**Board of Governors of the Federal Reserve System**

# Annual Report of Holding Companies—FR Y-6

RECEIVED
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NIC UNIT

## Report at the close of business as of the end of fiscal year

This Report is required by law: Section 5(c)(1)(A) of the Bank Holding Company Act (12 U.S.C. § 1844 (c)(1)(A)); Section 8(a) of the International Banking Act (12 U.S.C. § 3106(a)); Sections 11(a)(1), 25 and 25A of the Federal Reserve Act (12 U.S.C. §§ 248(a)(1), 602, and 611a); Section 211.13(c) of Regulation K (12 C.F.R. § 211.13(c)); and Section 225.5(b) of Regulation Y (12 C.F.R. § 225.5(b)) and section 10(c)(2)(H) of the Home Owners' Loan Act. Return to the appropriate Federal Reserve Bank the original and the number of copies specified.

This report form is to be filed by all top-tier bank holding companies and top-tier savings and loan holding companies organized under U.S. law, and by any foreign banking organization that does not meet the requirements of and is not treated as a qualifying foreign banking organization under Section 211.23 of Regulation K (12 C.F.R. § 211.23). (See page one of the general instructions for more detail of who must file.) The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, an information collection unless it displays a currently valid OMB control number.

NOTE: The *Annual Report of Holding Companies* must be signed by one director of the top-tier holding company. This individual should also be a senior official of the top-tier holding company. In the event that the top-tier holding company does not have an individual who is a senior official and is also a director, the chairman of the board must sign the report.

I, Harry J. Brooks
Name of the Holding Company Director and Official

Chairman
Title of the Holding Company Director and Official

attest that the *Annual Report of Holding Companies* (including the supporting attachments) for this report date has been prepared in conformance with the instructions issued by the Federal Reserve System and are true and correct to the best of my knowledge and belief.

*With respect to information regarding individuals contained in this report, the Reporter certifies that it has the authority to provide this information to the Federal Reserve. The Reporter also certifies that it has the authority, on behalf of each individual, to consent or object to public release of information regarding that individual. The Federal Reserve may assume, in the absence of a request for confidential treatment submitted in accordance with the Board's "Rules Regarding Availability of Information," 12 C.F.R. Part 261, that the Reporter and individual consent to public release of all details in the report concerning that individual.*

HJ Brooks
Signature of Holding Company Director and Official

03/25/2016
Date of Signature

*For holding companies not registered with the SEC–*
Indicate status of Annual Report to Shareholders:

- ☐ is included with the FR Y-6 report
- ☒ will be sent under separate cover
- ☐ is not prepared

**For Federal Reserve Bank Use Only**

RSSD ID 4211402
C.I. ______

**Date of Report** (top-tier holding company's fiscal year-end):
December 31, 2015
Month / Day / Year

NA
Reporter's Legal Entity Identifier (LEI) (20-Character LEI Code)

Reporter's Name, Street, and Mailing Address

Commercial Bancshares, Inc.
Legal Title of Holding Company

10203 Birchridge Dr, Suite B
(Mailing Address of the Holding Company) Street / P.O. Box

| Humble | TX | 77338 |
|---|---|---|
| City | State | Zip Code |

Physical Location (if different from mailing address)

Person to whom questions about this report should be directed:

| Shirley Enloe | EVP Operations |
|---|---|
| Name | Title |

281-318-4648
Area Code / Phone Number / Extension

281-319-4012
Area Code / FAX Number

shirley.enloe@csbec.com
E-mail Address

Address (URL) for the Holding Company's web page

*Does the reporter request confidential treatment for any portion of this submission?*

☒ Yes Please identify the report items to which this request applies:
Item 4-3Cand 4c

☒ In accordance with the instructions on pages GEN-2 and 3, a letter justifying the request is being provided.

☒ The information for which confidential treatment is sought is being submitted separately labeled "Confidential."

☐ No

# For Use By Tiered Holding Companies

*Top-tiered holding companies must list the names, mailing address, and physical locations of each of their subsidiary holding companies below.*

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

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City State Zip Code

Physical Location (if different from mailing address)

COMMERCIAL BANCSHARES, INC.
December 31, 2015

REPORT ITEM: 2A

## ORGANIZATIONAL CHART

COMMERCIAL BANCSHARES, INC. Humble, Texas, USA, Incorporated in Texas
(Top Tier Holding Company) LEI - NONE

100%

COMMERCIAL STATE BANK, El Campo,
Texas USA, Incorporated in Texas
(Commercial Bank) LEI - NONE

REPORT ITEM: 2B

Depository Inst. Branch Data Verification - E-Mailed 02/18/2016

See attached – Branch report
(FRY6 Depository Ins BR Data Verification – file sent to structure.verification@dal.frb.org
Subject line of email: CBI RSSD #4211402 BRANCH DATA VERIFICATION

AMENDED
SEP 06 2016

**Results:** A list of branches for your depository institution: COMMERCIAL STATE BANK (ID_RSSD: 662659).

This depository institution is held by COMMERCIAL BANCSHARES, INC. (4211402) of HUMBLE, TX.

The data are as of 12/31/2014. Data reflects information that was received and processed through 01/07/2015.

**Reconciliation and Verification Steps**

1. In the **Data Action** column of each branch row, enter one or more of the actions specified below.
2. If required, enter the date in the **Effective Date** column.

**Actions**

OK: If the branch information is correct, enter 'OK' in the **Data Action** column.

Change: If the branch information is incorrect or incomplete, revise the data, enter 'Change' in the **Data Action** column and the date when this information first became valid in the **Effective Date** column.

Close: If a branch listed was sold or closed, enter 'Close' in the **Data Action** column and the sale or closure date in the **Effective Date** column.

Delete: If a branch listed was never owned by this depository institution, enter 'Delete' in the **Data Action** column.

Add: If a reportable branch is missing, insert a row, add the branch data, and enter 'Add' in the **Data Action** column and the opening or acquisition date in the **Effective Date** column.

If printing this list, you may need to adjust your page setup in MS Excel. Try using landscape orientation, page scaling, and/or legal sized paper.

**Submission Procedure**

When you are finished, send a saved copy to your FRB contact. See the detailed instructions on this site for more information.

If you are e-mailing this to your FRB contact, put your institution name, city and state in the subject line of the e-mail.

Note:

To satisfy the **FR Y-10 reporting requirements**, you must also submit FR Y-10 Domestic Branch Schedules for each branch with a **Data Action** of Change, Close, Delete, or Add.

The FR Y-10 report may be submitted in a hardcopy format or via the FR Y-10 Online application - https://y10online.federalreserve.gov.

* FDIC UNINUM, Office Number, and ID_RSSD columns are for reference only. Verification of these values is not required.

| Data Action | Effective Date | Branch Service Type | Branch ID_RSSD* | Popular Name | Street Address | City | State | Zip Code | County | Country | FDIC UNINUM* | Office Number* | Head Office | Head Office ID_RSSD* | Comments |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| OK | | Full Service (Head Office) | 662659 | COMMERCIAL STATE BANK | 401 N. MECHANIC | EL CAMPO | TX | 77437-0150 | WHARTON | UNITED STATES | 1586 | 0 | COMMERCIAL STATE BANK | 662659 | |
| OK | | Full Service | 3530405 | FULSHEAR BRANCH | 29818 FM 1093 ROAD | FULSHEAR | TX | 77441-3918 | FORT BEND | UNITED STATES | 466642 | 2 | COMMERCIAL STATE BANK | 662659 | |
| OK | | Full Service | 4289728 | HUMBLE BRANCH | 10203 BIRCHRIDGE DRIVE, SUITE 100 | HUMBLE | TX | 77338-2256 | HARRIS | UNITED STATES | 520828 | 3 | COMMERCIAL STATE BANK | 662659 | |
| OK | | Full Service | 720166 | PALACIOS BRANCH | 459 MAIN ST | PALACIOS | TX | 77465-5463 | MATAGORDA | UNITED STATES | Not Required | Not Required | COMMERCIAL STATE BANK | 662659 | |

Commercial Bancshares, Inc.
Bank Holding Company

Report Item: #3

December 31, 2015
SHAREHOLDERS

| Item 1a | Item 1b | Item 1c | |
|---|---|---|---|
| Name, City and State | Country of Citizenship | Number of Shares | Percentage |
| Diana R. Melanson | USA | 618,971 | 19.29% |
| El Campo, Texas | | | |

| Item 2a | Item 2b | Item 2c | |
|---|---|---|---|
| Name, City and State | Country of Citizenship | Number of Shares | Percentage |
| N/A | | | |

FRY6
Commercial Bancshares Inc.
Report Item 4: Insiders
As of 12/31/2015

| 1. Name, City and State | 2. Principal Occupation | 3a. Title & Position with BHC | 3b. Title and Position with Sub | 3c. Title and Position with Other Business | 4a. %Voting Shares Bank Holding Co. | 4b. % of Voting Shares Shares in Sub | 4c. List names of other companies with 25% Voting |
|---|---|---|---|---|---|---|---|
| Harry J. Brooks<br>Humble, Texas | Banking | Chairman<br>Director, CEO | Chairman, Director,<br>CEO | PLEASE REFER TO THE CONFIDENTIAL DOCUMENT | 4.79% | N/A | PLEASE REFER TO THE CONFIDENTIAL DOCUMENT |
| John N. Bedford<br>Magnolia, Texas | Banking | Vice Chairman<br>Director | Vice Chairman, Director<br>Executive Officer | | 3.86% | N/A | |
| James B. Bishop<br>Houston, Texas | Manufacturing &<br>Marketing | Director | Director | | 1.56% | N/A | |
| Jeffrey M. Cravey<br>Bellaire, Texas | Accountant | Director | Director | | 0.47% | N/A | |
| Jerry Crawford<br>Houston, Texas | Real Estate &<br>Construction | Director | Director | | 0.78% | N/A | |
| Jesse Gonzalez<br>Houston, Texas | Construction | Director | Director | | 1.56% | N/A | |
| David R. Melanson<br>Fulshear, Texas | Banking | Director | Vice Chairman, Director<br>Executive Vice Pres. | | 0.05% | N/A | |
| Diana R. Melanson<br>El Campo, Texas | Banking | Director | Director | | 19.29% | N/A | |
| Robert C. Nickles, Jr.<br>Hockley, Texas | Banking | Director | Director | | 3.12% | N/A | |
| Scott Trull<br>Austin, Texas | Investments | Director | Director | | 1.93% | N/A | |
| Bruce Herlin<br>Palacios, Texas | Agriculture & Minerals | Director | Director | | 2.56% | N/A | |
| James Alexander<br>Spring, Texas | Banking | Director<br>Secretary | Director<br>President & CLO | | 1.44% | N/A | |
| Julie Barry, Esq.<br>Houston, Texas | Attorney | Director | Director | | 0.03% | N/A | |
| Ken Johnson<br>Palacios, Texas<br>FRY6 | Banking | Director | Director<br>EVP - South Regional Manager | | 0.02% | N/A | |

**Commercial Bancshares Inc.**
**Report Item 4: Insiders**
**As of 12/31/2015**

| 1. Name, City and State | 2. Principal Occupation | 3a. Title & Position with BHC | 3b. Title and Position with Sub | 3c. Title and Position with Other Business | 4a. %Voting Shares Bank Holding Co. | 4b. % of Voting Shares Shares in Sub | 4c. List names of other companies with 25% Voting |
|---|---|---|---|---|---|---|---|
| Shirley Enloe<br>Huntsville, Texas | Banking | Secretary | EVP Operations/HR Director | | 0.00% | N/A | |
| Karen Mermingas<br>Houston, Texas | Banking | Secretary | EVP - Audit/Compliance/Credit | | 0.09% | N/A | |
| Footnotes | Item 4b | Commercial State Bank is 100% owned by Commercial Bancshares, Inc. | | | | | |

# COMMERCIAL BANCSHARES, INC.
# AND SUBSIDIARY

## AUDITED
## CONSOLIDATED FINANCIAL STATEMENTS

## DECEMBER 31, 2015 AND 2014

FISHER, HERBST & KEMBLE
CERTIFIED PUBLIC ACCOUNTANTS

# TABLE OF CONTENTS

FHK | Experience. That counts!
CERTIFIED PUBLIC ACCOUNTANTS

9501 Console Drive, Suite 200
San Antonio, TX 78229
www.fhkcpa.com
210.614.2284
210.614.2285 fax

# REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

Board of Directors and Shareholders
Commercial Bancshares, Inc. and Subsidiary
El Campo, Texas

We have audited the accompanying consolidated balance sheets of Commercial Bancshares, Inc. and Subsidiary (the "Company") as of December 31, 2015 and 2014, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) and in accordance with U.S. generally accepted auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Commercial Bancshares, Inc. and Subsidiary as of December 31, 2015 and 2014, the results of its operations and its cash flows for the years then ended, in conformity with U.S. generally accepted accounting principles.

