors, borrowers and other commitments by either converting assets to cash or accessing new or existing sources of funds. Management monitors these funds requirements in such a manner as to satisfy these demands and provide the maximum earnings on its earning assets. The Company manages and monitors its liquidity position through a number of methods, including through the computation of liquidity risk targets and the preparation of various analyses of its funding sources and utilization of those sources on a monthly basis. The Company also uses proforma liquidity projections which are updated on a monthly basis in the management of its liquidity needs and also conducts periodic contingency testing on its liquidity plan.

Deposits, payments of principal and interest on loans, proceeds from maturities of investment securities and earnings on investment securities are the principal sources of funds for the Company. Borrowings from the FHLB, federal funds sold and federal funds purchased are utilized by the Company to manage its daily liquidity position. The Company has also been approved to participate in the Federal Reserve Bank's Discount Window Primary Credit Program, which it intends to use only as a contingency.

## REGULATORY MATTERS

During 2009, Management identified opportunities for improving risk management, addressing asset quality concerns, managing concentrations of credit risk and ensuring sufficient liquidity at the Bank as a result of its own investigation as well as examinations performed by certain bank regulatory agencies. In concert with the regulators, the Company and the Bank identified specific corrective



steps and actions to enhance its risk management, asset quality and liquidity policies, controls and procedures. The Company and the Bank may not declare or pay any cash dividends without the prior written approval of their regulators.

**Item 4: Controls and Procedures**

As of September 30, 2014, an evaluation was performed under the supervision and with the participation of the Chief Executive Officer and Chief Financial Officer of the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e)). Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective to ensure that the information required to be disclosed by the Company in the reports it files or submits under the Securities Exchange Act of 1934 is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

There were no changes in the Company's internal control over financial reporting that occurred during the period ended September 30, 2014 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**PART II - OTHER INFORMATION**

**Item 1: Legal Proceedings**

The Bank is involved in various legal matters and claims which are being defended and handled in the ordinary course of business. None of these matters is expected, in the opinion of Management, to have a material adverse effect upon the financial position or results of operations of the Company.

**Item 5: Other Information**

None.

**Item 6 - Exhibits and Reports on Form 8-K**

(a) Exhibits

- Exhibit 31.1: Certification of Chief Executive Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002
- Exhibit 31.2: Certification of Chief Financial Officer Pursuant to Section 302 of the Sarbanes - Oxley Act of 2002
- Exhibit 32.1: Certification of Chief Executive Officer Pursuant to 18 U.S.C. ss. 1350
- Exhibit 32.2: Certification of Chief Financial Officer Pursuant to 18 U.S.C. ss. 1350
- Exhibit 101 The following materials from the Company's quarterly report on Form 10-Q for the quarter ended September 30, 2014, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Condition at September 30, 2014 and December 31, 2013, (ii) Consolidated Statements of Operations for the quarters and nine months ended September 30, 2014 and 2013, (iii) Consolidated Statements of Comprehensive Income (Loss) for the quarters and nine months ended September 30, 2014 and 2013, (iv) Consolidated Statement of Changes in Shareholders' Equity for the nine months ended September 30, 2014, (v) Consolidated Statements of Cash Flows for the nine months ended September 30, 2014 and 2013 and (vi) Notes to the Unaudited Consolidated Financial Statements for the nine months ended September 30, 2014 and 2013.

(b) Reports on Form 8-K

A Form 8-K was filed on July 23, 2014 and October 22, 2014.

SIGNATURES

Pursuant to the requirement of Section 13 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.

PEOPLES FINANCIAL CORPORATION

(Registrant)

Date: November 13, 2014

By: /s/ Chevis C. Swetman  
Chevis C. Swetman  
Chairman, President and Chief Executive Officer  
(principal executive officer)

Date: November 13, 2014

By: /s/ Lauri A. Wood  
Lauri A. Wood  
Chief Financial Officer and Controller  
(principal financial and accounting officer)