AUBURN NATIONAL BANCORPORATION, INC
Form 10-K
March 24, 2014
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

þ **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the fiscal year ended December 31, 2013

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15 (d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from ______ to ______

Commission File Number: 0-26486

Auburn National Bancorporation, Inc.

(Exact name of registrant as specified in charter)

Delaware (State or other jurisdiction of incorporation)	63-0885779 (I.R.S. Employer Identification No.)
100 N. Gay Street, Auburn, Alabama (Address of principal executive offices)	36830 (Zip Code)

Registrant s telephone number, including area code: (334) 821-9200

Securities registered pursuant to Section 12 (b) of the Act:

Title of Each Class	Name of Exchange on which Registered
Common Stock, par value $0.01	Nasdaq Global Market

Securities registered to Section 12(g) of the Act: None

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Website, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes þ No ¨

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (Section 229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. þ

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

Large Accelerated filer ¨	Accelerated filer ¨	Non-accelerated filer ¨ (Do not check if a smaller reporting company)	Smaller reporting company þ

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

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity as of the last business day of the registrant s most recently completed second fiscal quarter: $50,893,590 as of June 30, 2013.

APPLICABLE ONLY TO CORPORATE REGISTRANTS

Indicate the number of shares outstanding of each of the registrant s classes of common stock, as of the latest practicable date: 3,643,173 shares of common stock as of March 14, 2014.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the Proxy Statement for the Annual Meeting of Shareholders, scheduled to be held May 13, 2014, are incorporated by reference into Part II, Item 5 and Part III of this Form 10-K.

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PART I

SPECIAL CAUTIONARY NOTE REGARDING FORWARD-LOOKING STATEMENTS

Various of the statements made herein under the captions Management s Discussion and Analysis of Financial Condition and Results of Operations , Quantitative and Qualitative Disclosures about Market Risk , Risk Factors and elsewhere, are forward-looking statements within the meaning and protections of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act).

Forward-looking statements include statements with respect to our beliefs, plans, objectives, goals, expectations, anticipations, assumptions, estimates, intentions and future performance, and involve known and unknown risks, uncertainties and other factors, which may be beyond our control, and which may cause the actual results, performance, achievements or financial condition of the Company to be materially different from future results, performance, achievements or financial condition expressed or implied by such forward-looking statements. You should not expect us to update any forward-looking statements.

All statements other than statements of historical fact are statements that could be forward-looking statements. You can identify these forward-looking statements through our use of words such as may, will, anticipate, assume, should, indicate, would, believe, conte expect, estimate, continue, plan, point to, project, could, intend, target and other similar words and expressions of the future. The forward-looking statements may not be realized due to a variety of factors, including, without limitation:

- the effects of future economic, business and market conditions and changes, domestic and foreign, including seasonality;
- governmental monetary and fiscal policies;
- legislative and regulatory changes, including changes in banking, securities and tax laws, regulations and rules and their application by our regulators, including capital and liquidity requirements, and changes in the scope and cost of FDIC insurance;
- changes in accounting policies, rules and practices;
- the risks of changes in interest rates on the levels, composition and costs of deposits, loan demand, and the values and liquidity of loan collateral, securities, and interest sensitive assets and liabilities, and the risks and uncertainty of the amounts realizable and the timing of dispositions of assets by the FDIC where we may have a participation or other interest;
- changes in borrower credit risks and payment behaviors;
- changes in the availability and cost of credit and capital in the financial markets, and the types of instruments that may be included as capital for regulatory purposes;
- changes in the prices, values and sales volumes of residential and commercial real estate;
- the effects of competition from a wide variety of local, regional, national and other providers of financial, investment and insurance services;

the failure of assumptions and estimates underlying the establishment of reserves for possible loan losses and other estimates;

the risks of mergers, acquisitions and divestitures, including, without limitation, the related time and costs of implementing such transactions, integrating operations as part of these transactions and possible failures to achieve expected gains, revenue growth and/or expense savings from such transactions;

changes in technology or products that may be more difficult, costly, or less effective than anticipated;

the effects of war or other conflicts, acts of terrorism or other catastrophic events that may affect general economic conditions;

the failure of assumptions and estimates, as well as differences in, and changes to, economic, market and credit conditions, including changes in borrowers credit risks and payment behaviors from those used in our loan portfolio stress test;

the risks that our deferred tax assets could be reduced if estimates of future taxable income from our operations and tax planning strategies are less than currently estimated, and sales of our capital stock could trigger a reduction in the amount of net operating loss carry-forwards that we may be able to utilize for income tax purposes; and

other factors and risks described under Risk Factors herein and in any of our subsequent reports that we make with the Securities and Exchange Commission (the Commission or SEC) under the Exchange Act.

All written or oral forward-looking statements that are made by us or are attributable to us are expressly qualified in their entirety by this cautionary notice. We have no obligation and do not undertake to update, revise or correct any of the forward-looking statements after the date of this report, or after the respective dates on which such statements otherwise are made.

ITEM 1. BUSINESS

Auburn National Bancorporation, Inc. (the Company) is a bank holding company registered with the Board of Governors of the Federal Reserve System (the Federal Reserve) under the Bank Holding Company Act of 1956, as amended (the BHC Act). The Company was incorporated in Delaware in 1990, and in 1994 it succeeded its Alabama predecessor as the bank holding company controlling AuburnBank, an Alabama state member bank with its principal office in Auburn, Alabama (the Bank). The Company and its predecessor have controlled the Bank since 1984. As a bank holding company, the Company may diversify into a broader range of financial services and other business activities than currently are permitted to the Bank under applicable laws, regulations and rules. The holding company structure also provides greater financial and operating flexibility than is presently permitted to the Bank.

The Bank has operated continuously since 1907 and currently conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank has been a member of the Federal Reserve System since April 1995 (the Charter Conversion). The Bank s primary regulators are the Federal Reserve and the Alabama Superintendent of Banks (the Alabama Superintendent). The Bank has been a member of the Federal Home Loan Bank of Atlanta (the FHLB) since 1991.

General

The Company s business is conducted primarily through the Bank and its subsidiaries. Although it has no immediate plans to conduct any other business, the Company may engage directly or indirectly in a number of activities that the Federal Reserve has determined to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

The Company s principal executive offices are located at 100 N. Gay Street, Auburn, Alabama 36830, and its telephone number at such address is (334) 821-9200. The Company maintains an Internet website at *www.auburnbank.com*. The Company s website and the information appearing on the website are not included or incorporated in, and are not part of, this report. The Company files annual, quarterly and current reports, proxy statements, and other information with the SEC. You may read and copy any document we file with the SEC at the SEC s public reference room at 100 F Street, N.E., Washington, DC 20549. Please call the SEC at 1-800-SEC-0330 for more information on the operation of the public reference rooms. The SEC maintains an Internet site that contains reports, proxy, and other information. Our SEC filings are also available to the public free of charge from the SEC s web site at *www.sec.gov*.

The Company directly owns all the common equity in one statutory trust, Auburn National Bancorporation Capital Trust I, a Delaware statutory trust, which was formed in 2003 for the purpose of issuing $7.0 million of floating rate capital securities, which are included in our Tier 1 capital.

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Services

The Bank offers checking, savings, transaction deposit accounts and certificates of deposit, and is an active residential mortgage lender in its primary service area. The Bank s primary service area includes the cities of Auburn and Opelika, Alabama and nearby surrounding areas in East Alabama, primarily in Lee County. The Bank also offers commercial, financial, agricultural, real estate construction and consumer loan products and other financial services. The Bank is one of the largest providers of automated teller services in East Alabama and operates ATM machines in 14 locations in its primary service area. The Bank offers Visa® Checkcards, which are debit cards with the Visa logo that work like checks but can be used anywhere Visa is accepted, including ATMs. The Bank s Visa Checkcards can be used internationally through the Cirrus® network. The Bank offers online banking and bill payment services through its Internet website, *www.auburnbank.com*

The Bank also has commercial loan production offices in Montgomery, Alabama and in Phenix City, Alabama.

Competition

The banking business in East Alabama, including Lee County, is highly competitive with respect to loans, deposits, and other financial services. The area is dominated by a number of regional and national banks and bank holding companies that have substantially greater resources, and numerous offices and affiliates operating over wide geographic areas. The Bank competes for deposits, loans and other business with these banks, as well as with credit unions, mortgage companies, insurance companies, and other local and nonlocal financial institutions, including institutions offering services through the mail, by telephone and over the Internet. As more and different kinds of businesses enter the market for financial services, competition from nonbank financial institutions may be expected to intensify further.

Among the advantages that larger financial institutions have over the Bank are their ability to finance extensive advertising campaigns, to diversify their funding sources, and to allocate and diversify their assets among loans and securities of the highest yield in locations with the greatest demand. Many of the major commercial banks or their affiliates operating in the Bank s service area offer services which are not presently offered directly by the Bank and they typically have substantially higher lending limits than the Bank.

Banks also have experienced significant competition for deposits from mutual funds, insurance companies and other investment companies and from money center banks offerings of high-yield investments and deposits. Certain of these competitors are not subject to the same regulatory restrictions as the Bank.

Selected Economic Data

Lee County s population was estimated to be 147,468 in 2012, and has increased approximately 5.0% from 2010 to 2012. The largest employers in the area are Auburn University, East Alabama Medical Center, a Wal-Mart Distribution Center, Mando America Corporation, and Briggs & Stratton. Auto manufacturing is of increasing importance along Interstate Highway 85 to the east and west of Auburn. Kia Motors has a large automobile factory in nearby LaGrange, Georgia, and Hyundai Motors has a large automobile factory in Montgomery, Alabama.

Loans and Loan Concentrations

The Bank makes loans for commercial, financial and agricultural purposes, as well as for real estate mortgages, real estate acquisition, construction and development and consumer purposes. While there are certain risks unique to each type of lending, management believes that there is more risk associated with commercial, real estate acquisition, construction and development, agricultural and consumer lending than with residential real estate mortgage loans. To help manage these risks, the Bank has established underwriting standards used in evaluating each extension of credit on an individual basis, which are substantially similar for each type of loan. These standards include a review of the economic conditions affecting the borrower, the borrower s financial strength and capacity to repay the debt, the underlying collateral and the borrower s past credit performance. We apply these standards at the time a loan is made and monitor them periodically throughout the life of the loan. See Legislative and Regulatory Changes for a discussion of regulatory guidance on commercial real estate lending.

The Bank has loans outstanding to borrowers in all industries within its primary service area. Any adverse economic or other conditions affecting these industries would also likely have an adverse effect on the local workforce, other local businesses, and individuals in the community that have entered into loans with the Bank. The auto manufacturing business and its suppliers have positively affected our local economy, but automobile manufacturing is cyclical and adversely affected by increases in interest rates. Decreases in automobile sales, including adverse changes due to interest rate increases, could adversely affect the Kia and Hyundai plants and their suppliers local spending and employment, and could adversely affect economic conditions in the markets we serve. However, management believes that due to the diversified mix of industries located within the Bank s primary service area, adverse changes in one industry may not necessarily affect other area industries to the same degree or within the same time frame. The Bank s primary service area also is subject to both local and national economic conditions and fluctuations. While most loans are made within our primary service area, some residential mortgage loans are originated outside the primary service area, and the Bank from time to time has purchased loan participations from outside its primary service area.

Employees

At December 31, 2013, the Company and its subsidiaries had 155 full-time equivalent employees, including 35 officers.

Statistical Information

Certain statistical information is included in response to Item 7 of this Annual Report on Form 10-K. Certain statistical information is also included in response to Item 6, Item 7A and Item 8 of this Annual Report on Form 10-K.

SUPERVISION AND REGULATION

The Company and the Bank are extensively regulated under federal and state laws applicable to financial institutions. The supervision, regulation and examination of the Company and the Bank and their respective subsidiaries by the bank regulatory agencies are intended primarily for the maintenance of the safety and soundness of financial institutions and the federal deposit insurance system, as well as protection of depositors, rather than holders of Company capital stock and other securities. Any change in applicable law or regulation may have a material effect on the Company s business. The following discussion is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below.

Bank Holding Company Regulation

The Company, as a bank holding company, is subject to supervision, regulation and examination by the Federal Reserve under the BHC Act. Bank holding companies are generally limited to the business of banking, managing or controlling banks, and other activities that the Federal Reserve determines to be so closely related to banking or managing or controlling banks as to be a proper incident thereto. The Company is required to file with the Federal Reserve periodic reports and such other information as the Federal Reserve may request. The Federal Reserve examines the Company, and may examine its subsidiaries. The State of Alabama currently does not regulate bank holding companies.

The BHC Act requires prior Federal Reserve approval for, among other things, the acquisition by a bank holding company of direct or indirect ownership or control of more than 5% of the voting shares or substantially all the assets of any bank, or for a merger or consolidation of a bank holding company with another bank holding company. With certain exceptions, the BHC Act prohibits a bank holding company from acquiring direct or indirect ownership or control of voting shares of any company that is not a bank or bank holding company and from engaging directly or indirectly in any activity other than banking or managing or controlling banks or performing services for its authorized subsidiary. A bank holding company may, however, engage in or acquire an interest in a company that engages in activities that the Federal Reserve has determined by regulation or order to be so closely related to banking or managing or controlling banks as to be a proper incident thereto.

Bank holding companies are and remain well-capitalized and well-managed, as defined in Federal Reserve Regulation Y, and have and maintain satisfactory or better ratings under the Community Reinvestment Act of 1977, as amended (the CRA), may elect to become financial holding companies. Financial holding companies and their subsidiaries are permitted to acquire or engage in previously impermissible activities such as insurance underwriting, securities underwriting, travel agency activities, broad insurance agency activities, merchant banking and other activities that the Federal Reserve determines to be financial in nature or complementary thereto. In addition, under the BHC s merchant banking authority and Federal Reserve regulations, financial holding companies are authorized to invest in companies that engage in activities that are not financial in nature, as long as the financial holding company makes its investment with the intention of limiting the terms of its investment, does not manage the company on a day-to-day basis, and the investee company does not cross-market with any depositary institutions controlled by the financial holding company. Financial holding companies continue to be subject to Federal Reserve supervision, regulation and examination, but the Gramm-Leach-Bliley Act of 1999 (the GLB Act) applies the concept of functional regulation to the activities conducted by subsidiaries. For example, insurance activities would be subject to supervision and regulation by state insurance authorities. While the Company has not elected to become a financial holding company, in order to exercise the broader activity powers provided by the GLB Act, it may elect to do so in the future.

The BHC Act permits acquisitions of banks by bank holding companies, subject to various restrictions, including deposit share limits, and that the acquirer be well capitalized and well managed . Under the Alabama Banking Code, with the prior approval of the Alabama Superintendent, an Alabama bank may acquire and operate one or more banks in other states pursuant to a transaction in which the Alabama bank is the surviving bank. In addition, one or more Alabama banks may enter into a merger transaction with one or more out-of-state banks, and an out-of-state bank resulting from such transaction may continue to operate the acquired branches in Alabama. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act), banks, including Alabama banks, may branch anywhere in the United States.

The Company is a legal entity separate and distinct from the Bank. Various legal limitations restrict the Bank from lending or otherwise supplying funds to the Company. The Company and the Bank are subject to Section 23A of the Federal Reserve Act and Federal Reserve Regulation W thereunder. Section 23A defines covered transactions, which include extensions of credit, and limits a bank s covered transactions with any affiliate to 10% of such bank s capital and surplus. All covered and exempt transactions between a bank and its affiliates must be on terms and conditions consistent with safe and sound banking practices, and banks and their subsidiaries are prohibited from purchasing low-quality assets from the bank s affiliates. Finally, Section 23A requires that all of a bank s extensions of credit to its affiliates be appropriately secured by permissible collateral, generally United States government or agency securities. The Company and the Bank also are subject to Section 23B of the Federal Reserve Act, which generally requires covered and other transactions among affiliates to be on terms and under circumstances, including credit standards, that are substantially the same as or at least as favorable to the bank or its subsidiary as those prevailing at the time for similar transactions with unaffiliated companies.

Federal Reserve policy, as well as the Federal Deposit Insurance Act, as amended by the Dodd-Frank Act, requires a bank holding company to act as a source of financial and managerial strength to its bank subsidiaries and to take measures to preserve and protect its bank subsidiaries in situations where additional investments in a bank subsidiary may not otherwise be warranted. In the event an FDIC-insured subsidiary becomes subject to a capital restoration plan with its regulators, the parent bank holding company is required to guarantee performance of such plan up to 5% of the bank s assets, and such guarantee is give priority in bankruptcy of the bank holding company. In addition, where a bank holding company has more than one bank or thrift subsidiary, each of the bank holding company s subsidiary depository institutions are responsible for any losses to the FDIC s Deposit Insurance Fund (DIF) as a result of an affiliated depository institution s failure. As a result, a bank holding company may be required to loan money to a bank subsidiary in the form of subordinate capital notes or other instruments which qualify as capital under bank regulatory rules. However, any loans from the holding company to such subsidiary banks likely will be unsecured and subordinated to such bank s depositors and to other creditors of the bank. See Capital.

Bank Regulation

The Bank is subject to supervision, regulation and examination by the Federal Reserve and the Alabama Superintendent, which monitor all areas of the operations of the Bank, including reserves, loans, mortgages, issuances and redemption of capital securities, payment of dividends, establishment of branches, capital adequacy and compliance with laws. The Bank is a member of the FDIC and, as such, its deposits are insured by the FDIC to the maximum extent provided by law. See FDIC Insurance Assessments.

Alabama law permits statewide branching by banks. The powers granted to Alabama-chartered banks by state law include certain provisions designed to provide such banks with competitive equality to the powers of national banks.

In 2007, the Alabama legislature amended the Alabama Banking Code to, among other things; strengthen the regulatory and enforcement authority of the Alabama State Banking Department and the Alabama Superintendent of Banks.

The Federal Reserve has adopted the Federal Financial Institutions Examination Council s (FFIEC) updated rating system, which assigns each financial institution a confidential composite CAMELS rating based on an evaluation and rating of six essential components of an institution s financial condition and operations: **C**apital Adequacy, **A**sset Quality, **M**anagement, **E**arnings, **L**iquidity and **S**ensitivity to market risk, as well as the quality of risk management practices. For most institutions, the FFIEC has indicated that market risk primarily reflects exposures to changes in interest rates. When regulators evaluate this component, consideration is expected to be given to: management s ability to identify, measure, monitor and control market risk; the institution s size; the nature and complexity of its activities and its risk profile; and the adequacy of its capital and earnings in relation to its level of market risk exposure. Market risk is rated based upon, but not limited to, an assessment of the sensitivity of the financial institution s earnings or the economic value of its capital to adverse changes in interest rates, foreign exchange rates, commodity prices or equity prices management s ability to identify, measure, monitor and control exposure to market risk; and the nature and complexity of interest rate risk exposure arising from non-trading positions.

The GLB Act and related regulations require banks and their affiliated companies to adopt and disclose privacy policies, including policies regarding the sharing of personal information they obtain from customers with third parties. The GLB Act also permits bank subsidiaries to engage in financial activities similar to those permitted to financial holding companies.

The federal bank regulators have updated their guidance several times on overdrafts, including overdrafts incurred at automated teller machines and point of sale terminals, and overdrafts have become a focus of the federal Consumer Financial Protection Bureau (CFPB). Among other things, the federal regulators require banks to monitor accounts and to limit the use of overdrafts by customers as a form of short-term, high-cost credit, including, for example, giving customers who overdraw their accounts on more than six occasions where a fee is charged in a rolling 12 month period a reasonable opportunity to choose a less costly alternative and decide whether to continue with fee-based overdraft coverage. It also encourages placing appropriate daily limits on overdraft fees, and asks banks to consider eliminating overdraft fees for transactions that overdraw an account by a *de minimis* amount. Overdraft policies, processes, fees and disclosures are frequently the subject of litigation against banks in various jurisdictions.

Community Reinvestment Act and Consumer Laws

The Bank is subject to the provisions of the CRA and the Federal Reserve s regulations thereunder. Under the CRA, all banks and thrifts have a continuing and affirmative obligation, consistent with their safe and sound operation, to help meet the credit needs for their entire communities, including low- and moderate-income neighborhoods. The CRA requires a depository institution s primary federal regulator, in connection with its examination of the institution, to assess the institution s record of assessing and meeting the credit needs of the community served by that institution, including low- and moderate-income neighborhoods. The bank regulatory agency s assessment of the institution s record is made available to the public. Further, such assessment is required of any institution which has applied to: (i) charter a national bank; (ii) obtain deposit insurance coverage for a newly-chartered institution; (iii) establish a new branch office that accepts deposits; (iv) relocate an office; or (v) merge or consolidate with, or acquire the assets or assume the liabilities of, a federally regulated financial institution. In the case of a bank holding company applying for approval to acquire a bank or other bank holding company, the Federal Reserve will assess the records of each subsidiary depository institution of the applicant bank holding company, and such records may be the basis for denying the application. A less than satisfactory CRA rating will slow, if not preclude branch expansion activities and may prevent a company from becoming a financial holding company.

As a result of the GLB Act, CRA agreements with private parties must be disclosed and annual CRA reports must be made to a bank s primary federal regulator. No new activities authorized under the GLB Act may be commenced by a bank holding company or by a bank financial subsidiary if any of its bank subsidiaries received less than a satisfactory CRA rating in its latest CRA examination. The federal CRA regulations require that evidence of discriminatory, illegal or abusive lending practices be considered in the CRA evaluation.

The Bank is also subject to, among other things, the provisions of the Equal Credit Opportunity Act (the ECOA) and the Fair Housing Act (the FHA), both of which prohibit discrimination based on race or color, religion, national origin, sex and familial status in any aspect of a consumer or commercial credit or residential real estate transaction. The Department of Justice (the DOJ), and the federal bank regulatory agencies have issued an Interagency Policy Statement on Discrimination in Lending in order to provide guidance to financial institutions in determining whether discrimination exists, how the agencies will respond to lending discrimination, and what steps lenders might take to prevent discriminatory lending practices. The DOJ has increased its efforts to prosecute what it regards as violations of the ECOA and FHA.

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The Dodd-Frank Act established the CFPB, which began exercising its regulatory authority upon the recess appointment of its director on January 4, 2012. The CFPB has the authority, previously exercised by the federal bank regulators to adopt regulations and enforce various laws, including the ECOA, and other fair lending laws, the Truth in Lending Act, the Electronic Funds Transfer Act, mortgage lending rules, Truth in Savings, Fair Credit Reporting and Privacy of Consumer Financial Privacy. Although the CFPB does not examine or supervise banks with less than $10 billion in assets, it exercises broad authority that affects bank regulation in these areas and bank regulators consumer examination and enforcement. Banks of all sizes will be subject to changes as the CFPB reviews and revises the regulations it administers. The CFPB has focused on various practices to date, including revising mortgage lending rules, credit card add-on products, indirect automobile lending, student lending, and payday and similar lending, and has a broad mandate to regulate consumer financial products, whether or not offered by banks or their affiliates.

Residential Mortgages

The CFPB s final regulations implementing the Dodd-Frank Act requirement that lenders determine whether a consumer has the ability to repay a mortgage loan became effective January 10, 2014. These establish certain minimum requirements for creditors when making ability to pay determinations, and provide certain safe harbors from liability for mortgages that are qualified mortgages and are not higher-priced. Generally, these CFPB regulations apply to all consumer, closed-end loans secured by a dwelling including home-purchase loans, refinances and home equity loans whether first or subordinate lien. Qualified mortgages must generally satisfy detailed requirements related to product features, underwriting standards, and a points and fees requirement whereby the total points and fees on a mortgage loan cannot exceed specified amounts or percentages of the total loan amount. Qualified mortgages must have: (1) a term not exceeding 30 years; (2) regular periodic payments that do not result in negative amortization, deferral of principal repayment, or a balloon payment; (3) and be supported with documentation of the borrower and its credit. We anticipate focusing our residential mortgage origination on qualified mortgages and those that meet our investors requirements, but we may make loans that do not meet the safe harbor requirements for qualified mortgages . Our residential mortgage strategy, product offerings, and profitability may change as these regulations are interpreted and applied in practice.

The bank generally services the loans it originates, including those it sells. The CFPB adopted new mortgage servicing standards, effective in January 2014. These include new requirements regarding force-placed insurance, certain notices prior to rate adjustments on adjustable rate mortgages, and periodic disclosures to borrowers. Servicers will be prohibited from processing foreclosures when a loan modification is pending, and must wait until a loan is more than 120 days delinquent before initiating a foreclosure action. Servicers must provide direct and ongoing access to its personnel, and provide prompt review of any loss mitigation application. Servicers must maintain accurate and accessible mortgage records for the life of a loan and until one year after the loan is paid off or transferred. These new standards are expected to increase the cost and compliance risks of servicing mortgage loans, and the mandatory delays in foreclosures could result in loss of value on collateral or the proceeds we may realize from a sale of foreclosed property.

Our residential mortgage strategy, product offerings, and profitability may change as these regulations are interpreted and applied in practice, and may also change due to the restructuring of Fannie Mae and Freddie Mac as part of the resolution of their conservatorships.

Other Laws and Regulations

The International Money Laundering Abatement and Anti-Terrorism Funding Act of 2001 specifies new know your customer requirements that obligate financial institutions to take actions to verify the identity of the account holders in connection with opening an account at any U.S. financial institution. Bank regulators are required to consider compliance with this Act s money laundering provisions in acting upon acquisition and merger proposals, and sanctions for violations of this Act can be imposed in an amount equal to twice the sum involved in the violating transaction, up to $1 million.

Under the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 (the USA PATRIOT Act), financial institutions are subject to prohibitions against specified financial transactions and account relationships as well as to enhanced due diligence and know your customer standards in their dealings with foreign financial institutions and foreign customers.

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The USA PATRIOT Act requires financial institutions to establish anti-money laundering programs, and sets forth minimum standards for these programs, including:

- the development of internal policies, procedures, and controls;
- the designation of a compliance officer;
- an ongoing employee training program; and
- an independent audit function to test the programs.

The Company is also required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as new rules and regulations adopted by the SEC, the Public Company Accounting Oversight Board and Nasdaq. In particular, the Company is required to report on internal controls as part of its annual report for the year ended December 31, 2013 pursuant to Section 404 of the Sarbanes-Oxley Act. The Company has evaluated its controls, including compliance with the SEC rules on internal controls, and has and expects to continue to spend significant amounts of time and money on compliance with these rules. If the Company fails to comply with these internal control rules in the future, it may materially adversely affect its reputation, its ability to obtain the necessary certifications to its financial statements, its relations with its regulators and other financial institutions with which it deals, and its ability to access the capital markets and offer and sell Company securities on terms and conditions acceptable to the Company. The Company s assessment of its financial reporting controls as of December 31, 2013 are included elsewhere in this report with no material weaknesses reported.

Payment of Dividends

The Company is a legal entity separate and distinct from the Bank. The Company s primary source of cash is dividends from the Bank. Prior regulatory approval is required if the total of all dividends declared by a state member bank (such as the Bank) in any calendar year will exceed the sum of such bank s net profits for the year and its retained net profits for the preceding two calendar years, less any required transfers to surplus. During 2013, the Bank paid cash dividends of approximately $3.3 million to the Company. At December 31, 2013, the Bank could have declared additional dividends of approximately $9.8 million without prior approval of regulatory authorities.

In addition, the Company and the Bank are subject to various general regulatory policies and requirements relating to the payment of dividends, including requirements to maintain capital above regulatory minimums. The appropriate federal and state regulatory authorities are authorized to determine when the payment of dividends would be an unsafe or unsound practice, and may prohibit such dividends. The Federal Reserve has indicated that paying dividends that deplete a state member bank s capital base to an inadequate level would be an unsafe and unsound banking practice. The Federal Reserve has indicated that depository institutions and their holding companies should generally pay dividends only out of current year s operating earnings.

Under a Federal Reserve policy adopted in 2010, the board of directors of a bank holding company must consider different factors to ensure that its dividend level is prudent relative to maintaining a strong financial position, and is not based on overly optimistic earnings scenarios, such as potential events that could affect its ability to pay, while still maintaining a strong financial position. As a general matter, the Federal Reserve has indicated that the board of directors of a bank holding company should consult with the Federal Reserve and eliminate, defer or significantly reduce the bank holding company s dividends if:

- its net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
- its prospective rate of earnings retention is not consistent with its capital needs and overall current and prospective financial condition; or

It will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

When fully-phased in by 2019, the Basel III capital rules will further limit permissible dividends, stock repurchases and discretionary bonuses by the Company and the Bank, respectively, unless the Company and the Bank meet the full capital conservation buffer requirement. See Basel III Capital Rules.

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Capital

The Federal Reserve has risk-based capital guidelines for bank holding companies and state member banks, respectively. These guidelines required at year end 2013 a minimum ratio of capital to risk-weighted assets (including certain off-balance sheet activities, such as standby letters of credit) of 8%. At least half of the total capital must consist of common equity, retained earnings and a limited amount of qualifying preferred stock, less goodwill and certain core deposit intangibles (Tier 1 capital). Voting common equity must be the predominant form of capital. The remainder may consist of non qualifying preferred stock, qualifying subordinated, perpetual, and/or mandatory convertible debt, term subordinated debt and intermediate term preferred stock, up to 45% of pretax unrealized holding gains on available for sale equity securities with readily determinable market values that are prudently valued, and a limited amount of general loan loss allowance (Tier 2 capital and, together with Tier 1 capital, Total Capital).

In addition, the Federal Reserve has established minimum leverage ratio guidelines for bank holding companies and state member banks, which provide for a minimum leverage ratio of Tier 1 capital to adjusted average quarterly assets (leverage ratio) equal to 3%, plus an additional cushion of 1.0% to 2.0%, if the institution has less than the highest regulatory rating. The minimum capital ratios sought by the regulators are increasing, and a 5% leverage ratio is the minimum for the largest institutions. The guidelines also provide that institutions experiencing internal growth or making acquisitions will be expected to maintain strong capital positions substantially above the minimum supervisory levels without significant reliance on intangible assets. Higher capital may be required in individual cases and depending upon a bank holding company s risk profile. All bank holding companies and banks are expected to hold capital commensurate with the level and nature of their risks including the volume and severity of their problem loans. Lastly, the Federal Reserve s guidelines indicate that the Federal Reserve will continue to consider a tangible Tier 1 leverage ratio (deducting all intangibles) in evaluating proposals for expansion or new activity. The level of Tier 1 capital to risk-adjusted assets is becoming more widely used by the bank regulators to measure capital adequacy. The Federal Reserve has not advised the Company or the Bank of any specific minimum leverage ratio or tangible Tier 1 leverage ratio applicable to them. Under Federal Reserve policies, bank holding companies are generally expected to operate with capital positions well above the minimum ratios. The Federal Reserve believes the risk-based ratios do not take into account the quality of capital and interest rate, liquidity, market and operational risks. Accordingly, supervisory assessments of capital adequacy may differ significantly from conclusions based solely on the level of an organization s risk-based capital ratio.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), among other things, requires the federal banking agencies to take prompt corrective action regarding depository institutions that do not meet minimum capital requirements. FDICIA establishes five capital tiers: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized. A depository institution s capital tier will depend upon how its capital levels compare to various relevant capital measures and certain other factors, as established by regulation.

All of the federal bank regulatory agencies have regulations establishing risk-adjusted measures and relevant capital levels implementing the prompt corrective action standards. The relevant capital measures are the total capital ratio, Tier 1 risk-based capital ratio, as well as, the leverage capital ratio. Under the regulations, a state member bank will be: (i) well capitalized if it has a total risk-based capital ratio of 10% or greater, a Tier 1 risk-based capital ratio of 6% or greater, a leverage capital ratio of 5% or greater and is not subject to any written agreement, order, capital directive or prompt corrective action directive by a federal bank regulatory agency to maintain a specific capital level for any capital measure; (ii) adequately capitalized if it has a total risk-based capital ratio of 8% or greater, a Tier 1 risk-based capital ratio of 4% or greater, and generally has a leverage capital ratio of 4% or greater; (iii) undercapitalized if it has a total risk-based capital ratio of less than 8%, a Tier 1 risk-based capital ratio of less than 4% or generally has a leverage capital ratio of less than 2%; (iv) significantly undercapitalized if it has a total risk-based capital ratio of less than 6%, a Tier 1 risk-based capital ratio of less than 3% or a leverage capital ratio of less than 3%; or (v) critically undercapitalized if its tangible equity is equal to or less than 2% to total assets. The federal bank regulatory agencies have authority to require additional capital, and have been indicating that higher capital levels may be required in light of current market conditions and risk.

The Dodd Frank Act significantly modified the capital rules applicable to the Company and calls for increased capital, generally.

The generally applicable prompt corrective action leverage and risk-based capital standards (the generally applicable standards), including the types of instruments that may be counted as Tier 1 capital, will be applicable on a consolidated basis to depository institution holding companies, as well as their bank and thrift subsidiaries.

The generally applicable standards in effect prior to the Dodd-Frank Act will be floors for the standards to be set by the regulators.

Bank and thrift holding companies with assets of less than $15 billion as of December 31, 2009, will be permitted to include trust preferred securities that were issued before May 19, 2010, as Tier 1 capital, but trust preferred securities issued by a bank holding company (other than those with assets of less than $500 million) after May 19, 2010, will no longer count as Tier 1 capital.

The Dodd-Frank Act also requires studies of the use of hybrid instruments as capital, and of smaller (consolidated assets of $5 billion or less) financial companies access to the capital markets.

Information concerning the Company s and the Bank s regulatory capital ratios at December 31, 2013 is included in Note 19 of the consolidated financial statements that accompany this report.

Depository institutions that are no longer well capitalized for bank regulatory purposes must receive a waiver from the FDIC prior to accepting or renewing brokered deposits. FDICIA generally prohibits a depository institution from making any capital distribution (including paying dividends) or paying any management fee to its holding company, if the depository institution would thereafter be undercapitalized. Institutions that are undercapitalized are subject to growth limitations and are required to submit a capital restoration plan for approval. A depository institution s parent holding company must guarantee that the institution will comply with such capital restoration plan. The aggregate liability of the parent holding company is limited to the lesser of 5% of the depository institution s total assets at the time it became undercapitalized and the amount necessary to bring the institution into compliance with applicable capital standards. If a depository institution fails to submit an acceptable plan, it is treated as if it is significantly undercapitalized. If the controlling holding company fails to fulfill its obligations under FDICIA and files (or has filed against it) a petition under the federal Bankruptcy Code, the claim against the holding company s capital restoration obligation would be entitled to a priority in such bankruptcy proceeding over third party creditors of the bank holding company. Significantly undercapitalized depository institutions may be subject to a number of requirements and restrictions, including orders to sell sufficient voting stock to become adequately capitalized, requirements to reduce total assets, and cessation of receipt of deposits from correspondent banks. Critically undercapitalized institutions are subject to the appointment of a receiver or conservator. Because the Company and the Bank exceed applicable capital requirements, the respective managements of the Company and the Bank do not believe that the provisions of FDICIA have had or will have any material impact on the Company and the Bank or their respective operations.

Basel III Capital Rules

The Federal Reserve and the other bank regulators adopted in June 2013 final capital rules for bank holding companies and banks implementing the Basel Committee on Banking Supervision s Basel III: A Global Regulatory Framework for more Resilient Banks and Banking Systems. These new U.S. capital rules are called the Basel III Rules.

The Basel III Rules limits Tier 1 capital to common stock and noncumulative perpetual preferred stock, as well as trust preferred securities and cumulative perpetual preferred stock issued before May 19, 2010, each of which are permanently grandfathered in Tier 1 capital for bank holding companies with less than $15 billion in assets. A new capital measure, Common Equity Tier I Capital or CET1, is introduced. CET1 includes common stock and related surplus, retained earnings and, subject to certain adjustments, minority common equity interests in subsidiaries. CET1 is reduced by deductions for:

Goodwill and other intangibles, other than mortgage servicing assets (MSAs), which are treated separately, net of associated deferred tax liabilities (DTLs);

- Deferred tax assets (DTAs) arising from operating losses and tax credit carryforwards net of allowances and DTLs;

- Gains on sale from any securitization exposure; and

- Defined benefit pension fund net assets (i.e., excess plan assets), net of associated DTLs.

The Company intends to make a one-time election in its first regulatory report in 2015 and, as a result, CET1 would not be further adjusted for certain accumulated other comprehensive income (AOCI).

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Additional threshold deductions of the following that are individually greater than 10% of CET1 or collectively greater than 15% of CET1 (after above deductions):

MSAs, net of associated DTLs;

DTAs arising from temporary differences that could not be realized through net operating loss carryback, net of any valuation allowances and DTLs; and

Significant common stock investments in unconsolidated financial institutions, net of associated DTLs.