Our audit was conducted for the purpose of forming an opinion on the consolidated financial statements as a whole. The accompanying supplementary information is presented for purposes of additional analysis and is not a required part of the consolidated financial statements. Such information is the responsibility of management and was derived from and relates directly to the underlying accounting and other records used to prepare the consolidated financial statements. The information has been subjected to the auditing procedures applied, including comparing and reconciling such information directly to the underlying accounting and other records used to prepare the consolidated financial statements or to the consolidated financial statements themselves, and other additional procedures in accordance with the standards of the Public Company Accounting Oversight Board (United States). In our opinion, the information is fairly stated in all material respects in relation to the consolidated financial statements as a whole.

Fisher, Herbst + Kemble, P.C.

Fisher, Herbst & Kemble, P.C.
San Antonio, Texas
February 25, 2016

## COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY

## CONSOLIDATED BALANCE SHEETS

| December 31, | 2015 | 2014 |
|---|---|---|
| **ASSETS** | | |
| Cash and Cash Equivalents | | |
| Cash and due from banks | $ 4,403,878 | $ 3,708,474 |
| Interest-bearing deposits in other banks | 36,648,660 | 49,170,407 |
| Total cash and cash equivalents | 41,052,538 | 52,878,881 |
| Time deposits in other banks | 1,000,000 | 3,006,772 |
| Investment securities, available-for-sale, at fair value | 45,642,117 | 39,176,294 |
| Loans receivable, net | 225,620,304 | 200,462,832 |
| Accrued interest receivable | 1,166,621 | 1,023,294 |
| Premises and equipment, net | 1,557,458 | 1,673,390 |
| Cash surrender value on bank owned life insurance | 7,186,448 | 6,974,888 |
| Prepaid expenses | 274,885 | 190,127 |
| Investment in Commercial Venture West, LLC | 822,293 | 823,099 |
| Deferred tax asset | 465,668 | 135,468 |
| Core deposit intangible | 147,808 | 310,346 |
| Goodwill | 535,725 | 535,725 |
| Other assets | 1,143,235 | 1,298,644 |
| **Total assets** | $ 326,615,100 | $ 308,489,760 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Deposits: | | |
| Demand deposits | $ 123,934,463 | $ 123,719,149 |
| Savings and NOW deposits | 111,180,250 | 92,193,372 |
| Time deposits | 52,759,907 | 56,521,727 |
| Total deposits | 287,874,620 | 272,434,248 |
| Accrued interest payable | 40,725 | 46,600 |
| Deferred compensation payable | 141,233 | 129,964 |
| Other liabilities | 143,108 | 523,942 |
| Total liabilities | 288,199,686 | 273,134,754 |
| Shareholders' Equity | | |
| Common stock, par value $1 per share: 10,000,000 shares authorized; **3,063,172** and 3,062,172 shares issued and outstanding in 2015 and 2014, respectively | 3,063,172 | 3,062,172 |
| Additional paid-in capital | 28,009,640 | 27,912,849 |
| Retained earnings | 7,043,011 | 3,962,509 |
| Accumulated other comprehensive income | 299,591 | 417,476 |
| Total shareholders' equity | 38,415,414 | 35,355,006 |
| **Total liabilities and shareholders' equity** | $ 326,615,100 | $ 308,489,760 |

**See accompanying notes to the consolidated financial statements.**

**COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF INCOME**

| Years Ended December 31, | 2015 | 2014 |
|---|---|---|
| **INTEREST INCOME** | | |
| Loans, including fees | **$ 11,504,962** | $ 10,445,851 |
| Securities available-for-sale | **855,484** | 928,051 |
| Other interest income | **412,114** | 294,225 |
| Total interest income | **12,772,560** | 11,668,127 |
| **INTEREST EXPENSE** | **512,646** | 469,772 |
| **NET INTEREST INCOME** | **12,259,914** | 11,198,355 |
| **PROVISION FOR LOAN LOSSES** | **150,000** | 440,000 |
| **NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES** | **12,109,914** | 10,758,355 |
| **NON-INTEREST INCOME** | | |
| Service charges on deposit accounts | **466,562** | 483,071 |
| Other service charges and fees | **366,468** | 401,073 |
| Income in Commercial Venture West, LLC | **58,719** | 59,751 |
| Gain on sales of SBA loans | **301,128** | - |
| Gain on sales of investment securities | **121,191** | - |
| Other income | **49,378** | 346,695 |
| Total non-interest income | **1,363,446** | 1,290,590 |
| **NON-INTEREST EXPENSE** | | |
| Salaries, wages and benefits | **5,528,094** | 5,447,436 |
| Occupancy expense | **1,205,441** | 1,276,403 |
| Data and check processing | **624,788** | 661,802 |
| Professional services | **455,978** | 466,817 |
| Telephone, postage and supplies | **327,816** | 382,502 |
| Advertising and contributions | **171,999** | 166,487 |
| Loan, credit card and ATM expenses | **200,912** | 188,153 |
| Training, travel and periodicals | **199,824** | 205,521 |
| Regulatory fees | **41,636** | 49,081 |
| Insurance expense | **201,274** | 187,149 |
| Other real estate expense, including write-downs | - | 3,083 |
| Amortization of core deposit intangible | **162,538** | 221,043 |
| Other expense | **42,815** | 50,189 |
| Total non-interest expense | **9,163,115** | 9,305,666 |
| **INCOME BEFORE INCOME TAXES** | **4,310,245** | 2,743,279 |
| **INCOME TAXES EXPENSE** | **1,229,743** | 712,074 |
| **NET INCOME** | **$ 3,080,502** | $ 2,031,205 |

**See accompanying notes to the consolidated financial statements.**

**COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

| Years Ended December 31, | 2015 | 2014 |
|---|---|---|
| **NET INCOME** | **$ 3,080,502** | $ 2,031,205 |
| **OTHER ITEMS OF COMPREHENSIVE INCOME** | | |
| Adjustment for gain on sale of available-for-sale securities | **(121,191)** | - |
| Unrealized holding gain (loss) arising during period | **(57,423)** | 1,031,723 |
| Total other items of comprehensive income | **(178,614)** | 1,031,723 |
| Comprehensive income before tax | **2,901,888** | 3,062,928 |
| **INCOME TAX EFFECT ON OTHER ITEMS OF COMPREHENSIVE INCOME** | | |
| Income tax - gain on sale of available-for-sale securities | **41,205** | - |
| Income tax - unrealized holding loss (gain) | **19,524** | (350,786) |
| Total income tax on comprehensive income | **60,729** | (350,786) |
| Comprehensive income after tax | **$ 2,962,617** | $ 2,712,142 |

**See accompanying notes to the consolidated financial statements.**

**COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY**

Years Ended December 31, 2015 and 2014

| | Common Stock | Additional Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
|---|---|---|---|---|---|
| Balance at December 31, 2013 | $ 3,040,011 | $ 27,620,028 | $ 1,931,304 | $ (263,461) | $ 32,327,882 |
| Contribution of capital | 11,350 | 124,850 | - | - | 136,200 |
| Stock option expense | - | 78,888 | - | - | 78,888 |
| Issuance of stock for acquisition | 10,811 | 89,083 | - | - | 99,894 |
| Net income | - | - | 2,031,205 | - | 2,031,205 |
| Unrealized change in market value of securities, net of tax | - | - | - | 680,937 | 680,937 |
| Balance at December 31, 2014 | 3,062,172 | 27,912,849 | 3,962,509 | 417,476 | 35,355,006 |
| Stock option expense | - | **87,141** | - | - | **87,141** |
| Exercise of stock options | **1,000** | **9,650** | - | - | **10,650** |
| Net income | - | - | **3,080,502** | - | **3,080,502** |
| Unrealized change in market value of securities, net of tax | - | - | - | **(117,885)** | **(117,885)** |
| Balance at December 31, 2015 | **$ 3,063,172** | **$ 28,009,640** | **$ 7,043,011** | **$ 299,591** | **$ 38,415,414** |

**See accompanying notes to the consolidated financial statements.**

**COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

| Years Ended December 31, | 2015 | 2014 |
|---|---|---|
| **OPERATING ACTIVITIES** | | |
| Net income | **$ 3,080,502** | $ 2,031,205 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | **360,603** | 405,899 |
| Amortization of core deposit intangible | **162,538** | 221,043 |
| Amortization of loan purchase premium | **197,529** | 197,529 |
| Income in Commercial Venture West, LLC | **(58,719)** | (59,751) |
| Options expense | **87,141** | 78,888 |
| Provision for loan losses | **150,000** | 440,000 |
| Net amortization of security discounts and premiums | **379,248** | 414,031 |
| Gain on sale of securities | **(121,191)** | - |
| Gain on sales of loans | **(301,128)** | - |
| Deferred gain on loans held-for-sale | **(90,336)** | - |
| Originations of loans held-for-sale | **(3,671,494)** | - |
| Proceeds from loans held-for-sale | **3,982,412** | - |
| Servicing assets | **80,546** | - |
| Net change in: | | |
| Accrued interest receivable | **(143,327)** | (97,319) |
| Accrued interest payable | **(5,875)** | (4,641) |
| Deferred compensation payable | **11,269** | 10,445 |
| Deferred taxes | **(269,471)** | (325,097) |
| Other assets and liabilities | **(401,549)** | (445,668) |
| Net cash provided by operating activities | **3,428,698** | 2,866,564 |
| **INVESTING ACTIVITIES** | | |
| Securities available-for-sale transactions: | | |
| Purchases | **(88,643,243)** | (111,202,542) |
| Proceeds from maturities, calls, and paydowns | **76,693,090** | 114,479,072 |
| Proceeds from sales | **5,047,659** | - |
| Maturities of time deposits with other banks | **2,006,772** | 2,939,796 |
| Increase in the cash surrender value of bank owned life insurance, net | **(211,560)** | (2,469,705) |
| Net change in loans | **(25,424,455)** | (30,457,412) |
| Purchases of premises and equipment | **(223,955)** | (189,170) |
| Proceeds from the sale of fixed assets | **16,000** | - |
| Purchases of software | **(21,371)** | (39,783) |
| Distributions from Commercial Venture West, LLC | **55,000** | 58,862 |
| Net cash used by investing activities | **(30,706,063)** | (26,880,882) |
| **FINANCING ACTIVITIES** | | |
| Net change in deposits | **15,440,372** | 11,864,877 |
| Stock options exercised | **10,650** | 99,894 |
| Contribution of capital | - | 136,200 |
| Net cash provided by financing activities | **15,451,022** | 12,100,971 |
| **NET DECREASE IN CASH AND CASH EQUIVALENTS** | **(11,826,343)** | (11,913,347) |
| **CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR** | **52,878,881** | 64,792,228 |
| **CASH AND CASH EQUIVALENTS AT END OF THE YEAR** | **$ 41,052,538** | $ 52,878,881 |

**See accompanying notes to the consolidated financial statements.**

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

**Basis of Presentation** – The accounting and reporting policies of Commercial Bancshares, Inc. and Subsidiary conform to U.S. generally accepted accounting principles ("GAAP") and to general practices within the banking industry. The financial statements have been prepared in accordance with U.S. generally accepted accounting principles.

**Consolidation** – The consolidated financial statements include the accounts of Commercial Bancshares, Inc. ("Bancshares") and its wholly-owned subsidiary, Commercial State Bank ("Bank") which are collectively referred to as the Company. All inter-company entries have been eliminated in consolidation.

**Nature of Operations** – The Company provides a variety of banking services to individuals, businesses, and nonprofit organizations within their communities. The Bank primarily serves counties in the southeast Texas region, with a primary focus in Wharton, Harris, Montgomery, Matagorda, and Fort Bend counties. It is the policy of the Bank, consistent with safe and sound banking operations, to meet the deposit and credit needs of the entire community and not to purposefully exclude or discriminate against any area of the community.

Because of agricultural involvement, the Company makes farm loans to farmers in counties surrounding Matagorda and Wharton Counties and to known farmers in nearby counties. The Company also makes real estate development loans in nearby counties. The Bank's primary deposit products are demand deposits and certificates of deposit, and its primary lending products are real estate, mortgage, commercial, and consumer loans.

**Variable Interest Entities** – The Company determines whether it has a controlling financial interest in an entity by first evaluating whether the entity is a voting interest entity or a variable interest entity under U.S. generally accepted accounting principles. The Company has no controlling interest in any entity that should be treated as a VIE.

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

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, realization of deferred taxes and the estimate of deferred compensation liabilities. In connection with the determination of the allowances for losses on loans and foreclosed real estate, management obtains independent appraisals for significant properties.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

**Cash and Cash Equivalents** – For the purpose of presentation in the consolidated financial statements of cash flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions "cash and due from banks" and "interest-bearing deposits in other banks". Generally, federal funds are purchased and sold in one-day periods. The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents.

The majority of cash and cash equivalents of the Company are maintained with major financial institutions in the United States. As such, interest bearing, non-transaction account deposits with these financial institutions may exceed the amount of insurance provided on such deposits; however, these deposits typically may be redeemed upon demand and therefore, bear minimal risk. As of December 31, 2015, the maximum credit risk exposure is **$35,019,509**. In monitoring this credit risk, the Company periodically evaluates the stability of the financial institutions with which it has deposits.

**Securities** – Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held-to-maturity" and are recorded at amortized cost.

Securities held principally for resale in the near term are classified as trading securities and recorded at their fair values. Unrealized gains and losses on trading securities are included in income.

Securities not classified as held-to-maturity or trading, including equity securities with readily determinable fair values, are classified as "available-for-sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Purchase premiums and discounts are recognized as interest income using methods approximating the level-yield method over the terms of the securities. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other-than-temporary, if any, are reflected in earnings as realized losses. In determining whether other-than-temporary impairment exists, management considers many factors, including the length of time and the extent to which the fair value has been less than cost, the financial condition and near term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Mortgage-backed securities represent participating interests in pools of long-term first mortgage loans originated and serviced by the issuers of the securities. Market interest rate fluctuations can affect the prepayment speed of principal and the yield on the security.

**Loans** – Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at their outstanding unpaid principal balances reduced by any charge-offs or specific valuation accounts and net of any deferred fees or costs on originated loans.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Interest income is recognized based upon principal amounts outstanding. The accrual of interest on a loan is discontinued when, in the opinion of management, there is doubt about the ability of the borrower to pay interest or principal. Interest previously accrued but uncollected on such loans is reversed and charged against current income. Subsequent interest collected on such loans is credited to loan principal if, in the opinion of management, collectibility of principal is doubtful; otherwise, the interest collected is recognized as income and resumption of interest accruals may occur. Loans are charged off as uncollectible when, in the opinion of management, collectibility of principal is improbable.

The estimates used in determining the adequacy of the allowance for loan losses, including the amounts and timing of future cash flows expected on impaired loans, are particularly susceptible to changes in the near term.

Impaired loans are loans for which it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Company individually evaluates such loans for impairment and does not aggregate impaired loans by major risk classifications.

The definition of "impaired loans" is not the same as the definition of "nonaccrual loans," although the two categories overlap. The Company may choose to place a loan on nonaccrual status due to payment delinquency or uncertain collectibility. Factors considered by management in determining impairment include payment status, collateral value, strength of guarantor(s), and expected company performance.

The amount of impairment on impaired loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loans. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Loans are considered past due or delinquent based on the contractual terms in the loan agreement and the current payment history of the borrower.

**Troubled Debt Restructured Loans** – A troubled debt restructured loan is a loan for which the Company, for reasons related to a borrower's financial difficulties, grants a concession to the borrower that the Company would not otherwise consider. The loan terms which have been modified or restructured due to a borrower's financial difficulty, include but are not limited to a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals, renewals and rewrites. A troubled debt restructured loan would generally be considered impaired in the year of modification and will be assessed periodically for continued impairment.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

**Allowance for Loan Losses** – The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, representing management's best estimate of probable losses that have been incurred in the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses inherent in the loan portfolio. The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions and unidentified losses inherent in the current loan portfolio, as well as trends in the foregoing. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged-off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including the performance of the Company's loan portfolio, the economy, changes in interest rates and the view of the regulatory authorities toward loan classifications.

**Other Real Estate** – Assets acquired through, or in lieu of, loan foreclosure are initially recorded at fair value less estimated selling cost at the date of foreclosure. All write-downs based on the asset's fair value at the date of acquisition are charged to the allowance for loan losses. After foreclosure, property held for sale is carried at the lower of the new cost basis or fair value less cost to sell and depreciation is not recorded. Impairment losses on property to be held and used are measured as the amount by which the carrying amount of a property exceeds its fair value and are depreciated based on the remaining useful life of the property. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of a property to the lower of its cost or fair value less cost to sell.

**Premises and Equipment** – Premises and equipment are stated at cost less accumulated depreciation based on the estimated useful lives of the assets, as follows:

| | |
|---|---|
| Buildings and improvements | 10 - 40 years |
| Furniture and equipment | 3 - 10 years |

Land is carried at cost. Bank premises, furniture and equipment, and leasehold improvements are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method over the estimated useful lives of the assets. When an asset is sold, retired, or otherwise disposed of, cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is included in current operations. Maintenance and repairs which do not extend the life of banking premises and equipment are charged to expense.

**Cash Surrender Value of Bank-Owned Life Insurance** – The Company has purchased life insurance policies on certain executives. Life insurance policies are initially recorded at cost at the date of purchase. Subsequent to purchase, the policies are periodically adjusted for changes in the contract value. The adjustment to contract value increases or decreases the carrying value of the policies and is recorded as income or expense on the consolidated statement of income.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

**Goodwill and Other Intangible Assets** – U.S. generally accepted accounting principles include guidance addressing the initial recognition and measurement of intangible assets acquired outside of a business combination and the accounting for goodwill and other intangible assets subsequent to their acquisition. The guidance provides that intangible assets with finite useful lives be amortized and that goodwill and intangible assets with indefinite lives not be amortized but rather be tested at least annually for impairment. No goodwill impairment is noted in 2015 or 2014.

**Income Taxes** – The Company accounts for income taxes under the asset and liability method which requires that deferred income taxes be recognized for the tax consequences of temporary differences (differences between the financial statement carrying amount and the tax bases of assets and liabilities) at the enacted statutory tax rates applicable to the future years in which those differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rate is recognized in income in the period that includes the enactment date.

U.S. generally accepted accounting principles require Company management to evaluate tax positions taken by the Company and recognize a tax liability (or asset) if the Company has taken an uncertain position that more likely than not would not be sustained upon examination by the Internal Revenue Service. The Company's management has analyzed the tax positions taken by the Company, and has concluded that as of December 31, 2015 and 2014, there are no uncertain positions taken or expected to be taken that would require recognition of a liability (or asset) or disclosure in the financial statements. The Company is subject to routine audits by taxing jurisdictions; however, there are currently no audits for any tax periods in progress. The Company's management believes it is no longer subject to income tax examinations for years prior to 2012 due to an Internal Revenue Service examination completed in 2014 covering these earlier periods.

**Financial Instruments With Off-Balance-Sheet Risk** – In the ordinary course of business, the Company has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are accrued and received.

**Concentrations** – The cash surrender value of Bank-owned life insurance is approximately **20%** and 14% of total equity as of December 31, 2015 and 2014, respectively. Concentrations for loans can be found in Note 4.

## 2. BUSINESS COMBINATIONS

During 2013, the Company purchased the assets and liabilities of City State Bancshares, Inc. ("CSBI") and its wholly owned subsidiary, City State Bank of Palacios. The effective date of the acquisition was July 31, 2013. The net purchase price totaled \$5,426,347 of which the Company issued 512,808 shares of common stock valued at \$4,825,385 and made \$600,962 in cash payments to CSBI stockholders not eligible to hold shares of the Company.

## 2. BUSINESS COMBINATIONS (continued)

Effective January 1, 2011, the Company acquired El Campo Bancshares, Inc. ("ECBI"), which owned 100% of Commercial State Bank. ECBI was collapsed and merged into the Company, which resulted in the Company wholly owning Commercial State Bank. The ECBI acquisition resulted in $535,725 in goodwill being recorded by the Company.

In connection with the ECBI and CSBI purchases, the Company recorded core deposit intangibles of $1,241,496 and the related accumulated amortization is as follows:

| | El Campo Bancshares, Inc. | City State Bancshares, Inc. | Total Core Deposit |
|---|---|---|---|
| Intangible | $ 996,268 | $ 245,228 | $ 1,241,496 |
| Accumulated amortization | (912,548) | (181,140) | (1,093,688) |
| Net intangible | $ 83,720 | $ 64,088 | $ 147,808 |
| Amortization expense for 2015 | **$ 102,139** | **$ 60,399** | **$ 162,538** |
| Amortization expense for 2014 | $ 136,461 | $ 84,582 | $ 221,043 |

The estimated amortization expense in future years is as follows:

| | El Campo Bancshares, Inc. | City State Bancshares, Inc. | Total Core Deposit |
|---|---|---|---|
| Year Ending December 31, | | | |
| 2016 | $ 61,953 | $ 60,399 | $ 122,352 |
| 2017 | 21,767 | 3,689 | 25,456 |
| Total | $ 83,720 | $ 64,088 | $ 147,808 |

## 3. INVESTMENT SECURITIES

Investment securities have been classified in the balance sheet according to management's intent (see Note 1). The amortized cost of securities and their approximate fair values at December 31 were as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Market Value |
|---|---|---|---|---|
| **Available-for-sale securities** | | | | |
| **December 31, 2015** | | | | |
| U.S. Government agencies | **$ 2,763,186** | **$ 25,113** | **$ 19,122** | **$ 2,769,177** |
| State and political subdivisions | **36,817,386** | **562,504** | **122,436** | **37,257,454** |
| Mortgage-backed securities | **5,607,619** | **121,796** | **113,929** | **5,615,486** |
| Total | **$ 45,188,191** | **$ 709,413** | **$ 255,487** | **$ 45,642,117** |
| December 31, 2014 | | | | |
| U.S. Government agencies | $ 1,823,141 | $ 36,068 | $ 2,801 | $ 1,856,408 |
| State and political subdivisions | 24,232,395 | 519,534 | 150,274 | 24,601,655 |
| Mortgage-backed securities | 12,488,218 | 369,219 | 139,206 | 12,718,231 |
| Total | $ 38,543,754 | $ 924,821 | $ 292,281 | $ 39,176,294 |

The scheduled maturities of securities available-for-sale at December 31, 2015 were as follows:

| | Amortized Cost | Estimated Market Value |
|---|---|---|
| Due in one year or less | **$ 698,293** | **$ 698,820** |
| Due in one to five years | **14,673,337** | **14,670,550** |
| Due in five to ten years | **20,617,987** | **20,822,757** |
| Due in over ten years | **3,590,955** | **3,834,504** |
| Total | **39,580,572** | **40,026,631** |
| Mortgage-backed securities | **5,607,619** | **5,615,486** |
| Total | **$ 45,188,191** | **$ 45,642,117** |

## 3. INVESTMENT SECURITIES (continued)

Assets were pledged to secure public deposits and for other purposes required or permitted by law and carried at **$20,360,643** and $15,184,772 as of December 31, 2015 and 2014, respectively.

| | **2015** | 2014 |
|---|---|---|
| Sale proceeds from sale of available-for-sale securities | **$ 5,047,659** | $ - |
| Gross gains on sale of available-for-sale securities | **$ 121,191** | $ - |
| Gross losses on sale of available-for-sale securities | **$ -** | $ - |

The following table shows investment's gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2015.