Noncumulative perpetual preferred stock, Tier 1 minority interest not included in CET1, subject to limits, and current Tier 1 capital instruments issued to the U.S. Treasury, including shares issued pursuant to the TARP or SBLF programs, will qualify as additional Tier I capital. All other qualifying preferred stock, subordinated debt and qualifying minority interests will be included in Tier 2 capital.

In addition to the minimum risk-based capital requirements, a new capital conservation buffer of CET1 capital of at least 2.5% of total risk weighted assets, will be required. The capital conservation buffer will be calculated as the *lowest* of:

the banking organization s CET1 capital ratio minus 4.5%;

the banking organization s tier 1 capital ratio minus 6.0%; and

the banking organization s total capital ratio minus 8.0%.

When fully-phased in by 2019, permissible dividends, stock repurchases and discretionary bonuses will be limited to the following percentages based on the capital conservation buffer as calculated above, subject to any further regulatory limitations, including those based on risk assessments and enforcement actions:

Buffer %	Buffer % Limit
More than 2.50%	None
> 1.875% - 2.50%	60.0%
> 1.250% - 1.875%	40.0
> 0.625% - 1.250%	20.0
£ 0.625	- 0 -

The various capital elements and total capital under the Basel III Rules, when fully phased by January 1, 2019 will be:

	Existing	January 1, 2015	Fully Phased In January 1, 2019
Minimum CET1		3.50%	4.5%
CET1 Conservation Buffer			2.5%
Total CET1		4.50%	7.0%

Deductions and threshold deductions		40%	100%
Minimum Tier 1 Capital	4.0%	6.0%	6.0%
Minimum Total Capital	8.0%	8.0%	8.0%
Minimum Total Capital *plus* conservation buffer	8.0%	8.0%	10.5%

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Changes in Risk-Weightings

The Basel III Rules also change some of the risk weightings used to determine risk-weighted capital adequacy. Among other things, the Basel III Rules:

- Assign a 250% risk weight to MSAs;
- Assign up to a 1,250% risk weight to structured securities, including private label mortgage securities, trust preferred CDOs and asset back securities;
- Retain existing risk weights for residential mortgages, but assign a 100% risk weight to most commercial real estate loans and a 150% risk-weight for high volatility commercial real estate loans;
- Assign a 150% risk weight to past due exposures (other than sovereign exposures and residential mortgages);
- Assign a 250% risk weight to DTAs, to the extent not deducted from capital (subject to certain maximums);
- Retain the existing 100% risk weight for corporate and retail loans; and
- Increase the risk weight for exposures to qualifying securities firms from 20% to 100%.

Changes to Prompt Corrective Action Rules

Under the Basel III Rules, the prompt corrective action rules and categories change as of January 1, 2015. The following illustrates the range of the changes from well capitalized, to undercapitalized to critically undercapitalized categories. The adequately capitalized and significantly undercapitalized categories also would be retained with appropriate changes, but are not included in the following illustration.

	Minimums	
	Current	Basel III
Well capitalized		
CET1		6.5%
Tier 1 risk-based capital	6.0%	8.0%
Total risk-based capital	10.0%	10.0%
Tier 1 leverage ratio	5.0%	5.0%
Undercapitalized		
CET1		< 4.5%
Tier 1 risk-based capital	< 4.0%	≤ 6.0%
Total risk-based capital	< 8.0%	< 8.0%
Tier 1 leverage ratio	< 5.0%	< 4.0%

Critically undercapitalized	Tangible equity to total assets ≤ 2.0%	Tier 1 capital plus non-Tier 1 perpetual preferred stock to total assets ≤ 2.0%

FDICIA

FDICIA directs that each federal bank regulatory agency prescribe standards for depository institutions and depository institution holding companies relating to internal controls, information systems, internal audit systems, loan documentation, credit underwriting, interest rate exposure, asset growth composition, a maximum ratio of classified assets to capital, minimum earnings sufficient to absorb losses, a minimum ratio of market value to book value for publicly traded shares, safety and soundness, and such other standards as the federal bank regulatory agencies deem appropriate.

Enforcement Policies and Actions

The Federal Reserve and the Alabama Superintendent monitor compliance with laws and regulations. Violations of laws and regulations, or other unsafe and unsound practices, may result in these agencies imposing fines or penalties, cease and desist orders, or taking other enforcement actions. Under certain circumstances, these agencies may enforce these remedies directly against officers, directors, employees and others participating in the affairs of a bank or bank holding company.

Fiscal and Monetary Policy

Banking is a business that depends on interest rate differentials. In general, the difference between the interest paid by a bank on its deposits and its other borrowings, and the interest received by a bank on its loans and securities holdings, constitutes the major portion of a bank s earnings. Thus, the earnings and growth of the Company and the Bank, as well as the values of, and earnings on, its assets and the costs of its deposits and other liabilities are subject to the influence of economic conditions generally, both domestic and foreign, and also to the monetary and fiscal policies of the United States and its agencies, particularly the Federal Reserve. The Federal Reserve regulates the supply of money through various means, including open market dealings in United States government securities, the discount rate at which banks may borrow from the Federal Reserve, and the reserve requirements on deposits.

The Federal Reserve lowered its target federal funds rate from 5.25% per annum on August 7, 2007 to 3.00% on January 30, 2008, and finally to 0-0.25% on December 16, 2008, where it remains today, and which the Federal Reserve has announced it intends to maintain through 2014. The Federal Reserve s discount rate, at 5.57% per annum on September 17, 2007, was steadily lowered to 4.75% on January 2, 2008, to 1.25% on October 28, 2008, and to 0.50% on December 16, 2008, where it remained until an increase on February 19, 2010 to 0.75%.

On April 30, 2010, the Federal Reserve Board amended Regulation D (Reserve Requirements of Depository Institutions) authorizing the Reserve Banks to offer term deposits to certain institutions. Term deposits, which are deposits with specified maturity dates, will be offered through a Term Deposit Facility (TDF). Term deposits will be one of several tools that the Federal Reserve could employ to drain reserves when policymakers judge that it is appropriate to begin moving to a less accommodative stance of monetary policy.

Beginning October 6, 2008, the Federal Reserve has been paying interest on depository institutions required and excess reserve balances. The payment of interest on excess reserve balances was expected to give the Federal Reserve greater scope to use its lending programs to address conditions in credit markets while also maintaining the federal funds rate close to the target rate established by the Federal Open Market Committee. The Federal Reserve has indicated that it may use this authority to implement a mandatory policy to reduce excess liquidity, in the event of inflation or the threat of inflation.

In 2011, the Federal Reserve repealed Regulation Q to permit banks to pay interest on demand deposits. The Federal Reserve has also engaged in several rounds of quantitative easing (QE) to reduce interest rates by buying bonds, and Operation Twist to reduce long term interest rates by buying long term bonds, while selling intermediate term securities. In 2013, the Federal Reserve began to taper its bond purchases under QE.

The nature and timing of any changes in such policies and their effect on the Company and the Bank cannot be predicted.

FDIC Insurance Assessments

The Bank s deposits are insured by the FDIC s DIF, and the Bank is subject to FDIC assessments for its deposit insurance, as well as assessments by the FDIC to pay interest on Financing Corporation (FICO) bonds.

The FDIC issued a final rule effective April 1, 2009 that changed the way that the FDIC s assessment system differentiates for risk, made corresponding changes to assessment rates beginning with the second quarter of 2009, and made other changes to the deposit insurance assessment rules. These rules included a decrease for long-term unsecured debt, including senior and subordinated debt and, for small institutions with assets under $10 billion, a portion of Tier 1 capital; (2) an increase for secured liabilities above a threshold amount; and (3) an increase for brokered deposits above a threshold amount. These assessment rules increased assessments for banks that use brokered deposits above a threshold level to fund rapid asset growth .

In 2009, the Bank paid $1.2 million in FDIC insurance premiums, including $0.4 million for a special industry-wide FDIC deposit insurance assessment of five basis points of an institution s assets minus Tier 1 capital as of June 30, 2009. In addition, to restore the FDIC s Deposit Insurance Fund, all FDIC-insured institutions were required to prepay their deposit premiums for the next 3 years on December 30, 2009. The FDIC ruling also provided for maintaining the assessment rates at their current levels through the end of 2010, with a uniform increase of $0.03 per $100 of covered deposits effective January 1, 2011. On December 30, 2009, the Bank prepaid $3.5 million of FDIC insurance premiums for the calendar quarters ending December 31, 2009 through December 31, 2012.

Effective April 1, 2011, and as discussed above under Recent Regulatory Developments , the FDIC began calculating assessments based on an institution s average consolidated total assets less its average tangible equity in accordance with changes mandated by the Dodd-Frank Act. The FDIC changed its assessment rates which shifted part of the burden of deposit insurance premiums toward depository institutions relying on funding sources other than U.S. deposits. Initial base assessment rates applicable to second quarter 2011 assessments (and prospectively until the DIF reserve ratio reaches 1.15 percent) are as follows:

Risk Category	Deposit Insurance Assessment Rate
I	5 to 9 basis points
II	14 basis points
III	23 basis points
IV	35 basis points

An institution s overall rate may be higher by as much as 10 basis points or lower by as much as 5 basis points depending on adjustments to the base rate for unsecured debt and/or brokered deposits. Furthermore, under the new system, different rate schedules will take effect when the DIF reserve ratio reaches certain levels. For example, for banks in risk category II, the initial base assessment rate will be 14 basis points when the DIF reserve ratio is below 1.15 percent, 12 basis points when the DIF reserve ratio is between 1.15 percent and 2 percent, 10 basis points when the DIF reserve ratio is between 2 percent and 2.5 percent and 9 basis points when the DIF reserve ratio is 2.5 percent or higher.

Since inception of the new schedule, the Bank s overall rate for assessment calculations has been 9 basis points or less, which is within the range of assessment rates for Risk Category I. The new methodology has reduced our expense related to FDIC insurance premiums in 2013, 2012 and 2011 compared to 2010. In 2010, the Company recorded $1.0 million to expense for FDIC insurance premiums. In 2011, the Company recorded $0.7 million in expense for FDIC insurance premiums, comprised of expense recognized for the first quarter of 2011 (under the old FDIC assessment rules), and expense recognized for the second, third and fourth quarters of 2011, respectively (under the new rules). In 2012 and 2013, the Company recorded $0.6 million and $0.5 million, respectively in expense for FDIC insurance premiums.

In addition, all FDIC-insured institutions are required to pay a pro rata portion of the interest due on FICO bonds. FICO assessments are set by the FDIC quarterly and ranged from 1.02 basis points in the first quarter of 2011 to 0.68 basis points in the last quarter of 2011, 0.66 basis points in all four quarters in 2012 and 0.64 basis points in all four quarters of 2013. The FICO assessment rate for the first quarter of 2014 is 0.62 basis points. FICO assessments of approximately $55,000, $45,000, and $44,000 were paid to the FDIC in 2011, 2012, and 2013, respectively.

TARP Capital Purchase Program and Small Business Lending Fund

The Company elected not to participate in the TARP Capital Purchase Program (CPP) or any other TARP Program, or under the Small Business Lending Fund (the SBLF), under the Small Business Jobs Act of 2010. We believed that we did not need funding under these programs.

Lending Practices

The federal bank regulatory agencies released guidance in 2006 on Concentrations in Commercial Real Estate Lending (the Guidance). The Guidance defines commercial real estate (CRE) loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50% or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of this property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risks in CRE markets would also be considered CRE loans under the Guidance. Loans on owner occupied CRE are generally excluded.

The Guidance requires that appropriate processes be in place to identify, monitor and control risks associated with real estate lending concentrations. This could include enhanced strategic planning, CRE underwriting policies, risk management, internal controls, portfolio stress testing and risk exposure limits as well as appropriately designed compensation and incentive programs. Higher allowances for loan losses and capital levels may also be required. The Guidance is triggered when either:

- Total reported loans for construction, land development, and other land of 100% or more of a bank s total capital; or

- Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land are 300% or more of a bank s total risk-based capital.

The Guidance also applies when a bank has a sharp increase in CRE loans or has significant concentrations of CRE secured by a particular property type.

The Guidance did not apply to the Bank s CRE lending activities at year-end 2013. At December 31, 2013, the Bank had outstanding $36.5 million in construction and land development loans and $154.0 million in total CRE loans (excluding owner occupied), which represent approximately 45.6% and 192.4%, respectively, of the Bank s total risk-based capital at December 31, 2013. The Company has always had significant exposures to loans secured by commercial real estate due to the nature of its markets and the loan needs of both its retail and commercial customers. The Company believes its long term experience in CRE lending, underwriting policies, internal controls, and other policies currently in place, as well as its loan and credit monitoring and administration procedures, are generally appropriate to managing its concentrations as required under the Guidance. The federal bank regulators continue to look at the risks of various assets and asset categories and risk management.

Other Dodd-Frank Act Provisions

The Dodd-Frank Act was signed into law on July 21, 2011. In addition to the capital, liquidity and FDIC deposit insurance changes discussed above, some of the provisions of the Dodd-Frank Act we believe may affect us are set forth below.

Financial Stability Oversight Council

The Dodd-Frank Act creates the Financial Stability Oversight Council or FSOC , which is chaired by the Secretary of the Treasury and composed of expertise from various financial services regulators. The FSOC has responsibility for identifying risks and responding to emerging threats to financial stability.

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Executive Compensation

The Dodd-Frank Act provides for a say on pay for shareholders of all public companies. Under the Dodd-Frank Act, each company must give its shareholders the opportunity to vote on the compensation of its executives at least once every three years. The Dodd-Frank Act also adds disclosure and voting requirements for golden parachute compensation that is payable to named executive officers in connection with sale transactions.

The SEC is required under the Dodd-Frank Act to issue rules obligating companies to disclose in proxy materials for annual meetings of shareholders information that shows the relationship between executive compensation actually paid to their named executive officers and their financial performance, taking into account any change in the value of the shares of a company s stock and dividends or distributions. The Dodd-Frank Act also provides that a company s compensation committee may only select a compensation consultant, legal counsel or other advisor after taking into consideration factors to be identified by the SEC that affect the independence of a compensation consultant, legal counsel or other advisor.

Section 954 of the Dodd-Frank Act added section 10D to the Exchange Act. Section 10D directs the SEC to adopt rules prohibiting a national securities exchange or association from listing a company unless it develops, implements, and discloses a policy regarding the recovery of executive compensation in certain circumstances. The policy must require that, in the event an accounting restatement due to material noncompliance with a financial reporting requirement under the federal securities laws, the company will recover from any current or former executive officer any incentive-based compensation (including stock options) received during the three year period preceding the date of the restatement, which is in excess of what would have been paid based on the restated financial statements. There is no requirement of wrongdoing by the executive, and the claw-back is mandatory and applies to all executive officers. Section 954 augments section 304 of the Sarbanes-Oxley Act of 2002 (SOX), which requires the CEO and CFO to return any bonus or other incentive or equity-based compensation received during the 12 months following the date of similarly inaccurate financial statements, as well as any profit received from the sale of employer securities during the period, if the restatement was due to misconduct. Unlike section 304, under which only the SEC may seek recoupment, the Dodd-Frank Act requires the company to seek the return of compensation. The SEC has yet to issue proposed rules under Section 954.

The Dodd-Frank Act requires the SEC, by rule, to require that each company disclose in the proxy materials for its annual meetings whether an employee or board member is permitted to purchase financial instruments designed to hedge or offset decreases in the market value of equity securities granted as compensation or otherwise held by the employee or board member.

Section 956 of the Dodd-Frank Act prohibits incentive-based compensation arrangements that encourage inappropriate risk taking by covered financial institutions and are deemed to be excessive, or that may lead to material losses. On June 21, 2010, the federal bank regulators adopted *Guidance on Sound Incentive Compensation Policies*, which, though targeted to larger, more complex organizations than the Company, includes principles that have been applied to smaller organizations similar to the Company. This Guidance applies to incentive compensation to executives as well as employees, who, individually or a part of a group, have the ability to expose the relevant banking organization to material amounts of risk. Incentive compensation should:

- Provide employees incentives that appropriately balance risk and reward;
- Be compatible with effective controls and risk-management;
- Be supported by strong corporate governance, including active and effective oversight by the organization s board of directors.

The federal bank regulators, the SEC and other regulators proposed regulations implementing Section 956 in April 2011, but no regulations have been adopted.

Other

The Dodd-Frank Act requires approximately 240-300 rulemakings and an estimated 130 studies. Many of the rules have not yet been proposed or adopted, and many are complex and require consultation among a variety of agencies, and their effects upon us, whether directly, or indirectly on the regulation and cost imposed on the markets and on others with whom we do business cannot be predicted.

Corporate Governance

The Dodd-Frank Act clarifies that the SEC may, but is not required to promulgate rules that would require that a company s proxy materials include a nominee for the board of directors submitted by a shareholder.

The Dodd-Frank Act requires stock exchanges to have rules prohibiting their members from voting securities that they do not beneficially own (unless they have received voting instructions from the beneficial owner) with respect to the election of a member of the board of directors (other than an uncontested election of directors of an investment company registered under the Investment Company Act of 1940), executive compensation or any other significant matter, as determined by the SEC by rule.

Credit Ratings

The Dodd-Frank Act includes a number of provisions that are targeted at improving the reliability of credit ratings. The federal bank regulators and the SEC have adopted rules to implement the Act s requirement to delete references to rating agency ratings for various purposes, including investment securities, which are permissible bank investments.

Debit Card Interchange Fees

The Durbin Amendment to the Dodd-Frank Act provides for a set of new rules requiring that interchange transaction fees for electric debit transactions be reasonable and proportional to certain costs associated with processing the transactions. The Federal Reserve has established standards for assessing whether interchange fees are reasonable and proportional, which a Federal District Court has ruled were improperly adopted. The Federal Reserve is appealing, and the district court s ruling has been stayed. Since it has under $10 billion in assets, the interchange rules do not apply to the Bank.

Derivatives

The Dodd-Frank Act requires a new regulatory system for the U.S. market for swaps and other over-the counter derivatives, which includes strict capital and margin requirements, central clearing of standardized over-the-counter derivatives, and heightened supervision of over-the-counter derivatives dealers and major market participants. These rules could increase the costs and collateral required to utilize derivatives that we could find useful to reduce our interest rate and other risks.

Other Legislative and Regulatory Changes

Various legislative and regulatory proposals, in addition to those mandated by the Dodd-Frank Act, regarding substantial changes in banking, and the regulation of banks, thrifts and other financial institutions, compensation, and the regulation of financial markets and their participants and financial instruments, and the regulators of all of these, as well as the taxation of these entities, are being considered by the executive branch of the federal government, Congress and various state governments, including Alabama. Certain of these proposals, if adopted, could significantly change the regulation or operations of banks and the financial services industry. New regulations and statutes are regularly proposed that contain wide-ranging proposals for altering the structures, regulations and competitive relationships of the nation s financial institutions.

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ITEM 1A. RISK FACTORS

Any of the following risks could harm our business, results of operations and financial condition and an investment in our stock. The risks discussed below also include forward-looking statements, and our actual results may differ substantially from those discussed in these forward-looking statements.

There can be no assurance that recent legislation and administrative actions will improve the long term stability of the U.S. financial system.

Numerous actions by the U.S. Congress, the Federal Reserve, the Treasury, the FDIC, the SEC and other governmental authorities have been taken to address the liquidity and credit crisis that commenced in 2007. These measures include various laws regulations and other actions, including, but not limited to, those described under Supervision and Regulation.

We cannot predict the actual effects of the Dodd-Frank Act and the numerous rules already thereunder that have been adopted, proposed or which are required to be adopted but that have not been proposed or adopted yet, or various governmental, regulatory, and fiscal and monetary initiatives, studies and rulemakings which have been and may be enacted, adopted or proposed will have on the financial markets, our competitors, counterparties and customers and on us. The terms and costs of these activities, or the failure of these actions to continue to stabilize the financial markets, asset prices, market liquidity or a worsening of current financial market and economic conditions could materially and adversely affect our business, financial condition, results of operations, and the trading prices of our common stock.

Difficult market conditions have adversely affected our industry.

We are exposed to downturns in the U.S. economy, although the local markets in which we operate in East Alabama have not been as adversely affected as various other areas of the country. Although declines in the housing market appear to be stabilizing to improving, the declines in home prices and high levels of foreclosures, unemployment and under-employment since 2007, have negatively affected the credit performance of mortgage loans and resulted in significant write-downs of asset values by various financial institutions, including government-sponsored entities as well as major commercial and investment banks. This market turmoil and the tightening of available credit have led to increased levels of commercial and consumer delinquencies, reduced consumer confidence, increased market volatility and reductions in business activity, although signs of stabilization and some recovery are beginning to evolve. Failures have increased among financial services companies, and various companies, weakened by market conditions, have merged with other institutions. We believe the following, among other things, may affect us in 2014:

- We expect to face further increased regulation of our industry as a result of Dodd-Frank Act rulemaking and other initiatives by the U.S. government and its regulatory agencies, including the CFPB. Compliance with such regulations may increase our costs, reduce our profitability, and limit our ability to pursue business opportunities and serve customers needs.

- Market developments, including employment and price levels, as well as personal income and after tax income in light of changes in federal taxes in January 2013, may affect consumer confidence levels from time to time in different directions, and may cause adverse changes in payment behaviors and payment rates, causing increases in delinquencies and default rates, which could affect our charge-offs and provisions for credit losses.

- Our ability to assess the creditworthiness of our customers and those we do business with, and to estimate the values of our assets and collateral for loans may be impaired if the models and approaches we use become less predictive of future behaviors, valuations, assumptions or estimates. The process we use to estimate losses inherent in our credit exposure or estimate the value of certain assets requires difficult, subjective, and complex judgments, including forecasts of economic conditions and how these economic predictions might affect the ability of our borrowers to repay their loans or the value of assets.

- Our ability to borrow from and engage in other business with other financial institutions on favorable terms or at all could be adversely affected by disruptions in the capital markets or other events, including, among other things, deteriorating investor expectations and changes in regulations.

We have invested previously in trust preferred securities issued by various financial institutions, and purchased loan participations from other financial institutions. At year end 2013, we owned approximately $1.1 million in FHLB-Atlanta stock and approximately $0.4 million of stock in a correspondent bank. We sold our remaining investments in trust preferred securities in the fourth quarter of 2013 and at December 31, 2013 had only approximately $1.4 million of loan participations purchased from others. We may purchase loans and loan participations or similar interests in the future, and our results of operations and financial condition could be adversely affected in the event the originating institutions or their borrowers experience financial difficulties or fail.

Failures of other depository institutions in our markets and increasing consolidation of financial services companies as a result of current market conditions could increase our deposits and assets and necessitate additional capital, and could have unexpected adverse effects upon us and our business.

The Volcker Rule, including final regulations adopted on December 10, 2013, may affect us adversely by reducing securities inventories at those institutions where we buy and sell securities for our portfolio and increasing the bid-ask spreads on securities we purchase or sell. These rules may decrease the range of permissible investments, such as collateral loan obligations (CLOs), which we could use to diversify our assets and for asset/liability management.

The soundness of other financial institutions could adversely affect us.

Our ability to engage in routine investment and banking transactions, as well as the quality and values of our investments in equity securities and obligations of other financial institutions, could be adversely affected by the actions, financial condition, and profitability of such other financial institutions with which we deal, including, without limitation, the FHLB and our correspondent banks. At December 31, 2013, the amortized cost of the Bank s investments in FHLB and our correspondent bank s common stock was approximately $1.5 million. Financial services institutions are interrelated as a result of shared credits, trading, clearing, counterparty and other relationships. As a result, defaults by, or even rumors or questions about, one or more financial institutions, or the financial services industry generally, have led to market-wide liquidity problems, losses of depositor, creditor or counterparty confidence in certain institutions and could lead to losses or defaults by other institutions, and in some cases, failure of such institutions. Any losses, defaults by, or failures of, the institutions we do business with could adversely affect our holdings of the debt of and equity in, such other institutions, our participation interests in loans originated by other institutions, and our business, including our liquidity, financial condition and earnings.

Nonperforming and similar assets take significant time to resolve and may adversely affect our results of operations and financial condition.

At December 31, 2013, our nonaccrual loans totaled $4.3 million, or 1.11% of total loans. In addition, we had approximately $3.9 million of other real estate owned at December 31, 2013. Our non-performing assets may adversely affect our net income in various ways. We do not record interest income on nonaccrual loans or OREO and these assets require higher loan administration and other costs, thereby adversely affecting our income. Decreases in the value of these assets, or the underlying collateral, or in the related borrowers performance or financial condition, whether or not due to economic and market conditions beyond our control, could adversely affect our business, results of operations and financial condition. In addition, the resolution of nonperforming assets requires commitments of time from management, which can be detrimental to the performance of their other responsibilities. There can be no assurance that we will not experience increases in nonperforming loans in the future.

Our allowance for loan losses may prove inadequate or we may be negatively affected by credit risk exposures.

Our business depends on the creditworthiness of our customers. We periodically review our allowance for loan losses for adequacy considering economic conditions and trends, collateral values and credit quality indicators, including past charge-off experience and levels of past due loans and nonperforming assets. We cannot be certain that our allowance for loan losses will be adequate over time to cover credit losses in our portfolio because of unanticipated adverse changes in the economy, market conditions or events adversely affecting specific customers, industries or markets, and changes in borrower behaviors. If the credit quality of our customer base materially decreases, if the risk profile of a market, industry or group of customers changes materially or weaknesses in the real estate markets persist or worsen, borrower payment behaviors change, or if our allowance for loan losses is not adequate, our business, financial condition, including our liquidity and capital, and results of operations could be materially adversely affected.

Weaknesses in the real estate markets, including the secondary market for residential mortgage loans, may continue to adversely affect us.

The effects of the CFPB changes to mortgage rules effective at the beginning of 2014, the effects of CFPB mortgage servicing rules that became effective in January 2014, enforcement actions, reviews and settlements, proposed changes in the securitization rules under the Dodd-Frank Act, and the Basel III Rules, combined with the continuing conservatorships of Fannie Mae and Freddie Mac, the levels of risky assets at the FHA and its relatively low reserves for losses, current

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levels of home sales, and the risks of interest rates increasing from historically low levels, could have serious adverse effects on the mortgage markets and our mortgage operations. Such effects could include, among other things, price reductions in single family home values, further adversely affecting the liquidity and value of collateral securing commercial loans for residential acquisition, construction and development, as well as residential mortgage loans that we hold, mortgage loan originations and gains on sale of mortgage loans. In March 2014, Senate Banking Committee leaders announced bipartisan legislation to substantially restructure Fannie Mae and Freddie Mac and their manner of operating. It is unknown whether this legislation will be adopted, and if adopted, what its affects may be.

Declining real estate prices and higher interest rates charged on mortgage loans have caused higher delinquencies and losses on certain mortgage loans, generally, particularly second lien mortgages and home equity lines of credit. Significant ongoing disruptions in the secondary market for residential mortgage loans have limited the market for and liquidity of most mortgage loans other than conforming Fannie Mae, Freddie Mac, and FHA loans. Declines in real estate values, low home sales volumes, financial stress on borrowers as a result of job losses or reduced incomes, interest rate increases, generally, including resets on adjustable rate mortgage loans, maturities of second lien mortgages or other factors could have further adverse effects on borrowers and changes in mortgage loan rules, could result in fewer mortgage originations, higher delinquencies and greater charge-offs in future periods, as well as increased regulation capital requirement which would adversely affect our financial condition, including capital and liquidity, and our results of operations. In the event our allowance for loan losses is insufficient to cover such losses, if any, our earnings, capital and liquidity could be adversely affected. Fannie Mae and Freddie Mac, the largest purchasers of residential mortgage loans, remain in federal conservatorship and the timing and effects of their resolution cannot be predicted.

Weaknesses in real estate markets may adversely affect the length of time and costs required to manage and dispose of, and the values realized from the sale of our OREO.

New CFPB residential mortgage origination rules may change our business and costs.

The CFPB s final regulations implementing the Dodd-Frank Act requirement that lenders determine whether a consumer has the ability to repay a mortgage loan became effective in January 2014. These encourage the origination of residential mortgages that meet the new requirements for qualified mortgages. These may adversely affect our product offerings, reduce our mortgage origination volume and increase our costs to originate residential mortgage loans, which could adversely affect our results of operation and financial condition, especially where residential mortgage origination volume is declining, generally.

We may be contractually obligated to repurchase mortgage loans we sold to third parties on terms unfavorable to us.

As a routine part of its business, the Company originates mortgage loans that it subsequently sells in the secondary market, including to governmental agencies and government sponsored entities, such as Fannie Mae. In connection with the sale of these loans, the Company makes customary representations and warranties, the breach of which could result in the Company being required to repurchase the loan or loans. Furthermore, the amount paid may be greater than the fair value of the loan or loans at the time of the repurchase. Requests for mortgage loan repurchases have increased generally in recent years, although we have received no such requests in 2013. Such requests, if these increased, could require the establishment of reserves for possible repurchases and adversely affect our results of operation and financial condition.

Servicing requirements may change and require us to incur additional costs and risks.

On February 9, 2012, the DOJ and various state attorneys general announced a $25 billion agreement with the nation s five largest mortgage servicers to address mortgage loan servicing and foreclosure abuses. While we were not a party to the settlement or a subject of the joint governmental investigation, we cannot be assured that the settlement may ultimately affect mortgage servicing standards generally, which could increase compliance and other costs of servicing residential mortgage loans. The CFPB continues to bring enforcement actions and develop proposals and rules that could increase the costs of providing mortgage servicing. This could reduce our income from servicing these types of loans and make it more difficult and costly to timely realize the value of collateral securing such loans upon a borrower default.

Changes in residential servicing regulations may have adverse effects on our resales and servicing of residential mortgage loans.

The CFPB adopted new residential mortgage servicing standards in January 2014 that add additional servicing requirements and that will increase our required servicer activities and delay foreclosures, among other things. These may adversely affect our costs to service residential mortgage loans, and together with the Basel III Rules, may decrease the returns on our MSRs.

Fannie Mae and Freddie Mac restructuring may adversely affect the mortgage markets and our sales of mortgages we originated

Fannie Mae and Freddie Mac remain in conservatorship. Recently, bi-partisan legislation was introduced in the U.S. Senate to restructure Fannie Mae and Freddie Mac to take them out of conservatorship and substantially change the way they conduct business in the future. Since these two entities dominate the residential mortgage markets, any changes could adversely affect our residential mortgage origination and servicing businesses and our results of operation and the returns on capital deployed in these businesses.

Our concentration of commercial real estate loans could result in further increased loan losses, and adversely affect our business, earnings, and financial condition.

Commercial real estate, or CRE, is cyclical and poses risks of possible loss due to concentration levels and risks of the assets being financed, which include loans for the acquisition and development of land and residential construction. We had 54.7 % of our portfolio in CRE loans, as defined by the Federal Reserve, at year-end 2013 compared to 55.1 % at year-end 2012. The banking regulators continue to give CRE lending greater scrutiny, and require banks with higher levels of CRE loans to implement improved underwriting, internal controls, risk management policies and portfolio stress testing, as well as higher levels of allowances for possible losses and capital levels as a result of CRE lending growth and exposures. Continued low demand for CRE, reduced availability of, and higher costs for, CRE lending could adversely affect our CRE loans and sales of our OREO, and therefore our earnings and financial condition, including our capital and liquidity.

We have experienced high levels of market volatility.

The capital and credit markets have experienced volatility and disruption since 2007. In some cases, the markets have produced downward pressure on stock prices and credit availability for certain issuers without regard to those issuers underlying financial condition or performance. Although market disruptions and volatility appear more stable currently, there can be no assurance that we will not experience future market conditions and volatility, which may have material adverse effects on our ability to access capital and on our business, financial condition (including liquidity) and results of operations.

Our ability to realize our deferred tax assets may be reduced in the future if our estimates of future taxable income from our operations and tax planning strategies do not support this amount, and the amount of net operating loss carry-forwards realizable for income tax purposes may be reduced under Section 382 of the Internal Revenue Code by sales of our capital securities.

We are allowed to carry-back losses for five years for Federal income tax purposes as otherwise permitted generally under the Worker, Homeownership, and Business Assistance Act of 2009 which was signed into law on November 6, 2009. As of December 31, 2013, we had net deferred tax assets of $5.4 million. These and future deferred tax assets may be further reduced in the future if our estimates of future taxable income from our operations and tax planning strategies do not support the amount of the deferred tax asset. The amount of net operating loss carry-forwards realizable for income tax purposes potentially could be further reduced under Section 382 of the Internal Revenue Code by a significant offering and/or other sales of our capital securities. The Basel III Rules reduce the regulatory capital benefits of deferred tax assets, also.

Our future success is dependent on our ability to compete effectively in highly competitive markets.

The East Alabama banking markets in which we do business are highly competitive and our future growth and success will depend on our ability to compete effectively in these markets. We compete for loans, deposits and other financial services in our markets with other local, regional and national commercial banks, thrifts, credit unions, mortgage lenders, and securities and insurance brokerage firms. Many of our competitors offer products and services different from us, and have substantially greater resources, name recognition and market presence than we do, which benefits them in attracting business. In addition, larger competitors may be able to price loans and deposits more aggressively than we are able to and have broader and more diverse customer and geographic bases to draw upon. The Dodd-Frank Act allows others to branch into our markets more easily from other states. Failures of other banks with offices in our markets could also lead to the entrance of new, stronger competitors in our markets.

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Our success depends on local economic conditions where we operate.

Our success depends on the general economic conditions in the geographic markets we serve in Alabama. The local economic conditions in our markets have a significant effect on our commercial, real estate and construction loans, the ability of borrowers to repay these loans and the value of the collateral securing these loans. Adverse changes in the economic conditions of the Southeastern United States in general, or in one or more of our local markets could negatively affect our results of operations and our profitability.

Our cost of funds may increase as a result of general economic conditions, interest rates, inflation and competitive pressures.

The Federal Reserve has taken aggressive actions to reduce interest rates generally, and the federal government continues large deficit spending. Our cost of funds may increase as a result of general economic conditions, interest rates and competitive pressures, and potential inflation resulting from government deficit spending and monetary policies. Traditionally, we have obtained funds principally through local deposits and borrowings from other institutional lenders. Generally, we believe local deposits are a cheaper and more stable source of funds than borrowings because interest rates paid for local deposits are typically lower than interest rates charged for borrowings from other institutional lenders. Increases in interest rates could also change consumers to shift their funds to more interest bearing instruments and to increase the competition for funds. The effects of the tapering of Federal Reserve bond purchases under QE are unpredictable and while the Federal Reserve has indicated it will seek to maintain low interest rates, interest rates could increase more than anticipated. See Fiscal and Monetary Policy .

The Federal Reserve has acknowledged the possibility of further recession and deflation. Should this occur, the financial services industry and our business could be adversely affected.

The recovery of the U.S. economy continues to progress slowly; national unemployment remains high at 6.7% in February 2014, and despite recent improvements, the housing market remains an important downside risk, subject to the risks of increases in interest rates and declining origination volumes. The restructuring of Fannie Mae and Freddie Mac, which dominate the residential mortgage markets, could adversely affect housing and the mortgage markets. Given the concerns about the U.S. economy and the costs of complying with new healthcare laws, U.S. employers continue to approach hiring with caution, and as a result unemployment may continue at high levels. Monetary and fiscal policy measures, including federal income tax changes at the beginning of 2013, may adversely affect the recovery, unemployment levels, and long-term stability in the financial markets. Any shift from fiscal stimulus efforts to fiscal restraint, and higher income and other taxes and government- imposed increased costs, such as those and under the Affordable Care Act, could adversely affect disposable income, the economy, and cause instability in the financial markets. Various governments in Europe have announced budget reductions and/or austerity measures as a means to limit fiscal budget deficits as a result of the economic crisis. Additionally, many state and local governments in the U.S. have also implemented budget reductions. Such economic factors could affect us in a variety of substantial and unpredictable ways, as well as affect our borrowers ability and willingness to meet their repayment obligations. These factors could have a material adverse effect on our results of operation and financial condition, liquidity and earnings.

Our profitability and liquidity may be affected by changes in interest rates and interest rate levels, the shape of the yield curve and economic conditions.

Our profitability depends upon net interest income, which is the difference between interest earned on assets, and interest expense on interest-bearing liabilities, such as deposits and borrowings. Net interest income will be adversely affected if market interest rates change where the interest we pay on deposits and borrowings increases faster than the interest earned on loans and investments. Interest rates, and consequently our results of operations, are affected by general economic conditions (domestic and foreign) and fiscal and monetary policies, as well as expectations of these rates and policies and the shape of the yield curve. Decreases in interest rates generally increase the market values of fixed-rate, interest-bearing investments and loans held, and increase the values of loan sales and mortgage loan activities. However, the production of mortgages and other loans and the value of collateral securing our loans, are dependent on demand within the markets we serve, as well as interest rates. While stabilizing to increasing, the levels of sales, as well as the values of real estate in our markets generally remain below the levels of several years ago. Declining interest rates reflect efforts by the Federal Reserve to stimulate the economy, but such efforts may not be effective, and otherwise adversely affect our net interest margin and thus may negatively affect our results of operations and financial condition, liquidity and earnings. Tapering of QE by the Federal Reserve, especially reductions in the Federal Reserve s purchases of residential mortgage-backed securities, could increase mortgage rates and decrease origination volumes, which have been declining generally in the second half of 2013.

Increases in interest rates generally decrease the market values of fixed-rate, interest-bearing investments and loans held and the production of mortgage and other loans and the value of collateral securing our loans, and therefore may adversely affect our liquidity and earnings, to the extent not offset by potential increases in our net interest margin.

Liquidity risks could affect operations and jeopardize our financial condition.

Liquidity is essential to our business. An inability to raise funds through deposits, borrowings, the repayment or sale of loans and other sources could have a substantial negative effect on our liquidity. Our funding sources include federal funds purchased securities sold under repurchase agreements, core and non-core deposits, and short- and long-term debt. We are also members of the FHLB and the Federal Reserve Bank of Atlanta, where we can obtain advances collateralized with eligible assets. We maintain a portfolio of securities that can be used as a source of liquidity. There are other sources of liquidity available to the Company or the Bank should they be needed, including our ability to acquire additional non-core deposits. We may be able, depending upon market conditions, to issue and sell debt securities, and preferred or common securities in public or private transactions. Our access to funding sources in amounts adequate to finance or capitalize our activities or on terms which are acceptable to us could be impaired by factors that affect us specifically or the financial services industry or economy in general. Our ability to borrow or obtain funding, if needed, could also be impaired by factors that are not specific to us, such as further disruption in the financial markets or negative views and expectations about the prospects for the financial services industry in light of the recent turmoil faced by banking organizations and the continued deterioration in credit markets, as well as the financial condition, liquidity and profitability of the financial institutions we deal with.

We are subject to extensive regulation that could limit or restrict our activities and adversely affect our earnings.

We and our subsidiaries are regulated by several regulators, including the Federal Reserve, the Alabama Superintendent, the SEC and the FDIC. Our success is affected by state and federal regulations affecting banks and bank holding companies, and the securities markets, and our costs of compliance could adversely affect our earnings. Banking regulations are primarily intended to protect depositors, not shareholders. The financial services industry also is subject to frequent legislative and regulatory changes and proposed changes, and a large number of required Dodd-Frank Act rules have yet to be proposed or finalized, and the effects of all these cannot be predicted. Federal bank regulatory agencies and the Treasury, as well as the Congress and the President, are evaluating the regulation of banks, other financial services providers and the financial markets and such changes, if any, could require us to maintain more capital and liquidity, and restrict our activities, which could adversely affect our growth, profitability and financial condition. Our consumer finance products, including residential mortgage loans, are subject to CFPB regulations and evolving standards reflecting CFPB releases, rule-making and enforcement actions.

Changes in accounting and tax rules applicable to banks could adversely affect our financial conditions and results of operations.

From time to time, the Financial Accounting Standards Board (the FASB) and the SEC change the financial accounting and reporting standards that govern the preparation of our financial statements. These changes can be hard to predict and can materially impact how we record and report our financial condition and results of operations. In some cases, we could be required to apply a new or revised standard retroactively, resulting in us restating prior period financial statements. FASB has proposed for comment significant changes to the manner in which banks allowance for loan losses would be calculated.

We are subject to internal control reporting requirements that increase compliance costs and failure to comply timely could adversely affect our reputation and the value of our securities.

We are required to comply with various corporate governance and financial reporting requirements under the Sarbanes-Oxley Act of 2002, as well as rules and regulations adopted by the SEC, the Public Company Accounting Oversight Board and Nasdaq. In particular, we are required to report on internal controls as part of our annual report on Form 10-K pursuant to Section 404 of the Sarbanes-Oxley Act. We expect to continue to spend significant amounts of time and money on compliance with these rules. Our failure to comply with these internal control rules may materially adversely affect our reputation, ability to obtain the necessary certifications to financial statements, and the value of our securities.

We are required to maintain capital to meet regulatory requirements, and if we fail to maintain sufficient capital, our financial condition, liquidity and results of operations would be adversely affected.

We and the Bank must meet regulatory capital requirements and maintain sufficient liquidity, including liquidity at the Company, as well as the Bank. If we fail to meet these capital and other regulatory requirements, including more rigorous requirements arising from our regulators implementation of Basel III, our financial condition, liquidity and results of operations would be materially and adversely affected. Our failure to remain well capitalized and well managed , including meeting the Basel III capital conservation buffers, for bank regulatory purposes could affect customer confidence, our ability to grow, our costs of funds and FDIC insurance, our ability to raise brokered deposits, our ability to pay dividends on our common stock and our ability to make acquisitions, and we would no longer meet the requirements for becoming a financial holding company. These could also affect our ability to use discretionary bonuses to attract and retain quality people.

The Dodd-Frank Act restricts our future issuance of trust preferred securities and cumulative preferred securities as eligible Tier 1 risk-based capital for purposes of the regulatory capital guidelines for bank holding companies.

Under the Dodd-Frank Act, banks and thrift holding companies with assets of less than $15 billion as of December 31, 2009 will be permitted to include trust preferred securities that were issued before May 19, 2010 as Tier 1 capital, only bank holding companies with assets of less than $500 million will be permitted to continue to issue trust preferred securities and have them count as Tier 1 capital. Accordingly, should we determine it is advisable, or should our regulators require us, based upon new capital or liquidity regulations or otherwise, to raise additional Tier 1 risk-based capital, we would not be able to issue additional trust preferred securities, and would instead have to issue preferred stock or common equity. To the extent we issue new equity, it could result in dilution to our shareholders. To the extent we issue preferred stock, dividends on the preferred stock, unlike distributions paid on trust preferred securities, would not be tax deductible, and the preferred stock would have a preference in liquidation and in dividends to our common stock.

We may need to raise additional capital in the future, but that capital may not be available when it is needed or on favorable terms.

We anticipate that our current capital resources will satisfy our capital requirements for the foreseeable future under currently effective rules. We may, however, need to raise additional capital to support our growth or currently unanticipated losses, or to meet the needs of our communities, resulting from failures or cutbacks by our competitors, and the Basel III Rules. Our ability to raise additional capital, if needed, will depend, among other things, on conditions in the capital markets at that time, which are currently disrupted and limited by events outside our control, and on our financial performance. If we cannot raise additional capital on acceptable terms when needed, our ability to further expand our operations through internal growth and acquisitions could be limited.

Future acquisitions and expansion activities may disrupt our business, dilute shareholder value and adversely affect our operating results.

We regularly evaluate potential acquisitions and expansion opportunities, including new branches and other offices. To the extent that we grow through acquisitions, we cannot assure you that we will be able to adequately or profitably manage this growth. Acquiring other banks, branches, or businesses, as well as other geographic and product expansion activities, involve various risks including:

- risks of unknown or contingent liabilities;
- unanticipated costs and delays;
- risks that acquired new businesses will not perform consistent with our growth and profitability expectations;
- risks of entering new markets or product areas where we have limited experience;
- risks that growth will strain our infrastructure, staff, internal controls and management, which may require additional personnel, time and expenditures;

exposure to potential asset quality issues with acquired institutions;

difficulties, expenses and delays of integrating the operations and personnel of acquired institutions;

- potential disruptions to our business;
- possible loss of key employees and customers of acquired institutions;
- potential short-term decreases in profitability; and
- diversion of our management s time and attention from our existing operations and business.

Attractive acquisition opportunities may not be available to us in the future.

While we seek continued organic growth, we also may consider the acquisition of other businesses. We expect that other banking and financial companies, many of which have significantly greater resources, will compete with us to acquire financial services businesses. This competition could increase prices for potential acquisitions that we believe are attractive. Also, acquisitions are subject to various regulatory approvals. If we fail to receive the appropriate regulatory approvals, we will not be able to consummate an acquisition that we believe is in our best interests, and regulatory approvals could contain conditions that reduce the anticipated benefits of any transaction. Among other things, our regulators consider our capital, liquidity, profitability, regulatory compliance and levels of goodwill and intangibles when considering acquisition and expansion proposals. Any acquisition could be dilutive to our earnings and shareholders equity per share of our common stock.

Technological changes affect our business, and we may have fewer resources than many competitors to invest in technological improvements.

The financial services industry is undergoing rapid technological changes with frequent introductions of new technology-driven products and services. In addition to serving clients better, the effective use of technology may increase efficiency and may enable financial institutions to reduce costs. Our future success will depend, in part, upon our ability to use technology to provide products and services that provide convenience to customers and to create additional efficiencies in operations. We may need to make significant additional capital investments in technology in the future, and we may not be able to effectively implement new technology-driven products and services. Many competitors have substantially greater resources to invest in technological improvements.

Our information systems may experience an interruption or security breach.

We rely heavily on communications and information systems, including those provided by third-party service providers, to conduct our business. Any failure, interruption, or security breach of these systems could result in failures or disruptions which could affect our customers privacy and our customer relationships, generally. While we have policies and procedures designed to prevent or limit the effect of the possible failure, interruption, cyber-attack , or security breaches, there is no assurance that these events will not occur and, if they do occur, that they will be adequately addressed without undue effects on our business, including loss of customers and added costs. In addition to the immediate costs of any failure, interruption or security breach, including those at our third-party service providers, these events could damage our reputation, result in a loss of customer business, subject us to additional regulatory scrutiny, or expose us to civil litigation and possible financial liability, any of which could have a material adverse effect on our financial condition and results of operations. Cyber attacks are increasing in general, and are a regulatory and business focus, as is vendor management for third parties who supply us with services, including information technology and customer products.

Severe weather, natural disasters, acts of war or terrorism or other external events could have significant effects on our business.

Severe weather and natural disasters, including hurricanes, tornados, drought and floods, acts of war or terrorism or other external events could have a significant effect on our ability to conduct business. Such events could affect the stability of our deposit base; impair the ability of borrowers to repay outstanding loans, impair the value of collateral securing loans, cause significant property damage, result in loss of revenue and/or cause us to incur additional expenses. Although management has established disaster recovery policies and procedures, the occurrence of any such event could have a material adverse effect on our business, which, in turn, could have a material adverse effect on our financial condition and results of operations.

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Our ability to continue to pay dividends to shareholders in the future is subject to profitability, capital, liquidity and regulatory requirements and these limitations may prevent us from paying dividends in the future.

Cash available to pay dividends to our shareholders is derived primarily from dividends paid to the Company by the Bank. The ability of the Bank to pay dividends, as well as our ability to pay dividends to our shareholders, will continue to be subject to and limited by the results of operations of our subsidiaries and our need to maintain appropriate liquidity and capital at all levels of our business consistent with regulatory requirements and the needs of our businesses. *See* Supervision and Regulation .

A limited trading market exists for our common shares, which could lead to price volatility.

Your ability to sell or purchase common shares depends upon the existence of an active trading market for our common stock. Although our common stock is quoted on the Nasdaq Global Market, the volume of trades on any given day has been limited historically. As a result, you may be unable to sell or purchase shares of our common stock at the volume, price and time that you desire. Additionally, whether the purchase or sales prices of our common stock reflects a reasonable valuation of our common stock also is affected by an active trading market, and thus the price you receive for a thinly-traded stock such as common stock, may not reflect its true or intrinsic value. The limited trading market for our common stock may cause fluctuations in the market value of our common stock to be exaggerated, leading to price volatility in excess of that which would occur in a more active trading market.

ITEM 1B. UNRESOLVED STAFF COMMENTS

None.

ITEM 2. DESCRIPTION OF PROPERTY

The Bank conducts its business from its main office and nine full-service branches. The Bank also operates commercial loan production offices in Montgomery and Phenix City, Alabama. The bank owns its main office building, which is located in downtown Auburn, Alabama, and has approximately 16,150 square feet of space. The original building was constructed in 1964, and an addition was completed in 1981. Portions of the building have been renovated to accommodate growth and changes in the Bank s operational structure and to adapt to technological changes. The main office offers the full line of the Bank s services and has one ATM. The Bank completed construction on a new drive-through facility located on the main office campus in October 2012. This drive-through facility has five drive-through lanes, including an ATM, and a walk-up teller window.

The Bank also owns a commercial office building, the AuburnBank Center (the Center), which is located next to the Bank s main office. The Center has approximately 23,000 square feet of space. The Bank s mortgage division, data processing activities, as well as other operations, are located in the Center. In total, the main office and Center parking lots provide parking for approximately 196 vehicles.

The Bank s Auburn Kroger branch was opened in August 1988 and is located in the Kroger supermarket in the Corner Village Shopping Center in Auburn, Alabama. The bank leases approximately 500 square feet of space for this branch. In September 2008, the Bank entered into a new lease agreement with the Kroger Corporation for five years with options for two 5-year extensions. In September 2013, the Bank exercised its option to extend the lease for another five years. This branch offers the full line of the Bank s deposit and other services including an ATM, except safe deposit boxes.

The Opelika branch is located in Opelika, Alabama. This branch, built in 1991, is owned by the Bank and has approximately 4,000 square feet of space. This branch offers the full line of the Bank s services and has drive-through windows and an ATM. This branch offers parking for approximately 36 vehicles.

The Bank s Hurtsboro branch was opened in June 1999. This branch is located in Hurtsboro, Alabama, about 35 miles south of Auburn, Alabama. The Bank owns this branch, which has approximately 1,000 square feet of space. The Bank leases the land for this branch from a third party. In June 2009, the Bank exercised its option to extend the lease for another five years. This branch offers the full line of the Bank s services including safe deposit boxes, a drive-through window and an ATM. This branch offers parking for approximately 12 vehicles, including a handicapped ramp.

The Bank s Auburn Wal-Mart Supercenter branch was opened in September 2000 inside the Wal-Mart shopping center on the south side of Auburn, Alabama. The lease is for approximately 700 square feet of space in the Wal-Mart. In September 2010, the Bank exercised its option to extend the lease for another five years. This branch offers the full line of the Bank s deposit and other services, including an ATM, except safe deposit boxes.

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The Bank s Notasulga branch was opened in August 2001. This branch is located in Notasulga, Alabama, about 15 miles south of Auburn, Alabama. This branch is owned by the Bank and has approximately 1,344 square feet of space. The Bank leased the land for this branch from a third party. In May 2012, the Bank s land lease renewed for another three year term. This branch offers the full line of the Bank s services including safe deposit boxes and a drive-through window. This branch offers parking for approximately 11 vehicles, including a handicapped ramp.

In July 2002, the Bank s Opelika Wal-Mart Supercenter branch was opened inside the Wal-Mart shopping center in Opelika, Alabama. In June 2012, the Bank exercised its option to extend the lease for another five years. The lease is for approximately 700 square feet of space in the Wal-Mart. This branch offers the full line of the Bank s deposits and other services including an ATM, except safe deposit boxes.

In November 2002, the Bank opened a loan production office in Phenix City, Alabama, about 35 miles south of Auburn, Alabama. In November 2013, the Bank renewed its lease for another year.

In July 2007, the Bank opened a new branch located in the Kroger supermarket in the TigerTown retail center in Opelika, Alabama. The Bank entered into a lease agreement with the Kroger Corporation for five years with options for two 5-year extensions. In July 2012, the Bank exercised its option to extend the lease for another five years. The Branch offers the full line of bank deposit and other services including an ATM, except for safe deposit boxes.

In February 2009, the Bank opened a branch located on Bent Creek Road in Auburn, Alabama. This branch is owned by the Bank and has approximately 4,000 square feet of space. This branch offers the full line of the Bank s services and has drive-through windows and a drive-up ATM. This branch offers parking for approximately 29 vehicles.

In September 2011, the Bank opened a loan production office in Montgomery, Alabama, about 50 miles west of Auburn, Alabama. In August 2013, the Bank renewed its lease for another two years.

In December 2011, the Bank opened a branch located on Fob James Drive in Valley, Alabama, about 30 miles northeast of Auburn, Alabama. This branch is owned by the Bank and has approximately 5,000 square feet of space. This branch offers the full line of the Bank s services and has drive-through windows and a drive-up ATM. This branch offers parking for approximately 35 vehicles. Prior to December 2011, the Bank leased office space for a loan production office in Valley, Alabama. The loan production office was originally opened in September 2004.

ITEM 3 LEGAL PROCEEDINGS

In the normal course of its business, the Company and the Bank from time to time are involved in legal proceedings. The Company s management believe there are no pending or threatened legal proceedings that, upon resolution, are expected to have a material adverse effect upon the Company s or the Bank s financial condition or results of operations.

ITEM 4. MINE SAFETY DISCLOSURES

Not applicable.

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PART II

ITEM 5. MARKET FOR REGISTRANT S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURITIES

The Company s Common Stock is listed on the Nasdaq Global Market, under the symbol AUBN . As of March 14, 2014, there were approximately 3,643,173 shares of the Company s Common Stock issued and outstanding, which were held by approximately 442 shareholders of record. The following table sets forth, for the indicated periods, the high and low closing sale prices for the Company s Common Stock as reported on the Nasdaq Global Market, and the cash dividends declared to shareholders during the indicated periods.

	Closing Price Per Share (1)		Cash Dividends Declared
	High	**Low**	
2013			
First Quarter	$ 22.60	$ 20.80	$ 0.21
Second Quarter	22.33	21.54	0.21
Third Quarter	24.71	22.00	0.21
Fourth Quarter	25.75	23.93	0.21
2012			
First Quarter	$ 21.99	$ 18.23	$ 0.205
Second Quarter	26.65	21.50	0.205
Third Quarter	23.20	21.00	0.205
Fourth Quarter	24.87	20.85	0.205

(1) The price information represents actual transactions.

The Company has paid cash dividends on its capital stock since 1985. Prior to this time, the Bank paid cash dividends since its organization in 1907, except during the Depression years of 1932 and 1933. Holders of Common Stock are entitled to receive such dividends as may be declared by the Company s Board of Directors. The amount and frequency of cash dividends will be determined in the judgment of the Board based upon a number of factors, including the Company s earnings, financial condition, capital requirements and other relevant factors. The Board currently intends to continue its present dividend policies.

Federal Reserve policy could restrict future dividends on our Common Stock, depending on our earnings and capital position and likely needs. See SUPERVISION AND REGULATION Payment of Dividends and MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS CAPITAL ADEQUACY.

The amount of dividends payable by the Bank is limited by law and regulation. The need to maintain adequate capital in the Bank also limits dividends that may be paid to the Company.

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Performance Graph

The following performance graph compares the cumulative, total return on the Company s Common Stock from December 31, 2008 to December 31, 2013, with that of the Nasdaq Composite Index and SNL Southeast Bank Index (assuming a $100 investment on December 31, 2008). Cumulative total return represents the change in stock price and the amount of dividends received over the indicated period, assuming the reinvestment of dividends.

	Period Ending					
Index	**12/31/08**	**12/31/09**	**12/31/10**	**12/31/11**	**12/31/12**	**12/31/13**
Auburn National Bancorporation, Inc.	100.00	101.30	107.43	103.28	120.53	149.88
NASDAQ Composite	100.00	145.36	171.74	170.38	200.63	281.22
SNL Southeast Bank	100.00	100.41	97.49	57.04	94.75	128.40

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ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number of Shares that May Yet Be Under the Plans or Programs
October 1 October 31, 2013				
November 1 November 30, 2013				
December 1 December 31, 2013				
Total				

Securities Authorized for Issuance Under Equity Compensation Plans

See the information included under Part III, Item 12, which is incorporated in response to this item by reference.

ITEM 6. SELECTED FINANCIAL DATA

See Table 2 Selected Financial Data and general discussion in Item 7, MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS .

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ITEM 7. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS
The following is a discussion of our financial condition at December 31, 2013 and 2012 and our results of operations for the years ended December 31, 2013, 2012, and 2011. The purpose of this discussion is to provide information about our financial condition and results of operations which is not otherwise apparent from the consolidated financial statements. The following discussion and analysis should be read along with our consolidated financial statements and the related notes included elsewhere herein. In addition, this discussion and analysis contains forward-looking statements, so you should refer to Item 1A, Risk Factors and Special Cautionary Notice Regarding Forward-Looking Statements .

OVERVIEW

The Company was incorporated in 1990 under the laws of the State of Delaware and became a bank holding company after it acquired its Alabama predecessor, which was a bank holding company established in 1984. The Bank, the Company s principal subsidiary, is an Alabama state-chartered bank that is a member of the Federal Reserve System and has operated continuously since 1907. Both the Company and the Bank are headquartered in Auburn, Alabama. The Bank conducts its business primarily in East Alabama, including Lee County and surrounding areas. The Bank operates full-service branches in Auburn, Opelika, Hurtsboro, Notasulga and Valley, Alabama. In-store branches are located in the Kroger and Wal-Mart SuperCenter stores in both Auburn and Opelika. The Bank also operates commercial loan production offices in Montgomery and Phenix City, Alabama.

Summary of Results of Operations

	Year ended December 31		
(Dollars in thousands, except per share data)	**2013**	**2012**	**2011**
Net interest income (a)	$ 22,362	$ 22,539	$ 20,944
Less: tax-equivalent adjustment	1,440	1,642	1,719
Net interest income (GAAP)	20,922	20,897	19,225
Noninterest income	7,298	10,483	5,177
Total revenue	28,220	31,380	24,402
Provision for loan losses	400	3,815	2,450
Noninterest expense	18,412	19,383	16,357
Income tax expense	2,290	1,419	57
Net earnings	$ 7,118	$ 6,763	$ 5,538
Basic and diluted earnings per share	$ 1.95	$ 1.86	$ 1.52

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures .

Financial Summary

The Company s net earnings were $7.1 million, or $1.95 per share, for the full year 2013, compared to $6.8 million, or $1.86 per share, for the full year 2012.

Net interest income (tax-equivalent) was $22.4 million for the full year 2013, compared to $22.5 million for the full year 2012. Although net interest income (tax-equivalent) declined slightly, continued improvement in the Company s funding mix and cost of funds largely offset declining yields on earning assets.

The provision for loan losses was $0.4 million for the full year 2013, compared to $3.8 million for the full year 2012. The decrease in the provision for loan losses was primarily due to a decline in net charge-offs and improvement in the overall credit quality of the loan portfolio, including lower levels of adversely classified and nonperforming loans. Net charge-offs were $1.9 million, or 0.48% of average loans, for the full year 2013, compared to $4.0 million, or 1.03% of average loans, for the full year 2012. This decrease was primarily due to a decline in net charge-offs for commercial real estate loans. In 2012, net charge-offs were impacted by a few individually significant charge-offs, including $3.1 million related to three borrowing relationships.

Noninterest income was $7.3 million in 2013, compared to $10.5 million in 2012. The decrease was primarily due to a non-recurring gain of $3.3 million realized in 2012 when the Company sold its interests in three affordable housing limited partnerships and a decrease in mortgage lending income of $0.6 million as rising rates negatively impacted refinance activity. These decreases were partially offset by a $1.0 million gain on sale of premises and equipment realized in 2013 when the Company sold certain real property in downtown Auburn that was no longer used for Company operations and was fully leased to third party tenants.

Noninterest expense was $18.4 million in 2013, compared to $19.4 million in 2012. The decrease was primarily due to a decrease in prepayment penalties on long-term debt of $0.7 million. During 2013, the Company repaid $35.0 million long-term debt with a weighted average interest rate of 3.46% and incurred prepayment penalties of $3.0 million. During 2012, the Company repaid $38.0 million of long-term debt with a weighted average interest rate of 4.26% and incurred prepayment penalties of $3.7 million.

Income tax expense for the full year 2013 was $2.3 million, compared to $1.4 million for the full year 2012. The Company s effective income tax rate was 24.34% for the full year 2013, compared to 17.34% for the full year 2012. In addition to a 15% increase in the level of earnings before taxes, the Company s effective tax rate increased because the Company s annualized effective tax rate for 2012 was reduced by the reversal of a $0.5 million deferred tax valuation allowance related to capital loss carry-forwards.

In 2013, the Company paid cash dividends of $3.1 million, or $0.84 per share. The Company remains well capitalized under current regulatory guidelines with a total risk-based capital ratio of 18.40%, a tier one risk-based capital ratio of 17.19%, and a tier one leverage capital ratio of 10.10% at December 31, 2013.

CRITICAL ACCOUNTING POLICIES

The accounting and financial reporting policies of the Company conform with U.S. generally accepted accounting principles and with general practices within the banking industry. In connection with the application of those principles, we have made judgments and estimates which, in the case of the determination of our allowance for loan losses, our assessment of other-than-temporary impairment, recurring and non-recurring fair value measurements, the valuation of other real estate owned, and the valuation of deferred tax assets, were critical to the determination of our financial position and results of operations. Other policies also require subjective judgment and assumptions and may accordingly impact our financial position and results of operations.

Allowance for Loan Losses

The Company assesses the adequacy of its allowance for loan losses prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolio, past loan loss experience, current asset quality trends, known and inherent risks in the portfolio, adverse situations that may affect a borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan loss rates and other pertinent factors, including regulatory recommendations. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. Loans are charged off, in whole or in part, when management believes that the full collectability of the loan is unlikely. A loan may be partially charged-off after a confirming event has occurred which serves to validate that full repayment pursuant to the terms of the loan is unlikely.

The Company deems loans impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Collection of all amounts due according to the contractual terms means that both the interest and principal payments of a loan will be collected as scheduled in the loan agreement.

An impairment allowance is recognized if the fair value of the loan is less than the recorded investment in the loan. The impairment is recognized through the allowance. Loans that are impaired are recorded at the present value of expected future cash flows discounted at the loan s effective interest rate, or if the loan is collateral dependent, impairment measurement is based on the fair value of the collateral, less estimated disposal costs.

The level of allowance maintained is believed by management to be adequate to absorb probable losses inherent in the portfolio at the balance sheet date. The allowance is increased by provisions charged to expense and decreased by charge-offs, net of recoveries of amounts previously charged-off.

In assessing the adequacy of the allowance, the Company also considers the results of its ongoing internal and independent loan review processes. The Company s loan review process assists in determining whether there are loans in the portfolio whose credit quality has weakened over time and evaluating the risk characteristics of the entire loan portfolio. The Company s loan review process includes the judgment of management, the input from our independent loan reviewers, and reviews that may have been conducted by bank regulatory agencies as part of their examination process. The Company incorporates loan review results in the determination of whether or not it is probable that it will be able to collect all amounts due according to the contractual terms of a loan.

As part of the Company s quarterly assessment of the allowance, management divides the loan portfolio into five segments: commercial and industrial, construction and land development, commercial real estate, residential real estate, and consumer installment loans. The Company analyzes each segment and estimates an allowance allocation for each loan segment.

The allocation of the allowance for loan losses begins with a process of estimating the probable losses inherent for these types of loans. The estimates for these loans are established by category and based on the Company s internal system of credit risk ratings and historical loss data. The estimated loan loss allocation rate for the Company s internal system of credit risk grades is based on its experience with similarly graded loans. For loan segments where the Company believes it does not have sufficient historical loss data, the Company may make adjustments based, in part, on loss rates of peer bank groups. At December 31, 2013 and 2012, and for the years then ended, the Company adjusted its historical loss rates for the commercial real estate portfolio segment based, in part, on loss rates of peer bank groups.

The estimated loan loss allocation for all five loan portfolio segments is then adjusted for management s estimate of probable losses for several qualitative and environmental factors. The allocation for qualitative and environmental factors is particularly subjective and does not lend itself to exact mathematical calculation. This amount represents estimated probable inherent credit losses which exist, but have not yet been identified, as of the balance sheet date, and are based upon quarterly trend assessments in delinquent and nonaccrual loans, credit concentration changes, prevailing economic conditions, changes in lending personnel experience, changes in lending policies or procedures and other influencing factors. These qualitative and environmental factors are considered for each of the five loan segments and the allowance allocation, as determined by the processes noted above, is increased or decreased based on the incremental assessment of these factors.

The Company regularly re-evaluates its practices in determining the allowance for loan losses. During 2013, the Company implemented certain refinements to its allowance for loan losses methodology, specifically the way that historical loss factors are calculated. Prior to June 30, 2013, the Company calculated average losses for all loan segments using a rolling 6 quarter historical period. Beginning with the quarter ended June 30, 2013, the Company calculated average losses for all loan segments (except for the commercial real estate loan segment) using a rolling 8 quarter historical period in order to better capture the effects of the current economic cycle on the Company s loan loss experience and continued this methodology through December 31, 2013. Based upon management s review of charge-off trends for each loan segment, the Company continues to calculate average losses for the commercial real estate loan segment using a rolling 6 quarter historical period. Other than the changes discussed above, the Company has not made any changes to its calculation of historical loss periods that would impact the calculation of the allowance for loan losses or provision for loan losses for the periods included in the accompanying consolidated balance sheets and statements of earnings.

Assessment for Other-Than-Temporary Impairment of Securities

On a quarterly basis, management makes an assessment to determine whether there have been events or economic circumstances to indicate that a security on which there is an unrealized loss is other-than-temporarily impaired. For equity securities with an unrealized loss, the Company considers many factors including the severity and duration of the impairment; the intent and ability of the Company to hold the security for a period of time sufficient for a recovery in value; and recent events specific to the issuer or industry. Equity securities for which there is an unrealized loss that is deemed to be other-than-temporary are written down to fair value with the write-down recorded as a realized loss in securities gains (losses).

For debt securities with an unrealized loss, an other-than-temporary impairment write-down is triggered when (1) the Company has the intent to sell a debt security, (2) it is more likely than not that the Company will be required to sell the debt security before recovery of its amortized cost basis, or (3) the Company does not expect to recover the entire amortized cost basis of the debt security. If the Company has the intent to sell a debt security or if it is more likely than not that that it will be required to sell the debt security before recovery, the other-than-temporary write-down is equal to the entire difference between the debt security s amortized cost and its fair value. If the Company does not intend to sell the security or it is not more likely than not that it will be required to sell the security before recovery, the other-than-temporary impairment write-down is separated into the amount that is credit related (credit loss component) and the amount due to all other factors. The credit loss component is recognized in earnings and is the difference between the security s amortized cost basis and the present value of its expected future cash flows. The remaining difference between the security s fair value and the present value of future expected cash flows is due to factors that are not credit related and is recognized in other comprehensive income, net of applicable taxes.

Fair Value Determination

U.S. GAAP requires management to value and disclose certain of the Company s assets and liabilities at fair value, including investments classified as available-for-sale and derivatives. ASC 820, *Fair Value Measurements and Disclosures*, which defines fair value, establishes a framework for measuring fair value in accordance with U.S. GAAP and expands disclosures about fair value measurements. For more information regarding fair value measurements and disclosures, please refer to Note 17, Fair Value, of the consolidated financial statements that accompany this report.

Fair values are based on active market prices of identical assets or liabilities when available. Comparable assets or liabilities or a composite of comparable assets in active markets are used when identical assets or liabilities do not have readily available active market pricing. However, some of the Company s assets or liabilities may lack an available or comparable trading market characterized by frequent transactions between willing buyers and sellers. In these cases, fair value is estimated using pricing models that use discounted cash flows and other pricing techniques. Pricing models and their underlying assumptions are based upon management s best estimates for appropriate discount rates, default rates, prepayments, market volatility and other factors, taking into account current observable market data and experience.

These assumptions may have a significant effect on the reported fair values of assets and liabilities and the related income and expense. As such, the use of different models and assumptions, as well as changes in market conditions, could result in materially different net earnings and retained earnings results.

Other Real Estate Owned

Other real estate owned (OREO), consists of properties obtained through foreclosure or in satisfaction of loans and is reported at the lower of cost or fair value, less estimated costs to sell at the date acquired with any loss recognized as a charge-off through the allowance for loan losses. Additional OREO losses for subsequent valuation adjustments are determined on a specific property basis and are included as a component of other noninterest expense along with holding costs. Any gains or losses on disposal of OREO are also reflected in noninterest expense. Significant judgments and complex estimates are required in estimating the fair value of OREO, and the period of time within which such estimates can be considered current is significantly shortened during periods of market volatility. As a result, the net proceeds realized from sales transactions could differ significantly from appraisals, comparable sales, and other estimates used to determine the fair value of other OREO.

Deferred Tax Asset Valuation

A valuation allowance is recognized for a deferred tax asset if, based on the weight of available evidence, it is more-likely-than-not that some portion or the entire deferred tax asset will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Based upon the level of taxable income over the last three years and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the we will realize the benefits of these deductible differences at December 31, 2013. The amount of the deferred tax assets considered realizable, however, could be reduced if estimates of future taxable income are reduced.

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Average Balance Sheet and Interest Rates

	Year ended December 31					
	2013		2012		2011	
(Dollars in thousands)	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate	Average Balance	Yield/ Rate
Loans and loans held for sale	$ 390,288	5.28%	$ 395,938	5.54%	$ 376,000	5.67%
Securities - taxable	195,850	2.00%	199,794	1.94%	223,638	2.69%
Securities - tax-exempt (a)	67,797	6.25%	77,447	6.24%	79,329	6.37%
Total securities	263,647	3.09%	277,241	3.14%	302,967	3.65%
Federal funds sold	48,671	0.22%	27,466	0.20%	28,905	0.19%
Interest bearing bank deposits	5,634	0.75%	793		1,394	0.05%
Total interest-earning assets	708,240	4.08%	701,438	4.38%	709,266	4.57%
Deposits:						
NOW	101,034	0.32%	99,664	0.35%	90,565	0.58%
Savings and money market	171,413	0.52%	153,668	0.56%	138,428	0.72%
Certificates of deposits less than $100,000	105,631	1.36%	108,726	1.63%	114,490	1.95%
Certificates of deposits and other time deposits of $100,000 or more	155,781	1.77%	161,128	2.08%	181,242	2.38%
Total interest-bearing deposits	533,859	1.01%	523,186	1.21%	524,725	1.54%
Short-term borrowings	2,817	0.50%	2,970	0.54%	2,423	0.50%
Long-term debt	31,518	3.59%	49,115	3.73%	86,899	3.91%
Total interest-bearing liabilities	568,194	1.15%	575,271	1.42%	614,047	1.87%
Net interest income and margin (a)	$ 22,362	3.16%	$ 22,539	3.21%	$ 20,944	2.95%

(a) Tax-equivalent. See Table 1 - Explanation of Non-GAAP Financial Measures .

RESULTS OF OPERATIONS

Net Interest Income and Margin

2013 vs. 2012 comparison

Net interest income (tax-equivalent) was $22.4 million in 2013, compared to $22.5 million in 2012. Although net interest income (tax-equivalent) declined slightly, management continues to seek to increase earnings by growing the Company s loan portfolio (in total and as a percentage of earning assets), focusing on deposit pricing, and repaying higher-cost wholesale funding sources. These efforts to increase earnings were offset by management s decision to reduce the Company s securities portfolio as a percentage of total interest earning assets and carry higher levels of short-term interest earning assets (e.g. federal funds sold) during 2013. As a result, the Company s net interest margin (tax-equivalent) declined to 3.16% in 2013, compared to 3.21% in 2012.

The tax-equivalent yield on total interest-earning assets decreased by 30 basis points in 2013 from 2012 to 4.08%. The decrease was primarily due to the shift in our asset mix described above and increased pricing competition for quality loan opportunities in our markets, which has limited the Company s ability to increase loans, generally, and to increase the yields on new and renewed loans, over the last several quarters.

The cost of total interest-bearing liabilities decreased 27 basis points in 2013 from 2012 to 1.15%. The net decrease was largely the result of the continued shift in our deposit mix, as we increased our lower-cost noninterest-bearing demand deposits, interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposit and other higher-cost time deposits and long-term debt (i.e. wholesale funding).

The Company continues to deploy various asset liability management strategies to manage its risk to interest rate fluctuations. The Company s net interest margin could experience pressure due to lower reinvestment yields in the securities portfolio given the current interest rate environment, increased pricing competition for quality loan opportunities, and fewer opportunities to further reduce our cost of funds due to the already low level of deposit rates currently.