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government agencies (4) | **$ 1,450,974** | **$ 19,122** | **$ -** | **$ -** | **$ 1,450,974** | **$ 19,122** |
| State and political subdivisions (44) | **10,707,951** | **102,883** | **1,572,738** | **19,553** | **12,280,689** | **122,436** |
| Mortgage-backed securities (5) | **2,427,788** | **113,929** | **-** | **-** | **2,427,788** | **113,929** |
| Total debt securities | **$ 14,586,713** | **$ 235,934** | **$ 1,572,738** | **$ 19,553** | **$ 16,159,451** | **$ 255,487** |

**U.S. Government Securities** – The unrealized losses on the Company's investments in U.S. Government securities were caused by interest rate increases. The Company purchased some of these investments at a premium relative to their face amount, and the contractual cash flows of these investments have an implied guarantee by the U.S. Government. At December 31, 2015, the outstanding premium related to the U.S. government agency security in a loss position is **$4,109**. Accordingly, it is expected that the securities with premiums could be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2015.

**State and Political Subdivisions** – The unrealized losses on the Company's investments in state and political subdivisions were caused by interest rate increases. The Company purchased some of these investments at a premium relative to their face amount. At December 31, 2015, the outstanding premium related to the state and political subdivisions in a loss position is **$673,008**. Accordingly, it is expected that the securities with premiums could be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2015.

## 3. INVESTMENT SECURITIES (continued)

**Mortgage Backed Securities** – The unrealized losses on the Company's investments in mortgage backed securities were caused by interest rate increases. The Company purchased some of these investments at a premium relative to their face amount. At December 31, 2015, the outstanding premium related to the mortgage backed securities in a loss position is **$157,398**. Accordingly, it is expected that the securities with premiums could be settled at a price less than the amortized cost of the Company's investment. Because the decline in market value is attributable to changes in interest rates and not credit quality and because the Company has the ability and intent to hold these investments until a recovery of fair value, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2015.

**Other-than-temporary Impairment** – Management evaluates securities for other-than-temporary impairment at least quarterly, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) evaluation by the Company of (a) its intent to sell a debt security prior to recovery and (b) whether it is more likely than not the Company will have to sell the debt security prior to recovery. As of December 31, 2015, no investment securities were other-than-temporarily impaired.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES

The components of loans receivable in the balance sheets are as follows at December 31, 2015 and 2014:

| | **2015** | 2014 |
|---|---|---|
| Real estate | **$ 164,416,135** | $ 142,788,784 |
| Commercial | **57,866,286** | 54,561,201 |
| Consumer | **5,465,416** | 4,818,652 |
| Total loans | **227,747,837** | 202,168,637 |
| Less: Allowance for loan losses | **(2,522,604)** | (2,298,418) |
| Total loans less allowance for loan losses | **225,225,233** | 199,870,219 |
| Loan purchase premium | **395,071** | 592,613 |
| Total, net | **$ 225,620,304** | $ 200,462,832 |

As of December 31, 2015, the Company's unsecured portion of the total SBA loan portfolio was **$850,121**. The total SBA loan portfolio at December 31, 2015 was **$3,671,494**. As of December 31, 2015, the Company net servicing asset was **$56,607**.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

**Loan Origination/Risk Management** – The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. The intent of management is to make loans to borrowers of good character and integrity. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial loans are underwritten after evaluating and understanding the borrower's ability to repay the loan through operating profitably and effectively growing its business. The Company's management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial loans are primarily made based on the credit quality and cash flows of the borrower and secondarily on the underlying collateral provided by the borrower.

The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and generally incorporate a personal guarantee to add strength to the credit and reduce the risk on a transaction to an acceptable level; however, some short-term loans may be made on an unsecured basis to the most credit worthy borrowers. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers. Due to the nature of accounts receivable and inventory secured loans, the Company closely monitors credit availability and collateral through the use of various tools, including but not limited to borrowing-base formulas, monthly or quarterly accounts receivable agings, periodic inventory audits, and/or collateral inspections.

Real estate (commercial real estate or consumer real estate) loans are subject to underwriting standards and processes similar to commercial loans. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral and risk grade criteria. As a general rule, the Company avoids financing special use projects unless strong secondary support is present to help mitigate risk.

With respect to loans to developers and builders, the Company generally requires the borrower to have a proven record of success and an expertise in the building industry. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the completed project. These estimates may be inaccurate.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to the ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing. Due to the nature of the real estate industry, the Company evaluates the borrower's ability to service the debt from sources other than the sale of the constructed property.

Agricultural loans are made to sound and prudent farmers and ranchers within the Company's market area even though agriculture may be an unstable industry. In order to minimize the Company's risk, sound lending policies are extremely important, taking into consideration not only the value of collateral offered but also the performance history and anticipated cash flow from a given farming or ranching operation. All agricultural loan applications require a cash flow projection for the coming farming season, and the projection must show a margin between income and expense that is sufficient to repay the loan from normal farm operations. All agriculture loans will be supported by a perfected first security interest position in the products being produced.

The Company's non-real estate consumer loans are based on the borrower's proven earning capacity over the term of the loan. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, by management. This activity, coupled with a relatively small volume of consumer loans, minimizes risk.

The Company engages an external consulting firm to complete an independent loan review that reviews and validates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk ratings and credit quality assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

An aged analysis of past due loans, segregated by class of loans, as of December 31, 2015 and 2014, were as follows:

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Still Accruing |
|---|---|---|---|---|---|---|---|
| **December 31, 2015** | | | | | | | |
| Real estate | $ - | $ - | $ 787,647 | $ 787,647 | $ 163,628,488 | $ 164,416,135 | $ 787,647 |
| Commercial | - | 427,511 | 1,189,858 | 1,617,369 | 56,248,917 | 57,866,286 | 1,512,500 |
| Consumer | - | - | - | - | 5,465,416 | 5,465,416 | - |
| Total | $ - | $ 427,511 | $ 1,977,505 | $ 2,405,016 | $ 225,342,821 | $ 227,747,837 | $ 2,300,147 |

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Recorded Investment > 90 Days and Still Accruing |
|---|---|---|---|---|---|---|---|
| December 31, 2014 | | | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ 142,788,784 | $ 142,788,784 | $ - |
| Commercial | - | - | - | - | 54,561,201 | 54,561,201 | - |
| Consumer | - | - | - | - | 4,818,652 | 4,818,652 | - |
| Total | $ - | $ - | $ - | $ - | $ 202,168,637 | $ 202,168,637 | $ - |

Impaired loans, segregated by class of loans, as of December 31, 2015 and 2014 are set forth in the following tables. The balance of impaired loans at December 31, 2015 and 2014 represented all non-accrual loans. No interest income was recognized on impaired loans subsequent to their classification as impaired.

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| **December 31, 2015** | | | | | |
| With no related allowance: | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ - |
| Commercial | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| With a related allowance: | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ - |
| Commercial | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total: | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ - |
| Commercial | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total | $ - | $ - | $ - | $ - | $ - |

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Prior to Impairment |
|---|---|---|---|---|---|
| December 31, 2014 | | | | | |
| With no related allowance: | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ - |
| Commercial | - | - | - | 205,154 | - |
| Consumer | - | - | - | - | - |
| With a related allowance: | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ - |
| Commercial | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total: | | | | | |
| Real estate | $ - | $ - | $ - | $ - | $ - |
| Commercial | - | - | - | 205,154 | - |
| Consumer | - | - | - | - | - |
| Total | $ - | $ - | $ - | $ 205,154 | $ - |

At December 31, 2015, there were no commitments to lend additional funds to borrowers whose loans are classified as impaired.

**Credit Quality Indicators** – As part of the on-going monitoring of the credit quality of the Company's loan portfolio, the Company utilizes a risk grading system to assign a risk grade to each of its loans. Accurate and timely credit grading is a primary component of an effective loan review system. Loans are graded on a scale of 1 to 10.

A description of the general characteristics of the 10 risk grades are as follows:

**Grade 1 "Excellent Quality / Minimal Risk"** – This category includes any loan that is 100% secured by CSB deposits, U.S. Government agency securities and any publicly traded stock that is properly margined – usually at 120%.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

**Grade 2 "High Quality / Nominal Risk"** – This grade is assigned to borrowers that have a stable record of strong earnings, a substantial current position, sound capitalization, and solid cash flow, and whose management team has experience and depth in a sound and stable industry. This category includes loans secured by U.S. Government or Agency Securities and other publicly traded securities if the collateral Loan-to-Value ("LTV") is within the guidelines specified within the Company's Loan Policy and/or supervisory LTV guidelines.

**Grade 3 "Good Quality / Low Risk"** – Borrowers assigned this grade are considered above average with higher than average credit standards based on leverage, liquidity and debt service coverage ratios

**Grade 4 "Average Quality / Average Risk"** – This grade includes borrowers that have average leverage, liquidity, and debt service coverage ratios that compare favorably with industry standards. The loans would be secured by acceptable collateral and having LTV ratios within policy guidelines.

**Grade 5 "Pass-Watch / Moderate Risk"** – Credit facilities falling under this grade have developing weakness that deserves extra attention from the loan officer and other management personnel. Overall financial ratios are still considered acceptable but are deteriorating and not at historically favorable levels or compare less favorably with industry standards.

**Grade 6 "Special Mention / Elevated Risk"** – Assets criticized Special Mention include any asset with a potential weakness that, if left uncorrected, will likely result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified.

**Grade 7 "Substandard / Performing / High Risk"** – Loans and other credit extensions bearing this grade are considered to be inadequately protected by the current sound worth and paying capacity of the borrower or of the collateral pledged, if any. These obligations, even if apparently protected by collateral value, have well-defined weaknesses related to adverse financial, managerial, economic, market, or political conditions which have clearly jeopardized repayment.

**Grade 8 "Substandard / Non-Performing / High Risk"** – Loans in this category bear all of the characteristics of those in the 7 "Substandard Accrual" category with the added characteristics of meeting the criteria of being placed on a non-accrual status.

**Grade 9 "Doubtful / Maximum Risk"** – Loans and other credit extensions graded "9" have all the weaknesses inherent in those graded "7" and "8" with the added characteristics that severity of the weakness makes collection or liquidation in full highly questionable or improbable based upon currently existing facts, conditions, and values. The probability of some loss is extremely high, but because of certain important and reasonably specific factors, the amount of the loss cannot be determined.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

**Grade 10 "Loss"** – Loans in this classification are considered uncollectible and cannot be justified as a viable asset of the Company. This classification does not mean the loan has absolutely no recovery value, but that it is neither practical nor desirable to defer writing off this loan even though partial recovery may be obtained in the future.

The following tables represent loans as of December 31, 2015 and 2014, by class of loans based on internally assigned risk grades and payment activity:

| | Real Estate | Commercial | Consumer | Total |
|---|---|---|---|---|
| **December 31, 2015** | | | | |
| *Credit Risk Profile by Internally Assigned Grade* | | | | |
| Grade: | | | | |
| Pass (Grade 1-5) | $ 162,853,931 | $ 53,844,318 | $ 5,457,169 | $ 222,155,418 |
| Special mention | 275,726 | 2,639,628 | - | 2,915,354 |
| Substandard | 1,286,478 | 1,382,340 | 8,247 | 2,677,065 |
| Doubtful | - | - | - | - |
| Loss | - | - | - | - |
| Total | $ 164,416,135 | $ 57,866,286 | $ 5,465,416 | $ 227,747,837 |
| *Credit Risk Profile Based on Payment Activity* | | | | |
| Performing | $ 163,628,488 | $ 56,676,428 | $ 5,465,416 | $ 225,770,332 |
| Nonperforming | 787,647 | 1,189,858 | - | 1,977,505 |
| Total | $ 164,416,135 | $ 57,866,286 | $ 5,465,416 | $ 227,747,837 |

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

| | Real Estate | Commercial | Consumer | Total |
|---|---|---|---|---|
| December 31, 2014 | | | | |
| *Credit Risk Profile by Internally Assigned Grade* | | | | |
| Grade: | | | | |
| Pass (Grade 1-5) | $ 141,817,417 | $ 50,422,509 | $ 4,795,491 | $ 197,035,417 |
| Special mention | 807,191 | 4,138,692 | - | 4,945,883 |
| Substandard | 164,176 | - | 23,161 | 187,337 |
| Doubtful | - | - | - | - |
| Loss | - | - | - | - |
| Total | $ 142,788,784 | $ 54,561,201 | $ 4,818,652 | $ 202,168,637 |
| *Credit Risk Profile Based on Payment Activity* | | | | |
| Performing | $ 142,788,784 | $ 54,561,201 | $ 4,818,652 | $ 202,168,637 |
| Nonperforming | - | - | - | - |
| Total | $ 142,788,784 | $ 54,561,201 | $ 4,818,652 | $ 202,168,637 |

**Allowance for Loan Losses** – The allowance for loan losses is a reserve established through a provision for losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Company's allowance for loan loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, changes in the composition and volume of the portfolio, and specific loss allocations, with adjustments for current events and conditions. The Company's process for determining the appropriate level of the allowance for loan losses is designed to account for credit deterioration as it occurs.

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the borrower's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. The initial analysis is performed by the relationship manager and credit rating is reviewed and approved by the Special Asset Committee.

Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things. Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Company calculates historical loss ratios for classifications of similar loans based on the proportion of actual charge-offs experienced to the total population of loans in the category. The historical loss ratios are periodically updated based on actual charge-off experience.

The Company's categories of similar loans include similarly risk-graded groups of commercial loans, commercial real estate loans, consumer real estate loans and consumer and other loans. General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) the experience, ability and effectiveness of the Bank's lending management and staff; (ii) the effectiveness of the Company's loan policies, procedures and internal controls; (iii) trends in asset quality; (iv) changes in loan portfolio volume; (v) the composition and concentrations of credit; (vi) the effectiveness of the loan review function; (vii) the impact of national and local economic business conditions; and (viii) the impact of external factors, such as competition or legal and regulatory requirements.

Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate or low degree of risk. The results are then input into a "general allocation matrix" to determine an appropriate general valuation allowance. Loans identified as losses by management, external loan review and/or bank examiners are charged-off.

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The following table details activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2015 and 2014. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

***Allowance for Loan Losses***

| | Real Estate | Commercial | Consumer | Total |
|---|---|---|---|---|
| **December 31, 2015** | | | | |
| Beginning balance | **$ 1,695,001** | **$ 572,539** | **$ 30,878** | **$ 2,298,418** |
| Charge-offs | **(2,765)** | **(109,517)** | **-** | **(112,282)** |
| Recoveries | **26,744** | **156,524** | **3,200** | **186,468** |
| Provision | **178,073** | **(26,513)** | **(1,560)** | **150,000** |
| Ending balance | **$ 1,897,053** | **$ 593,033** | **$ 32,518** | **$ 2,522,604** |
| Ending balance allocated to loans individually evaluated for impairment | **$ 50,000** | **$ -** | **$ -** | **$ 50,000** |
| Ending balance allocated to loans collectively evaluated for impairment | **1,847,053** | **593,033** | **32,518** | **2,472,604** |
| Total allowance for loan losses | **$ 1,897,053** | **$ 593,033** | **$ 32,518** | **$ 2,522,604** |
| December 31, 2014 | | | | |
| Beginning balance | $ 1,017,250 | $ 808,564 | $ 37,502 | $ 1,863,316 |
| Charge-offs | - | (239,525) | - | (239,525) |
| Recoveries | 13,706 | 214,798 | 6,123 | 234,627 |
| Provision | 664,045 | (211,298) | (12,747) | 440,000 |
| Ending balance | $ 1,695,001 | $ 572,539 | $ 30,878 | $ 2,298,418 |
| Ending balance allocated to loans individually evaluated for impairment | $ - | $ - | $ - | $ - |
| Ending balance allocated to loans collectively evaluated for impairment | 1,695,001 | 572,539 | 30,878 | 2,298,418 |
| Total allowance for loan losses | $ 1,695,001 | $ 572,539 | $ 30,878 | $ 2,298,418 |

## 4. LOANS AND ALLOWANCE FOR LOAN LOSSES (continued)

The Company's recorded investment in loans as of December 31, 2015 and 2014 related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Company's impairment methodology was as follows:

***Loan Receivable***

| | Real Estate | Commercial | Consumer | Total |
|---|---|---|---|---|
| **December 31, 2015** | | | | |
| Ending balance of loans individually evaluated for impairment | **$ 50,000** | **$ -** | **$ -** | **$ 50,000** |
| Ending balance of loans collectively evaluated for impairment | **164,366,135** | **57,866,286** | **5,465,416** | **227,697,837** |
| Ending balance | **$ 164,416,135** | **$ 57,866,286** | **$ 5,465,416** | **$ 227,747,837** |
| December 31, 2014 | | | | |
| Ending balance of loans individually evaluated for impairment | $ - | $ - | $ - | $ - |
| Ending balance of loans collectively evaluated for impairment | 142,788,784 | 54,561,201 | 4,818,652 | 202,168,637 |
| Ending balance | $ 142,788,784 | $ 54,561,201 | $ 4,818,652 | $ 202,168,637 |

## 5. OTHER REAL ESTATE

The Company did not have any activity in other real estate during 2015 or 2014.

## 6. PREMISES AND EQUIPMENT

Components of premises and equipment included in the balance sheet at December 31, 2015 and 2014 were as follows:

| | 2015 | 2014 |
|---|---|---|
| Land | $ 362,735 | $ 378,735 |
| Bank premises | 1,638,755 | 1,638,755 |
| Building improvements | 695,572 | 668,104 |
| Furniture and equipment | 1,958,076 | 1,763,353 |
| Less: accumulated depreciation | (3,097,680) | (2,775,557) |
| Net book value | $ 1,557,458 | $ 1,673,390 |

Other assets include the following at December 31, 2015 and 2014:

| | 2015 | 2014 |
|---|---|---|
| Software | $ 224,073 | $ 202,702 |
| Less: accumulated amortization | (190,907) | (158,716) |
| Total | $ 33,166 | $ 43,986 |
| Depreciation expense | $ 323,887 | $ 355,654 |
| Amortization expense | $ 32,191 | $ 45,720 |

## 7. INVESTMENTS IN COMMERCIAL VENTURE WEST, LLC

The Company has a branch operating from a building that is owned by a limited liability company that is fifty percent (50%) owned by the Company. The limited liability company was formed for the purpose of owning and leasing the building. The Company has a month-to-month lease agreement with the limited liability company. The Company's investment in the limited liability company is recorded using the equity method of accounting. As of December 31, 2015 and 2014, the Company has a recorded investment of **$822,293** and $823,099, respectively. The Company recognized earnings of **$58,719** and $59,751 at the Bank and depreciation expense of **$4,525** and $4,525 at Bancshares for the years ending December 31, 2015 and 2014, respectively.

The Company has also provided financing to the other fifty percent (50%) member for the construction of the building. As of December 31, 2015 and 2014, the Company has a loan of **$439,767** and $470,162, respectively, outstanding to this member.

## 8. BANK OWNED AND OTHER LIFE INSURANCE

The Company holds life insurance policies on bank officers and directors and the Company is the sole beneficiary of the policies. The policies were purchased to fund survivor benefits to the officers' beneficiaries upon the officers' death. The survivor benefits range from $100,000 to $277,000 per officer if death occurs while the officer is employed.

After retirement, the survivor benefits decrease and range from $0 to $150,000 per officer. No death benefits will be paid to the survivors in the event the officer reaches the age of 85. For the years ending December 31, 2015 and 2014, the Bank recognized income of **$211,560** and $203,706, respectively, related to the increase in the cash surrender value of the insurance policies. As of December 31, 2015 and 2014, the cash surrender value of these policies was **$7,186,448** and $6,974,888, respectively. Additionally, the Bank has recognized a post-retirement benefit obligation of **$141,233** and $129,964 as of December 31, 2015 and 2014, respectively. The liability recorded is based on several estimates including life expectancy, estimated retirement age and others. Actual results could differ from these estimates which could have a direct and material impact on the liability recorded.

## 9. DEPOSITS

At December 31, 2015 and 2014, the Company had **$9,685,336** and $9,020,739, respectively, in time deposits $250,000 and over.

Interest paid on deposits for 2015 and 2014 was **$518,521** and $474,413, respectively.

Following are maturities of time deposits for the year ending December 31, 2015:

| | |
|---|---|
| 2016 | **$ 43,997,358** |
| 2017 | **4,996,269** |
| 2018 | **594,750** |
| 2019 | **2,154,558** |
| 2020 | **1,016,972** |
| Total | **$ 52,759,907** |

## 10. INCOME TAXES

Federal and state income tax consisted of the following for the years ended December 31, 2015 and 2014:

| | **2015** | 2014 |
|---|---|---|
| Federal income taxes current | **$ 1,485,274** | $ 1,012,922 |
| State income tax | **13,944** | 17,914 |
| Deferred taxes (credit) relating to: | | |
| Depreciation | **(34,888)** | (56,792) |
| Provision for loan losses | **(143,388)** | (215,096) |
| Margin tax accrual | **(2,924)** | (3,780) |
| Deferred compensation | **(3,831)** | (3,552) |
| Core deposit intangible | **(55,263)** | (75,155) |
| Loan discount | **38,259** | 67,914 |
| Securities amortization | **25,842** | - |
| Partnership income | **(365)** | 453 |
| Organization amortization | **2,611** | 2,611 |
| Investment premium | **(19,834)** | 2,059 |
| Accrual to cash - 481 adjustment | **(37,863)** | (21,061) |
| Tax bad debt reserve - 481 adjustment | **(37,828)** | (22,697) |
| Other | **(3)** | 6,334 |
| Total income tax expense | **$ 1,229,743** | $ 712,074 |

Federal income tax for financial reporting purposes differs from the amount computed by applying the statutory income tax rate of 34% to income before federal income taxes as follows:

| | **2015** | 2014 |
|---|---|---|
| Tax expense to statutory rate | **$ 1,465,483** | $ 932,715 |
| State income tax | **9,203** | 11,757 |
| Deduct effects of: | | |
| Tax-exempt interest | **(218,086)** | (179,694) |
| Interest expense exclusion | **3,365** | 2,586 |
| Earnings on BOLI | **(71,930)** | (69,260) |
| 50% meals and entertainment | **6,267** | 5,892 |
| Officers life insurance | **3,831** | 3,291 |
| Stock option expense | **29,628** | 3,297 |
| Club dues | **1,986** | 1,106 |
| Other | **(4)** | 384 |
| Total income tax expense | **$ 1,229,743** | $ 712,074 |

## 10. INCOME TAXES (continued)

As of December 31, 2015 and 2014, the Company had deferred tax assets and liabilities as follows:

| | **2015** | 2014 |
|---|---|---|
| **Deferred tax assets:** | | |
| Provision for loan losses | $ **723,362** | $ 579,974 |
| Organization cost | **26,110** | 28,721 |
| Deferred compensation | **48,019** | 44,188 |
| Margin tax | **10,104** | 7,180 |
| Purchase accounting loans | **-** | 38,259 |
| Purchase accounting securities | **77,527** | 103,369 |
| Purchase accounting fixed assets | **9,075** | 9,075 |
| Total gross deferred tax assets | **894,197** | 810,766 |
| **Deferred tax liabilities:** | | |
| Core deposit intangible | **(50,255)** | (105,518) |
| Depreciation | **(118,489)** | (153,377) |
| Unrealized gain on securities available-for-sale | **(154,335)** | (215,063) |
| Investment premium | **(44,809)** | (64,643) |
| Accrual to cash - 481 adjustment | **(30,291)** | (68,154) |
| Tax bad debt reserve - 481 adjustment | **(30,262)** | (68,090) |
| Investment in partnership | **(88)** | (453) |
| Total gross deferred tax liabilities | **(428,529)** | (675,298) |
| Net deferred tax asset | $ **465,668** | $ 135,468 |

## 11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized on the balance sheets.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments. The Company uses the same credit policies and collateral requirement evaluations in making commitments and conditional obligations as it does for on-balance-sheet instruments.