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2012 vs. 2011 comparison

Net interest income (tax-equivalent) was $22.5 million in 2012, compared to $20.9 million in 2011, as net interest margin improvement offset a decline in average interest-earning assets of 1%. Net interest margin (tax-equivalent) was 3.21% in 2012, compared to 2.95% in 2011. The improved net interest margin reflected management s efforts to increase earnings by shifting the Company s asset mix through loan growth, focusing on deposit pricing, and repaying higher-cost wholesale funding sources. The cost of total interest-bearing liabilities decreased 45 basis points in 2012 from 2011 to 1.42%. The net decrease was largely the result of the continued shift in our deposit mix, as we increased our lower-cost noninterest-bearing demand deposits, interest bearing demand deposits (NOW accounts), and savings and money market accounts and concurrently reduced balances of higher-cost certificates of deposit and other higher-cost time deposits and long-term debt (i.e. wholesale funding).

The tax-equivalent yield on total interest-earning assets decreased by 19 basis points in 2012 from 2011 to 4.38%. This decrease was primarily driven by a 51 basis point reduction in the tax-equivalent yield on total securities to 3.14% as reinvestment yields in the securities portfolio declined due to the continued low interest rate environment. Also, loan pricing for creditworthy borrowers continues to be competitive in our markets and has limited the Company s ability to increase yields on new and renewed loans.

Provision for Loan Losses

The provision for loan losses represents a charge to earnings necessary to provide an allowance for loan losses that, in management s evaluation, should be adequate to provide coverage for the probable losses on outstanding loans. The provision for loan losses amounted to $0.4 million, $3.8 million, and $2.5 million for the years ended December 31, 2013, 2012, and 2011, respectively.

The provision for loan losses decreased in 2013 compared to 2012 primarily due to a decline in net charge-offs and improvement in the overall credit quality of the loan portfolio, including lower levels of adversely classified and nonperforming loans. Net charge-offs were $1.9 million, or 0.48% of average loans, in 2013, compared to $4.0 million, or 1.03% of average loans, in 2012. This decrease was primarily due to a decline in net charge-offs for commercial real estate loans. In 2012, net charge-offs were impacted by a few individually significant charge-offs, including $3.1 million related to three borrowing relationships.

The provision for losses increased in 2012 compared to 2011 due to an increase in net charge-offs and loan portfolio growth. Net charge-offs were $4.0 million for 2012, compared to $3.2 million in 2011. This increase was primarily due to an increase in net charge-offs in the commercial real estate loan portfolio of $2.7 million, which was partially offset by declines in net charge-offs of $1.6 million and $0.4 million, respectively, in the construction and land development and commercial and industrial loan portfolios.

Based upon its assessment of the loan portfolio, management adjusts the allowance for loan losses to an amount it believes to be appropriate to adequately cover probable losses in the loan portfolio. The Company s allowance for loan losses to total loans decreased to 1.37% at December 31, 2013 from 1.69% at December 31, 2012. Based upon our evaluation of the loan portfolio, management believes the allowance for loan losses to be adequate to absorb our estimate of probable losses existing in the loan portfolio at December 31, 2013. While our policies and procedures used to estimate the allowance for loan losses, as well as the resultant provision for loan losses charged to operations, are believed adequate by management and are reviewed from time to time by our regulators, they are based on estimates and judgment and are therefore approximate and imprecise. Factors beyond our control, such as conditions in the local and national economy, a local real estate market or particular industry conditions exist which may negatively and materially affect our asset quality and the adequacy of our allowance for loan losses and, thus, the resulting provision for loan losses.

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Noninterest Income

	Year ended December 31		
(Dollars in thousands)	2013	2012	2011
Service charges on deposit accounts	$ 930	$ 1,111	$ 1,167
Mortgage lending	2,895	3,445	1,922
Bank-owned life insurance	427	445	460
Gain on sale of affordable housing investments		3,268	
Affordable housing investment losses			(646)
Gain on sale of premises and equipment	1,018		
Securities gains, net	651	679	878
Other	1,377	1,535	1,396
Total noninterest income	$ 7,298	$ 10,483	$ 5,177

The Company s income from mortgage lending is primarily attributable to the (1) origination and sale of new mortgage loans and (2) servicing of mortgage loans. Origination income, net, is comprised of gains or losses from the sale of the mortgage loans originated, origination fees, underwriting fees and other fees associated with the origination of loans, which are netted against the commission expense associated with these originations. The Company s normal practice is to originate mortgage loans for sale in the secondary market and to either sell or retain the associated mortgage servicing rights (MSRs) when the loan is sold.

MSRs are recognized based on the fair value of the servicing right on the date the corresponding mortgage loan is sold. Subsequent to the date of transfer, the Company has elected to measure its MSRs under the amortization method. Servicing fee income is reported net of any related amortization expense.

MSRs are also evaluated for impairment periodically. Impairment is determined by grouping MSRs by common predominant characteristics, such as interest rate and loan type. If the aggregate carrying amount of a particular group of MSRs exceeds the group s aggregate fair value, a valuation allowance for that group is established. The valuation allowance is adjusted as the fair value changes. An increase in mortgage interest rates typically results in an increase in the fair value of the MSRs while a decrease in mortgage interest rates typically results in a decrease in the fair value of MSRs.

The following table presents a breakdown of the Company s mortgage lending income for 2013, 2012, and 2011.

	Year ended December 31		
(Dollars in thousands)	2013	2012	2011
Origination income	$ 2,030	$ 3,430	$ 1,680
Servicing fees, net	479	284	359
Decrease (increase) in MSR valuation allowance	386	(269)	(117)
Total mortgage lending income	$ 2,895	$ 3,445	$ 1,922

2013 vs. 2012 comparison

The decrease in service charges on deposit accounts was primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

The decrease in mortgage lending income was primarily due to a decline in origination income as refinance activity slowed. This decline was partially offset by a decrease in the valuation allowance for amortized MSRs and an increase in net servicing fees. Changes in the valuation allowance for amortized MSRs are recognized in earnings as a component of mortgage lending income. The decrease in the valuation allowance was primarily due to a slowing of prepayment speeds, which increased the value of our amortized MSRs.

The Company recognized a gain on sale of $3.3 million related to the sale of its interests in three affordable housing limited partnerships in January 2012. There were no such transactions in 2013.

In 2013, the Company recognized a $1.0 million gain on sale of premises and equipment when the Company sold certain real property in downtown Auburn that was no longer used for Company operations and was fully leased to third party tenants.

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Net securities gains consist of realized gains and losses on the sale of securities and other-than-temporary impairment charges. Net securities gains were $0.7 million in both 2013 and 2012. Gross realized gains of $0.8 million in 2013 were reduced by gross realized losses of $0.1 million. Gross realized gains of $1.0 million in 2012 were reduced by gross realized losses of $0.2 million and $0.1 million in other-than-temporary impairment charges related to trust preferred securities. In December 2013, the Company sold all remaining trust preferred securities held by the Company for a net loss of $0.1 million.

2012 vs. 2011 comparison

Service charges on deposit accounts were $1.1 million in 2012, compared to $1.2 million in 2011. The decrease was primarily due to a decline in insufficient funds charges, reflecting changes in customer behavior and spending patterns.

Mortgage lending income was $3.4 million in 2012, compared to $1.9 million in 2011. A increase in the level of mortgage refinance activity during 2012 when compared to the levels experienced during 2011 contributed to the increase in mortgage lending income. The Company s income from mortgage lending typically fluctuates as mortgage interest rates change and is primarily attributable to origination and sale of new mortgage loans.

The Company recognized a gain on sale of $3.3 million related to the sale of its interests in three affordable housing limited partnerships in January 2012. Accordingly, the Company did not receive any federal tax credits related to affordable housing partnership investments in 2012. Prior to the sale of these interests, the Company accrued its pro-rata share of partnership losses in noninterest income. In 2011, the Company accrued approximately $0.6 million related to affordable housing investment losses.

The net gain on securities was $0.7 million in 2012, compared to a net gain of $0.9 million in 2011. Gross realized gains of $1.0 million in 2012 were reduced by gross realized losses of $0.2 million and other-than-temporary impairment charges of $0.1 million related to trust preferred securities. Gross realized gains of $1.7 million in 2011 were reduced by gross realized losses of $0.5 million and $0.3 million in other-than-temporary impairment charges related to trust preferred securities.

Noninterest Expense

(Dollars in thousands)	2013	Year ended December 31 2012	2011
Salaries and benefits	$ 8,788	$ 8,691	$ 8,167
Net occupancy and equipment	1,335	1,332	1,404
Professional fees	774	704	735
FDIC and other regulatory assessments	512	686	792
Other real estate owned, net	570	323	2,007
Prepayment penalties on long-term debt	3,028	3,720	
Other	3,405	3,927	3,252
Total noninterest expense	$ 18,412	$ 19,383	$ 16,357

2013 vs. 2012 comparison

Salaries and benefits expense increased primarily due to routine increases in salaries and wages. This increase was largely offset by a decrease in group health insurance costs. Beginning in 2013, the Company returned to a fully insured group health plan and was able to lower its benefits costs compared to 2012. Previously, the Company s group health plan was self insured.

The decrease in FDIC and other regulatory assessments expense was primarily due to a decrease in the Bank s quarterly assessment rate as several variables utilized by the FDIC in calculating our deposit insurance assessments improved.

Other real estate owned expense, net was $0.6 million in 2013, compared to $0.3 million in 2012. The increase was primarily due to realized holding losses or write-downs on the valuations of certain OREO properties. These properties could also be subject to future valuation adjustments as a result of updated appraisal information and further deterioration in real estate values, thus causing additional fluctuations in other real estate owned expense, net. Also, the Company will continue to incur expenses associated with maintenance costs and property taxes associated with these assets.

During 2013, the Company repaid $35.0 million long-term debt with a weighted average interest rate of 3.46% and incurred prepayment penalties of $3.0 million. During 2012, the Company repaid $38.0 million of long-term debt with a weighted average interest rate of 4.26% and incurred prepayment penalties of $3.7 million.

2012 vs. 2011 comparison

Salaries and benefits expense was $8.7 million in 2012, compared to $8.2 million in 2011. The increase in 2012 when compared to 2011 reflected routine increases coupled with an increase in the number of full-time equivalent employees due to the opening of a new branch during December 2011 in Valley, Alabama.

FDIC and other regulatory assessments expense was $0.7 million in 2012, compared to $0.8 million in 2011. The decrease in 2012 when compared to 2011 was primarily due to the FDIC redefining the deposit insurance assessment base effective April 1, 2011. As a result, most FDIC insured institutions with less than $10 billion in assets experienced a reduction in their FDIC deposit insurance assessments.

Other real estate owned expense, net was $0.3 million in 2012, compared to $2.0 million in 2011. The decrease was primarily due to a decline in realized holding losses or write-downs on the valuations of certain OREO properties. Despite the improvement in net expenses related to OREO, these properties could also be subject to future valuation adjustments as a result of updated appraisal information and further deterioration in real estate values, thus causing additional fluctuations in other real estate owned expense, net. Also, the Company will continue to incur expenses associated with maintenance costs and property taxes associated with these assets.

On January 19, 2012, the Company restructured its balance sheet by paying off $38.0 million of FHLB advances with a weighted average interest rate of 4.26% and a weighted average duration of 2.6 years. In connection with repaying the FHLB advances, the Company incurred a $3.7 million prepayment penalty in 2012, compared to none in 2011.

Income Tax Expense

2013 vs. 2012 comparison

Income tax expense for 2013 was $2.3 million, compared to $1.4 million in 2012. The Company s effective income tax rate was 24.34% in 2013, compared to 17.34% in 2012. In addition to a 15% increase in the level of earnings before taxes, the Company s effective tax rate increased because the Company s annualized effective tax rate for 2012 was reduced by the reversal of a $0.5 million deferred tax valuation allowance related to capital loss carry-forwards.

2012 vs. 2011 comparison

Income tax expense for 2012 was $1.4 million, compared to $0.1 million in 2011. The Company s effective income tax rate was 17.34% in 2012, compared to 1.02% in 2011. The increase in the Company s effective tax rate was due to a 46% increase in the level of earnings before taxes and a decrease in federal tax credits related to the Company s investments in affordable housing limited partnerships, which were sold in January 2012. The impact of these changes on the Company s effective tax rate for the full year 2012 was partially reduced by the reversal of a previously established deferred tax asset valuation allowance of $0.5 million related to capital loss carry-forwards. Excluding the reversal of the valuation allowance, the Company s effective tax rate for 2012 would have been approximately 23.51%.

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BALANCE SHEET ANALYSIS

Securities

Securities available-for-sale, were $271.2 million at December 31, 2013, an increase of $11.8 million, or 4%, compared to $259.5 million as of December 31, 2012. This increase reflects an increase in the amortized cost basis of securities available-for-sale of $27.1 million, which was partially offset by a decline in the fair value of securities-available-for sale of $15.4 million. The increase in the amortized cost basis of securities available-for-sale was primarily attributable to management allocating more funding to the investment portfolio as the loan portfolio declined and investment yields improved in 2013. The decrease in the fair value of securities was primarily due to an increase in long-term interest rates. The average tax-equivalent yields earned on total securities were 3.09% in 2013 and 3.14% in 2012.

The following table shows the carrying value and weighted average yield of securities available-for-sale as of December 31, 2013 according to contractual maturity. Actual maturities may differ from contractual maturities of residential mortgage-backed securities (RMBS) because the mortgages underlying the securities may be called or prepaid with or without penalty.

(Dollars in thousands)		1 year or less	1 to 5 years	5 to 10 years	After 10 years	December 31, 2013 Total Fair Value
Agency obligations	$			23,247	21,275	44,522
Agency RMBS				8,306	154,052	162,358
State and political subdivisions			1,735	21,366	41,238	64,339
Total available-for-sale	$		1,735	52,919	216,565	271,219
Weighted average yield:						
Agency obligations				2.06%	2.79%	2.34%
Agency RMBS				1.74%	2.35%	2.32%
State and political subdivisions			4.14%	4.05%	4.12%	4.10%
Total available-for-sale			4.14%	2.81%	2.70%	2.74%

Loans

(In thousands)		2013	2012	2011	2010	December 31 2009
Commercial and industrial	$	57,780	59,334	54,988	53,288	53,884
Construction and land development		36,479	37,631	39,814	47,850	56,820
Commercial real estate		174,920	183,611	162,435	166,241	156,928
Residential real estate		101,706	105,631	101,725	96,241	97,407
Consumer installment		12,893	12,219	11,454	10,676	11,236
Total loans		383,778	398,426	370,416	374,296	376,275
Less: unearned income		(439)	(233)	(153)	(81)	(172)
Loans, net of unearned income	$	383,339	398,193	370,263	374,215	376,103

Total loans, net of unearned income, were $383.3 million at December 31, 2013, a decrease of $14.9 million, or 4%, from $398.2 million at December 31, 2012. The decrease was primarily attributable to reduced loan demand and increased competition for quality loan opportunities in our markets and management s efforts to resolve problem loans as nonaccrual loans declined by $6.3 million in 2013. Four loan categories represented the majority of the loan portfolio as December 31, 2013: commercial real estate mortgage loans (46%), residential real estate mortgage loans (27%), commercial and industrial loans (15%) and construction and land development loans (10%).

Within its residential real estate mortgage portfolio, the Company had junior lien mortgages of approximately $15.8 million, or 4%, of total loans, net of unearned income at both December 31, 2013 and 2012. For residential real estate mortgage loans with a consumer purpose, approximately $1.2 million and $1.3 million required interest-only payments at December 31, 2013 and 2012, respectively. The Company s residential real estate mortgage portfolio does not include any option ARM loans, subprime loans, or any material amount of other high-risk consumer mortgage products.

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Purchased loan participations included in the Company s loan portfolio were approximately $1.4 million and $3.1 million as of December 31, 2013 and 2012, respectively. All purchased loan participations are underwritten by the Company independent of the selling bank. In addition, all loans, including purchased participations, are evaluated for collectability during the course of the Company s normal loan review procedures. If the Company deems a participation loan impaired, it applies the same accounting policies and procedures as described in CRITICAL ACCOUNTING POLICIES.

The average yield earned on loans and loans held for sale was 5.28% in 2013 and 5.54% in 2012.

The specific economic and credit risks associated with our loan portfolio include, but are not limited to, the effects of current economic conditions on our borrowers cash flows, real estate market sales volumes, valuations, and availability and cost of financing for properties, real estate industry concentrations, deterioration in certain credits, interest rate fluctuations, reduced collateral values or non-existent collateral, title defects, inaccurate appraisals, financial deterioration of borrowers, fraud, and any violation of applicable laws and regulations.

The Company attempts to reduce these economic and credit risks by adhering to loan to value guidelines for collateralized loans, investigating the creditworthiness of borrowers and monitoring borrowers financial position. Also, we establish and periodically review our lending policies and procedures. Banking regulations limit a bank s credit exposure by prohibiting unsecured loan relationships that exceed 10% of its capital accounts; or 20% of capital accounts, if loans in excess of 10% are fully secured. Under these regulations, we are prohibited from having unsecured loan relationships in excess of approximately $16.0 million. Furthermore, we have an internal limit for aggregate credit exposure (loans outstanding plus unfunded commitments) to a single borrower of $14.4 million. Our loan policy requires that the Loan Committee of the Board of Directors approve any loan relationships that exceed this internal limit. At December 31, 2013, the Bank had no loan relationships exceeding these limits.

We periodically analyze our commercial loan portfolio to determine if a concentration of credit risk exists in any one or more industries. We use classification systems broadly accepted by the financial services industry in order to categorize our commercial borrowers. Loan concentrations to borrowers in the following classes exceeded 25% of the Bank s total risk-based capital at December 31, 2013 (and related balances at December 31, 2012).

	December 31	
(In thousands)	**2013**	**2012**
Lessors of 1-4 family residential properties	$ 43,835	$ 47,544
Multi-family residential properties	27,673	30,392
Shopping centers	29,953	20,760

Allowance for Loan Losses

The Company maintains the allowance for loan losses at a level that management believes appropriate to adequately cover the Company s estimate of probable losses in the loan portfolio. As of December 31, 2013 and 2012, respectively, the allowance for loan losses was $5.3 million and $6.7 million, respectively, which management believed to be adequate at each of the respective dates. The judgments and estimates associated with the determination of the allowance for loan losses are described under CRITICAL ACCOUNTING POLICIES .

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A summary of the changes in the allowance for loan losses and certain asset quality ratios for each of the five years in the five year period ended December 31, 2013 is presented below.

		Year ended December 31				
(Dollars in thousands)		2013	2012	2011	2010	2009
Allowance for loan losses:						
Balance at beginning of period	$	6,723	6,919	7,676	6,495	4,398
Charge-offs:						
Commercial and industrial		(514)	(289)	(679)	(537)	(495)
Construction and land development		(39)	(231)	(1,758)	(1,487)	(2,088)
Commercial real estate		(262)	(3,184)	(422)		
Residential real estate		(808)	(545)	(533)	(552)	(704)
Consumer installment		(397)	(85)	(21)	(111)	(61)
Total charge-offs		(2,020)	(4,334)	(3,413)	(2,687)	(3,348)
Recoveries:						
Commercial and industrial		48	54	34	63	47
Construction and land development		6	46	2	54	50
Commercial real estate		4	71			
Residential real estate		88	134	155	151	92
Consumer installment		19	18	15	20	6
Total recoveries		165	323	206	288	195
Net charge-offs		(1,855)	(4,011)	(3,207)	(2,399)	(3,153)
Provision for loan losses		400	3,815	2,450	3,580	5,250
Ending balance	$	5,268	6,723	6,919	7,676	6,495
as a % of loans		1.37%	1.69	1.87	2.05	1.73
as a % of nonperforming loans		124%	64	67	65	69
Net charge-offs as a % of average loans		0.48%	1.03	0.86	0.64	0.84

As noted under CRITICAL ACCOUNTING POLICIES , management assesses the adequacy of the allowance prior to the end of each calendar quarter. The level of the allowance is based upon management s evaluation of the loan portfolios, past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower s ability to repay (including the timing of future payment), the estimated value of any underlying collateral, composition of the loan portfolio, economic conditions, industry and peer bank loan quality indications and other pertinent factors. This evaluation is inherently subjective as it requires various material estimates and judgments including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change. The ratio of our allowance for loan losses to total loans outstanding was 1.37% at December 31, 2013, compared to 1.69% at December 31, 2012. In the future, the allowance to total loans outstanding ratio will increase or decrease to the extent the factors that influence our quarterly allowance assessment in their entirety either improve or weaken.

Net charge-offs were $1.9 million, or 0.48% of average loans, in 2013, compared to net charge-offs of $4.0 million, or 1.03%, in 2012. In 2012, net charge-offs were affected by a few individually significant charge-offs in the commercial real estate portfolio segment, including $3.1 million related to three borrowing relationships.

At December 31, 2013 and 2012, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 124% and 64%, respectively. The increase was primarily due to payoffs received on three nonperforming commercial loans real estate loans during 2013 with a total recorded investment of $5.9 million and no related allowance for loan losses at December 31, 2012. Excluding these nonperforming loans, the ratio of our allowance for loan losses as a percentage of nonperforming loans was 144% at December 31, 2012.

At December 31, 2013 and 2012, the Company s recorded investment in loans considered impaired was $5.6 million and $10.5 million, respectively, with corresponding valuation allowances (included in the allowance for loan losses) at each respective date of $0.3 million.

Our regulators, as an integral part of their examination process, periodically review the Company s allowance for loan losses, and may require the Company to make additional provisions to the allowance for loan losses based on their judgment about information available to them at the time of their examinations.

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Nonperforming Assets

At December 31, 2013 the Company had $8.1 million in nonperforming assets compared to $15.5 million at December 31, 2012. Nonperforming assets decreased during 2013 due to continued efforts by management to reduce and resolve problem assets. The majority of the balance in nonperforming assets at December 31, 2013 related to deterioration in the commercial real estate and construction and land development loan portfolios.

The table below provides information concerning total nonperforming assets and certain asset quality ratios.

						December 31
(Dollars in thousands)		**2013**	**2012**	**2011**	**2010**	**2009**
Nonperforming assets:						
Nonperforming (nonaccrual) loans	$	4,261	10,535	10,354	11,833	9,352
Other real estate owned		3,884	4,919	7,898	8,125	7,292
Total nonperforming assets	$	8,145	15,454	18,252	19,958	16,644
as a % of loans and foreclosed properties		2.10%	3.83	4.83	5.22	4.34
as a % of total assets		1.08%	2.03	2.35	2.61	2.15
Nonperforming loans as a % of total loans		1.11%	2.65	2.80	3.16	2.49
Accruing loans 90 days or more past due	$	73	58			5

The table below provides information concerning the composition of nonaccrual loans at December 31, 2013 and 2012, respectively.

			December 31
(In thousands)		**2013**	**2012**
Nonaccrual loans:			
Commercial and industrial	$	55	60
Construction and land development		1,582	1,706
Commercial real estate		1,456	6,714
Residential real estate		1,168	2,055
Total nonaccrual loans / nonperfoming loans	$	4,261	10,535

The Company discontinues the accrual of interest income when (1) there is a significant deterioration in the financial condition of the borrower and full repayment of principal and interest is not expected or (2) the principal or interest is more than 90 days past due, unless the loan is both well-secured and in the process of collection. At December 31, 2013, the Company had $4.3 million in loans on nonaccrual, compared to $10.5 million at December 31, 2012. The decrease was primarily attributable to a decrease of $5.3 million and $0.9 million in nonaccrual loans for the commercial real estate and residential real estate loan portfolio segments, respectively.

Due to the weakening credit status of a borrower, the Company may elect to formally restructure certain loans to facilitate a repayment plan that minimizes the potential losses that we might incur. Restructured loans, or troubled debt restructurings (TDRs), are classified as impaired loans, and if the loans are on nonaccrual status as of the date of restructuring, the loans are included in the nonaccrual loan balances noted above. Nonaccrual loan balances do not include loans that have been restructured that were performing as of the restructure date. At December 31, 2013 and 2012, the Company had $1.6 million and $1.1 million, respectively, in accruing TDRs.

At December 31, 2013 there were $73,000 in loans 90 days past due and still accruing interest compared to $58,000 at December 31, 2012.

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The table below provides information concerning the composition of OREO at December 31, 2013 and 2012, respectively.

		December 31	
(In thousands)		2013	2012
Other real estate owned:			
Commercial:			
Building	$	1,772	608
Developed lots		1,260	1,275
Residential:			
Condominiums			425
Undeveloped land		113	1,464
Other		739	1,147
Total other real estate owned	$	3,884	4,919

At December 31, 2013, the Company held $3.8 million in OREO, which we acquired from borrowers, a decrease of $1.0 million, or 21%, compared to December 31, 2012. At December 31, 2013, approximately $3.2 million, or 82%, of the total balance in OREO related to properties acquired from three borrowers.

Potential Problem Loans

Potential problem loans represent those loans with a well-defined weakness and where information about possible credit problems of borrowers has caused management to have serious doubts about the borrower s ability to comply with present repayment terms. This definition is believed to be substantially consistent with the standards established by the Federal Reserve, the Company s primary regulator, for loans classified as substandard, excluding nonaccrual loans. Potential problem loans, which are not included in nonperforming assets, amounted to $10.6 million, or 2.7% of total loans at December 31, 2013, compared to $12.6 million, or 3.2% of total loans at December 31, 2012.

The table below provides information concerning the composition of potential problem loans at December 31, 2013 and 2012, respectively.

		December 31	
(In thousands)		2013	2012
Potential problem loans:			
Commercial and industrial	$	482	563
Construction and land development		1,101	1,125
Commercial real estate		1,683	2,727
Residential real estate		7,182	7,978
Consumer installment		146	214
Total potential problem loans	$	10,594	12,607

At December 31, 2013, approximately $0.8 million or 7.6% of total potential problem loans were past due at least 30 but less than 90 days. At December 31, 2013, the remaining balance of potential problem loans were current or past due less than 30 days.

The following table is a summary of the Company s performing loans that were past due at least 30 days but less than 90 days as of December 31, 2013 and 2012, respectively.

		December 31	
(In thousands)		**2013**	**2012**
Performing loans past due 30 to 89 days:			
Commercial and industrial	$	167	173
Construction and land development		14	8
Commercial real estate		861	230
Residential real estate		1,343	1,537
Consumer installment		100	62
Total performing loans past due 30 to 89 days	$	2,485	2,010

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Deposits

		December 31	
(In thousands)		**2013**	**2012**
Noninterest bearing demand	$	125,740	118,014
NOW		99,406	96,332
Money market		147,116	124,676
Savings		35,383	34,600
Certificates of deposit under $100,0000		104,964	106,371
Certificates of deposit and other time deposits of $100,000 or more		139,721	134,591
Brokered certificates of deposit		16,514	22,233
Total deposits	$	668,844	636,817

Total deposits were $668.9 million and $636.8 million at December 31, 2013 and 2012, respectively. The increase in total deposits of $32.0 million reflects market share growth in Chambers County due to the business development efforts of the Bank s full-service branch in Valley, Alabama which opened in December 2011 and changes in customer preferences for short-term instruments in a low interest rate environment.

The average rates paid on total interest-bearing deposits were 1.01% in 2013 and 1.21% in 2012. Noninterest bearing deposits were 19% of total deposits at both December 31, 2013 and 2012.

Other Borrowings

Other borrowings consist of short-term borrowings and long-term debt. Short-term borrowings consist of federal funds purchased and securities sold under agreements to repurchase with an original maturity of one year or less. The Bank had available federal fund lines totaling $41.0 million with none outstanding at December 31, 2013, compared to $40.0 million with none outstanding at and December 31, 2012. Securities sold under agreements to repurchase totaled $3.4 million and $2.7 million at December 31, 2013 and 2012, respectively.

The average rates paid on short-term borrowings were 0.50% in 2013 and 0.54% in 2012. Information concerning the average balances, weighted average rates, and maximum amounts outstanding for short-term borrowings during the three-year period ended December 31, 2013 is included in Note 10 to the accompanying consolidated financial statements included in this annual report.

Long-term debt includes FHLB advances with an original maturity greater than one year, securities sold under agreements to repurchase with an original maturity greater than one year, and subordinated debentures related to trust preferred securities. The Bank had $5.0 million in long-term FHLB advances at December 31, 2013, compared to $25.0 million at December 31, 2012. During 2013, the Company repaid $20.0 million of FHLB advances with a weighted average interest rate of 3.38%. At December 31, 2013, the Bank had no securities sold under agreements to repurchase with an original maturity greater than one year, compared to $15.0 million at December 31, 2012. During 2013, the Company repaid $15.0 million of securities sold under agreements to repurchase with an interest rate of 3.58%. At both December 31, 2013 and 2012, the Company had $7.2 million in junior subordinated debentures related to trust preferred securities outstanding.

The average rates paid on long-term debt were 3.59% in 2013 and 3.73% in 2012.

CAPITAL ADEQUACY

The Company s consolidated stockholders equity was $64.5 million and $70.1 million as of December 31, 2013 and 2012, respectively. The change from December 31, 2012 was primarily driven by an other comprehensive loss due to the change in unrealized gains (losses) on securities available-for-sale of $9.7 million and cash dividends paid of $3.1 million, partially offset by net earnings of $7.1 million.

The Company s tier 1 leverage ratio was 10.10%, tier 1 risk-based capital ratio was 17.19% and total risk-based capital ratio was 18.40% at December 31, 2013. These ratios exceed the minimum regulatory capital percentages of 4.0% for Tier 1 leverage ratio, 4.0% for Tier 1 risk-based capital ratio and 8.0% for Total risk-based capital ratio. Based on current regulatory standards, the Company is classified as well capitalized.

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MARKET AND LIQUIDITY RISK MANAGEMENT

Management s objective is to manage assets and liabilities to provide a satisfactory, consistent level of profitability within the framework of established liquidity, loan, investment, borrowing, and capital policies. The Bank s Asset Liability Management Committee (ALCO) is charged with the responsibility of monitoring these policies, which are designed to ensure acceptable composition of asset/liability mix. Two critical areas of focus for ALCO are interest rate risk and liquidity risk management.

Interest Rate Risk Management

In the normal course of business, the Company is exposed to market risk arising from fluctuations in interest rates. The Company is subject to interest rate risk because assets and liabilities may mature or reprice at different times. For example, if liabilities reprice faster than assets, and interest rates are generally rising, earnings will initially decline. In addition, assets and liabilities may reprice at the same time but by different amounts. For example, when the general level of interest rates is rising, the Company may increase rates paid on interest bearing demand deposit accounts and savings deposit accounts by an amount that is less than the general increase in market interest rates. Also, short-term and long-term market interest rates may change by different amounts. For example, a flattening yield curve may reduce the interest spread between new loan yields and funding costs. Further, the remaining maturity of various assets and liabilities may shorten or lengthen as interest rates change. For example, if long-term mortgage interest rates decline sharply, mortgage-backed securities in the securities portfolio may prepay significantly earlier than anticipated, which could reduce earnings. Interest rates may also have a direct or indirect effect on loan demand, loan losses, mortgage origination volume, the fair value of MSRs and other items affecting earnings.

ALCO measures and evaluates the interest rate risk so that we can meet customer demands for various types of loans and deposits. ALCO determines the most appropriate amounts of on-balance sheet and off-balance sheet items. Measurements used to help manage interest rate sensitivity include an earnings simulation and an economic value of equity model.

Earnings simulation. Management believes that interest rate risk is best estimated by our earnings simulation modeling. On at least a quarterly basis, the following 12 month time period is simulated to determine a baseline net interest income forecast and the sensitivity of this forecast to changes in interest rates. The baseline forecast assumes an unchanged or flat interest rate environment. Forecasted levels of earning assets, interest-bearing liabilities, and off-balance sheet financial instruments are combined with ALCO forecasts of market interest rates for the next 12 months and other factors in order to produce various earnings simulations and estimates.

To limit interest rate risk, we have guidelines for earnings at risk which seek to limit the variance of net interest income to less than a 10 percent decline for a 200 basis point gradual change up or down in rates from management s baseline net interest income forecast over the next 12 months. The following table reports the variance of net interest income over the next 12 months assuming a gradual change in interest rates of 200 basis points when compared to the baseline net interest income forecast at December 31, 2013.

Changes in Interest Rates	Net Interest Income % Variance
200 basis points	1.35%
(200) basis points	NM

NM=not meaningful

At December 31, 2013, our earnings simulation model indicated a slightly asset-sensitive position over the next 12 months, which could serve to improve net interest income during that time period if interest rates increased by 200 basis points. The actual realized change in net interest income would depend upon several factors, which could also serve to diminish, or eliminate the asset sensitivity noted above. The impact of rate scenarios assuming a gradual downward 200 basis point change in interest rates was not considered meaningful because of the historically low interest rate environment.

Economic Value of Equity. Economic value of equity (EVE) measures the extent that estimated economic values of our assets, liabilities and off-balance sheet items will change as a result of interest rate changes. Economic values are estimated by discounting expected cash flows from assets, liabilities and off-balance sheet items, which establishes a base case EVE. In contrast with our earnings simulation model which evaluates interest rate risk over a 12 month timeframe, EVE uses a terminal horizon which allows for the re-pricing of all assets, liabilities, and off-balance sheet items. Further, EVE is measured using values as of a point in time and does not reflect any actions that ALCO might take in responding to or anticipating changes in interest rates, or market and competitive conditions.

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To help limit interest rate risk, we have a guideline stating that for a 200 basis point instantaneous change in interest rates up or down, EVE should not decrease by more than 25 percent. The following table reports the variance of EVE assuming an immediate change in interest rates of 200 basis points when compared to the base case EVE at December 31, 2013.

Changes in Interest Rates	**EVE % Variance**
200 basis points	(16.16) %
(200) basis points	NM

NM=not meaningful

At December 31, 2013, the results of our EVE model would indicate that we are in compliance with our guidelines. The actual realized change in the economic value of equity would depend upon several factors, which could also serve to diminish, or eliminate the interest sensitivity noted above. The impact of rate shock scenarios assuming a downward 200 basis point change in interest rates was not considered meaningful because of the historically low interest rate environment.

Earnings simulation and EVE are both modeling analyses, which change quarterly and consist of hypothetical estimates based upon numerous assumptions, including the interest rate levels, shape of the yield curve, prepayments on loans and securities, rates on loans and deposits, reinvestments of paydowns and maturities of loans, investments and deposits, and others. While assumptions are developed based on the current economic and market conditions, management cannot make any assurances as to the predictive nature of these assumptions, including how these estimates may be affected by customer preferences, competitors, or competitive conditions, or that the predictions will be realized.

In addition, each of the preceding analyses may not, on its own, be an accurate indicator of how our net interest income will be affected by changes in interest rates. Income associated with interest-earning assets and costs associated with interest-bearing liabilities may not be affected uniformly by changes in interest rates. In addition, the magnitude and duration of changes in interest rates may have a significant impact on net interest income. For example, although certain assets and liabilities may have similar maturities or periods of repricing, they may react in different degrees to changes in market interest rates, and other economic and market factors. Interest rates on certain types of assets and liabilities fluctuate in advance of changes in general market rates, while interest rates on other types may lag behind changes in general market rates. In addition, certain assets, such as adjustable rate mortgage loans, have features (generally referred to as interest rate caps and floors) which limit changes in interest rates. Prepayment and early withdrawal levels also could deviate significantly from those assumed in calculating the maturity of certain instruments. The ability of many borrowers to service their debts also may decrease during periods of rising interest rates or economic stress, which may differ across industries and economic sectors. Depositor and borrower behaviors also affect those relationships and results. ALCO reviews each of the above interest rate sensitivity analyses along with several different interest rate scenarios in seeking satisfactory, consistent levels of profitability within the framework of the Company s established liquidity, loan, investment, borrowing, and capital policies.

The Company may also use derivative financial instruments to improve the balance between interest-sensitive assets and interest-sensitive liabilities and as one tool to manage interest rate sensitivity while continuing to meet the credit and deposit needs of our customers. From time to time, the Company may enter into interest rate swaps (swaps) to facilitate customer transactions and meet their financing needs. These swaps qualify as derivatives, but are not designated as hedging instruments. At December 31, 2013 and 2012, the Company had no derivative contracts to assist in managing interest rate sensitivity.

Liquidity Risk Management

Liquidity is the Company s ability to convert assets into cash equivalents in order to meet daily cash flow requirements, primarily for deposit withdrawals, loan demand and maturing obligations. Without proper management of its liquidity, the Company could experience higher costs of obtaining funds due to insufficient liquidity, while excessive liquidity can lead to a decline in earnings due to the opportunity cost of foregoing alternative higher-yielding investment opportunities.