## 11. FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK (continued)

| | **2015** | 2014 |
|---|---|---|
| Commitments to extend credit | $ **72,589,612** | $ 49,713,302 |
| Standby letters of credit | $ **145,488** | $ 716,663 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the counter party.

The Company has collateral agreements for most of the contract amount of these commitments. Collateral held varies, but consists primarily of equipment, inventory, and accounts receivable. Other collateral includes certificates of deposit, FSA payments, property, plant and equipment.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Standby letters of credit generally have fixed expiration dates or other termination clauses and may require payment of a fee. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit.

## 12. SIGNIFICANT GROUP CONCENTRATION OF CREDIT RISK

The loan portfolio consists primarily of real estate loans including residential, construction and land development.

In addition, the Company grants agribusiness, commercial, and residential loans to customers throughout the southeast Texas region (see Note 1). Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their obligations is dependent upon the real estate market and agribusiness economic sector of this region. Under usual circumstances, the loans are expected to be repaid from cash flow of the borrowers or proceeds from sale of assets. Should significant deterioration of the climate and economic conditions and significant changes in government programs occur, these factors could impact the Company's collectability of its loans receivable and its deposit base.

The distribution of commitments to extend credit approximates the distribution of loans outstanding. Commercial and standby letters of credit were granted primarily to commercial borrowers.

## 13. 401(k) PLAN

The Company has implemented a 401(k) plan in which all employees with at least one (1) calendar quarter of service can participate. A contribution to match fifty percent (50%) of employee deferrals not to exceed six percent (6%) of an employees' salary may be made at the discretion of the Board of Directors. The Company's contribution is subject to vesting requirements. The Company made matching contributions to the Plan totaling **$90,352** and $89,227 in 2015 and 2014, respectively.

## 14. RELATED PARTY TRANSACTIONS

The Company leases one Branch office from a related party. The Fulshear Branch is leased from Commercial Venture West, LLC, and the Company paid approximately **$120,000** in rent in 2015 and 2014.

The Company has entered into transactions with its executive officers, directors, significant shareholders, and their affiliates (related parties). Fees paid to directors during 2015 and 2014 totaled **$121,150** and $114,560, respectively. Deposits from related parties held by the Company at December 31, 2015 and 2014 amounted to **$13,236,607** and $16,940,657, respectively.

The aggregate amount of loans to such related parties as of December 31, 2015 and 2014 was as follows:

| | **2015** | 2014 |
|---|---|---|
| Principal outstanding, beginning of year | **$ 6,840,944** | $ 5,902,217 |
| New loans made in current year | **9,960,135** | 1,276,694 |
| Loan issued to individuals no longer related | **(2,541,289)** | - |
| Repayments | **(2,559,497)** | (337,967) |
| Principal outstanding, end of year | **$ 11,700,293** | $ 6,840,944 |

## 15. COMMITMENTS AND CONTINGENCIES

In the ordinary course of business, the Company may have various outstanding commitments and contingent liabilities. As of December 31, 2015, management was not aware of any material commitments or contingent liabilities requiring accrual or disclosure.

Certain Bank facilities and equipment are leased under various noncancelable operating leases. Expenses under operating leases were **$440,864** and $447,813 in 2015 and 2014, respectively.

## 15. COMMITMENTS AND CONTINGENCIES (continued)

Future minimum rental commitments under noncancelable leases for the year ending December 31, 2015 are as follows:

| | | |
|---|---|---|
| 2016 | $ | **260,834** |
| 2017 | | **253,742** |
| 2018 | | **253,318** |
| 2019 | | **28,308** |
| Total | $ | **796,202** |

The Company has the following lines of credit available for federal funds purchased:

| | Amount | Expiration Date |
|---|---|---|
| Amegy Bank | $ 20,000,000 | September 30, 2016 |
| BBVA Compass Bank | $ 5,000,000 | None |
| Community Bank of Texas | $ 5,000,000 | December 31, 2016 |
| TIB – The Independent Bankers Bank | $ 10,000,000 | None |
| Texas Capital Bank | $ 10,000,000 | August 1, 2016 |

The Company has entered into a borrowing agreement with the Federal Home Loan Bank of Dallas ("FHLB") under which the FHLB has placed a blanket lien on the Bank's loan portfolio with borrowing capacity of up to $80.0 million at December 31, 2015. The terms and conditions of any borrowings will be dependent on terms, conditions and interest rates being offered by the FHLB when any borrowing occurs. Any borrowing that does occur is also dependent on the Bank purchasing stock in the FHLB equal to 4.1% of any borrowed amount.

The Company has approximately $2 million in securities, at market value, pledged to the Federal Reserve Bank of Dallas under which it may borrow funds at the Federal Reserve Bank's discount window on terms and conditions negotiated when any borrowing occurs.

The Company also has a $10 million reverse repurchase line of credit with BBVA Compass Bank under which the Bank would sell unencumbered securities to BBVA Compass Bank with an agreement to repurchase the securities within an established period of time. The Bank has $2.3 million in securities pledged to BBVA Compass Bank under the reverse repurchase line of credit as of December 31, 2015.

There were no balances outstanding as of December 31, 2015 or 2014 on these lines of credit.

## 16. REGULATORY MATTERS

**Cash Reserve Requirements** – The Company is required to maintain average reserve balances through available vault cash or deposits with the Federal Reserve Bank. The average amounts of those reserve balances for the years ended December 31, 2015 and 2014 were approximately **$1,969,000** and $1,603,000, respectively.

**Capital Requirements** – Banks are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

The Basel III Capital Rules became effective for Commercial State Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the table below) of Common Equity Tier 1 capital, Tier 1 capital and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

Commercial State Bank's Common Equity Tier 1 capital consists of common stock and related paid-in capital, net of treasury stock, and retained earnings. In connection with the adoption of the Basel III Capital Rules, the election was made to opt-out of the requirement to include most components of accumulated other comprehensive income in Common Equity Tier 1. Common Equity Tier 1 for Commercial State Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities and subject to transition provisions.

Tier 1 capital includes Common Equity Tier 1 capital and additional Tier 1 capital as allowed by regulation. Commercial State Bank did not have any additional Tier 1 capital beyond Common Equity Tier 1 as of December 31, 2015. Total capital includes Tier 1 capital and Tier 2 capital. Tier 2 capital for Commercial State Bank includes a permissible portion of the allowance for loan losses.

Prior to January 1, 2015, Commercial State Bank's Tier 1 capital consisted of total shareholders' equity excluding accumulated other comprehensive income, goodwill and other intangible assets. Commercial State Bank's Total capital was comprised of Tier 1 capital plus a permissible portion of the allowance for loan losses.

The Common Equity Tier 1 (beginning in 2015), Tier 1 and Total capital ratios are calculated by dividing the respective capital amounts by risk-weighted assets. Risk-weighted assets are calculated based on regulatory requirements and include total assets, excluding goodwill and other intangible assets, allocated by risk weight category, and certain off-balance-sheet items, among other things. The leverage ratio is calculated by dividing Tier 1 capital by adjusted quarterly average total assets, which exclude goodwill and other intangible assets, among other things.

## 16. REGULATORY MATTERS (continued)

When fully phased in on January 1, 2019, the Basel III Capital Rules will require Commercial State Bank to maintain (i) a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% Common Equity Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum ratio of Common Equity Tier 1 capital to risk-weighted assets of at least 7.0% upon full implementation), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total capital (that is, Tier 1 plus Tier 2) to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) a minimum leverage ratio of 4.0%, calculated as the ratio of Tier 1 capital to average quarterly assets.

The implementation of the capital conservation buffer will begin on January 1, 2016 at the 0.625% level and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to Commercial State Bank.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of December 31, 2015 for Commercial State Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2015 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

| | Actual | | Minimum Capital Required - Basel III Phase-In Schedule | | Minimum Capital Required - Basel III Fully Phase-In | | Required to be Considered Well Capitalized | |
|---|---|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2015:** | | | | | | | | |
| Common Equity Tier I Capital (to Risk-Weighted Assets) | **$ 36,090,798** | **15.2%** | **$ 10,684,776** | **4.5%** | **$ 16,620,763** | **7.0%** | **$ 15,433,566** | **6.5%** |
| Tier I Capital (to Risk-Weighted Assets) | **$ 36,090,798** | **15.2%** | **$ 14,246,368** | **6.0%** | **$ 20,182,355** | **8.5%** | **$ 18,995,158** | **8.0%** |
| Total Capital (to Risk-Weighted Assets) | **$ 38,613,402** | **16.2%** | **$ 19,068,347** | **8.0%** | **$ 25,027,205** | **10.5%** | **$ 23,835,433** | **10.0%** |
| Tier I Leverage Ratio (to Average Assets) | **$ 36,090,798** | **10.9%** | **$ 13,244,330** | **4.0%** | **$ 13,244,330** | **4.0%** | **$ 16,555,413** | **5.0%** |

## 16. REGULATORY MATTERS (continued)

The following table presents actual and required capital ratios as of December 31, 2014 for Commercial State Bank under the regulatory capital rules then in effect.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| **As of December 31, 2014** | | | | | | |
| Total Capital ratio (to Risk-Weighted Assets) | **$ 34,865,375** | **11.6%** | **$ 24,045,086** | **8.0%** | **$ 30,056,358** | **10.0%** |
| Tier 1 Capital Ratio (to Risk-Weighted Assets) | **$ 32,566,957** | **10.9%** | **$ 11,951,177** | **4.0%** | **$ 17,926,765** | **6.0%** |
| Tier I Leverage ratio (to Average Assets) | **$ 32,566,957** | **11.1%** | **$ 11,735,840** | **4.0%** | **$ 14,669,800** | **5.0%** |

As of December 31, 2015, capital levels at Commercial State Bank exceed all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis. Based on the ratios presented above, capital levels as of December 31, 2015 at Commercial State Bank exceed the minimum levels necessary to be considered "well capitalized."

Commercial State Bank is subject to the regulatory capital requirements administered by the Texas State Department of Banking and the Federal Deposit Insurance Corporation ("FDIC"). Regulatory authorities can initiate certain mandatory actions if Commercial State Bank fails to meet the minimum capital requirements, which could have a direct material effect on the financial statements. Management believes, as of December 31, 2015, that Commercial State Bank meets all capital adequacy requirements to which it is subject.

*Dividend Restrictions.* The Bank is required to obtain supervisory approval prior to declaring any dividends payable to the shareholders that would result in the Bank falling below the minimum capital ratios described above.

## 17. STOCK BASED COMPENSATION

In 2011, the Board of Directors of the Company adopted the Commercial Bancshares, Inc. 2011 Stock Option Plan (the "Plan"). The Plan allows the Company to grant up to 429,015 of the authorized but unissued number of shares for incentive stock options.

In 2015, the Board of Directors of the Company adopted the Commercial Bancshares, Inc. 2015 Stock Option Plan (the "Plan"). The Plan allows the Company to grant up to 30,000 of the authorized but unissued number of shares for incentive stock options.

## 17. STOCK BASED COMPENSATION (continued)

Options granted may be exercisable for a period of up to 10 years from the date of grant and vest over periods ranging from five to ten years.

The following schedule summarizes the pertinent information with regard to options to purchase shares of the Company's common stock for the years ended December 31:

| | Number of Shares | Exercise Price |
|---|---|---|
| Balance at December 31, 2013 | 381,313 | $ 9.75 |
| Granted | 46,326 | 12.00 |
| Exercised | (10,811) | 9.24 |
| Terminated | - | - |
| Balance at December 31, 2014 | 416,828 | 10.01 |
| Granted | **14,000** | **16.00** |
| Exercised | **(1,000)** | **10.65** |
| Terminated | **(11,500)** | **12.00** |
| Balance at December 31, 2015 | **418,328** | **$ 9.62** |

The following table summarizes information about stock options outstanding at December 31, 2015:

| | Options Outstanding | | | Options Exercisable | |
|---|---|---|---|---|---|
| Ranges of Exercise Prices | Number Outstanding | Weighted Average Exercise Price | Weighted Average Remaining Contractual Life | Number Exercisable | Weighted Average Exercise Price |
| **$ 9.24** | **257,404** | **$ 9.24** | **6** | **115,903** | **$ 9.24** |
| **$ 10.65** | **87,264** | **10.65** | **6** | **69,811** | **10.65** |
| **$ 12.00** | **59,660** | **12.00** | **7.43** | **-** | **12.00** |
| **$ 16.00** | **14,000** | **16.00** | **10** | **-** | **16.00** |
| **$ 9.24 - $ 12.00** | **418,328** | **$ 9.62** | | **185,714** | **$ 9.77** |

## 17. STOCK BASED COMPENSATION (continued)

The fair value of each stock option granted is estimated on the date of grant using the Black-Scholes stock option valuation model with the following assumptions:

| | May 2015 | September 2015 |
|---|---|---|
| Dividend yield | 0.00% | 0.00% |
| Volatility ratio | 19.49% | 19.49% |
| Forfeiture rate | 0% | 0% |
| Risk-free interest rate | 2.26% | 2.17% |
| Expected life (in years) | 7 | 7 |
| Value of options granted | $ 19,029 | $ 29,104 |
| Per share weighted average | $ 3.46 | $ 3.42 |

Total stock option expense recognized for the years ending December 31, 2015 and 2014 was **$87,141** and $78,888, respectively.

## 18. FAIR VALUE DISCLOSURES

The authoritative guidance on fair value measurements defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market for the asset or liability. The price in the principal (or most advantageous) market used to measure the fair value of the asset or liability shall not be adjusted for transaction costs. An orderly transaction is a transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets and liabilities; it is not a forced transaction. Market participants are buyers and sellers in the principal market that are (i) independent, (ii) knowledgeable, (iii) able to transact and (iv) willing to transact.

The authoritative guidance on fair value measurements requires the use of valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. The market approach uses prices and other relevant information generated by market transactions involving identical or comparable assets and liabilities. The income approach uses valuation techniques to convert future amounts, such as cash flows or earnings, to a single present amount on a discounted basis. The cost approach is based on the amount that currently would be required to replace the service capacity of an asset (replacement costs). Valuation techniques should be consistently applied. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability.

**18. FAIR VALUE DISCLOSURES** (continued)

Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances. In that regard, the guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs.

The fair value hierarchy is as follows:

**Level 1 Inputs** – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

**Level 2 Inputs** – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (for example, interest rates, volatilities, prepayment speeds, loss severities, credit risks and default rates) or inputs that are derived principally from or corroborated by observable market data by correlation or other means.

**Level 3 Inputs** – Significant unobservable inputs that reflect an entity's own assumptions that market participants would use in pricing the assets or liabilities.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

A description of the valuation methodologies used for assets and liabilities measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

**Financial Assets and Financial Liabilities**

Financial assets and financial liabilities measured at fair value on a recurring and nonrecurring basis include the following:

**Securities Available-for-Sale** – Securities classified as available for sale are reported at fair value utilizing Level 2 inputs. For these securities, the Company obtains fair value measurements from an independent pricing service. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U. S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayments speeds, credit information and the bond's terms and conditions, among other things.

## 18. FAIR VALUE DISCLOSURES (continued)

**Impaired Loans** – A loan may be considered impaired when it is determined that it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement. Once a loan is identified as individually impaired, management measures for impairment using the practical expedients permitted by applicable authoritative accounting guidance, at the fair value of the loan's collateral, if the loan is collateral dependent. If a loan is determined to be collateral dependent, the fair value of the collateral is determined by independent appraisals or valuations adjusted for costs related to the liquidation of the collateral and are classified as Level 3.

The following table summarizes financial assets and financial liabilities measured at fair value on a recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|---|---|---|---|---|
| **December 31, 2015** | | | | |
| U.S. Government agencies | $ - | $ **2,769,177** | $ - | $ **2,769,177** |
| State and political subdivisions | $ - | $ **37,257,454** | $ - | $ **37,257,454** |
| Mortgage-backed securities | $ - | $ **5,615,486** | $ - | $ **5,615,486** |
| December 31, 2014 | | | | |
| U.S. Government agencies | $ - | $ 1,856,408 | $ - | $ 1,856,408 |
| State and political subdivisions | $ - | $ 24,601,655 | $ - | $ 24,601,655 |
| Mortgage-backed securities | $ - | $ 12,718,231 | $ - | $ 12,718,231 |

Certain financial assets are measured at fair value on a non-recurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).

The following table summarizes financial assets measured at fair value on a non-recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value:

| | Level 1 Inputs | Level 2 Inputs | Level 3 Inputs | Total Fair Value |
|---|---|---|---|---|
| **December 31, 2015** | | | | |
| Impaired loans | $ - | $ - | $ - | $ - |
| December 31, 2014 | | | | |
| Impaired loans | $ - | $ - | $ - | $ - |

## 18. FAIR VALUE DISCLOSURES (continued)

During the years ended December 31, 2015 and 2014, certain impaired loans were remeasured and reported at fair value through a specific valuation allowance allocation of the allowance for loan losses based upon the fair value of the underlying collateral based on collateral valuations utilizing Level 3 valuation inputs.

| | 2015 | 2014 |
|---|---|---|
| Carrying value of impaired loans | $ - | $ - |
| Specific valuation allowance allocations | - | - |
| Fair value of impaired loans | $ - | $ - |

### Non-Financial Assets and Non-Financial Liabilities

Application of authoritative accounting guidance to non-financial assets and non-financial liabilities became effective January 1, 2009. The Company has no non-financial assets or non-financial liabilities measured at fair value on a recurring or non-recurring basis.

### Fair Value of Financial Instruments

The Company is required under current authoritative guidance to disclose the estimated fair value of its financial instrument assets and liabilities including those subject to the requirements discussed above. For the Company, as for most financial institutions, substantially all of its assets and liabilities are considered financial instruments as defined. Many of the Company's financial instruments, however, lack an available trading market as characterized by a willing buyer and willing seller engaging in an exchange transaction.

The estimated fair value amounts of financial instruments have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is required to interpret data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts. In addition, reasonable comparability between financial institutions may not be likely due to the wide range of permitted valuation techniques and numerous estimates that must be made given the absence of active secondary markets for many of the financial instruments. This lack of uniform valuation methodologies also introduces a greater degree of subjectivity to these estimated fair values.

Financial instruments with stated maturities and fixed rates have been valued using a present value discounted cash flow with a discount rate approximating current market for similar assets and liabilities. Financial instrument assets with variable rates and financial instrument liabilities with no stated maturities have an estimated fair value equal to both the amount payable on demand and the carrying value.

The carrying amounts of financial instruments with a relatively short period of time between their origination and their expected realization approximate fair value.

## 18. FAIR VALUE DISCLOSURES (continued)

The carrying value and the estimated fair value of the Company's contractual off-balance-sheet unfunded lines of credit, loan commitments and letters of credit, which are generally priced at market at the time of funding, are not material.

The estimated fair values and carrying values of all financial instruments under current authoritative guidance at December 31, 2015 and 2014 were as follows (000's):

| | December 31, 2015 | | December 31, 2014 | |
|---|---|---|---|---|
| | **Carrying Amount** | **Fair Value** | Carrying Amount | Fair Value |
| **Financial Assets** | | | | |
| *Level 2 Inputs:* | | | | |
| Cash and cash equivalents | **$ 41,053** | **$ 41,053** | $ 52,879 | $ 52,879 |
| Time deposits with other banks | **1,000** | **1,000** | 3,007 | 3,007 |
| Investments | **45,642** | **45,642** | 39,176 | 39,176 |
| Accrued interest receivable | **1,167** | **1,167** | 1,023 | 1,023 |
| Cash surrender value of life insurance | **7,186** | **7,186** | 6,975 | 6,975 |
| *Level 3 Inputs:* | | | | |
| Loans receivable, net | **$ 225,620** | **$ 227,111** | $ 200,463 | $ 199,900 |
| **Financial Liabilities** | | | | |
| *Level 2 Inputs:* | | | | |
| Deposits | **$ 287,875** | **$ 288,651** | $ 272,434 | $ 273,299 |
| Accrued interest payable | **41** | **41** | 47 | 47 |
| Deferred compensation payable | **141** | **141** | 130 | 130 |

## 19. LEGAL CONTINGENCIES

The Company is party to litigation arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the Company's financial position.

## 20. SUBSEQUENT EVENTS

The Company has performed a review of subsequent events through the date of the opinion, which is the date the financial statements were available for issuance, and concludes there were no events or transactions occurring during this period that required recognition or disclosure in the financial statements. Any events occurring after this date have not been factored into the financial statements being presented.

## 21. RECENTLY ISSUED AUTHORITATIVE GUIDANCE

In February 2016, the FASB amended its authoritative guidance regarding leases. The amended guidance affects all entities with leases and includes both lessees and lessors with the primary changes impacting lessees. An accounting policy election can be made to exclude leases with terms of 12 months or less. Lessees will be required to recognize a lease liability and a right-of-use asset measured at the present value of the lease payments required and reasonably certain (as defined) lease options. The right-of-use asset represents the lessee's right to control the use of the asset for the specified lease term. For finance leases (as defined), a lessee is required to separately recognize interest on the lease liability and amortization of the right-of-use asset on the statement of income. For finance leases (as defined) the repayments of the principal portion of the lease liability is recognized in financing activities and payments of interest on the lease liability and variable lease payments within the operating activities on the statement of cash flow. For operating leases (as defined), a lessee is required to recognize interest on the lease liability and amortization of the right-of-use asset on the statement of income as a single lease cost on a straight line basis and as operating activities on the statement of cash flows. The new authoritative guidance will be effective for annual reporting periods beginning after December 15, 2020. Early application is permitted for all entities. In transition the Company is permitted to elect a modified retrospective approach for existing leases and will be allowed to account for leases under previous GAAP unless the leases are modified. At the date of application, the lease liability and a right-of-use asset will be recognized based on the remaining present value of lease payments. Management is evaluating the amended guidance but expects the adoption will have a significant impact on the Company's consolidated financial statements.

In 2016, the FASB amended its authoritative guidance related to equity investments which requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income and requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset. Early adoption is permitted. The amendment will be effective for annual reporting periods beginning after December 15, 2018 and is not expected to have a significant impact on the Company's financial statements.

In 2015, the FASB amended its authoritative guidance related to the presentation of deferred taxes. The amendment eliminates the current requirement for entities to present deferred tax liabilities and assets as current and noncurrent in a classified balance sheet. Instead, the entity will be required to classify all deferred tax assets and liabilities as noncurrent. Early adoption is permitted for financial statements that have not been issued. The amendment will be effective for annual reporting periods beginning after December 15, 2018 and is not expected to have a significant impact on the Company's financial statements.

## 21. RECENTLY ISSUED AUTHORITATIVE GUIDANCE (continued)

In 2015, the FASB amended its authoritative guidance related to business combinations. The amendments require adjustments to provisional amounts that are identified during the measurement period, including the cumulative effect of changes in depreciation, amortization, or other income effects to be recognized in the current-period financial statements. Prior periods should no longer be adjusted. Lastly, the amendment requires the entity to present separately on the face of the income statement or disclose in the notes the portion of the amount recorded in current-period earnings by line item that would have been recorded in previous reporting periods if the adjustment to the provisional amounts had been recognized as of the acquisition date. The amendment will be effective for annual reporting periods beginning after December 15, 2016 and is not expected to have a significant impact on the Company's financial statements.