Liquidity is managed at two levels: at the Company and at the Bank. The management of liquidity at both levels is essential, because the Company and the Bank have different funding needs and sources, are separate legal entities, and each are subject to regulatory guidelines and requirements.

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The primary source of funding and the primary source of liquidity for the Company includes dividends received from the Bank, and secondarily proceeds from the issuance of common stock or other securities. Primary uses of funds for the Company include dividends paid to shareholders, stock repurchases, and interest payments on junior subordinated debentures issued by the Company in connection with trust preferred securities. The junior subordinated debentures are presented as long-term debt in the accompanying consolidated balance sheets and the related trust preferred securities are includible in Tier 1 Capital for regulatory capital purposes.

Primary sources of funding for the Bank include customer deposits, other borrowings, repayment and maturity of securities, and sale and repayment of loans. The Bank has access to federal funds lines from various banks and borrowings from the Federal Reserve discount window. In addition to these sources, the Bank has participated in the FHLB s advance program to obtain funding for its growth. Advances include both fixed and variable terms and are taken out with varying maturities. As of December 31, 2013, the Bank had a remaining available line of credit with the FHLB totaling $212.4 million. As of December 31, 2013, the Bank also had $41.0 million of federal funds lines, with none outstanding. Primary uses of funds include repayment of maturing obligations and growing the loan portfolio.

The following table presents additional information about our contractual obligations as of December 31, 2013, which by their terms had contractual maturity and termination dates subsequent to December 31, 2013:

		Payments due by period			
(Dollars in thousands)	**Total**	**1 year or less**	**1 to 3 years**	**3 to 5 years**	**More than 5 years**
Contractual obligations:					
Deposit maturities (1)	$ 668,844	536,260	75,784	46,369	10,431
Long-term debt	12,217			5,000	7,217
Operating lease obligations	617	287	285	45	
Total	$ 681,678	$ 536,547	$ 76,069	$ 51,414	$ 17,648

(1) Deposits with no stated maturity (demand, NOW, money market, and savings deposits) are presented in the 1 year or less column

Management believes that the Company and the Bank have adequate sources of liquidity to meet all known contractual obligations and unfunded commitments, including loan commitments and reasonable borrower, depositor, and creditor requirements over the next 12 months.

Off-Balance Sheet Arrangements

At December 31, 2013, the Bank had outstanding standby letters of credit of $8.6 million and unfunded loan commitments outstanding of $38.9 million. Because these commitments generally have fixed expiration dates and many will expire without being drawn upon, the total commitment level does not necessarily represent future cash requirements. If needed to fund these outstanding commitments, the Bank has the ability to liquidate federal funds sold or securities available-for-sale, or on a short-term basis to borrow and purchase federal funds from other financial institutions.

Mortgage lending activities

Since 2009, we have primarily sold residential mortgage loans in the secondary market to Fannie Mae while retaining the servicing of these loans. The sale agreements for these residential mortgage loans with Fannie Mae and other investors include various representations and warranties regarding the origination and characteristics of the residential mortgage loans. Although the representations and warranties vary among investors, they typically cover ownership of the loan, validity of the lien securing the loan, the absence of delinquent taxes or liens against the property securing the loan, compliance with loan criteria set forth in the applicable agreement, compliance with applicable federal, state, and local laws, among other matters.

As of December 31, 2013, the unpaid principal balance of the residential mortgage loans, which we have originated and sold, but retained the servicing rights was $356.3 million. Although these loans are generally sold on a non-recourse basis, except for breaches of customary seller representations and warranties, we may have to repurchase residential mortgage loans in cases where we breach such representations or warranties or the other terms of the sale, such as where we fail to deliver required documents or the documents we deliver are defective. Investors also may require the repurchase of a mortgage loan when an early payment default underwriting review reveals significant underwriting deficiencies, even if the mortgage loan has subsequently been brought current. Repurchase demands are typically reviewed on an individual loan by loan basis to validate the claims made by the investor and to determine if a contractually required repurchase event has occurred. We seek to reduce and manage the risks of potential repurchases or other claims by mortgage loan investors through our underwriting, quality assurance and servicing practices, including good communications with our residential mortgage investors.

We were not required to repurchase any residential mortgage loans in 2013 or 2011. In 2012, we repurchased one residential mortgage loan with an unpaid principal balance of $0.3 million. This loan was current as to principal and interest at the time of repurchase, and we incurred no losses upon repurchase.

We service all residential mortgage loans originated and sold by us to Fannie Mae. As servicer, our primary duties are to: (1) collect payments due from borrowers; (2) advance certain delinquent payments of principal and interest; (3) maintain and administer any hazard, title, or primary mortgage insurance policies relating to the mortgage loans; (4) maintain any required escrow accounts for payment of taxes and insurance and administer escrow payments; and (5) foreclose on defaulted mortgage loans or take other actions to mitigate the potential losses to investors consistent with the agreements governing our rights and duties as servicer.

The agreement under which we act as servicer generally specifies a standard of responsibility for actions taken by us in such capacity and provides protection against expenses and liabilities incurred by us when acting in compliance with the respective servicing agreements. However, if we commit a material breach of our obligations as servicer, we may be subject to termination if the breach is not cured within a specified period following notice. The standards governing servicing and the possible remedies for violations of such standards are determined by servicing guides issued by Fannie Mae as well as the contract provisions established between Fannie Mae and the Bank. Remedies could include repurchase of an affected loan.

Although to date repurchase requests related to representation and warranty provisions, and servicing activities have been limited, it is possible that requests to repurchase mortgage loans may increase in frequency if investors more aggressively pursue all means of recovering losses on their purchased loans. As of December 31, 2013, we believe that this exposure is not material due to the historical level of repurchase requests and loss trends, in addition to the fact that 99.5% of our residential mortgage loans serviced for Fannie Mae were current as of such date. We maintain ongoing communications with our investors and will continue to evaluate this exposure by monitoring the level and number of repurchase requests as well as the delinquency rates in our investor portfolios.

Effects of Inflation and Changing Prices

The consolidated financial statements and related consolidated financial data presented herein have been prepared in accordance with GAAP and practices within the banking industry which require the measurement of financial position and operating results in terms of historical dollars without considering the changes in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all the assets and liabilities of a financial institution are monetary in nature. As a result, interest rates have a more significant impact on a financial institution s performance than the effects of general levels of inflation.

CURRENT ACCOUNTING DEVELOPMENTS

The following Accounting Standards Updates (Updates or ASUs) have been issued by the FASB but are not yet effective.

- ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists;*
- ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*; and
- ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure.*

Information about these pronouncements is described in more detail below.

ASU 2013-11, *Presentation of an Unrecognized Tax Benefit When a Net Operating Loss Carryforward, a Similar Tax Loss, or a Tax Credit Carryforward Exists,* is expected to eliminate diversity in practice as it provides guidance on financial statement presentation of an unrecognized tax benefit when a net operating loss (NOL) carryforward, a similar tax loss, or a tax credit carryforward exists. These changes are effective for the Company in the first quarter of 2014 with prospective application applied to all unrecognized tax benefits that exist at the effective date. Early adoption and retrospective application are permitted. Adoption of this ASU will not have a significant impact on the financial statements of the Company.

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ASU 2014-01, *Accounting for Investments in Qualified Affordable Housing Project*s, amends the criteria a company must meet to elect to account for investments in qualified affordable housing projects using a method other than the cost or equity methods. If the criteria are met, a company is permitted to amortize the initial investment cost in proportion to and over the same period as the total tax benefits the company expects to receive. The amortization of the initial investment cost and tax benefits are to be recorded in the income tax expense line. The Update also requires new disclosures about all investments in qualified affordable housing projects regardless of the accounting method used. These changes are effective for the Company in the first quarter of 2015 with retrospective application. Early adoption is permitted. The Company is evaluating the impact this ASU will have on our consolidated financial statements.

ASU 2014-04, *Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure*, clarifies the timing of when a creditor is considered to have taken physical possession of residential real estate collateral for a consumer mortgage loan, resulting in the reclassification of the loan receivable to real estate owned. A creditor has taken physical possession of the property when either (1) the creditor obtains legal title through foreclosure, or (2) the borrower transfers all interests in the property to the creditor via a deed in lieu of foreclosure or a similar legal agreement. The Update also requires disclosure of the amount of foreclosed residential real estate property held by the creditor and the recorded investment in residential real estate mortgage loans that are in process of foreclosure. These changes are effective for the Company in the first quarter of 2015 with retrospective application. Early adoption is permitted. Adoption of this ASU will not have a significant impact on the financial statements of the Company.

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Table 1 Explanation of Non-GAAP Financial Measures

In addition to results presented in accordance with GAAP, this annual report on Form 10-K includes certain designated net interest income amounts presented on a tax-equivalent basis, a non-GAAP financial measure, including the presentation of total revenue and the calculation of the efficiency ratio.

The Company believes the presentation of net interest income on a tax-equivalent basis provides comparability of net interest income from both taxable and tax-exempt sources and facilitates comparability within the industry. Although the Company believes these non-GAAP financial measures enhance investors understanding of its business and performance, these non-GAAP financial measures should not be considered an alternative to GAAP. The reconciliation of these non-GAAP financial measures from GAAP to non-GAAP are presented below.

					2013				**2012**
(in thousands)		**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**	**Fourth Quarter**	**Third Quarter**	**Second Quarter**	**First Quarter**
Net interest income (GAAP)	$	5,279	5,270	5,232	5,141	5,325	5,259	5,312	5,001
Tax-equivalent adjustment		342	351	365	382	396	416	416	414
Net interest income (Tax-equivalent)	$	5,621	5,621	5,597	5,523	5,721	5,675	5,728	5,415

						Year ended December 31
(In thousands)		**2013**	**2012**	**2011**	**2010**	**2009**
Net interest income (GAAP)	$	20,922	20,897	19,225	18,899	18,815
Tax-equivalent adjustment		1,440	1,642	1,719	1,765	1,633
Net interest income (Tax-equivalent)	$	22,362	22,539	20,944	20,664	20,448

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Table 2 - Selected Financial Data

		Year ended December 31				
(Dollars in thousands, except per share amounts)		**2013**	**2012**	**2011**	**2010**	**2009**
Income statement						
Tax-equivalent interest income (a)	$	28,898	30,709	32,425	35,237	38,467
Total interest expense		6,536	8,170	11,481	14,573	18,019
Tax equivalent net interest income (a)		22,362	22,539	20,944	20,664	20,448
Provision for loan losses		400	3,815	2,450	3,580	5,250
Total noninterest income		7,298	10,483	5,177	6,718	2,433
Total noninterest expense		18,412	19,383	16,357	15,893	13,934
Net earnings before income taxes and tax-equivalent adjustment		10,848	9,824	7,314	7,909	3,697
Tax-equivalent adjustment		1,440	1,642	1,719	1,765	1,633
Income tax expense (benefit)		2,290	1,419	57	798	(340)
Net earnings	$	7,118	6,763	5,538	5,346	2,404
Per share data:						
Basic and diluted net earnings	$	1.95	1.86	1.52	1.47	0.66
Cash dividends declared	$	0.84	0.82	0.80	0.78	0.76
Weighted average shares outstanding						
Basic and diluted		3,643,003	3,642,831	3,642,735	3,642,851	3,644,691
Shares outstanding		3,643,118	3,642,903	3,642,738	3,642,718	3,643,117
Book value	$	17.70	19.26	17.96	15.47	15.42
Common stock price						
High	$	25.75	26.65	20.37	22.00	30.00
Low		20.80	18.23	18.52	16.86	18.07
Period-end	$	25.00	20.85	18.52	20.06	19.69
To earnings ratio		12.89x	11.21	12.10	13.74	29.39
To book value		141 %	108	103	130	128
Performance ratios:						
Return on average equity		10.33 %	9.85	9.10	9.00	4.23
Return on average assets		0.94 %	0.90	0.72	0.68	0.31
Dividend payout ratio		43.08 %	44.09	52.63	53.06	115.15
Average equity to average assets		9.07 %	9.09	7.89	7.61	7.21
Asset Quality:						
Allowance for loan losses as a % of:						
Loans		1.37 %	1.69	1.87	2.05	1.73
Nonperforming loans		124 %	64	67	65	69
Nonperforming assets as a % of:						
Loans and foreclosed properties		2.10 %	3.83	4.83	5.22	4.34
Total assets		1.08 %	2.03	2.35	2.61	2.15
Nonperforming loans as % of loans		1.11 %	2.65	2.80	3.16	2.49
Net charge-offs as a % of average loans		0.48 %	1.03	0.86	0.64	0.84
Capital Adequacy:						
Tier 1 risk-based capital ratio		17.19 %	16.20	15.40	14.57	13.73
Total risk-based capital ratio		18.40 %	17.46	16.66	15.82	14.98

Tier 1 Leverage ratio	10.10 %	9.58	8.82	8.47	8.13
Other financial data:					

Advanced technologies contracts revenue for the year ended October 31, 2014 was $17.5 million, which increased $3.0 million when compared to $14.4 million of revenue for the year ended October 31, 2013. The increase is primarily attributable to revenue recognized on a data center fuel cell power plant research project and increased activity on solid oxide fuel cell development under the U.S. Department of Energy Solid State Energy Conversion Alliance (SECA) program, and accelerating commercialization of carbon capture solutions with activity under both a DOE contract and a contract from private industry. Cost of advanced technologies contracts increased $2.8 million to $16.7 million for the year ended October 31, 2014, compared to $13.9 million for the prior year. Gross profit from advanced technologies contracts for the year ended October 31, 2014 was $0.8 million compared to $0.6 million for the year ended October 31, 2013.

Administrative and selling expenses

Administrative and selling expenses were $22.8 million for the year ended October 31, 2014 compared to $21.2 million during the year ended October 31, 2013. Administrative and selling expenses increased primarily due to increased business development activity and project proposal expenses for multi-megawatt fuel cell park projects.

Research and development expenses

Research and development expenses increased $2.5 million to $18.2 million during the year ended October 31, 2014, compared to $15.7 million during the year ended October 31, 2013. Our internal research and development continues to be focused on initiatives that have near term product implementation potential and product cost reduction opportunities. The increase in research and development expenses resulted from continued product development initiatives to consolidate select componentry and processes for the balance of plant functions as part of ongoing cost reduction programs, product enhancements to further enhance the customer value proposition such as high-efficiency solutions for targeted applications, and a program to support European market development.

Loss from operations

Loss from operations for the year ended October 31, 2014 was $27.3 million compared to a loss of $29.8 million in fiscal year 2013. The decrease was a result of favorable gross profit from product sales and service agreements and license revenue, partially offset by higher operating expenses.

Interest expense

Interest expense for the years ended October 31, 2014 and 2013 was $3.6 million and $4.0 million, respectively. Interest expense includes the interest associated with the 8.0% Unsecured Convertible Debt issued in June 2013. Interest expense for both periods also includes interest for the amortization of the redeemable preferred stock of a subsidiary fair value discount of $2.0 million.

Income/(loss) from equity investments

Income of $0.05 million from equity investments recorded in the year ended October 31, 2013 represents our share of Versa's income through the acquisition date in December 2012.

Other income (expense), net

Other income (expense), net, was expense of $7.5 million for the year ended October 31, 2014 compared to net expense of $1.2 million for the same period in fiscal year 2013. The current period expense includes a charge of $8.4 million related to the make-whole payment upon conversion of the $38.0 million of principal of the 8.0% Convertible Notes. The Company primarily used common stock to settle this make-whole obligation. The prior year period expense was primarily associated with the non-cash fair value adjustment of certain embedded derivatives.

Provision for income taxes

We have not paid federal or state income taxes in several years due to our history of net operating losses (NOL), although we have paid income taxes in South Korea. For the year ended October 31, 2014, our provision for income taxes was $0.5 million. We are manufacturing products that are gross margin profitable on a per unit basis; however, we cannot estimate when production volumes will be sufficient to generate taxable domestic income. Accordingly, no tax benefit has been recognized for these net operating losses or other deferred tax assets as significant uncertainty exists surrounding the recoverability of these deferred tax assets.

At October 31, 2014, we had $655.0 million of federal NOL carryforwards that expire in the years 2020 through 2034 and $396.0 million in state NOL carryforwards that expire in the years 2014 through 2034. Additionally, we had $10.4 million of state tax credits available, of which $1.0 million expires in 2018. The remaining credits do not expire.

Net loss attributable to noncontrolling interest

The net loss attributed to the noncontrolling interest for the years ended October 31, 2014 and 2013 was $0.8 million and $1.0 million, respectively.

Preferred Stock dividends

Dividends recorded and paid on the Series B Preferred Stock were $3.2 million in each of the years ended October 31, 2014 and 2013.

Net loss attributable to common shareholders and loss per common share

Net loss attributable to common shareholders represents the net loss for the period, less the net loss attributable to noncontrolling interest and less the preferred stock dividends on the Series B Preferred Stock. For the years ended October 31, 2014 and 2013, net loss attributable to common shareholders was $41.3 million and $37.6 million, respectively, and basic and diluted loss per common share was $0.17 and $0.20, respectively.

Comparison of the Years Ended October 31, 2013 and October 31, 2012
Revenues and Costs of revenues
Our revenues and cost of revenues for the years ended October 31, 2013 and 2012 were as follows:

	Years Ended October 31,		Change	
(dollars in thousands)	2013	2012	$	%
Total revenues	$ 187,658	$ 120,603	$ 67,055	56
Total costs of revenues	$ 180,536	$ 120,158	$ 60,378	50
Gross profit	$ 7,122	$ 445	$ 6,677	1,500
Gross margin	3.8 %	0.4 %		

Total revenues for the year ended October 31, 2013 increased $67.1 million, or 56 percent, to $187.7 million from $120.6 million during the same period last year. Total cost of revenues for the year ended October 31, 2013 increased by $60.4 million, or 50 percent, to $180.5 million from $120.2 million during the same period last year.
A discussion of the changes in product sales and service agreement revenues and advanced technologies contract revenues follows. Refer to Critical Accounting Policies and Estimates for more information on revenue and cost of revenue classifications.

Product sales

Our product sales, cost of sales and gross profit for the years ended October 31, 2013 and 2012 were as follows:

	Years Ended October 31,		Change	
(dollars in thousands)	2013	2012	$	%
Product sales	$ 145,071	$ 94,950	$50,121	53
Cost of product sales	136,989	93,876	43,113	46
Gross profit from product sales	$ 8,082	$ 1,074	$7,008	653
Product sales gross margin	5.6 %	1.1 %		

Product sales for the year ended October 31, 2013 included $117.1 million of power plant revenue and fuel cell kits revenue and $28.0 million of revenue primarily related to power plant component sales and EPC services relating to the Bridgeport Fuel Cell Park project. This is compared to product sales for the year ended October 31, 2012 which included $77.0 million of power plant revenue and fuel cell kits and $18.0 million of revenue primarily from power plant component sales and EPC services.

Cost of product sales increased $43.1 million for the year ended October 31, 2013 to $137.0 million, compared to $93.9 million in the same prior year period. Gross profit increased $7.0 million to a gross profit of $8.1 million for the year ended October 31, 2013 compared to a gross profit of $1.1 million for the year ended October 31, 2012. The increase was due to improved overhead absorption from higher production levels combined with a sales mix that included complete power plants along with fuel cell kits, partially offset by additional costs incurred in the first quarter of the year ended October 31, 2013 due to a select number of fuel cell stacks requiring repair and costs related to the increase in production.

The annual production run-rate was increased to 70 MW at May 1, 2013 to meet demand, and maintained for the remainder of the fiscal year. Higher production volumes supported increased quarterly revenue in the year ended October 31, 2013 and we believe will lead to expanding margins from improved absorption of fixed overhead costs and broadening of the revenue mix to include complete power plant sales in North America and Europe.

Service Agreements and License Revenues and Cost of Revenues

	Years Ended October 31,		Change	
(dollars in thousands)	2013	2012	$	%
Service agreements and license revenues	$ 28,141	$ 18,183	$9,958	55
Cost of Service agreements and license revenues	29,683	19,045	10,638	56
Gross profit (loss) from service agreements and license revenues	$ (1,542)	$ (862)	$(680)	(79)
Service agreement and license revenues gross margin	(5.5)%	(4.7)%		

Revenues for the year ended October 31, 2013 from service agreements and license fee and royalty agreements totaled $28.1 million, compared to $18.2 million the prior fiscal year. Service agreement revenue increased year over year due to the recognition of service revenue related to a new Master Service Agreement with POSCO Energy entered into during the fourth quarter of the year ended October 31, 2013. Costs incurred under the Master Service Agreement during the fourth quarter of fiscal year 2013 of $10.1 million resulted in associated revenue recognized of $10.2 million. Such costs primarily related to the provision of fuel cell stacks to POSCO Energy upon execution of the agreement to service the installations under the ongoing service contract. There was minimal revenue recorded relating to scheduled module replacement compared to approximately $3.0 million of service revenue recognized during fiscal year 2012 from scheduled module exchanges. Service revenue from scheduled module exchanges is recognized at the time of the module exchange activity whereas the remaining portion of service revenue from service agreements is recognized ratably over the life of the service contract. Also, license and royalty income was included within revenues beginning in the first quarter of fiscal year 2013. This change is a result of the new license agreement entered into on October 31, 2012 for our core technology and harmonization of the agreements to reflect fees and royalties for the manufacture of complete DFC Power Plants. Classification as revenue is reflective of our Asia market partnership and royalty based strategy and this business activity

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has become a significant component of non-product revenue and is expected to continue to grow over time. Service agreements and license cost of revenues increased to $29.7 million from $19.0 million for the prior year period primarily as a result of the costs recorded relating to the Master Service Agreement with POSCO Energy. The gross loss on service agreements and license agreements increased to $1.5 million for the year ended October 31, 2013, compared to $0.9 million for the comparable prior year period. The increase in service and license agreement negative margins is primarily due to costs associated with unplanned module exchanges partially offset by the inclusion of license and royalty income in revenues beginning in fiscal year 2013. The historical loss on service agreements has been due to high maintenance, stack replacement and other costs on older and sub-MW product designs. As profitable megawatt-class service agreements are executed and as early generation sub-megawatt products are retired or become a smaller overall percentage of the installed fleet, we expect the margins on service agreements to increase.

Advanced technologies contracts

Advanced technologies contracts revenue and related costs for the years ended October 31, 2013 and 2012 were as follows:

	Years Ended October 31,		Change	
(dollars in thousands)	2013	2012	$	%
Advanced technologies contracts	$ 14,446	$ 7,470	$6,976	93
Cost of advanced technologies contracts	13,864	7,237	6,627	92
Gross profit	$ 582	$ 233	$349	150

Advanced technologies contracts revenue for the year ended October 31, 2013 was $14.4 million, which increased $7.0 million when compared to $7.5 million of revenue for the year ended October 31, 2012. The increase was primarily related to solid oxide fuel cell development programs, particularly the unmanned aerial program with Boeing which was included in advanced technologies contract revenues as a result of the December 2012 acquisition of Versa. Cost of advanced technologies contracts increased $6.6 million to $13.9 million for the year ended October 31, 2013, compared to $7.2 million for the same period in the prior year. Gross profit from advanced technologies contracts for the year ended October 31, 2013 was $0.6 million compared to $0.2 million for the year ended October 31, 2012.

Administrative and selling expenses

Administrative and selling expenses were $21.2 million for the year ended October 31, 2013 compared to $18.2 million during the year ended October 31, 2012. Administrative and selling expenses increased as a result of expenditures to develop and expand the European market for megawatt-class fuel cell power plants and to continue efforts to commercialize solid oxide fuel cell technology.

Research and development expenses

Research and development expenses increased $1.3 million to $15.7 million during the year ended October 31, 2013, compared to $14.4 million during fiscal year 2012. The increase is a result of the consolidation of Versa's results with the results of the Company beginning in fiscal year 2013 combined with initiatives to continue to reduce the cost profile of large scale multi-megawatt installations through consolidating certain aspects of the balance of plant functions. Our internal research and development continues to be focused on cost reduction opportunities and product enhancements that have near term product implementation potential.

Loss from operations

Loss from operations for the year ended October 31, 2013 was $29.8 million compared to a loss of $32.1 million in fiscal 2012. The change year-over-year is a result of favorable gross profit from product sales offset by the impact of increased business development activity in the North American and European markets and increased research and development costs associated with consolidating Versa.

Interest expense

Interest expense for the years ended October 31, 2013 and 2012 was $4.0 million and $2.3 million, respectively. Interest expense increased primarily as a result of interest expense associated with the 8.0% Unsecured Convertible Debt issued in June 2013.

Interest expense for both periods also includes interest for the amortization of the redeemable preferred stock of a subsidiary of $2.0 million.

Income/(loss) from equity investments

Income of $0.05 million from equity investments recorded in the year ended October 31, 2013 represents our share of Versa's income through the acquisition date. A loss of $0.6 million was recorded for our share of Versa's losses for the year ended October 31, 2012.

License fee and royalty income

License fee income for the year ended October 31, 2012 was $1.6 million which represents the license fee and royalty income earned from POSCO Energy. Beginning in fiscal year 2013, license fees and royalty income have been included within revenues under service agreements and license revenues.

Impairment of Equity Investment

An impairment charge was recorded in the fourth quarter of the year ended October 31, 2012 as an adjustment to the carrying value of the investment in Versa to its estimated fair value.

Other income (expense), net

Other income (expense), net, was expense of $1.2 million for the year ended October 31, 2013 compared to other income of $1.2 million for the same period in fiscal year 2012. The current period expense recorded is primarily associated with the non-cash fair value adjustment of certain embedded derivatives and the prior year income recorded primarily represents proceeds received relating to an insurance recovery from a prior year claim and income received from scrap sales.

Provision for income taxes

We have not paid U.S. federal or state income taxes in several years due to our history of net operating losses (NOL), although we have paid foreign taxes in South Korea. For the year ended October 31, 2013 our provision for income taxes was $0.4 million. We have begun manufacturing products that are gross margin profitable on a per unit basis; however, we cannot estimate when production volumes will be sufficient to generate taxable domestic income. Accordingly, no tax benefit has been recognized for these net operating losses or other deferred tax assets as significant uncertainty exists surrounding the recoverability of these deferred tax assets.

At October 31, 2013, we had $631.0 million of federal NOL carryforwards that expire in the years 2020 through 2033 and $372.0 million in state NOL carryforwards that expire in the years 2013 through 2033. Additionally, we had $9.9 million of state tax credits available, of which $1.0 million expires in 2018. The remaining credits do not expire.

Net loss attributable to noncontrolling interest

The net loss attributed to the noncontrolling interest for the years ended October 31, 2013 and 2012 was $1.0 million and $0.4 million, respectively.

Preferred Stock dividends

Dividends recorded and paid on the Series B Preferred Stock were $3.2 million in each of the years ending October 31, 2013 and 2012.

Net loss attributable to common shareholders and loss per common share

Net loss attributable to common shareholders represents the net loss for the period, less the net loss attributable to noncontrolling interest and less the preferred stock dividends on the Series B Preferred Stock. For the years ended October 31, 2013 and 2012, net loss attributable to common shareholders was $37.6 million and $38.7 million, respectively and basic and diluted loss per common share was $0.20 and $0.23, respectively.

Customer Concentrations

We contract with a concentrated number of customers for the sale of our products and for research and development contracts. Refer to Note 1 of notes to consolidated financial statements for more information on customer concentrations. There can be no assurance that we will continue to achieve historical levels of sales of our products to our largest customers. Even though our customer base is expected to expand, diversifying our revenue streams, a substantial portion of net revenues could continue to depend on sales to a concentrated number of customers. Our agreements with these customers may be canceled if we fail to meet certain product specifications or materially breach the agreements, and our customers may seek to renegotiate the terms of current agreements or renewals. The loss of or reduction in sales to one or more of our larger customers could have a material adverse effect on our business, financial condition and results of operations.

LIQUIDITY AND CAPITAL RESOURCES

At October 31, 2014, we believe that our cash, cash equivalents on hand, cash flows from operating activities, availability under our loan and revolving credit facilities and access to the capital markets will be sufficient to meet our working capital and capital expenditure needs for at least the next 12 months.

Cash and cash equivalents including restricted cash totaled $108.8 million at October 31, 2014 compared to $77.7 million at October 31, 2013. In addition, the Company has revolver availability of approximately $3.1 million with JPMorgan Chase and $40.0 million of availability under its project finance loan agreement with NRG Energy. The Company has also executed a Letter of Intent with the State of Connecticut which will provide up to $20.0 million of term loans for expansion of our Torrington, Connecticut manufacturing facility. Additionally, we have an effective shelf registration statement with the SEC for issuance of debt or equity securities.

The Company's future liquidity will be dependent on obtaining the order volumes and cost reductions necessary to achieve profitable operations. Increasing annual order volume and reduced product costs are expected to further increase revenues and margins and improve operating cash flows. The Company is currently producing 70 MW annually at our production facility in Torrington, Connecticut which has an annual manufacturing capacity of 100 MW under its current configuration. Our current backlog, which includes fuel cell kits to be delivered to POSCO Energy under a multi-year order which extends through 2016, combined with scheduled fuel cell module exchanges under service agreements, provides a base level of production of approximately 45-50 MW per year. The Company is targeting converting approximately 30-40 MW of our sales pipeline into incremental backlog annually in order to utilize our available capacity. With this level of expected activity, the Company is targeting total average quarterly revenues in the $50 - $60 million range at the current production level. The Company is targeting break-even cash flow as measured by earnings before interest, taxes, depreciation and amortization (EBITDA) at the current 70MW run-rate, dependent on sales mix. Timing may vary depending on customer order and delivery dates as well as the scope of such orders.

The Company has a contract backlog totaling approximately $333.9 million at October 31, 2014. This backlog includes approximately $196.8 million of service agreements, with an average term in excess of ten years and utility service contracts up to 20 years in duration, providing a committed source of revenue to the year 2034. The Company also has a strong sales and service pipeline of potential projects in various stages of development in both North America and Europe. This pipeline includes projects for on-site 'behind-the-meter' applications and for grid support multi-megawatt fuel cell parks. Behind-the-meter applications provide end users with predictable long-term economics, on-site power including micro-grid capabilities and reduced carbon emissions. On-site projects being developed are for project sizes ranging from 1.4MW - 14.0 MW for end users such as pharmaceuticals, technology companies, hospitals and universities. In addition, a number of multi-megawatt utility grid support projects are being developed for utilities and independent power producers to support the grid where power is needed. These projects help both utilities and states meet their renewable portfolio standards. We expect to convert much of our sales pipeline into contracted backlog over time. In addition to our existing pipeline, we are actively developing opportunities directly and through our business partners. The 15 MW project in Bridgeport CT owned by Dominion has now been operating for twelve months and performance of the fuel cell park has met the expectations of Dominion.

Factors that may impact our liquidity in 2015 and beyond include;

- Our expanding development of large scale turn-key projects in the United States requires liquidity and is expected to continue to have liquidity requirements in the future. Our business model is evolving whereby we develop turn-key projects and may commence construction upon the execution of a multi-year power purchase agreement with an end-user that has a strong credit profile. We may choose to substantially complete the construction of a project before it is sold to a project investor. We may choose to retain ownership of one or more of these projects after they become operational if we determine it would be of economic and strategic benefit to do so. If, for example, we cannot sell a project at economics that are attractive to us, we may instead elect to own and operate such projects, generally until such time that we can sell a project on economically attractive terms. Delays in construction progress or in completing the sale of our projects which we are self-financing may impact our liquidity. We have secured $40.0 million of financing to enable this strategy but may seek to use our cash reserves or other forms of financing as necessary.

- As project sizes evolve, project cycle times may increase. We may need to make significant up-front investments of resources in advance of the receipt of any cash from the sale of our projects. These amounts include development costs, interconnection costs, posting of letters of credit or other forms of security, and incurring engineering, permitting, legal, and other expenses.

- The amount of accounts receivable at October 31, 2014 was $64.4 million. Included in accounts receivable at October 31, 2014 was $53.0 million of unbilled accounts receivable. Unbilled accounts receivable represents revenue that has been recognized in advance of billing the customer under the terms of the underlying contracts. Such costs have been funded with working capital and the unbilled amounts are expected to be billed and collected from customers once we meet the billing criteria under a construction contract. At this time, we bill our customers according to the contract terms. Our accounts receivable balances may fluctuate as of any balance sheet date depending on the timing of individual contract milestones and progress on completion of our projects.

- The amount of total inventory at October 31, 2014 was $55.9 million, which includes work in process and finished goods inventory totaling $30.4 million. As we continue to execute on our business plan we must produce fuel cell modules and procure balance of plant components in required volumes to support our planned construction schedules and potential customer contractual requirements. As a result, we may manufacture modules or acquire balance of plant or perform site construction activities in advance of receiving payment for such activities. This may result in fluctuations of inventory and use of cash as of any balance sheet date.

- Under the terms of certain contracts, the Company will provide performance security for future contractual obligations. We have pledged approximately $25.1 million of our cash and cash equivalents as collateral and letters of credit for certain banking requirements and contracts at October 31, 2014. This balance may increase with a growing backlog and installed fleet.

- During fiscal year 2015, we expect to spend between $8.0 million to $15.0 million for capital expenditures, including expenditures for upgrades to existing machinery, equipment and investments in automation equipment that we believe will improve the efficiency and cost profile of our operations and facilitate the start of our Torrington facility expansion. The first phase of the Torrington expansion involves the expansion of the existing 65,000 square foot manufacturing facility by 90,000 square feet for a total size of 155,000 square feet. Initially, this additional space will be used to enhance and streamline logistics functions and provide the space needed to reconfigure the existing production process to improve manufacturing efficiencies and realize cost savings. The Company expects to enter into a long term lease of up to 15 years as part of this expansion. Construction is expected to be completed by early 2016.

- The second phase of our manufacturing expansion will commence as demand supports. This includes adding manufacturing equipment to increase annual capacity from the current 100 megawatts to at least 200 megawatts. Plans for this phase also include the installation of a megawatt scale tri-generation fuel cell plant to power and heat the facility as well as provide hydrogen for the manufacturing process of the fuel cell components, and the creation of an Advanced Technology Technology Center for technology testing and prototype manufacturing. In addition, the final stage of the fuel cell module manufacturing will be relocated to the Torrington facility from its current location at the Danbury, Connecticut headquarters, which will reduce logistics costs. The total investment for both phases of the expansion could be up to $65.0 million over a five year period. The State of Connecticut has extended a financial package through the Department of Economic and Community Development for both stages, including $20.0 million of low interest long-term loans and up to $10.0 million of tax credits, predicated on certain terms and conditions, including the forgiveness of 50 percent of the loan principal if certain job retention and job creation targets are reached.

In addition to cash flows from operations, we may also pursue raising capital through a combination of: (i) sales of equity to public markets or strategic investors, (ii) debt financing (with improving operating results as the business grows, the Company expects to have increased access to the debt markets to finance working capital and capital expenditures) and (iii) potential local or state Government loans or grants in return for manufacturing job creation and retention. The timing and size of any financing will depend on multiple factors including market conditions, future order flow and the need to adjust production capacity. If we are unable to raise additional capital, our growth potential may be adversely affected and we may have to modify our plans.

Cash Flows

Cash and cash equivalents and restricted cash and cash equivalents totaled $108.8 million at October 31, 2014 compared to $77.7 million at October 31, 2013. At October 31, 2014, restricted cash and cash equivalents was $25.1 million, of which $5.5 million was classified as current and $19.6 million was classified as long-term compared to $10.0 million total restricted cash and cash equivalents at October 31, 2013, of which $5.1 million was classified as current and $4.9 million was classified as long-term.

The following table summarizes our consolidated cash flows:

	2014	2013	2012
Consolidated Cash Flow Data:			
Net cash used in operating activities	$(57,468)	$(16,658)	$(58,659)
Net cash (used in) provided by investing activities	(7,079)	(6,194)	7,547
Net cash provided by financing activities	80,821	43,634	54,957
Effects on cash from changes in foreign currency rates	(260)	35	51
Net increase in cash and cash equivalents	$16,014	$20,817	$3,896

The key components of our cash inflows and outflows were as follows:

Operating Activities - Cash used in operating activities was $57.5 million during fiscal year 2014 compared to $16.7 million used in operating activities during fiscal year 2013. Net cash used in operating activities during fiscal year 2014 is a result of a an increase in accounts receivable of $15.4 million due to revenue recognized on multiple projects, a decrease in deferred revenue of $12.3 million due to the timing of revenue recognition, a decrease in accrued liabilities of $11.1 million which is partially comprised of three replacement modules that were provided to POSCO Energy to satisfy the previously accrued obligation to provide such modules, and a decrease in accounts payable of $1.6 million resulting from the timing of installation activities in the prior year and vendor payments. These were partially offset by a decrease in other assets of $3.4 million due to the reduction in debt issuance costs relating to the Convertible note conversions during fiscal year 2014. Net cash used in fiscal 2013 was a result of increases in accounts receivable of $12.0 million and an increase in inventory of $5.9 million. These were offset by increases in deferred revenue of $9.1 million due to achieving customer milestone billings, an increase in accounts payable of $11.8 million due to the increased production rate and a decrease in other assets of $6.1 million, primarily due to the provisioning of fuel cell stacks to POSCO Energy under the terms of the Master Service Agreement.

Investing Activities - Cash used in investing activities was $7.1 million during fiscal year 2014 compared to net cash used in investing activities was $6.2 million during fiscal year 2013. Net cash used during fiscal year 2014 related to capital expenditures. Net cash used during fiscal 2013 related to capital expenditures of $6.6 million, partially offset by cash acquired from the Versa acquisition of $0.4 million.

Financing Activities - Net cash provided by financing activities was $80.8 million during fiscal year 2014 compared to net cash provided by financing activities of $43.6 million in the prior year period. Net cash provided by financing activities during fiscal year 2014 related to the Securities Purchase Agreement entered into with NRG wherein 14.6 million shares were issued for net proceeds of $35.0 million, a public offering of 25.3 million shares of common stock for net proceeds of $29.5 million and proceeds from open market sales of common stock of $41.3 million partially offset by an increase in restricted cash of $15.1 million for the placement of funds in a Grantor's Trust account to secure the Company's obligations under a 15-year service agreement for the Bridgeport Fuel Cell Park Project, the net paydown of the J. P. Morgan Chase revolving credit facility of $5.7 million and the payment of preferred dividends and return of capital of $4.3 million. The net cash provided by financing activities during fiscal year 2013 was related to proceeds received from the convertible debt issuance of $38.0 million, proceeds from the Connecticut Clean Energy and Finance Investment Authority (CEFIA, now known as the CT Green Bank) Loan of $4.8 million, a draw down on the J. P. Morgan Chase revolving credit facility of $2.5 million, a decrease in restricted cash of $0.6 million for letters of credit issued to support the Company's obligations under customer contracts offset by the payment of preferred dividends and return of capital payments of $4.4 million and the capitalization of financing costs associated with the convertible debt issuance of $2.5 million.

Commitments and Significant Contractual Obligations

A summary of our significant future commitments and contractual obligations at October 31, 2014 and the related payments by fiscal year is summarized as follows:

(dollars in thousands)	Payments Due by Period				
		Less than	1 - 3	3 - 5	More Than
Contractual Obligations	Total	1 year	years	years	5 years
Purchase commitments (1)	$82,782	$76,378	$6,289	$115	$—
Series 1 Preferred obligation (2)	10,670	1,117	2,233	2,233	5,087
Term loans (principal and interest)	12,451	671	1,342	3,049	7,389
Capital and operating lease commitments (3)	5,775	2,294	2,234	929	318
Revolving Credit Facility (4)	945	945	—	—	—
Series B Preferred dividends payable (5)	—	—	—	—	—
Total	$112,623	$81,405	$12,098	$6,326	$12,794

(1) Purchase commitments with suppliers for materials, supplies and services incurred in the normal course of business.

(2) The terms of the Class A Cumulative Redeemable Exchangeable Preferred Share Agreement (the "Series 1 Preferred Share Agreement") require payments of (i) an annual amount of Cdn. $500,000 for dividends and (ii) an amount of Cdn. $750,000 as return of capital payments payable in cash. These payments will end on December 31, 2020. Dividends accrue at a 1.25% quarterly rate on the unpaid principal balance, and additional dividends will accrue on the cumulative unpaid dividends at a rate of 1.25% per quarter, compounded quarterly. On December 31, 2020 the amount of all accrued and unpaid dividends on the Class A Preferred Shares of Cdn. $21.1 million and the balance of the principal redemption price of Cdn. $4.4 million will be due to the holders of the Series 1 preferred shares. The Company has the option of making dividend payments in the form of common stock or cash under terms outlined in the preferred share agreement. For purposes of preparing the above table, the final balance of accrued and unpaid dividends due December 31, 2020 of Cdn. $21.1 million is assumed to be paid in the form of common stock and not included in this table.

(3) Future minimum lease payments on capital and operating leases.

(4) The amount represents the amount outstanding at October 31, 2014 on the $4.0 million revolving credit facility with JPMorgan Chase Bank, N.A. and the Export-Import Bank of the United States. The credit facility is used for working capital to finance the manufacture and production and subsequent export sale of the Company's products or services. This agreement was renewed on August 1, 2014 and the current expiration is one year from the date of renewal. The outstanding principal balance of the facility bears interest, at the option of the Company of either the one-month LIBOR plus 1.5 percent or the prime rate of JP Morgan Chase. The facility is secured by certain working capital assets and general intangibles, up to the amount of the outstanding facility balance.

(5) We pay $3.2 million in annual dividends on our Series B Preferred Stock. The $3.2 million annual dividend payment has not been included in this table as we cannot reasonably determine the period when or if we will be able to convert the Series B Preferred Stock into shares of our common stock. We may, at our option, convert these shares into the number of shares of our common stock that are issuable at the then prevailing conversion rate if the closing price of our common stock exceeds 150 percent of the then prevailing conversion price ($11.75) for 20 trading days during any consecutive 30 trading day period.

In October 2014, the State of Connecticut extended a financial package through a letter of intent from the Department of Economic and Community Development for a two stage expansion project to improve manufacturing and logistics efficiencies. This financial package includes $20.0 million of low interest long-term loans and up to $10.0 million of tax credits, predicated on certain terms and conditions, including the foregiveness of 50 percent of the loan principal if certain job retention and job creation targets are reached. Each stage is eligible for a $10.0 million loan at an interest rate of 2.0 percent, repayable over 15 years and $5.0 million of each loan is forgivable. The project also qualifies for up to $10.0 million of urban and industrial sites reinvestment tax credits, which the Company can monetize over a ten year period.

On July 30, 2014, the Company's subsidiary, FuelCell Energy Finance LLC ("FuelCell Finance") entered into a Loan Agreement with NRG. Pursuant to the Loan Agreement, NRG has extended a $40.0 million revolving construction and term financing facility to FuelCell Finance for the purpose of accelerating project development by the Company and its subsidiaries. FuelCell Finance and its subsidiaries may draw on the facility to finance the construction of projects through the commercial operating date of the power plants. FuelCell Finance has the option to continue the financing term for each project after the commercial operating date for a maximum term of five years per project. The interest rate is 8.5 percent per annum for construction-period financing and 8.0 percent thereafter. At October 31, 2014, there were no drawdowns on the facility.

On March 5, 2013 the Company closed on a long-term loan agreement with the Connecticut Clean Energy and Finance Investment Authority (CEFIA, now known as the CT Green Bank) totaling $5.9 million in support of the Bridgeport Fuel Cell Project. The loan agreement carries an interest rate of 5.0% and principal repayments will commence on the eighth anniversary of the project's provisional acceptance date in December 2021. Outstanding amounts are secured by future cash flows from the Bridgeport contracts. The outstanding balance on the CEFIA Note at October 31, 2014 was $6.1 million.

In April 2008, we entered into a 10-year loan agreement with the Connecticut Development Authority allowing for a maximum amount borrowed of $4.0 million. At October 31, 2014, we had an outstanding balance of $3.0 million on this loan. The interest rate is 5%. Interest only payments commenced in January 2014 and the loan is collateralized by the assets procured under this loan as well as $4.0 million of additional machinery and equipment. Repayment terms require interest and principal payments through May, 2018.

We have pledged approximately $25.1 million of our cash and cash equivalents as collateral and letters of credit for certain banking requirements and contracts. At October 31, 2014, outstanding letters of credit totaled $7.4 million. These expire on various dates through April 2019. Under the terms of certain contracts, the Company will provide performance security for future contractual obligations. The restricted cash balance at October 31, 2014 includes $15.0 million which has been placed in a Grantor's Trust account to secure certain FCE obligations under the 15-year service agreement for the Bridgeport Fuel Cell Park Project and has been reflected as long-term restricted cash. The restrictions on the $15.0 million will be removed upon completion of the final module exchange at the Bridgeport Fuel Cell Park Project under the terms of the services agreement.

At October 31, 2014, we have uncertain tax positions aggregating $41.7 million and have reduced our net operating loss carryforwards by this amount. Because of the level of net operating losses and valuation allowances, unrecognized tax benefits, even if not resolved in our favor, would not result in any cash payment or obligation and therefore have not been included in the contractual obligation table above.

In addition to the commitments listed in the table above, we have the following outstanding obligations:

Service and warranty agreements

We warranty our products for a specific period of time against manufacturing or performance defects. Our standard warranty period is generally 15 months after shipment or 12 months after acceptance of the product. We have agreed to warranty kits and components for 21 months from the date of shipment due to the additional shipping and customer manufacture time required. In addition to the standard product warranty, we have contracted with certain customers to provide services to ensure the power plants meet minimum operating levels for terms ranging from one to 20 years. Pricing for service contracts is based upon estimates of future costs, which could be materially different from actual expenses. Also see Critical Accounting Policies and Estimates for additional details.

Advanced technologies contracts (Research and development contracts)

We have contracted with various government agencies and certain companies from private industry to conduct research and development as either a prime contractor or sub-contractor under multi-year, cost-reimbursement and/or cost-share type contracts or cooperative agreements. Cost-share terms require that participating contractors share the total cost of the project based on an agreed upon ratio. In many cases, we are reimbursed only a portion of the costs incurred or to be incurred on the contract. While government research and development contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and Congress authorizes the funds. At October 31, 2014, Advanced technologies contracts backlog totaled $24.0 million, of which $21.0 million is funded. Should funding be delayed or if business initiatives change, we may choose to devote resources to other activities, including internally funded research and development.

Critical Accounting Policies and Estimates

The preparation of financial statements and related disclosures requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, revenue recognition, contract loss accruals, excess, slow-moving and obsolete inventories, product warranty costs, loss accruals on service agreements, share-based compensation expense, allowance for doubtful accounts, depreciation and amortization, impairment of goodwill and in-process research and development intangible assets, impairment of long-lived assets, income taxes and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.

Our critical accounting policies are those that are both most important to our financial condition and results of operations and require the most difficult, subjective or complex judgments on the part of management in their application, often as a result of the need to make estimates about the effect of matters that are inherently uncertain. Our accounting policies are set forth below.

Goodwill and Intangible Assets

Goodwill represents the excess of the aggregate purchase price over the fair value of the net assets acquired in a purchase business combination and is reviewed for impairment at least annually.

Accounting Standards Codification Topic 350, "Intangibles - Goodwill and Other," (ASC 350) permits the assessment of qualitative factors to determine whether events and circumstances lead to the conclusion that it is necessary to perform the two-step goodwill impairment test required under ASC 350.

The Company completed its annual impairment analysis at July 31 of goodwill and intangible assets with indefinite lives during the fourth quarter of fiscal year 2014 which was completed at the reporting unit level. The goodwill and intangible assets all relate to the Company's Versa power Systems, Inc. (Versa) reporting unit, since Versa has a segment manager that regularly reviews the results of that operation. Goodwill and other indefinite lived intangible assets are also reviewed for possible impairment whenever changes in conditions indicate that the fair value of a reporting unit is more likely than not below its carrying value. No impairment charges were recorded during fiscal year 2013 or fiscal year 2014.

Impairment of Long Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. If events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable, we compare the carrying amount of an asset group to future undiscounted net cash flows, excluding interest costs, expected to be generated by the asset group and their ultimate disposition. If the sum of the undiscounted cash flows is less than the carrying value, the impairment to be recognized is measured by the amount by which the carrying amount of the asset group exceeds the fair value of the asset group. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less costs to sell.

Revenue Recognition

We earn revenue from (i) the sale and installation of fuel cell power plants (ii) the sale of component part kits, modules and spare parts to customers, (iii) site engineering and construction services, (iv) providing services under service agreeements, (v) the sale of electricity under PPAs, (vi) license fees and royalty income from manufacturing and technology transfer agreements, and (vii) customer-sponsored advanced technology projects.

The Company periodically enters into arrangements with customers that involve multiple elements of the above items. We assess such contracts to evaluate whether there are multiple deliverables, and whether the consideration under the arrangement is being appropriately allocated to each of the deliverables.

Our revenue is primarily generated from customers located throughout the U.S., Europe and Asia and from agencies of the U.S. Government. Revenue from the sale and installation of fuel cell power plants; the sale of component part kits, modules and spare parts; site engineering and construction services is recorded as product sales in the consolidated statements of operations. Revenue from service agreements, PPAs, license and royalty revenue and engineering services revenue is recorded as service and license revenues. Revenue from customer-sponsored advanced technology research and development projects is recorded as advanced technologies contract revenues in the consolidated statements of operations.

For customer contracts for complete DFC Power Plants which the Company has adequate cost history and estimating experience, and that management believes it can reasonably estimate total contract costs, revenue is recognized under the percentage of completion method of accounting. The use of percentage of completion accounting requires significant judgment relative to estimating total contract costs, including assumptions relative to the length of time to complete the contract, the nature and complexity of the work to be performed, anticipated increases in wages and prices for subcontractor services and materials, and the availability of subcontractor services and materials. Our estimates are based upon the professional knowledge and experience of our engineers, program managers and other personnel, who review each long-term contract on a quarterly basis to assess the contract's schedule, performance, technical matters and estimated cost at completion. When changes in estimated contract costs are identified, such revisions may result in current period adjustments to operations applicable to performance in prior periods. Revenues are recognized based on the percentage of the contract value that incurred costs to date bear to estimated total contract costs, after giving effect to estimates of costs to complete based on most recent information. For customer contracts for new or significantly customized products, where management does not believe it has the ability to reasonably estimate total contract costs, revenue is recognized using the completed contract method and therefore all revenue and costs for the contract are deferred and not recognized until installation and acceptance of the power plant is complete. We recognize anticipated contract losses as soon as they become known and estimable. Actual results could vary from initial estimates and reserve estimates will be updated as conditions change.

Revenue from fuel cell kits and spare parts sales is recognized upon shipment or title transfer under the terms of the customer contract. Terms for certain contracts provide for a transfer of title and risk of loss to our customers at our factory locations upon completion of our contractual requirement to produce products and prepare the products for shipment. A shipment in place may occur in the event that the customer is not ready to take delivery of the products on the contractually specified delivery dates.

Site engineering and construction services revenue is recognized on a percentage of completion basis as costs are incurred.

Revenue from service agreements is generally recorded ratably over the term of the service agreement, as our performance of routine monitoring and maintenance under these service agreements are generally expected to be incurred on a straight-line basis. For service agreements where we expect to have a module exchange at some point during the term (generally service agreements in excess of five years), the costs of performance are not expected to be incurred on a straight-line basis, and therefore, a portion of the initial contract value related to the module exchange is deferred and is recognized upon such module replacement event.

Under PPAs, revenue from the sale of electricity is recognized as electricity is provided to the customer.

The Company receives license fees and royalty income from POSCO Energy as a result of manufacturing and technology transfer agreements entered into in 2007, 2009 and 2012. The Cell Technology Transfer Agreement we entered into on October 31, 2012 provides POSCO Energy with the technology to manufacture Direct FuelCell power plants in South Korea and the exclusive market access to sell power plants throughout Asia. In conjunction with this agreement we amended the 2010 manufacturing and distribution agreement with POSCO Energy and the 2009 License Agreement. The 2012 agreement and the previously referenced amendments contain multiple elements, including the license of technology and market access rights, fuel cell module kit product deliverables, as well as professional service deliverables. We identified these three items as deliverables under the multiple-element arrangement guidance and evaluated the estimated selling prices to allocate the relative fair value to these deliverables, as vendor-specific objective evidence and third-party evidence was not available. The Company's determination of estimated selling prices involved the consideration of several factors based on the specific facts and circumstances of each arrangement. Specifically, the Company considered the cost to produce the tangible product and cost of professional service deliverables, the anticipated margin on those deliverables, prices charged when those deliverables are sold on a stand-alone basis in limited sales, and the Company's ongoing pricing strategy and practices used to negotiate and price overall bundled product, service and license arrangements. We are recognizing the consideration allocated to the license of technology and market access rights as revenue over the 15 year license term on a straight-line basis, and will recognize the amounts allocated to the module kit deliverables and professional service deliverables when such items are delivered to POSCO Energy. We also determined that based on the utility to the customer of the fully developed technology that was licensed in the Cell Technology Transfer Agreement, there is stand-alone value for this deliverable.

Revenue from funded advanced technology contracts is recognized as direct costs are incurred plus allowable overhead less cost share requirements, if any. Revenue from customer funded advanced technology programs are generally multi-year, cost-reimbursement and/or cost-shared type contracts or cooperative agreements. We are reimbursed for reasonable and allocable costs up to the reimbursement limits set by the contract or cooperative agreement, and on certain contracts we are reimbursed only a portion of the costs incurred. While advanced technology contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and funds are authorized.

Inventories and Advance Payments to Vendors

Inventories consist principally of raw materials and work-in-process. In certain circumstances, we will make advance payments to vendors for future inventory deliveries. These advance payments are recorded as other current assets on the consolidated balance sheets.

Inventories are reviewed to determine if valuation adjustments are required for obsolescence (excess, obsolete, and slow-moving inventory). This review includes analyzing inventory levels of individual parts considering the current design of our products and production requirements as well as the expected inventory needs for maintenance on installed power plants.

Warranty and Service Expense Recognition

We warranty our products for a specific period of time against manufacturing or performance defects. Our warranty is limited to a term generally 15 months after shipment or 12 months after acceptance of our products, except for fuel cell kits. We have agreed to warranty fuel cell kits and components for 21 months from the date of shipment due to the additional shipping and customer manufacture time required. We accrue for estimated future warranty costs based on historical experience. We also provide for a specific accrual if there is a known issue requiring repair during the warranty period. Estimates used to record warranty accruals are updated as we gain further operating experience. At October 31, 2014 and October 31, 2013, the warranty accrual, which is classified in accrued liabilities on the consolidated balance sheet, totaled $1.2 million and $0.9 million, respectively.

In addition to the standard product warranty, we have entered into service agreements with certain customers to provide monitoring, maintenance and repair services for fuel cell power plants. Under the terms of these service agreements, the power plant must meet a minimum operating output during the term. If minimum output falls below the contract requirement, we may be subject to performance penalties or may be required to repair and/or replace the customer's fuel cell module. The Company has accrued for performance guarantees of $0.8 million and $0.5 million at October 31, 2014 and October 31, 2013, respectively.

The Company provides for loss accruals on all service agreements when the estimated cost of future module exchanges and maintenance and monitoring activities exceed the remaining contract value. Estimates for future costs on service agreements are determined by a number of factors including the estimated remaining life of the module, used replacement modules available, our limit of liability on service agreements and future operating plans for the power plant. Our estimates are performed on a contract by contract basis and include cost assumptions based on what we anticipate the service requirements will be to fulfill obligations for each contract. At October 31, 2014 and October 31, 2013, our accruals on service agreement contracts totaled $3.0 million and $3.7 million, respectively.

At the end of our service agreements, customers are expected to either renew the service agreement or, based on the Company's rights to title for the module, the module will be returned to the Company as the plant is no longer being monitored or having routine service performed. At October 31, 2014, the asset related to the residual value of replacement modules in power plants under service agreements was $2.7 million compared to $2.9 million at October 31, 2013.

During fiscal 2011, the Company committed to a repair and upgrade program for a select group of 1.2 megawatt (MW) fuel cell modules produced between 2007 and early 2009. At October 31, 2014, the obligation to supply modules to POSCO Energy has been fulfilled and there is no remaining balance compared to $7.3 million accrued at October 31, 2013.

Share-Based Compensation

We account for restricted stock awards (RSAs) and restricted stock units (RSUs) based on the closing market price of the Company's common stock on the date of grant. We account for stock options awarded to employees and non-employee directors under the fair value method of accounting using the Black-Scholes valuation model to estimate fair value at the grant date. The model requires us to make estimates and assumptions regarding the expected life of the option, the risk-free interest rate, the expected volatility of our common stock price and the expected dividend yield. The fair value of equity awards is amortized to expense over the vesting period, which is generally four years. Share-based compensation expense was $2.9 million, $2.2 million and $2.1 million for the years ended October 31, 2014, 2013 and 2012, respectively.

Income Taxes

Income taxes are accounted for under the liability method. Deferred tax assets and liabilities are determined based on net operating loss (“NOL”) carryforwards, research and development credit carryforwards, and differences between financial reporting and income tax bases of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates and laws expected to be in effect when the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recorded against deferred tax assets if it is unlikely that some or all of the deferred tax assets will be realized.

We apply the guidance regarding how a company should recognize, measure, present, and disclose in its financial statements uncertain tax positions that the Company has taken or expects to take on a tax return (including a decision whether to file or not file a return in a particular jurisdiction). The Company's financial statements reflect expected future tax consequences of such positions presuming the taxing authorities' full knowledge of the position and all relevant facts.

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The evaluation of a tax position is a two-step process. The first step is recognition: the Company determines whether it is more likely than not that a tax position will be sustained upon examination, including resolution of any related appeals or litigation processes, based on the technical merits of the position. The second step is measurement: a tax position that meets the “more likely than not” recognition threshold is measured to determine the amount of benefit to recognize in the financial statements. The tax position is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement.
Certain transactions involving the Company's beneficial ownership occurred in fiscal year 2014 and prior years, which could have resulted in a stock ownership change for purposes of Section 382 of the Internal Revenue Code of 1986, as amended. We have completed a detailed Section 382 study in fiscal year 2014 to determine if any of our NOL and credit carryovers will be subject to limitation. Based on that study, we have determined that there was no ownership change as of the end of our 2014 fiscal year under Section 382. The acquisition of Versa in fiscal year 2013 triggered a Section 382 ownership change which will limit future usage of some of the Federal and state NOLs. The Federal and state NOLs that are non 382-limited are included in the NOL deferred tax assets as disclosed in Item 8, footnote 15.
ACCOUNTING GUIDANCE UPDATE

Recently Adopted Accounting Guidance

None.

Recent Accounting Guidance Not Yet Effective

In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, “Revenue from Contracts with Customers (Topic 606).” This topic provides for five principles which should be followed to determine the appropriate amount and timing of revenue recognition for the transfer of goods and services to customers. The principles in this ASU should be applied to all contracts with customers regardless of industry. The amendments in this ASU are effective for fiscal years, and interim periods within those years beginning after December 15, 2016, with two transition methods of adoption allowed. Early adoption for reporting periods prior to December 15, 2016 is not permitted. We are evaluating the financial statement impacts of the guidance in this ASU and determining which transition method we will utilize.

Item 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Interest Rate Exposure

We typically invest in U.S. treasury securities with maturities ranging from less than three months to one year or more. We typically hold these investments until maturity and accordingly, these investments are carried at cost and not subject to mark-to-market accounting. At October 31, 2014, we had no U.S. treasury investments. Cash is invested overnight with high credit quality financial institutions and therefore we are not exposed to market risk on our cash holdings from changing interest rates. Based on our overall interest rate exposure at October 31, 2014, including all interest rate sensitive instruments, a change in interest rates of one percent would not have a material impact on our results of operations.

Foreign Currency Exchange Risk

At October 31, 2014, approximately four percent of our total cash, cash equivalents and investments were in currencies other than U.S. dollars (primarily the Euro, Canadian dollars and South Korean Won) and we have no plans of repatriation. We make purchases from certain vendors in currencies other than U.S. dollars. Although we have not experienced significant foreign exchange rate losses to date, we may in the future, especially to the extent that we do not engage in currency hedging activities. The economic impact of currency exchange rate movements on our operating results is complex because such changes are often linked to variability in real growth, inflation, interest rates, governmental actions and other factors. These changes, if material, may cause us to adjust our financing and operating strategies.

Derivative Fair Value Exposure

Series 1 Preferred Stock

The conversion feature and the variable dividend obligation of our Series 1 Preferred shares are embedded derivatives that require bifurcation from the host contract. The aggregate fair value of these derivatives included within long-term debt and other liabilities at October 31, 2014 and 2013 was $0.7 million. The fair value was based on valuation models using various assumptions including historical stock price volatility, risk-free interest rate and a credit spread based on the yield indexes of technology high yield bonds, foreign exchange volatility as the Series 1 Preferred security is denominated in Canadian dollars, and the closing price of our common stock. Changes in any of these assumptions would change the underlying fair value with a corresponding charge or credit to operations. However, any changes to these assumptions would not have a material impact on our results of operations.

Senior Unsecured Convertible Notes

The change in control put redemption feature and the interest make-whole payments upon conversion embedded in the Senior Unsecured Convertible Notes met the definition of derivatives that each require bifurcation from the host contract. As a result of the conversion of all the outstanding Senior Unsecured Convertible Notes, there was no remaining derivative balance at October 31, 2014. The aggregate fair value of these derivatives at October 31, 2013 was $4.7 million. The fair values were determined using a lattice-based valuation model. In determining the fair value of these bifurcated derivatives, various assumptions were used. Stock price was projected assuming a log-normal distribution. The stock volatility, the interest rate curve, the borrowing cost and credit spread are all assumed to be deterministic. The value is calculated as the difference between the value of the original note and a note with no change of control or make-whole payments upon conversion features.

Item 8. CONSOLIDATED FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Report of Independent Registered Public Accounting Firm

The Board of Directors and Stockholders
FuelCell Energy, Inc.:

We have audited the accompanying consolidated balance sheets of FuelCell Energy, Inc. and subsidiaries as of October 31, 2014 and 2013, and the related consolidated statements of operations and comprehensive income (loss), changes in equity (deficit), and cash flows for each of the years in the three year period ended October 31, 2014. We also have audited FuelCell Energy Inc's internal control over financial reporting as of October 31, 2014, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). FuelCell Energy Inc.'s management is responsible for these consolidated financial statements, for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying management report on internal controls over financial reporting. Our responsibility is to express an opinion on these consolidated financial statements and an opinion on the Company's internal control over financial reporting based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the consolidated financial statements included 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, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FuelCell Energy, Inc. and subsidiaries as of October 31, 2014 and 2013, and the results of its operations and its cash flows for each of the years in the three year period ended October 31, 2014, in conformity with U.S. generally accepted accounting principles. Also in our opinion, FuelCell Energy, Inc. maintained, in all material respects, effective internal control over financial reporting as of October 31, 2014, based on criteria established in Internal Control - Integrated Framework (1992) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

/s/ KPMG LLP

Hartford, Connecticut
January 9, 2015

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FUELCELL ENERGY, INC.
Consolidated Balance Sheets
October 31, 2014 and 2013
(Amounts in thousands, except share and per share amounts)

	2014	2013
ASSETS		
Current assets:		
Cash and cash equivalents	$83,710	$67,696
Restricted cash and cash equivalents - short-term	5,523	5,053
Accounts receivable, net of allowance for doubtful accounts of $132 and $14 at October 31, 2014 and 2013, respectively	64,375	49,116
Inventories	55,895	56,185
Other current assets	7,528	11,279
Total current assets	217,031	189,329
Restricted cash and cash equivalents - long-term	19,600	4,950
Property, plant and equipment, net	26,609	24,225
Goodwill	4,075	4,075
Intangible assets	9,592	9,592
Other assets, net	3,729	5,465
Total assets	$280,636	$237,636
LIABILITIES AND EQUITY (DEFICIT)		
Current liabilities:		
Current portion of long-term debt	$1,439	$6,931
Accounts payable	22,969	24,535
Accrued liabilities	12,066	21,912
Deferred revenue	37,626	51,857
Preferred stock obligation of subsidiary	961	1,028
Total current liabilities	75,061	106,263
Long-term deferred revenue	20,705	18,763
Long-term preferred stock obligation of subsidiary	13,197	13,270
Long-term debt and other liabilities	13,367	52,675
Total liabilities	122,330	190,971
Redeemable preferred stock (liquidation preference of $64,020 at October 31, 2014 and October 31, 2013)	59,857	59,857
Total equity (deficit):		
Shareholders’ equity (deficit)		
Common stock ($.0001 par value; 400,000,000 and 275,000,000 shares authorized at October 31, 2014 and 2013, respectively; 287,160,003 and 196,310,402 shares issued and outstanding at October 31, 2014 and 2013, respectively)	29	20
Additional paid-in capital	909,431	758,656
Accumulated deficit	(809,314)	(771,189)
Accumulated other comprehensive income (loss)	(159)	101
Treasury stock, Common, at cost (45,550 and 5,679 shares at October 31, 2014 and 2013, respectively)	(95)	(53)
Deferred compensation	95	53
Total shareholders’ equity (deficit)	99,987	(12,412)
Noncontrolling interest in subsidiaries	(1,538)	(780)
Total equity (deficit)	98,449	(13,192)
Total liabilities and equity (deficit)	$280,636	$237,636

See accompanying notes to consolidated financial statements.

FUELCELL ENERGY, INC.
Consolidated Statements of Operations and Comprehensive Income (Loss)
For the Years Ended October 31, 2014, 2013, and 2012
(Amounts in thousands, except share and per share amounts)

	2014	2013	2012
Revenues:			
Product sales (including $115.0 million, $81.6 million and $83.9 million of related party revenue)	$136,842	$145,071	$94,950
Service agreements and license revenues (including $14.9 million, $20.1 million and $8.4 million of related party revenue)	25,956	28,141	18,183
Advanced technologies contract revenues (including $0.4 million, $0.3 million and $0.02 million of related party revenue)	17,495	14,446	7,470
Total revenues	180,293	187,658	120,603
Costs of revenues:			
Cost of product sales	126,866	136,989	93,876
Cost of service agreements and license revenues	23,037	29,683	19,045
Cost of advanced technologies contract revenues	16,664	13,864	7,237
Total cost of revenues	166,567	180,536	120,158
Gross profit	13,726	7,122	445
Operating expenses:			
Administrative and selling expenses	22,797	21,218	18,220
Research and development expenses	18,240	15,717	14,354
Total operating expenses	41,037	36,935	32,574
Loss from operations	(27,311)	(29,813)	(32,129)
Interest expense	(3,561)	(3,973)	(2,304)
Income (loss) from equity investments	—	46	(645)
Impairment of equity investment	—	—	(3,602)
License fee and royalty income	—	—	1,599
Other income (expense), net	(7,523)	(1,208)	1,244
Loss before provision for income taxes	(38,395)	(34,948)	(35,837)
Provision for income taxes	(488)	(371)	(69)
Net loss	(38,883)	(35,319)	(35,906)
Net loss attributable to noncontrolling interest	758	961	411
Net loss attributable to FuelCell Energy, Inc.	(38,125)	(34,358)	(35,495)
Preferred stock dividends	(3,200)	(3,200)	(3,201)
Net loss to common shareholders	$(41,325)	$(37,558)	$(38,696)
Net loss to common shareholders per share			
Basic	$(0.17)	$(0.20)	$(0.23)
Diluted	$(0.17)	$(0.20)	$(0.23)
Weighted average shares outstanding			
Basic	245,686,983	186,525,001	165,471,261
Diluted	245,686,983	186,525,001	165,471,261

	2014	2013	2012
Net loss	$(38,883)	$(35,319)	$(35,906)
Other comprehensive income (loss):			
Foreign currency translation adjustments	(260)	35	51
Comprehensive loss	$(39,143)	$(35,284)	$(35,855)

See accompanying notes to consolidated financial statements.

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FUELCELL ENERGY, INC.
Consolidated Statements of Changes in Equity (Deficit)
For the Years Ended October 31, 2014, 2013, and 2012
(Amounts in thousands, except share and per share amounts)

	Common Stock								
	Shares	Amount	Additional Paid-in Capital	Accumulated Deficit	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Deferred Compensation	Noncontrolling Interest in Subsidiaries	Total Equity (Deficit)
Balance, October 31, 2011	138,400,497	$ 13	$ 687,857	$ (701,336)	$ 15	$ (53)	$ 53	$ (924)	$ (14,375)
Sale of common stock	45,012,306	5	63,998	—	—	—	—	—	64,003
Share based compensation	—	—	2,054	—	—	—	—	—	2,054
Stock issued under benefit plans net of taxes paid upon vesting of restricted stock awards	2,443,320	—	548	—	—	—	—	—	548
Preferred dividends — Series B	—	—	(3,201)	—	—	—	—	—	(3,201)
Sale of noncontrolling interest in subsidiary	—	—	—	—	—	—	—	954	954
Noncontrolling interest in subsidiaries	—	—	—	—	—	—	—	(411)	(411)
Effect of foreign currency translation	—	—	—	—	51	—	—	—	51
Net loss attributable to FuelCell Energy, Inc.	—	—	—	(35,495)	—	—	—	—	(35,495)
Balance, October 31, 2012	185,856,123	$ 18	$ 751,256	$ (736,831)	$ 66	$ (53)	$ 53	$ (381)	$ 14,128
Sale of common stock	4,295,800	1	5,547	—	—	—	—	—	5,548
Common stock issued for acquisition	3,526,764	1	3,562	—	—	—	—	—	3,563
Share based compensation	—	—	2,226	—	—	—	—	—	2,226
	2,631,715	—	(173)	—	—	—	—	—	(173)

Taxes paid upon vesting of restricted stock awards, net of stock issued under benefit plans									
Reclass of noncontrolling interest due to liquidation of subsidiaries	—	—	(562)	—	—	—	—	562	—
Preferred dividends — Series B	—	—	(3,200)	—	—	—	—	—	(3,200)
Noncontrolling interest in subsidiaries	—	—	—	—	—	—	—	(961)	(961)
Effect of foreign currency translation	—	—	—	—	35	—	—	—	35
Net loss attributable to FuelCell Energy, Inc.	—	—	—	(34,358)	—	—	—	—	(34,358)
Balance, October 31, 2013	196,310,402	$ 20	$ 758,656	$ (771,189)	$ 101	$ (53)	$ 53	$ (780)	$ (13,192)
Sale of common stock	59,683,252	$ 6	$ 105,960	—	—	—	—	—	105,966
Common stock issued for convertible note conversions including interest	24,766,752	3	33,303	—	—	—	—	—	33,306
Common stock issued to settle make-whole obligation	5,514,272	—	12,883	—	—	—	—	—	12,883
Share based compensation	—	—	2,908	—	—	—	—	—	2,908
Taxes paid upon vesting of restricted stock awards, net of stock issued under benefit plans	913,627	—	(1,079)	—	—	—	—	—	(1,079)
Noncontrolling interest in subsidiaries	—	—	—	—	—	—	—	(758)	(758)
Preferred dividends - Series B	—	—	(3,200)	—	—	—	—	—	(3,200)

Adjustment for deferred compensation	(28,302)	—	—	—	—	(42)	42	—	—
Effect of foreign currency translation	—	—	—	—	(260)	—	—	—	(260)
Net loss attributable to FuelCell Energy, Inc.	—	—	—	(38,125)	—	—	—	—	(38,125)
Balance, October 31, 2014	287,160,003	$ 29	$ 909,431	$ (809,314)	$ (159)	$ (95)	$ 95	$ (1,538)	$ 98,449

See accompanying notes to consolidated financial statements.