In 2015, the FASB issued authoritative guidance regarding debt issuance costs which requires entities to present debt issuance costs related to a recognized debt liability be presented within the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendment. The new authoritative guidance will be effective for financial statements issued for fiscal years beginning after December 15, 2015 and is not expected to have a significant impact on the Company's financial statements.

In 2015, the FASB amended its authoritative guidance regarding inventory. The amendment requires an entity to measure inventory at the lower of cost and net realizable value. The amendments do not apply to inventory that is measured using last-in, first-out ("LIFO") or the retail inventory method. The amendments apply to all other inventory, which includes inventory that is measured using first-in, first-out ("FIFO") or average cost. Net realizable value is the estimated selling prices in the ordinary course of business, less reasonably predictable costs of completion, disposal, and transportation. Subsequent measurement is unchanged for inventory measured using LIFO or the retail inventory method. The amendment will be effective for annual reporting periods beginning after December 15, 2015 and is not expected to have a significant impact on the Company's financial statements.

In 2015, the FASB amended its authoritative guidance for disclosures for investments in certain entities that calculate net asset value ("NAV") per share. The amendment eliminates the requirement to categorize within the fair value hierarchy all investments for which fair value is measured using the NAV practical expedient. Additionally, the amendment removes the requirement to make certain disclosures for all investments that are eligible to be measured at fair value using the NAV practical expedient. Rather, those disclosures are limited to investments for which the entity has elected to measure the fair value using that practical expedient. The amendment will be effective for annual and interim reporting periods beginning after December 15, 2016, and is not expected to have a significant impact on the Company's financial statements.

## 21. RECENTLY ISSUED AUTHORITATIVE GUIDANCE (continued)

In 2015, the FASB amended its authoritative guidance regarding accounting for a cloud computing arrangement. If a cloud computing arrangement includes a software license, then the entity should account for the software license element of the arrangement consistent with the acquisition of other software licenses that are capitalized. Otherwise, an entity should account for the arrangement as a service contract, which would usually be expensed. The amendment will be effective for annual periods beginning after December 15, 2015 and is not expected to have a significant impact on the Company's financial statements.

In 2015, the FASB amended its authoritative guidance for consolidations for legal entities such as limited partnerships and their equivalents, as well as structured vehicles such as issuers of collateralized debt obligations. The amendment modifies the evaluation of whether limited partnerships and their equivalents are variable interest entities ("VIEs") or voting interest entities, eliminates the presumption that a general partner should consolidate a limited partnership, and modifies the consolidation analysis of reporting entities that are involved with VIEs, particularly those with fee arrangements and related party relationships. The amendment will be effective for annual reporting periods beginning after December 15, 2016 and is not expected to have a significant impact on the Company's financial statements.

In 2015, the FASB amended its authoritative guidance to eliminate the concept of extraordinary items from U.S. GAAP. Items that are either unusual in nature or infrequently occurring will continue to be reported as a separate component of income from continuing operations. Alternatively, these amounts may still be disclosed in the notes to the financial statements. The amendment will be effective for annual and interim reporting periods beginning after December 15, 2015 and is not expected to have a significant impact on the Company's financial statements.

In 2014, the FASB amended its authoritative guidance regarding business combinations and accounting for identifiable intangible assets. The amendment allows a private company to elect to not recognize separately from goodwill certain assets arising from customer relationships and non-competition agreements upon recognition. Alternatively, these assets would be subsumed into goodwill and goodwill would then be amortized. The election is intended to reduce cost and complexity for private companies. Early adoption is permitted for annual financial statements that have not been made available for issuance. The effective date of the adoption depends on the timing of the first transaction. The amendment can be adopted upon the occurrence of the first transaction for annual reporting periods beginning after December 15, 2015 and is not expected to have a significant impact on the Company's financial statements.

In 2014, the FASB amended its authoritative guidance to provide a definition as to when and how companies are required to disclose going concern uncertainties. The guidance is intended to guide management to determine whether substantial doubt exists regarding the going concern presumption. If a substantial doubt exists and cannot be mitigated, disclosure indicating a going concern exists will be included in the financial statements, as well as the principal conditions/events that raise substantial doubt, management's evaluation of the significance of the events in relation to the company's ability to meet its obligations and management's plan to mitigate the conditions/events. Early adoption is permitted for financial statements which have not been previously issued. The amendment will be effective for annual and interim reporting periods beginning after December 15, 2016 and is not expected to have a significant impact on the Company's financial statements.

## 21. RECENTLY ISSUED AUTHORITATIVE GUIDANCE (continued)

In 2014, the FASB amended its authoritative guidance regarding stock based compensation. The amendment requires that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. Therefore, the performance target should not be reflected in estimating the grant-date fair value of the award and compensation cost should be recognized in the period in which it becomes probable that the performance target will be achieved. The total amount of compensation cost recognized during and after the requisite service period should reflect the number of awards that are expected to vest and should be adjusted to reflect those awards that ultimately vest. The requisite service period ends when the employee can cease rendering service and still be eligible to vest in the award if the performance target is achieved. Early adoption is permitted. The amendment will be effective for annual reporting periods beginning after December 15, 2015 and is not expected to have a significant impact on the Company's financial statements.

In 2014, the FASB issued a comprehensive new revenue recognition standard that will supersede substantially all existing revenue recognition guidance. The new standard's core principle is that an entity will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In doing so, entities will need to use more judgment and make more estimates than under existing guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. Early adoption is permitted for annual reporting periods beginning after December 15, 2016. The new authoritative guidance will be effective for annual and interim reporting periods ending after December 15, 2019, and is not expected to have a significant impact to the Company's financial statements.

# SUPPLEMENTARY INFORMATION

## COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY

## CONSOLIDATING BALANCE SHEET

December 31, 2015

| | Commercial Bancshares, Inc. | Commercial State Bank | Eliminations | Consolidated Commercial Bancshares, Inc. and Subsidiary |
|---|---|---|---|---|
| **ASSETS** | | | | |
| Cash and due from banks | $ 658,788 | $ 4,403,878 | $ (658,788) | **$ 4,403,878** |
| Interest-bearing deposits in other banks | - | 36,648,660 | - | **36,648,660** |
| Total cash and cash equivalents | 658,788 | 41,052,538 | (658,788) | **41,052,538** |
| Time deposits in other banks | - | 1,000,000 | - | **1,000,000** |
| Investment securities, available-for-sale, at fair value | - | 45,642,117 | - | **45,642,117** |
| Loans receivable, net | 395,071 | 225,225,233 | - | **225,620,304** |
| Accrued interest receivable | - | 1,166,621 | - | **1,166,621** |
| Premises and equipment, net | 212,867 | 1,344,591 | - | **1,557,458** |
| Cash surrender value on bank owned life insurance | - | 7,186,448 | - | **7,186,448** |
| Prepaid expenses | - | 274,885 | - | **274,885** |
| Inter-company receivables | 77,878 | (77,878) | - | **-** |
| Investment in subsidiary | 36,494,289 | - | (36,494,289) | **-** |
| Investment in Commercial Venture West, LLC | 130,375 | 691,918 | - | **822,293** |
| Deferred tax asset | - | 709,973 | (244,305) | **465,668** |
| Core deposit intangible | 83,720 | 64,088 | - | **147,808** |
| Goodwill | 535,725 | - | - | **535,725** |
| Other assets | 71,006 | 1,072,229 | - | **1,143,235** |
| **Total assets** | $ 38,659,719 | $ 325,352,763 | $ (37,397,382) | **$ 326,615,100** |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | | | |
| Deposits: | | | | |
| Demand deposits | $ - | $ 124,593,251 | $ (658,788) | **$ 123,934,463** |
| Savings and NOW deposits | - | 111,180,250 | - | **111,180,250** |
| Time deposits | - | 52,759,907 | - | **52,759,907** |
| Total deposits | - | 288,533,408 | (658,788) | **287,874,620** |
| Accrued interest payable | - | 40,725 | - | **40,725** |
| Deferred compensation payable | - | 141,233 | - | **141,233** |
| Deferred tax liability | 244,305 | - | (244,305) | **-** |
| Other liabilities | - | 143,108 | - | **143,108** |
| Inter-company payables | - | - | - | **-** |
| Total liabilities | 244,305 | 288,858,474 | (903,093) | **288,199,686** |
| Shareholders' Equity | | | | |
| Common stock, par value | 3,063,172 | 1,200,000 | (1,200,000) | **3,063,172** |
| Additional paid-in capital | 28,009,640 | 23,310,634 | (23,310,634) | **28,009,640** |
| Retained earnings | 7,043,011 | 11,597,083 | (11,597,083) | **7,043,011** |
| Accumulated other comprehensive income | 299,591 | 386,572 | (386,572) | **299,591** |
| Total shareholders' equity | 38,415,414 | 36,494,289 | (36,494,289) | **38,415,414** |
| **Total liabilities and shareholders' equity** | $ 38,659,719 | $ 325,352,763 | $ (37,397,382) | **$ 326,615,100** |

**See accompanying notes to the consolidated financial statements.**

## COMMERCIAL BANCSHARES, INC. AND SUBSIDIARY

## CONSOLIDATING STATEMENT OF INCOME

Year Ended December 31, 2015

| | Commercial Bancshares, Inc. | Commercial State Bank | Eliminations | Consolidated Commercial Bancshares, Inc. and Subsidiary |
|---|---|---|---|---|
| **INTEREST INCOME** | | | | |
| Loans, including fees | $ (197,545) | $ 11,702,507 | $ - | **$ 11,504,962** |
| Securities available-for-sale | (58,338) | 913,822 | - | **855,484** |
| Other interest income | - | 412,114 | - | **412,114** |
| Total interest income | (255,883) | 13,028,443 | - | **12,772,560** |
| **INTEREST EXPENSE** | - | 512,646 | - | **512,646** |
| **NET INTEREST INCOME** | (255,883) | 12,515,797 | - | **12,259,914** |
| **PROVISION FOR LOAN LOSSES** | - | 150,000 | - | **150,000** |
| **NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES** | (255,883) | 12,365,797 | - | **12,109,914** |
| **NON-INTEREST INCOME** | | | | |
| Service charges on deposit accounts | - | 466,562 | - | **466,562** |
| Other service charges and fees | - | 366,468 | - | **366,468** |
| Undistributed earnings in subsidiary | 3,329,132 | - | (3,329,132) | - |
| Net income on subsidiary | - | - | - | - |
| Income in Commercial Venture West, LLC | - | 58,719 | - | **58,719** |
| Gain on sales of SBA Loans | - | 301,128 | - | **301,128** |
| Gain on sales of investment securities | - | 121,191 | - | **121,191** |
| Other income | - | 49,378 | - | **49,378** |
| Total non-interest income | 3,329,132 | 1,363,446 | (3,329,132) | **1,363,446** |
| **NON-INTEREST EXPENSE** | | | | |
| Salaries, wages and benefits | - | 5,528,094 | - | **5,528,094** |
| Occupancy expense | 18,716 | 1,186,725 | - | **1,205,441** |
| Data and check processing | - | 624,788 | - | **624,788** |
| Professional services | - | 455,978 | - | **455,978** |
| Telephone, postage and supplies | - | 327,816 | - | **327,816** |
| Advertising and contributions | - | 171,999 | - | **171,999** |
| Loan, credit card and ATM expenses | - | 200,912 | - | **200,912** |
| Training, travel and periodicals | - | 199,824 | - | **199,824** |
| Regulatory fees | - | 41,636 | - | **41,636** |
| Insurance expense | - | 201,274 | - | **201,274** |
| Amortization of core deposit intangible | 102,139 | 60,399 | - | **162,538** |
| Other expense | (21) | 42,836 | - | **42,815** |
| Total non-interest expense | 120,834 | 9,042,281 | - | **9,163,115** |
| **INCOME BEFORE INCOME TAXES** | 2,952,415 | 4,686,962 | (3,329,132) | **4,310,245** |
| **INCOME TAXES EXPENSE (BENEFIT)** | (128,087) | 1,357,830 | - | **1,229,743** |
| **NET INCOME** | $ 3,080,502 | $ 3,329,132 | $ (3,329,132) | **$ 3,080,502** |

**See accompanying notes to the consolidated financial statements.**