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FUELCELL ENERGY, INC.
Consolidated Statements of Cash Flows
For the Years Ended October 31, 2014, 2013 and 2012
(Amounts in thousands, except share and per share amounts)

	2014	2013	2012
Cash flows from operating activities:			
Net loss	$(38,883)	$(35,319)	$(35,906)
Adjustments to reconcile net loss to net cash used in operating activities:			
Share-based compensation	2,908	2,226	2,054
(Income) loss in equity investments	—	(46)	645
Impairment of equity investment	—	—	3,602
(Gain) loss from change in fair value of embedded derivatives	(126)	1,359	180
Make whole derivative expense	8,347	—	—
Depreciation	4,384	4,097	5,192
Amortization of convertible note discount and interest expense	2,140	2,480	2,018
Other non-cash transactions	(425)	(382)	(297)
(Increase) decrease in operating assets:			
Accounts and license fee receivables	(15,378)	(12,000)	(14,066)
Inventories	1,059	(5,901)	(7,600)
Other assets	3,417	6,076	3,032
Increase (decrease) in operating liabilities:			
Accounts payable	(1,566)	11,776	(1,790)
Accrued liabilities	(11,056)	(172)	(6,081)
Deferred revenue	(12,289)	9,148	(9,642)
Net cash used in operating activities	(57,468)	(16,658)	(58,659)
Cash flows from investing activities:			
Capital expenditures	(7,079)	(6,551)	(4,453)
Cash acquired from acquisition	—	357	—
Treasury notes matured	—	—	12,000
Net cash (used in) provided by investing activities	(7,079)	(6,194)	7,547
Cash flows from financing activities:			
Repayment of debt	(5,971)	(374)	(173)
Proceeds from debt	250	45,250	—
Financing costs for convertible debt securities	—	(2,472)	—
Proceeds received for noncontrolling interest in subsidiary	—	—	954
(Increase) decrease in restricted cash and cash equivalents	(15,120)	632	(2,203)
Proceeds from sale of common stock, net of registration fees	105,844	5,040	64,003
Payment of preferred dividends and return of capital	(4,343)	(4,442)	(7,624)
Common stock issued for stock plans and related expenses	161	—	—
Net cash provided by financing activities	80,821	43,634	54,957
Effects on cash from changes in foreign currency rates	(260)	35	51
Net increase in cash and cash equivalents	16,014	20,817	3,896
Cash and cash equivalents-beginning of year	67,696	46,879	42,983
Cash and cash equivalents-end of year	$83,710	$67,696	$46,879

See accompanying notes to the consolidated financial statements.

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Note 1. Nature of Business, Basis of Presentation and Significant Accounting Policies

Nature of Business and Basis of Presentation

FuelCell Energy, Inc. and its subsidiaries (the “Company”, “FuelCell Energy”, “we”, “us”, or “our”) is a leading integrated fue cell company with a growing global presence. We design, manufacture, install, operate and service ultra-clean, efficient and reliable stationary fuel cell power plants. Our Direct FuelCell power plants continuously produce base load electricity and usable high quality heat around the clock for commercial, industrial, government and utility customers. We have commercialized our stationary carbonate fuel cells and are also pursuing the complementary development of planar solid oxide fuel cells and other fuel cell technologies. We continue to invest in new product and market development and, as such, we are not currently generating net income from our operations. Our operations are funded primarily through cash generated from product sales, service and advanced technologies contracts, license fee income and sales of equity and debt securities. In order to continually produce positive cash flow from operations, we need to be successful at increasing annual order volume and production and in our cost reduction efforts.

The consolidated financial statements include our accounts and those of our wholly-owned subsidiaries, including FCE FuelCell Energy Ltd. (“FCE Ltd.”), our Canadian subsidiary; Waterbury Renewable Energy, LLC (“WRE”), FuelCell Energy Finance, LLC, which was formed for the purpose of financing projects within the U.S., UB Fuel Cell LLC, DFC-ERG Milford, LLC and DFC-ERG CT, LLC, which were formed for the purpose of developing projects within Connecticut; UCI Fuel Cell, LLC, which was formed for the purpose of developing a project within California; Long Beach Clean Energy, LLC, which was formed for the purpose of developing projects within New York; and FCE Korea, Ltd., which was formed to facilitate our business operations in South Korea. FuelCell Energy Solutions GmbH (“FCES GmbH”), a joint venture with Fraunhofer IKTS (Fraunhofer), was formed in the fourth quarter of fiscal year 2011 to facilitate business development in Europe. We have an 86 percent interest in FCES GmbH and accordingly, the financial results are consolidated with our financial results. Alliance Star Energy, LLC (“Alliance Star”) is a joint venture with Alliance Power, Inc. (“Alliance”) established to construct fuel cell power plants and sell power under power purchase agreements (“PPAs”). We have an 80 percent interest in the entity and accordingly, the financial results of Alliance Star are consolidated with our financial results. Versa Power Systems, Inc. ("Versa"), a domestic entity, which includes its Canadian subsidiary Versa Power Systems Ltd., is a sub-contractor for the Department of Energy ("DOE") large-scale hybrid project to develop a coal-based, multi-megawatt solid oxide fuel cell ("SOFC") based hybrid system. We had a 39 percent ownership interest and historically accounted for Versa under the equity method of accounting. On December 20, 2012, the Company acquired the remaining 61 percent ownership position of Versa and it is now a wholly-owned subsidiary and consolidated with our financial results. All intercompany accounts and transactions have been eliminated.

Certain reclassifications have been made to the prior year amounts to conform to the current year presentation.

Significant Accounting Policies

Cash and Cash Equivalents and Restricted Cash

All cash equivalents consist of investments in money market funds with original maturities of three months or less at date of acquisition. We place our temporary cash investments with high credit quality financial institutions. At October 31, 2014, $25.1 million of cash and cash equivalents was pledged as collateral for letters of credit for certain banking requirements and contractual commitments, compared to $10.0 million pledged at October 31, 2013. The restricted cash balance at October 31, 2014 includes $15.0 million which has been placed in a Grantor's Trust account to secure certain FCE obligations under a 15-year service agreement for the Bridgeport Fuel Cell Park project and has been classified as Restricted cash and cash equivalents - long-term. At October 31, 2014 and 2013, we had outstanding letters of credit of $7.4 million and $7.7 million, respectively.

Inventories and Advance Payments to Vendors

Inventories consist principally of raw materials and work-in-process. In certain circumstances, we will make advance payments to vendors for future inventory deliveries. These advance payments are recorded as other current assets on the consolidated balance sheets.

Inventories are reviewed to determine if reserves are required for obsolescence (excess, obsolete, and slow-moving inventory). This review includes analyzing inventory levels of individual parts considering the current design of our products and production requirements as well as the expected inventory requirements for maintenance on installed power plants.

Property, Plant and Equipment

Property, plant and equipment are stated at cost, less accumulated depreciation provided on the straight-line method over the estimated useful lives of the respective assets. Leasehold improvements are amortized on the straight-line method over the shorter

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of the estimated useful lives of the assets or the term of the lease. When property is sold or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts and any resulting gain or loss is reflected in operations for the period.

Intellectual Property

Intellectual property, including internally generated patents and know-how, is carried at no value.

Goodwill and Intangible Assets

Goodwill represents the excess of the aggregate purchase price over the fair value of the net assets acquired in a purchase business combination and is reviewed for impairment at least annually.

Accounting Standards Codification Topic 350, "Intangibles - Goodwill and Other", (ASC 350) permits the assessment of qualitative factors to determine whether events and circumstances lead to the conclusion that it is necessary to perform the two-step goodwill impairment test required under ASC 350.

The Company completed its annual impairment analysis of goodwill and intangible assets with indefinite lives at July 31, 2014 during the fourth quarter of fiscal year 2014 which was completed at the reporting unit level. The goodwill and intangible assets all relate to the Company's Versa reporting unit, since Versa has a segment manager that regularly reviews the results of that operation. Goodwill and other indefinite lived intangible assets are also reviewed for possible impairment whenever changes in conditions indicate that the fair value of a reporting unit is more likely than not below its carrying value. No impairment charges were recorded during fiscal year 2014 or fiscal year 2013.

Impairment of Long Lived Assets

Long-lived assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset group may not be recoverable. If events or changes in circumstances indicate that the carrying amount of the asset group may not be recoverable, we compare the carrying amount of an asset group to future undiscounted net cash flows, excluding interest costs, expected to be generated by the asset group and their ultimate disposition. If the sum of the undiscounted cash flows is less than the carrying value, the impairment to be recognized is measured by the amount by which the carrying amount of the asset group exceeds the fair value of the asset group. Assets to be disposed of are reported at the lower of the carrying amount or fair value, less costs to sell.

Revenue Recognition

We earn revenue from (i) the sale and installation of fuel cell power plants (ii) the sale of fuel cell modules, component part kits and spare parts to customers, (iii) site engineering and construction services, (iv) providing services under service agreements, (v) the sale of electricity under PPAs , (vi) license fees and royalty income from manufacturing and technology transfer agreements, and (vii) customer-sponsored advanced technology projects.

The Company periodically enters into arrangements with customers that involve multiple elements of the above items. We assess such contracts to evaluate whether there are multiple deliverables, and whether the consideration under the arrangement is being appropriately allocated to each of the deliverables.

Our revenue is primarily generated from customers located throughout the U.S. and Asia and from agencies of the U.S. Government. Revenue from product and module kit sales, construction services and component part revenue is recorded as product sales in the consolidated statements of operations. Construction services includes engineering, procurement and construction (EPC) services of the overall fuel cell project. The installation of a power plant at a customer site includes significant site preparation which is included in the EPC component and is required to be completed before integration of the fuel cell power plant. Revenue from service agreements, PPAs, license and royalty revenue and engineering services revenue is recorded as service and license revenues. Revenue from customer-sponsored advanced technology research and development projects is recorded as advanced technologies contract revenues in the consolidated statements of operations.

For customer contracts for complete DFC Power Plants which the Company has adequate cost history and estimating experience, and that management believes it can reasonably estimate total contract costs, revenue is recognized under the percentage of completion method of accounting. The use of percentage of completion accounting requires significant judgment relative to estimating total contract costs, including assumptions relative to the length of time to complete the contract, the nature and complexity of the work to be performed, anticipated increases in wages and prices for subcontractor services and materials, and the availability of subcontractor services and materials. Our estimates are based upon the professional knowledge and experience of our engineers, program managers and other personnel, who review each long-term contract on a quarterly basis to assess the contract's schedule, performance, technical matters and estimated cost at completion. When changes in estimated contract costs

are identified, such revisions may result in current period adjustments to operations applicable to performance in prior periods. Revenues are recognized based on the percentage of the contract value that incurred costs to date bear to estimated total contract costs, after giving effect to estimates of costs to complete based on most recent information. For customer contracts for new or significantly customized products, where management does not believe it has the ability to reasonably estimate total contract costs, revenue is recognized using the completed contract method and therefore all revenue and costs for the contract are deferred and not recognized until installation and acceptance of the power plant is complete. For all types of contracts, we recognize anticipated contract losses as soon as they become known and estimable. We have recorded an estimated contract loss reserve of $0.03 million and $0.09 million at October 31, 2014 and October 31, 2013, respectively. Actual results could vary from initial estimates and reserve estimates will be updated as conditions change.
Revenue from the sale of fuel cell modules, kits and spare parts is recognized upon shipment or title transfer under the terms of the customer contract. Terms for certain contracts provide for a transfer of title and risk of loss to our customers at our factory locations upon completion of our contractual requirement to produce products and prepare the products for shipment. A shipment in place may occur in the event that the customer is not ready to take delivery of the products on the contractually specified delivery dates.

Site engineering and construction services revenue is recognized on a percentage of completion basis as costs are incurred.
Revenue from service agreements is generally recorded ratably over the term of the service agreement, as our performance of routine monitoring and maintenance under these service agreements are generally expected to be incurred on a straight-line basis. For service agreements where we expect to have a module exchange at some point during the term (generally service agreements in excess of five years), the costs of performance are not expected to be incurred on a straight-line basis, and therefore, a portion of the initial contract value related to the module exchange is deferred and is recognized upon such module replacement event.

Under PPAs, revenue from the sale of electricity is recognized as electricity is provided to the customer.

Beginning in fiscal year 2013, license fees and royalty income are included within revenues on the consolidated statement of operations. This change is a result of the license agreement entered into on October 31, 2012 for our core technology and the harmonization of the existing agreements to provide fees and royalties for the manufacture of complete DFC Power Plants. Classification as revenue is reflective of our Asia market partnership and royalty based strategy and this business activity is a significant component of non-product revenue.

Revenue from funded advanced technology contracts is recognized as direct costs are incurred plus allowable overhead less cost share requirements, if any. Revenue from customer funded advanced technology programs are generally multi-year, cost-reimbursement and/or cost-shared type contracts or cooperative agreements. We are reimbursed for reasonable and allocable costs up to the reimbursement limits set by the contract or cooperative agreement, and on certain contracts we are reimbursed only a portion of the costs incurred. While advanced technology contracts may extend for many years, funding is often provided incrementally on a year-by-year basis if contract terms are met and funds are authorized.
Warranty and Service Expense Recognition
We warranty our products for a specific period of time against manufacturing or performance defects. Our warranty is limited to a term generally 15 months after shipment or 12 months after acceptance of our products, except for fuel cell kits. We have agreed to warranty fuel cell kits and components for 21 months from the date of shipment due to the additional shipping and customer manufacture time required. We accrue for estimated future warranty costs based on historical experience. We also provide for a specific accrual if there is a known issue requiring repair during the warranty period. Estimates used to record warranty accruals are updated as we gain further operating experience. At October 31, 2014 and October 31, 2013, the warranty accrual, which is classified in accrued liabilities on the consolidated balance sheet totaled $1.2 million and $0.9 million, respectively.

In addition to the standard product warranty, we have entered into service agreements with certain customers to provide monitoring, maintenance and repair services for fuel cell power plants. Under the terms of these service agreements, the power plant must meet a minimum operating output during the term. If minimum output falls below the contract requirement, we may be subject to performance penalties or may be required to repair and/or replace the customer's fuel cell module. The Company has accrued for performance guarantees of $0.8 million and $0.5 million at October 31, 2014 and 2013, respectively.

The Company provides for loss accruals for all service agreements when the estimated cost of future module exchanges and maintenance and monitoring activities exceed the remaining contract value. Estimates for future costs on service agreements are determined by a number of factors including the estimated remaining life of the module, used replacement modules available, our limit of liability on service agreements and future operating plans for the power plant. Our estimates are performed on a contract by contract basis and include cost assumptions based on what we anticipate the service requirements will be to fulfill obligations for each contract. At October 31, 2014, our loss accruals on service agreements totaled $3.0 million compared to $3.7 million at October 31, 2013.

At the end of our service agreements, customers are expected to either renew the service agreement or, based on the Company's rights to title of the module, the module will be returned to the Company as the plant is no longer being monitored or having routine service performed. At October 31, 2014, the asset related to the residual value of replacement modules in power plants under service agreements was $2.7 million compared to $2.9 million at October 31, 2013.

During fiscal year 2011, the Company committed to a repair and upgrade program for a select group of 1.2 megawatt (MW) fuel cell modules produced between 2007 and early 2009. At October 31, 2014, the obligation to supply modules to POSCO Energy has been fulfilled and there is no remaining balance compared to $7.3 million accrued at October 31, 2013.

License Agreements and Royalty Income

We generally recognize license fees and other revenue over the term of the associated agreement. Beginning in fiscal year 2013, license fees and royalty income have been included within revenues on the consolidated statement of operations. This change is a result of the new license agreement entered into on October 31, 2012 for our core technology and the harmonization of the existing agreements to provide license fees and royalties for the value of complete DFC Power Plants sold by POSCO Energy. Classification as revenue is reflective of our Asia market partnership and royalty based strategy having become a significant component of non-product revenue. Prior to November 1, 2012, license fee and royalty income were classified as such in the accompanying Statement of Operations.

The Company receives license fees and royalty income from POSCO Energy as a result of manufacturing and technology transfer agreements entered into in 2007, 2009 and 2012. The Cell Technology Transfer Agreement ("CTTA") we entered into on October 31, 2012 provides POSCO Energy with the technology to manufacture Direct FuelCell power plants in South Korea and the exclusive market access to sell power plants throughout Asia. In conjunction with this agreement we amended the 2010 manufacturing and distribution agreement with POSCO Energy and the 2009 License Agreement. The 2012 agreement and the previously referenced amendments contain multiple elements, including the license of technology and market access rights, fuel cell module kit product deliverables, as well as professional service deliverables. We identified these three items as deliverables under the multiple-element arrangement guidance and evaluated the estimated selling prices to allocate the relative fair value to these deliverables, as vendor-specific objective evidence and third-party evidence was not available. The Company's determination of estimated selling prices involves the consideration of several factors based on the specific facts and circumstances of each arrangement. Specifically, the Company considers the cost to produce the tangible product and cost of professional service deliverables, the anticipated margin on those deliverables, prices charged when those deliverables are sold on a stand-alone basis in limited sales, and the Company's ongoing pricing strategy and practices used to negotiate and price overall bundled product, service and license arrangements. We are recognizing the consideration allocated to the license of technology and market access rights as revenue over the 15 year license term on a straight-line basis, and will recognize the amounts allocated to the module kit deliverables and professional service deliverables when such items are delivered to POSCO Energy. We have also determined that based on the utility to the customer of the fully developed technology that was licensed in the Cell Technology Transfer Agreement, there is stand-alone value for this deliverable.

In conjunction with the CTTA, a $10.0 million fee was paid to the Company on November 1, 2012. Future fees, totaling $8.0 million are payable on a milestone basis between 2014 and 2016. In conjunction with the CTTA, the Company also amended the royalty provisions in the 2007 Technology Transfer, Distribution and Licensing Agreement ("TTA") and the 2009 Stack Technology Transfer and License Agreement ("STTA") revising the royalty from 4.1 percent to 3.0 percent of POSCO Energy net sales. The reduction in the royalty rate resulted in a net fee of $6.7 million paid to the Company in January 2013.

Under the terms of the 2007 TTA, POSCO Energy manufactures balance of plant (“BOP”) in South Korea using its design, procurement and manufacturing expertise. The 2009 STTA allows POSCO Energy to produce fuel cell modules which will be combined with BOP manufactured in South Korea to complete electricity-producing fuel cell power plants for sale in South Korea. Under the STTA and prior to the CTTA, we were receiving 4.1 percent of the revenues generated from sales of fuel cell modules manufactured and sourced by POSCO Energy. The STTA also provided for an upfront license fee of $10.0 million. License fee income was recognized ratably over the 10-year term of the STTA through October 31, 2012. As a result of the CTTA, the remaining license fee income of $7.0 million is being recognized ratably over an additional 15 years beginning November 1, 2012.

In September 2013, the Company entered into a revised Master Service Agreement with POSCO Energy, hereby POSCO Energy assumed more responsibility for servicing installations in Asia that utilize power plants manufactured by POSCO Energy. The Company will perform engineering and support services for each unit in the installed fleet and receive quarterly fees as well as a royalty on each scheduled fuel cell module replacement under service agreements that were built by POSCO Energy and installed at any plant in Asia.

The Company recorded license and royalty income of $4.3 million, $4.1 million and $1.6 million for the years ended October 31, 2014, 2013 and 2012, respectively, relating to the above agreements. Future license and royalty income will consist of amortization of the payments discussed above as well as a 3.0 percent royalty on POSCO Energy net product sales related to FCE's technology and a 3.0 percent royalty on each scheduled fuel cell module replacement under terms of our Master Service Agreement.

Deferred Revenue and Customer Deposits

We receive payments from customers upon the acceptance of a purchase order and when contractual milestones are reached. These payments may be deferred based on the nature of the payment and status of the specific project. Deferred revenue is recognized as revenue in accordance with our revenue recognition policies summarized above.

Research and Development Costs

We perform both customer-sponsored research and development projects based on contractual agreement with customers and company-sponsored research and development projects. Costs incurred for customer-sponsored projects include manufacturing and engineering labor, applicable overhead expenses, materials to build and test prototype units and other costs associated with customer-sponsored research and development contracts. These costs are recorded as Advanced Technologies contract revenues in the consolidated statements of operations.

Costs incurred for company-sponsored research and development projects consist primarily of labor, overhead, materials to build and test prototype units and consulting fees. These costs are recorded as research and development expenses in the consolidated statements of operations.

Share-Based Compensation

We account for restricted stock awards (RSAs) and restricted stock units (RSUs) based on the closing market price of the Company's common stock on the date of grant. We account for stock options awarded to employees and non-employee directors under the fair value method of accounting using the Black-Scholes valuation model to estimate fair value at the grant date. The model requires us to make estimates and assumptions regarding the expected life of the option, the risk-free interest rate, the expected volatility of our common stock price and the expected dividend yield. The fair value of equity awards is amortized to expense over the vesting period, which is generally four years. Refer to Note 14 for additional information.

Income Taxes

Income taxes are accounted for under the liability method. Deferred tax assets and liabilities are determined based on net operating loss (“NOL”) carryforwards, research and development credit carryforwards, and differences between financial reporting and the income tax basis of assets and liabilities. Deferred tax assets and liabilities are measured using enacted tax rates and laws expected to be in effect when the differences are expected to reverse. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. A valuation allowance is recorded against deferred tax assets if it is unlikely that some or all of the deferred tax assets will be realized.

The Company’s financial statements reflect expected future tax consequences of uncertain tax positions that the Company has taken or expects to take on a tax return (including a decision whether to file or not file a return in a particular jurisdiction) presuming the taxing authorities’ full knowledge of the position and all relevant facts.

Concentrations
We contract with a concentrated number of customers for the sale of our products, for service agreement contracts and for advanced technologies contracts. For the years ended October 31, 2014, 2013 and 2012, our top five customers accounted for 88 percent, 88 percent and 83 percent, respectively, of our total annual consolidated revenue.
The percent of consolidated revenues from each customer for the years ended October 31, 2014, 2013 and 2012, respectively are presented below.

	2014		2013		2012	
POSCO Energy	69	%	54	%	76	%
The United Illuminating Company	9	%	—	%	—	%
Bridgeport Dominion Fuel Cell, LLC	3	%	29	%	—	%
Department of Energy	4	%	5	%	7	%
NRG Energy	3	%	—	%	—	%
Total	88	%	88	%	83	%

POSCO Energy is a related party and owns approximately 11.0 percent of the outstanding common shares of the Company and NRG Energy is a related party and owns approximately 6 percent of the outstanding common shares of the Company.
Derivatives
We do not use derivatives for speculative purposes and through fiscal year end 2014, have not used derivatives for hedging or trading purposes. Derivative instruments consist of embedded derivatives in our Series 1 Preferred Shares. Derivative instruments also consisted of embedded derivatives for the change of control put redemption and an interest make-whole payment upon conversion feature embedded in the 8.0% Senior Unsecured Convertible Notes which required bifurcation from the host debt contract. We account for these derivatives using the fair-value method with changes in the underlying fair value recorded to earnings. Refer to Notes 10 and 12 for additional information.
Use of Estimates
The preparation of financial statements and related disclosures in conformity with accounting principles generally accepted in the U.S. requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses and the disclosure of contingent assets and liabilities. Actual results could differ from those estimates. Estimates are used in accounting for, among other things, revenue recognition, excess, slow-moving and obsolete inventories, product warranty costs, service agreement loss accruals, allowance for uncollectible receivables, depreciation and amortization, impairment of assets, taxes, and contingencies. Estimates and assumptions are reviewed periodically, and the effects of revisions are reflected in the consolidated financial statements in the period they are determined to be necessary.
Foreign Currency Translation
The translation of FuelCell Korea Ltd's and FCES GmbH's financial statements results in translation gains or losses, which are recorded in accumulated other comprehensive income within stockholders' equity (deficit).
Our Canadian subsidiary, FCE Ltd., is financially and operationally integrated and therefore the temporal method of translation of foreign currencies is followed. The functional currency is U.S. dollars. We are subject to foreign currency transaction gains and losses as certain transactions are denominated in foreign currencies. We recognized a gain of $0.6 million, a gain of $0.4 million and a gain of $0.1 million for the years ended October 31, 2014, 2013 and 2012, respectively. These amounts have been classified as other income (expense), net in the consolidated statements of operations.

Recently Adopted Accounting Guidance
None

Recent Accounting Guidance Not Yet Effective
In May 2014, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2014-09, "Revenue from Contracts with Customers (Topic 606)." This topic provides for five principles which should be followed to determine the appropriate amount and timing of revenue recognition for the transfer of goods and

services to customers. The

principles in this ASU should be applied to all contracts with customers regardless of industry. The amendments in this ASU are effective for fiscal years, and interim periods within those years beginning after December 15, 2016, with two transition methods of adoption allowed. Early adoption for reporting periods prior to December 15, 2016 is not permitted. We are evaluating the financial statement impacts of the guidance in this ASU and determining which transition method we will utilize.

Note 2. Acquisitions

Versa was previously one of our sub-contractors under the DOE's large-scale hybrid project to develop a coal-based, multi-megawatt SOFC based hybrid system. Versa is developing advanced SOFC systems for various stationary and mobile applications since 2001. Prior to December 20, 2012, we had a 39 percent ownership interest and accounted for Versa under the equity method of accounting. We recognized our share of the income or losses as income (loss) from equity investment on the consolidated statements of operations.

On December 20, 2012, the Company acquired the remaining 61 percent ownership position of Versa in a stock transaction by exchanging approximately 3.5 million shares of its common stock for the outstanding Versa shares held by the other Versa shareholders.

The transaction has been accounted for using the acquisition method of accounting which requires, among other things, that assets acquired and liabilities assumed be recognized at their fair values as of the acquisition date. Step-acquisition accounting guidance was applied and an impairment charge of $3.6 million relating to the previously held equity investment was recorded in the fourth quarter of 2012 and is included in Impairment of equity investment on the consolidated statement of operations. The pre-acquisition value of the ownership in Versa was $6.2 million and represents the book value of the investment as of the acquisition date.

The following table summarizes the final allocation of the purchase price to the estimated fair value of the assets acquired and liabilities assumed as of the acquisition date.

Cash and cash equivalents	$ 357
Accounts receivable	1,133
Other current assets	23
Property, plant and equipment	480
Goodwill	4,075
In-process research and development	9,592
Other assets	101
Accounts payable	(302)
Other current liabilities	(1,492)
Deferred tax liabilities [1]	(3,377)
Other long-term liabilities	(155)
Total identifiable net assets	$ 10,435

(1) Classified in Long-term debt and other liabilities on the consolidated balance sheets.

The acquisition date fair value of the 61 percent investment was approximately $10.2 million and is included in the measurement of the consideration transferred. The acquisition date fair value represented the fair value of our common stock on the acquisition date provided to the other Versa shareholders in exchange for their shares of Versa. The cost approach was used to value the in-process research and development value as this represents an indication of the intangible asset's value by the cost to replace or rebuild the asset. The carrying value for the remaining assets and liabilities acquired approximated fair value.

Acquisition-related costs of $0.1 million were expensed as incurred. These costs were recognized in administrative and selling expenses on the statement of operations and comprehensive (loss) income for the year ended October 31, 2013.

Versa has been consolidated into the Company's financial statements as of the acquisition date. Versa receives revenue under a number of research contracts including the U.S. Department of Energy Solid State Energy Conversion

Alliance (SECA) coal-based systems program and a research contract with The Boeing Company. Revenue and associated costs are recognized under advanced technologies contract revenues in the consolidated statements of operations.

Note 3. Accounts Receivable

Accounts receivable at October 31, 2014 and 2013 consisted of the following:

	2014	2013
Advanced Technology (including U.S. Government [(1)]):		
Amount billed	$2,517	$786
Unbilled recoverable costs	2,886	639
	5,403	1,425
Commercial customers:		
Amount billed	8,871	17,344
Unbilled recoverable costs	50,101	30,347
	58,972	47,691
	$64,375	$49,116

. (1) Total U.S. Government accounts receivable outstanding at October 31, 2014 is $1.7 million

We bill customers for power plant and module kit sales based on certain contractual milestones being reached. We bill service agreements based on the contract price and billing terms of the contracts. Generally, our advanced technology contracts are billed based on actual recoverable costs incurred, typically in the month subsequent to incurring costs. Some advanced technology contracts are billed based on contractual milestones or costs incurred. Unbilled recoverable costs relate to revenue recognized on customer contracts that have not been billed. Accounts receivable are presented net of an allowance for doubtful accounts of $0.1 million and $0.01 million at October 31, 2014 and 2013, respectively.

Commercial customers accounts receivable (including Unbilled recoverable costs) are amounts due from POSCO Energy of $29.9 million and $17.4 million at October 31, 2014 and 2013, respectively.

Note 4. Inventories

Inventories at October 31, 2014 and 2013 consisted of the following:

	2014	2013
Raw materials	$25,460	$20,599
Work-in-process [(1)]	30,435	35,586
Net inventories	$55,895	$56,185

(1) Work-in-process includes the standard components of inventory used to build the typical modules or module components that are intended to be used in future power plant orders or to service our service agreements. Included in Work-in-process at October 31, 2014 and 2013 is $19.2 million and $5.8 million, respectively, of completed standard components.

Raw materials consist mainly of various nickel powders and steels, various other components used in producing cell stacks and purchased components for balance of plant. Work-in-process inventory is comprised of material, labor, and overhead costs incurred to build fuel cell stacks and modules, which are subcomponents of a power plant.

Raw materials and work in process are net of valuation allowances of approximately $1.4 million and $1.4 million at October 31, 2014 and 2013, respectively.

Note 5. Property, Plant and Equipment

Property, plant and equipment at October 31, 2014 and 2013 consisted of the following:

	2014	2013	Estimated Useful Life
Land	$524	$524	—
Building and improvements	9,117	8,679	10-26 years
Machinery, equipment and software	75,868	73,051	3-8 years
Furniture and fixtures	2,955	2,899	10 years
Power plants for use under PPAs	996	8,216	3-10 years
Construction in progress	10,534	9,537	
	99,994	102,906	
Less: Accumulated depreciation	(73,385)	(78,681)	
Property, plant and equipment, net	$26,609	$24,225	

Depreciation expense was $4.4 million, $4.1 million and $5.2 million for the years ended October 31, 2014, 2013 and 2012, respectively.

Note 6. Goodwill and Intangible Assets

At October 31, 2014 and 2013, the Company had goodwill of $4.1 million and intangible assets of $9.6 million associated with the Versa acquisition. Versa's goodwill resulted from the purchase price residual value method. All identifiable assets and liabilities were deducted from the total purchase price and the difference represents the implied fair value of goodwill. The intangible asset represents indefinite lived in-process research and development for which the fair value was determined utilizing the cost approach which estimated the costs to replicate cumulative research and development efforts associated with the development of SOFC stationary power generation and had a 10 percent obsolescence factor applied to account for improvements that could be made on the current technology.

The Company has completed a qualitative assessment at July 31, 2014 and determined that the goodwill and indefinite-lived intangible assets recorded as a result of the Versa acquisition which are included within the Versa reporting unit are not impaired.

Note 7. Other Current Assets

Other current assets at October 31, 2014 and 2013 consisted of the following:

	2014	2013
Advance payments to vendors (1)	$2,372	$4,235
Debt issuance costs (2)	—	494
Deferred finance costs (3)	129	—
Notes receivable	529	478
Prepaid expenses and other (4)	4,498	6,072
Total	$7,528	$11,279

(1) Advance payments to vendors relate to inventory purchases.

(2) Represents the current portion of capitalized debt issuance costs relating to the convertible debt issuance. The convertible notes have been converted and the debt issuance costs have been adjusted to additional paid in capital.

(3) Represents the current portion of direct deferred finance costs relating to securing a $40.0 million loan facility and will be amortized over the five-year life of the facility.

(4) Primarily relates to other prepaid vendor expenses including insurance, rent and lease payments.

Note 8. Other Assets, net

Other assets, net at October 31, 2014 and 2013 consisted of the following:

	2014	2013
Long-term stack residual value (1)	$2,725	$2,898
Debt issuance costs (2)	—	1,721
Deferred finance costs(3)	$483	$—
Other	521	846
Other assets, net	$3,729	$5,465

(1) Relates to expected residual value for module exchanges performed under the Company's service agreements where the useful life extends beyond the contractual term of the service agreement and the Company obtains title for the module from the customer upon expiration or non-renewal of the service agreement. If the Company does not obtain rights to title from the customer, the cost of the module is expensed at the time of the module exchange.

(2) Represents the long-term portion of debt issuance costs capitalized relating to the convertible debt issuance. At October 31, 2014, the convertible notes have been converted and the debt issuance costs have been adjusted to additional paid in capital.

(3) Represents the long-term portion of direct deferred finance costs relating to securing a $40.0 million loan facility and will be amortized over the five-year life of the facility.

Note 9. Accrued Liabilities

Accrued liabilities at October 31, 2014 and 2013 consisted of the following:

	2014	2013
Accrued payroll and employee benefits	$4,432	$4,647
Accrued contract and operating costs	34	87
Accrued product warranty costs (1)	1,156	860
Accrued service agreement costs	3,882	4,186
Accrued B1200 repair and upgrade program and modules due POSCO Energy (2)	—	7,267
Accrued taxes, legal, professional and other	2,562	4,865
	$12,066	$21,912

(1) Activity in the accrued product warranty costs during the year ended October 31, 2014 and 2013 included additions for estimates of potential future warranty obligations of $2.4 million and $1.2 million, respectively, on contracts in the warranty period and reductions related to actual warranty spend of $1.2 million and $0.3 million, respectively, as contracts progress through the warranty period or are beyond the warranty period.

(2) The balance of the accrual at October 31, 2013 related to three replacement modules due to POSCO Energy, which were delivered in the first quarter of 2014.

Note 10. Debt and Leases

Debt at October 31, 2014 and 2013, consisted of the following:

	2014	2013
Revolving credit facility	$945	$6,500
Senior Unsecured Convertible Notes	—	38,000
Connecticut Development Authority Note	3,033	3,246
Connecticut Clean Energy and Finance Investment Authority Note	6,052	5,744
Capitalized lease obligations	721	497
Total debt	$10,751	$53,987
Less: Unamortized debt discount	—	(3,106)
	10,751	50,881
Less: Current portion of long-term debt	(1,439)	(6,931)
Long-term debt	$9,312	$43,950

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Aggregate annual principal payments under our loan agreements (excluding payments relating to the revolving credit facility) and capital lease obligations for the years subsequent to October 31, 2014 are as follows:

Year 1	493
Year 2	537
Year 3	351
Year 4	2,368
Year 5	5
Thereafter	6,052
	$9,806

On July 30, 2014, the Company's subsidiary, FuelCell Energy Finance, LLC (“FuelCell Finance”) entered into a Loan Agreement (the “Loan Agreement”) with NRG Energy, Inc. ("NRG"). Pursuant to the Loan Agreement, NRG has extended a $40.0 million revolving construction and term financing facility to FuelCell Finance for the purpose of accelerating project development by the Company and its subsidiaries. FuelCell Finance and its subsidiaries may draw on the facility to finance the construction of projects through the commercial operating date of the power plants. FuelCell Finance has the option to continue the financing term for each project after the commercial operating date for a maximum term of five years per project. The interest rate is 8.5 percent per annum for construction-period financing and 8.0 percent thereafter. Fees that were paid by FuelCell Finance to NRG for making the loan facility available and related legal fees incurred were capitalized and will be amortized straight-line over the life of the related loan agreement, which is five years.

On June 25, 2013, the Company sold $38.0 million in aggregate principal amount of 8.0% Senior Unsecured Convertible Notes ("Notes"). During the year ended October 31, 2014, the total $38.0 million of outstanding principal was converted by Note holders and the Company issued 24.5 million shares of common stock. In connection with the conversion of the Notes, the Company recorded an increase in common stock and additional paid in capital based on the carrying value of the converted Notes which included the converted Notes principal, a proportional amount of unamortized debt discount, and a proportional amount of unamortized debt issuance costs. The change of control put redemption and interest make-whole payment upon conversion features embedded in the Notes required bifurcation from the host debt contract. As a result of the conversion of all the outstanding Notes, there is no remaining derivative balance at October 31, 2014. The aggregate fair value of these derivatives at October 31, 2013 was $4.7 million. The fair values were determined using a lattice-based valuation model. In determining the fair value of these bifurcated derivatives, various assumptions were used. Stock price was projected assuming a log-normal distribution. The stock volatility, the interest rate curve, the borrowing cost and credit spread are all assumed to be deterministic. The value was calculated as the difference between the value of the original note and a note with no change of control or make-whole payments upon conversion features. The inputs used to estimate the fair value of the control put redemption feature ad make-whole payment embedded derivatives include several significant unobservable inputs (Level 3).

As a result of the Note conversions, 5.5 million shares were issued and a payment of $0.3 million was made to settle the make-whole payment. The total fair value of the shares issued for the make-whole payment was $12.9 million which resulted in a charge of $8.7 million and a reduction to the embedded derivative liability of $4.6 million. The derivatives were included in Long term debt and other liabilities on the consolidated balance sheets and the make-whole charge is included in Other income (expense), net on the consolidated statements of operations.

On August 1, 2014, the Company entered into a new revolving credit facility with JPMorgan Chase Bank, N.A. (the "Bank") which has a total borrowing capacity of $4.0 million. This credit facility replaces the Company's previous credit facility with the Bank. The credit facility is used for working capital to finance the manufacture and production and subsequent export sale of the Company’s products or services. The agreement has a one year term with renewal provisions and the current expiration date is August 1, 2015. The outstanding principal balance of the facility will bear interest, at the option of the Company of either the one-month LIBOR plus 1.5 percent or the prime rate of JP Morgan Chase. The facility is secured by certain working capital assets and general intangibles, up to the amount of the outstanding facility balance.

In April 2008, we entered into a 10-year loan agreement with the Connecticut Development Authority to finance equipment purchases associated with manufacturing capacity expansion allowing for a maximum amount borrowed of $4.0 million. The interest rate is 5.0 percent and the loan is collateralized by the assets procured under this loan as well as $4.0 million of additional machinery and equipment. Repayment terms require interest and principal payments through May 2018.

On March 5, 2013 the Company closed on a long-term loan agreement with the Connecticut Clean Energy and Finance Investment Authority (CEFIA, now known as the CT Green Bank) totaling $5.9 million in support of the Bridgeport Fuel Cell Park project. The loan agreement carries an interest rate of 5.0 percent. Interest only payments commenced in January 2014 and principal payments will commence on the eighth anniversary of the project's provisional acceptance date, which is December 20, 2021, payable in forty eight equal monthly installments. Outstanding amounts are secured by future cash flows from the Bridgeport Fuel Cell Park service agreement.
We lease computer equipment under master lease agreements. Lease payment terms are generally thirty-six months from the date of acceptance for leased equipment.

Note 11. Shareholders' Equity (Deficit)
Common Stock and Warrant Issuances
During the year ended October 31, 2014, investors elected to convert the total outstanding $38.0 million in aggregate principal of the 8.0% Senior Unsecured Convertible Notes. As a result of these conversions, the Company issued 24.5 million shares of common stock related to the conversions, 5.5 million shares to settle the make-whole obligation and 0.3 million shares for accrued interest.

On July 30, 2014, the Company entered into a Securities Purchase Agreement with NRG and issued 14,644,352 shares of common stock to NRG at a per share price of $2.39 for a total purchase price of $35.0 million. The per share price was equal to the per share closing NASDAQ market price on July 29, 2014. In conjunction with the sale of common stock to NRG, the Company also issued a warrant to NRG. Pursuant to the Warrant Agreement, NRG has the right to purchase up to 2.0 million shares of the Company's common stock at an exercise price of $3.35 per share. The Warrant has a term of three years from the Closing Date. The warrants qualified for permanent equity accounting treatment.

On January 23, 2014, the Company completed a public offering of 23.0 million shares of common stock, including 3.0 million shares sold pursuant to the full exercise of an over-allotment option granted to the underwriters. All shares were offered by the Company at a price of $1.50 per share. Total net proceeds to the Company were approximately $32.0 million.

The Company may sell common stock on the open market from time to time. The proceeds of these sales may be used for general corporate purposes or to pay obligations related to the Company's outstanding Series I and Series B preferred shares. During fiscal year 2014 and 2013, the Company sold 19.7 million and 4.3 million shares, respectively of the Company's common stock at prevailing market prices through periodic trades on the open market and raised approximately $41.3 million and $5.6 million, respectively, net of fees.

On December 20, 2012, the Company issued 3.5 million shares of common stock for the remaining 61 percent of outstanding Versa shares.

On September 4, 2013, the Company entered into a co-marketing agreement with NRG Energy ("NRG") for the marketing and sales of the Company's power plants. The terms of the agreement included the issuance of warrants to NRG that permit NRG to purchase up to 5.0 million shares of the Company's common stock at predetermined prices based on attaining minimum sales goals. The first tranche of 1.25 million warrants expired unvested on March 1, 2014. There are two tranches remaining of warrants with varying strike prices, varying minimum levels of qualifying orders, and different vesting and expiration dates. The weighted average strike price for the remaining 3.75 million warrants is $2.08. The qualifying order vesting dates range from December 2014 through September 2015 and the expiration dates range from December 2017 through August 2018. Any costs associated with the warrants will be recorded as a reduction of potential future revenue recorded under the arrangement. No warrants were vested at October 31, 2014 and no expense has been recorded.

On April 30, 2012, POSCO Energy purchased, and the Company issued, 20.0 million shares of common stock at a price of $1.50 per share for proceeds of $30.0 million.

On March 27, 2012, the Company completed a public offering of 23.0 million shares of common stock, including 3.0 million shares sold pursuant to the full exercise of an over-allotment option previously granted to the underwriters. All shares were offered by the Company at a price of $1.50 per share. Total net proceeds to the Company were approximately $32.0 million.

Note 12. Redeemable Preferred Stock
Redeemable Series B Preferred Stock
We have 250,000 shares of our 5 percent Series B Cumulative Convertible Perpetual Preferred Stock (Liquidation Preference $1,000) ("Series B Preferred Stock") authorized for issuance. At October 31, 2014 and 2013, there were 64,020 shares of Series B Preferred Stock issued and outstanding, with a carrying value of $59.9 million. The following is a summary of certain provisions of our Series B Preferred Stock.

- Ranking — Shares of Series B Preferred Stock rank with respect to dividend rights and rights upon our liquidation, winding up or dissolution:
- senior to shares of our common stock;
- junior to our debt obligations; and
- effectively junior to our subsidiaries' (i) existing and future liabilities and (ii) capital stock held by others.
- Dividends - The Series B Preferred Stock pays cumulative annual dividends of $50 per share which are payable quarterly in arrears on February 15, May 15, August 15 and November 15, and if declared by the board of directors. Dividends accumulate and are cumulative from the date of original issuance. Accumulated dividends on the Series B Preferred Stock do not bear interest.

The dividend rate is subject to upward adjustment as set forth in the Certificate of Designation if we fail to pay, or to set apart funds to pay, any quarterly dividend. The dividend rate is also subject to upward adjustment as set forth in the Registration Rights Agreement entered into with the Initial Purchasers if we fail to satisfy our registration obligations with respect to the Series B Preferred Stock (or the underlying common shares) under the Registration Rights Agreement.
The dividend on the Series B Preferred Stock may be paid in cash; or at the option of the holder, in shares of our common stock, which will be registered pursuant to a registration statement to allow for the immediate sale of these common shares in the public market. Dividends of $3.2 million were paid in cash in each of the years ended October 31, 2014, 2013 and 2012. There were no cumulative unpaid dividends at October 31, 2014 and 2013.

- Liquidation - The Series B Preferred Stock stockholders are entitled to receive, in the event that we are liquidated, dissolved or wound up, whether voluntary or involuntary, $1,000 per share plus all accumulated and unpaid dividends to the date of that liquidation, dissolution, or winding up ("Liquidation Preference"). Until the holders of Series B Preferred Stock receive their Liquidation Preference in full, no payment will be made on any junior shares, including shares of our common stock. After the Liquidation Preference is paid in full, holders of the Series B Preferred Stock will not be entitled to receive any further distribution of our assets. At October 31, 2014 and 2013, the Series B Preferred Stock had a Liquidation Preference of $64.0 million.

- Conversion Rights - Each Series B Preferred Stock share may be converted at any time, at the option of the holder, into 85.1064 shares of our common stock (which is equivalent to an initial conversion price of $11.75 per share) plus cash in lieu of fractional shares. The conversion rate is subject to adjustment upon the occurrence of certain events, as described below, but will not be adjusted for accumulated and unpaid dividends. If converted, holders of Series B Preferred Stock do not receive a cash payment for all accumulated and unpaid dividends; rather, all accumulated and unpaid dividends are canceled.

We may, at our option, cause shares of Series B Preferred Stock to be automatically converted into that number of shares of our common stock that are issuable at the then prevailing conversion rate. We may exercise our conversion right only if the closing price of our common stock exceeds 150 percent of the then prevailing conversion price ($11.75 at October 31, 2014) for 20 trading days during any consecutive 30 trading day period, as described in the Certificate of Designation.
If holders of Series B Preferred Stock elect to convert their shares in connection with certain fundamental changes, as defined, we will in certain circumstances increase the conversion rate by a number of additional shares of common

stock upon conversion or, in lieu thereof, we may in certain circumstances elect to adjust the conversion rate and related conversion obligation so that shares of our Series B Preferred Stock are converted into shares of the acquiring or surviving company, in each case as described in the Certificate of Designation.

The adjustment of the conversion price is to prevent dilution of the interests of the holders of the Series B Preferred Stock from certain dilutive transactions with holders of common stock.

- Redemption — We do not have the option to redeem the shares of Series B Preferred Stock. However, holders of the Series B Preferred Stock can require us to redeem all or part of their shares at a redemption price equal to the Liquidation Preference of the shares to be redeemed in the case of a fundamental change, as defined.

We may, at our option, elect to pay the redemption price in cash or, in shares of our common stock valued at a discount of 5 percent from the market price of shares of our common stock, or any combination thereof. Notwithstanding the foregoing, we may only pay such redemption price in shares of our common stock that are registered under the Securities Act of 1933 and eligible for immediate sale in the public market by non-affiliates of the Company.

- Voting Rights - Holders of Series B Preferred Stock currently have no voting rights.

Series 1 Preferred Shares

In connection with our acquisition of Global Thermoelectric Inc. ("Global") in November 2003, we acquired the obligations of Global pursuant to its outstanding 1,000,000 Series 2 Preferred Shares ("Series 2 Preferred Shares") which continued to be held by Enbridge, Inc. With the sale of Global in May of 2004, the Series 2 Preferred Shares were canceled, and replaced with substantially equivalent Series 1 Preferred Shares ("Series 1 Preferred Shares") issued by FuelCell Energy Ltd. ("FCE Ltd").

On March 31, 2011, the Company entered into an agreement with Enbridge, Inc. ("Enbridge") to modify the Class A Cumulative Redeemable Exchangeable Preferred Shares agreement (the "Series 1 preferred share agreement") between FCE Ltd, a wholly-owned subsidiary of FuelCell, and Enbridge, the sole holder of the Series 1 preferred shares. Consistent with the previous Series 1 preferred share agreement, FuelCell continues to guarantee the return of principal and dividend obligations of FCE Ltd. to the Series 1 preferred shareholders under the modified agreement. The modified terms of the Series 1 Preferred Shares provides for payments of (i) annual dividend payments of Cdn. $500,000 and (ii) annual return of capital payments of Cdn. $750,000. These payments commenced on March 31, 2011 and will end on December 31, 2020. On December 31, 2020 the amount of all accrued and unpaid dividends on the Series 1 Preferred Shares of Cdn. $21.1 million and the balance of the principal redemption price of Cdn. $4.4 million shall be paid to the holders of the Series 1 Preferred Shares. FCE Ltd. has the option of making dividend payments in the form of common stock or cash under the Series 1 Preferred Shares provisions.

The Company assessed the accounting guidance related to the classification of the preferred shares after the modification on March 31, 2011 and concluded that the preferred shares should be classified as a mandatorily redeemable financial instrument, and presented as a liability on the consolidated balance sheet.

The Company made its scheduled payments of Cdn. $1.3 million, Cdn. $1.3 million and Cdn. $4.4 million during fiscal year 2014, 2013 and 2012, under the terms of the modified agreement, including the recording of interest expense, which reflects the fair value discount, of approximately Cdn. $2.1 million, Cdn. $2.0 million and Cdn. $2.0 million, respectively. At October 31, 2014 and 2013, the carrying value of the Series 1 Preferred shares was Cdn. $15.8 million ($14.2 million USD) and Cdn. $15.0 million ($14.3 million USD), respectively and is classified as preferred stock obligation of subsidiary on the consolidated balance sheets.

In addition to the above, the significant terms of the Series 1 Preferred Shares include the following:

- Voting Rights —The holders of the Series 1 Preferred Shares are not entitled to any voting rights.
- Dividends — Dividend payments can be made in cash or common stock of the Company, at the option of FCE Ltd., and if common stock is issued it may be unregistered. If FCE Ltd. elects to make such payments by issuing common stock of the Company, the number of common shares is determined by dividing the cash dividend obligation by 95 percent of the volume weighted average price in US dollars at which board lots of the common shares have been traded on NASDAQ during the 20 consecutive trading days preceding the end of the calendar quarter for which such dividend in common shares is to be paid converted into Canadian dollars using the Bank of Canada's noon rate of exchange on the day of determination.
- Redemption — The Series 1 Preferred Shares are redeemable by FCE Ltd. for Cdn. $25 per share less any amounts paid as a return of capital in respect of such share plus all unpaid dividends and accrued interest. Holders of the Series 1 Preferred Shares do not have any mandatory or conditional redemption rights.
- Liquidation or Dissolution — In the event of the liquidation or dissolution of FCE Ltd., the holders of Series 1 Preferred Shares will be entitled to receive Cdn. $25 per share less any amounts paid as a return of capital in respect of such share plus all unpaid dividends and accrued interest. The Company has guaranteed any liquidation obligations of FCE Ltd.

- Exchange Rights — A holder of Series 1 Preferred Shares has the right to exchange such shares for fully paid and non-assessable common stock of the Company at the following exchange prices:

- Cdn. $129.46 per share of common stock after July 31, 2010 until July 31, 2015;
- Cdn. $138.71 per share of common stock after July 31, 2015 until July 31, 2020; and
- at any time after July 31, 2020, at a price equal to 95 percent of the then current market price (in Cdn. $) of the Company’s common stock at the time of conversion.

The exchange rates set forth above shall be adjusted if the Company: (i) subdivides or consolidates the common stock; (ii) pays a stock dividend; (iii) issues rights, options or other convertible securities to the Company's common stockholders enabling them to acquire common stock at a price less than 95 percent of the then-current price; or (iv) fixes a record date to distribute to the Company's common stockholders shares of any other class of securities, indebtedness or assets.

Derivative liability related to Series 1 Preferred Shares

The conversion feature and variable dividend contained in the terms of the Series 1 Preferred Shares are not clearly and closely related to the characteristics of the Series 1 Preferred Shares. Accordingly, these features qualify as embedded derivative instruments and are required to be accounted for separately and recorded as derivative financial instruments at fair value.

The conversion feature is valued using a lattice model. Based on the pay-off profiles of the Series 1 Preferred Shares, it is assumed that we will exercise the call option to force conversion in 2020. Conversion after 2020 delivers a fixed pay-off to the investor, and is modeled as a fixed payment in 2020. The cumulative dividend is modeled as a quarterly cash dividend component (to satisfy minimum dividend payment requirement), and a one-time cumulative dividend payment in 2020.

The variable dividend is valued using a Monte Carlo simulation model.

The assumptions used in these valuation models include historical stock price volatility, risk-free interest rate and a credit spread based on the yield indexes of technology high yield bonds, foreign exchange volatility as the security is denominated in Canadian dollars, and the closing price of our common stock. The aggregate fair value of these derivatives included within long-term debt and other liabilities on the consolidated balance sheets at October 31, 2014 and 2013 was $0.7 million.

Note 13. Segment Information

We are engaged in the development, design, production, sale and servicing of high temperature fuel cells for clean electric power generation. Critical to the success of our business is, among other things, our research and development efforts, both through customer-sponsored projects and Company-sponsored projects. The research and development activities are viewed as another product line that contributes to the development, design, production and sale of fuel cell products, however, it is not considered a separate operating segment. Due to the nature of the internal financial and operational reports reviewed by the chief operating decision maker, who does not review and assess financial information at a discrete enough level to be able to assess performance of research and development activities as if it operated as a standalone business segment, we have identified one business segment: fuel cell power plant production and research.

Revenues, by geographic location (based on the customer’s ordering location) for the years ended October 31, 2014, 2013 and 2012 was as follows:

	2014	2013	2012
United States	$52,765	$80,199	$26,929
South Korea	124,669	101,928	92,163
England	119	2,036	1,061
Indonesia	—	—	147
Germany	869	1,503	128
Canada	820	1,912	175
Spain	1,051	80	—
Total	$180,293	$187,658	$120,603

Service agreement revenue which is included within Service agreements and license revenues on the consolidated statement of operations was $21.7 million, $24.0 million and $18.2 million, for the years ended October 31, 2014, 2013 and 2012, respectively.

Long-lived assets located outside of the United States at October 31, 2014 and 2013 are not significant individually or in the aggregate.

Note 14. Benefit Plans

We have shareholder approved equity incentive plans, a shareholder approved Section 423 Stock Purchase Plan (the "ESPP") and an employee tax-deferred savings plan, which are described in more detail below.

Equity Incentive Plans

The Board adopted the 2006 and 2010 Equity Incentive Plans (collectively, the "Equity Plans"). Pursuant to the Equity Plans, 18.0 million shares of common stock were reserved for issuance. The Board is authorized to grant incentive stock options, nonstatutory stock options, stock appreciation rights ("SARs"), restricted stock awards ("RSAs"), restricted stock units ("RSUs"), performance units, performance shares, dividend equivalent rights and other stock based awards to our officers, key employees and non-employee directors. Stock options, RSAs and SARs have restrictions as to transferability. Stock option exercise prices are fixed by the Board but shall not be less than the fair market value of our common stock on the date of the grant. SARs may be granted in conjunction with stock options. Stock options generally vest ratably over 4 years and expire 10 years from the date of grant. During the second quarter of fiscal year 2013, the Company established an international award program to provide RSUs for the benefit of certain employees outside the United States. At October 31, 2014, there were 7.5 million shares available for grant. As of October 31, 2014 equity awards outstanding consisted of incentive stock options, nonstatutory stock options, RSAs and RSUs. The 1998 Equity Incentive Plan remains in effect only to the extent of awards outstanding under the plan as of October 31, 2014.

Share-based compensation was reflected in the consolidated statements of operations as follows:

	2014	2013	2012
Cost of revenues	$751	$584	$587
General and administrative expense	1,718	1,325	1,182
Research and development expense	436	308	280
Total share-based compensation	$2,905	$2,217	$2,049

Stock Options

We account for stock options awarded to employees and non-employee directors under the fair value method. The fair value of stock options is estimated on the grant date using the Black-Scholes option valuation model and the following weighted-average assumptions:

	2014		2013		2012	
Expected life (in years)	7.0		7.0		7.0	
Risk free interest rate	2.3	%	1.2	%	1.6	%
Volatility	81.1	%	76.5	%	75.5	%
Dividends yield	—	%	—	%	—	%

The expected life is the period over which our employees are expected to hold the options and is based on historical data for similar grants. The risk free interest rate is based on the expected U.S. Treasury rate over the expected life. Expected volatility is based on the historical volatility of our stock. Dividend yield is based on our expected dividend payments over the expected life.

The following table summarizes our stock option activity for the year ended October 31, 2014:

Options	Shares		Weighted-Average Option Price
Outstanding at October 31, 2013	3,181,464		$6.42
Granted	146,841		$2.42
Canceled	(300,225	)	$12.18
Outstanding at October 31, 2014	3,028,080		$5.66

The weighted average grant-date fair value per share for options granted during the years ended October 31, 2014, 2013 and 2012 was $1.79, $0.66 and $0.89, respectively. There were no options exercised in fiscal year 2014, 2013 or 2012.

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The following table summarizes information about stock options outstanding and exercisable at October 31, 2014:

	Options Outstanding			Options Exercisable	
Range of Exercise Prices	Number outstanding	Weighted Average Remaining Contractual Life	Weighted Average Exercise Price	Number exercisable	Weighted Average Exercise Price
\$0.26 — \$5.10	1,367,028	7.0	\$1.89	1,293,606	\$1.86
\$5.11 — \$9.92	1,218,404	2.4	\$8.09	1,218,404	\$8.09
\$9.93 — \$14.74	442,648	1.5	\$10.60	442,648	\$10.60
	3,028,080	4.3	\$5.66	2,954,658	\$5.74

There was no intrinsic value for options outstanding and exercisable at October 31, 2014.

Restricted Stock Awards and Units

The following table summarizes our RSA and RSU activity for the year ended October 31, 2014:

Restricted Stock Awards and Units	Shares	Weighted-Average Price
Outstanding at October 31, 2013	5,036,104	\$1.20
Granted	1,410,479	\$2.39
Vested	(1,654,775)	\$1.36
Forfeited	(67,728)	\$1.24
Outstanding at October 31, 2014	4,724,080	\$1.49

RSA and RSU expense is based on the fair value of the award at the date of grant and is amortized over the vesting period, which is generally four years. At October 31, 2014, there were 4.7 million outstanding RSAs and RSUs had an average remaining life of 2.5 years and an aggregate intrinsic value of \$8.8 million.

At October 31, 2014, total compensation cost related to nonvested stock options and RSAs including RSUs not yet recognized was \$0.1 million and \$5.5 million, respectively, which is expected to be recognized over the next 0.4 and 2.5 years, respectively, on a weighted-average basis.

Stock Awards

Stock may be issued to employees as part of the annual incentive bonus. During fiscal year 2012, we issued 550,355 shares of common stock, respectively, in lieu of cash bonuses, with a value of \$0.6 million to fulfill the accrued obligation from the prior fiscal year. Beginning in fiscal year 2013, the bonus was paid in cash to fulfill the accrued obligation from the prior fiscal year and no stock awards were issued for fiscal year 2013 and fiscal year 2014.

During the years ended October 31, 2014 and 2013, we awarded 11,570 shares and 29,787 shares, respectively, of fully vested, unrestricted shares of common stock to the independent members of our board of directors as a component of board of director compensation which resulted in recognizing \$0.1 million or less of expense for each of the respective years.

Employee Stock Purchase Plan

Under the ESPP, eligible employees have the right to purchase shares of common stock at the lesser of (i) 85 percent of the last reported sale price of our common stock on the first business day of the offering period, or (ii) 85 percent of the last reported sale price of the common stock on the last business day of the offering period, in either case rounded up to avoid impermissible trading fractions. Shares issued pursuant to the ESPP contain a legend restricting the transfer or sale of such common stock for a period of six months after the date of purchase. At October 31, 2014, there were 282,209 shares of common stock available for issuance under the ESPP.

ESPP activity for the year ended October 31, 2014 was as follows:

ESPP	Number of Shares
Balance at October 31, 2013	549,584
Issued @ $0.85	(124,334)
Issued @ $1.13	(143,041)
Available for issuance at October 31, 2014	282,209

The fair value of shares under the ESPP was determined at the grant date using the Black-Scholes option-pricing model with the following weighted average assumptions:

	2014	2013	2012
Expected life (in years)	0.5	0.5	0.5
Risk free interest rate	0.08 %	0.15 %	0.07 %
Volatility	75.0 %	75.0 %	92.0 %
Dividends yield	— %	— %	— %

The weighted-average fair value of shares issued under the ESPP during fiscal year 2014 was $1.00 per share.

Employee Tax-Deferred Savings Plans

We offer a 401(k) plan (the "Plan") to all full time employees that provides for tax-deferred salary deductions for eligible employees (beginning the first month following an employee's hire date). Employees may choose to make voluntary contributions of their annual compensation to the Plan, limited to an annual maximum amount as set periodically by the Internal Revenue Service. Employee contributions are fully vested when made. Under the Plan, there is no option available to the employee to receive or purchase our common stock. After suspending our matching contribution in February 2009, we commenced matching contributions of 1 percent in January 2012 and increased the amount to 2 percent in January 2013. Matching contributions under the Plan were $0.3 million and $0.3 million for the years ended October 31, 2014 and 2013, respectively.

Note 15. Income Taxes

The components of loss from continuing operations before income taxes for the years ended October 31, 2014, 2013, and 2012 were as follows:

	2014	2013	2012
U.S.	$(35,167)	$(31,044)	$(35,535)
Foreign	(3,228)	(3,904)	(302)
Loss before income taxes	$(38,395)	$(34,948)	$(35,837)

There was current income tax expense of $0.5 million, $0.4 million and $0.07 million related to foreign withholding taxes and income taxes in South Korea and no deferred federal income tax expense (benefit) for each of the years ended October 31, 2014, 2013 and 2012, respectively. Franchise tax expense, which is included in administrative and selling expenses, was $0.2 million for the years ended October 31, 2014, 2013 and 2012, respectively.

The reconciliation of the federal statutory income tax rate to our effective income tax rate for the years ended October 31, 2014, 2013 and 2012 was as follows:

	2014	2013	2012
Statutory federal income tax rate	(34.0)%	(34.0)%	(34.0)%
Increase (decrease) in income taxes resulting from:			
State taxes net of Federal benefits	(1.8)%	(1.7)%	(2.6)%
Foreign withholding tax	1.0 %	0.9 %	0.2 %
Net operating loss adjustment and true-ups	(25.4)%	0.1 %	(34.9)%
Nondeductible expenditures	14.5 %	0.8 %	1.2 %
Change in state tax rate	(0.8)%	10.5 %	(6.8)%
Other, net	0.4 %	4.1 %	(0.1)%
Valuation allowance	47.1 %	20.3 %	77.2 %
Effective income tax rate	1.0 %	1.0 %	0.2 %

Our deferred tax assets and liabilities consisted of the following at October 31, 2014 and 2013:

	2014	2013
Deferred tax assets:		
Compensation and benefit accruals	$7,591	$6,452
Bad debt and other reserves	1,859	1,841
Capital loss and tax credit carry-forwards	13,486	13,582
Net operating losses (domestic and foreign)	247,170	228,154
Deferred license revenue	8,894	8,033
Lower of cost or market inventory reserves	521	509
Investment in partnerships	404	419
Accumulated depreciation	590	625
Gross deferred tax assets:	280,515	259,615
Valuation allowance	(280,515)	(259,615)
Deferred tax assets after valuation allowance	—	—
Deferred tax liability:		
In process research and development	(3,377)	(3,377)
Net deferred tax liability	$(3,377)	$(3,377)

We continually evaluate our deferred tax assets as to whether it is “more likely than not” that the deferred tax assets will be realized. In assessing the realizability of our deferred tax assets, management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies. Based on the projections for future taxable income over the periods in which the deferred tax assets are realizable, management believes that significant uncertainty exists surrounding the recoverability of the deferred tax assets. As a result, we recorded a full valuation allowance against our deferred tax assets. Approximately $4.3 million of the valuation allowance will reduce additional paid in capital upon subsequent recognition of any related tax benefits. In connection with our acquisition of Versa we recorded a deferred tax liability for IPR&D, which has an indefinite life. Accordingly, we do not consider it to be a source of taxable income in evaluating the recoverability of our deferred tax assets.

At October 31, 2014, we had federal and state NOL carryforwards of $655.0 million and $396.0 million, respectively, for which a portion of the NOL has not been recognized in connection with share-based compensation. The Federal NOL carryforwards expire in varying amounts from 2020 through 2034 while state NOL carryforwards expire in varying amounts from fiscal year 2014 through 2034. Additionally, we had $10.4 million of state tax credits available, of which $1.0 million expires in fiscal year 2018. The remaining credits do not expire.

Certain transactions involving the Company’s beneficial ownership occurred in fiscalyear 2014 and prior years, which could have resulted in a stock ownership change for purposes of Section 382 of the Internal Revenue Code of 1986, as amended. We have completed a detailed Section 382 study in fiscal year 2014 to determine if any of our NOL and credit carryovers will be subject to limitation. Based on that study we have determined that there was no ownership change as of the end of our fiscal year 2014 under Section 382. The acquisition of VERSA in the prior fiscal year triggered a Section 382 ownership change which will limit

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the future usage of some of the Federal and state NOLs. The Federal and state NOLs that are non 382-limited are included in the NOL deferred tax assets as disclosed.

As discussed in Note 1, the Company's financial statements reflect expected future tax consequences of uncertain tax positions that the Company has taken or expects to take on a tax return (including a decision whether to file or not file a return in a particular jurisdiction) presuming the taxing authorities' full knowledge of the position and all relevant facts.

The liability for unrecognized tax benefits at October 31, 2014 and 2013 was $15.7 million. This amount is directly associated with a tax position taken in a year in which federal and state NOL carryforwards were generated. Accordingly, the amount of unrecognized tax benefit has been presented as a reduction in the reported amounts of our federal and state NOL carryforwards. It is our policy to record interest and penalties on unrecognized tax benefits as income taxes; however, because of our significant NOLs, no provision for interest or penalties has been recorded.

We file income tax returns in the U.S. and various states, primarily Connecticut and California, as well as income tax returns required internationally for South Korea and Germany. We are open to examination by the Internal Revenue Service and various states in which we file for fiscal years 1998 to the present. We are currently not under any income tax examinations.

Note 16. Earnings Per Share

Basic earnings (loss) per common share ("EPS") are generally calculated as income (loss) available to common shareholders divided by the weighted average number of common shares outstanding. Diluted EPS is generally calculated as income (loss) available to common shareholders divided by the weighted average number of common shares outstanding plus the dilutive effect of common share equivalents.

The calculation of basic and diluted EPS for the years ended October 31, 2014, 2013 and 2012 was as follows:

	2014	2013	2012
Numerator			
Net loss	$(38,883)	$(35,319)	$(35,906)
Net loss attributable to noncontrolling interest	758	961	411
Preferred stock dividend	(3,200)	(3,200)	(3,201)
Net loss to common shareholders	$(41,325)	$(37,558)	$(38,696)
Denominator			
Weighted average basic common shares	245,686,983	186,525,001	165,471,261
Effect of dilutive securities (1)	—	—	—
Weighted average diluted common shares	245,686,983	186,525,001	165,471,261
Basic loss per share	(0.17)	(0.20)	(0.23)
Diluted loss per share (1)	(0.17)	(0.20)	(0.23)

(1) Due to the net loss to common shareholders in each of the years presented above, diluted earnings per share was computed without consideration to potentially dilutive instruments as their inclusion would have been antidilutive. Potentially dilutive instruments include stock options, warrants, unvested RSAs and RSUs, convertible preferred stock and convertible notes. At October 31, 2014, 2013 and 2012, there were options to purchase 3.0 million, 3.2 million and 3.1 million shares of common stock, respectively and at October 31, 2014 and 2013, there were warrants to purchase 5.75 million and 5.0 million, respectively shares of common stock that were not included in the calculation of diluted earnings per share as they would be antidiulutive. There were no warrants outstanding at October 31, 2012.

Note 17. Commitments and Contingencies

Lease agreements

At October 31, 2014 and 2013, we had capital lease obligations of $0.7 million and $0.5 million, respectively. Lease payment terms are thirty-six months from the date of lease.

We also lease certain computer and office equipment and manufacturing facilities in Torrington, and Danbury, Connecticut under operating leases expiring on various dates through 2015. Rent expense was $1.7 million, $1.6 million and $1.6 million for the years ended October 2014, 2013 and 2012, respectively.

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Non-cancelable minimum payments applicable to operating and capital leases at October 31, 2014 were as follows:

	Operating Leases	Capital Leases
2015	$1,978	$276
2016	1,087	310
2017	711	110
2018	578	20
2019	330	5
Thereafter	318	—
Total	$5,002	$721

Service and warranty agreements

Under the provisions of our service agreements, we provide services to maintain, monitor, and repair customer power plants to meet minimum operating levels. Under the terms of our service agreements, the power plant must meet a minimum operating output during the term. If minimum output falls below the contract requirement, we may be subject to performance penalties and/or may be required to repair or replace the customer's fuel cell module. An estimate is not recorded for a potential performance guarantee liability until a performance issue has occurred on a particular power plant. At that point, the actual power plant's output is compared against the minimum output guarantee and an accrual is recorded. The review of power plant performance is updated for each reporting period to incorporate the most recent performance of the power plant and minimum output guarantee payments made to customers, if any. The Company has provided for an accrual for performance guarantees, based on actual historical fleet performance, which totaled $0.8 million and $0.5 million at October 31, 2014 and 2013, respectively, and is recorded in Accrued Liabilities.

Our loss accrual on service agreements, excluding the accrual for performance guarantees, totaled $3.0 million and $3.7 million at October 31, 2014 and 2013, respectively and is recorded in Accrued Liabilities. Our accrual estimates are performed on a contract by contract basis and include cost assumptions based on what we anticipate the service requirements will be to fulfill obligations for each contract.

Power purchase agreements

Under the terms of our PPAs, customers agree to purchase power from our fuel cell power plants at negotiated rates. Electricity rates are generally a function of the customers' current and future electricity pricing available from the grid. As owner of the power plants, we are responsible for all operating costs necessary to maintain, monitor and repair the power plants. Under certain agreements, we are also responsible for procuring fuel, generally natural gas, to run the power plants. We are typically not required to produce minimum amounts of power under our PPA agreements and we typically have the right to terminate PPA agreements by giving written notice to the customer, subject to certain exit costs.

Other

We are involved in legal proceedings, claims and litigation arising out of the ordinary conduct of our business. Although we cannot assure the outcome, management presently believes that the result of such legal proceedings, either individually, or in the aggregate, will not have a material adverse effect on our consolidated financial statements, and no material amounts have been accrued in our consolidated financial statements with respect to these matters.

Note 18. Supplemental Cash Flow Information

The following represents supplemental cash flow information:

	Year Ended October 31,		
	2014	2013	2012
Cash interest paid	$1,892	$280	$302
Income taxes paid	$35	17	—
Noncash financing and investing activity:			
Common stock issued for convertible note conversions and make-whole settlements	$46,186	$—	$—
Common stock issued for employee annual incentive bonus	$—	—	550
Common stock issued for Employee Stock Purchase Plan in settlement of prior year accrued employee contributions	$106	85	84
Common stock issued for acquisition of Versa	$—	3,563	—
Accrued sale of common stock, cash received in a subsequent period	$633	509	$—

Note 19. Quarterly Information (Unaudited)

Selected unaudited financial data for each quarter of fiscal year 2014 and 2013 is presented below. We believe that the information reflects all normal recurring adjustments necessary for a fair presentation of the information for the periods presented.

	First Quarter	Second Quarter	Third Quarter	Fourth Quarter	Full Year
Year ended October 31, 2014					
Revenues	$44,434	$38,274	$43,176	$54,409	$180,293
Gross profit	2,199	1,611	3,961	5,955	13,726
Loss on operations	(7,570)	(8,773)	(6,000)	(4,968)	(27,311)
Net loss	(10,815)	(16,039)	(7,139)	(4,890)	(38,883)
Preferred stock dividends	(800)	(800)	(800)	(800)	(3,200)
Net loss to common shareholders	(11,404)	(16,643)	(7,778)	(5,500)	(41,325)
Net loss to common shareholders per basic and diluted common share (1)	$(0.06)	$(0.07)	$(0.03)	$(0.02)	$(0.17)
Year ended October 31, 2013					
Revenues	$36,358	$42,436	$53,707	$55,157	$187,658
Gross profit (loss)	(2,311)	2,314	4,522	2,597	7,122
Loss on operations	(11,070)	(7,197)	(4,594)	(6,952)	(29,813)
Net loss	(11,879)	(7,629)	(5,814)	(9,997)	(35,319)
Preferred stock dividends	(800)	(800)	(800)	(800)	(3,200)
Net loss to common shareholders	(12,481)	(8,165)	(6,412)	(10,500)	(37,558)
Net loss to common shareholders per basic and diluted common share (1)	$(0.07)	$(0.04)	$(0.03)	$(0.06)	(0.20)

(1) The full year net loss to common shareholders basic and diluted share may not equal the sum of the quarters due to weighting of outstanding shares.

Item 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

Item 9A. CONTROLS AND PROCEDURES

Disclosure Controls and Procedures.

The Company maintains disclosure controls and procedures, which are designed to provide reasonable assurance that information required to be disclosed in the Company's periodic SEC reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

We carried out an evaluation, under the supervision and with the participation of our principal executive officer and principal financial officer, of the effectiveness of the design and operation of our disclosure controls and procedures as of the end of the period covered by this report. Based on that evaluation, the Company's principal executive officer and principal financial officer have concluded that the Company's disclosure controls and procedures were effective to provide reasonable assurance that information required to be disclosed in the Company's periodic SEC reports is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to its principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure.

Management's Annual Report on Internal Control Over Financial Reporting.

We, as members of management of FuelCell Energy, Inc., and its subsidiaries (the "Company"), are responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles in the United States of America. Internal control over financial reporting includes those policies and procedures that:

- Pertain to the maintenance of records that in reasonable detail accurately and fairly reflect the transactions and dispositions of the assets of the Company;
- Provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles of the United States of America, and that receipts and expenditures of the Company are being made only in accordance with authorizations of management and directors of the Company; and
- Provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of the Company's assets that could have a material effect on the financial statements.

Under the supervision and with the participation of management, including our principal executive and financial officers, we assessed the Company's internal control over financial reporting as of October 31, 2014, based on criteria for effective internal control over financial reporting established in the Internal Control — Integrated Framework (1992), issued by the Committee of Sponsoring Organizations of the Treadway Commission ("COSO"). Based on this assessment, we have concluded that the Company maintained effective internal control over financial reporting as of October 31, 2014 based on the specified criteria.

Changes in Internal Control Over Financial Reporting.

There have been no changes in the Company's internal controls over financial reporting during the most recent fiscal quarter that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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Item 9B. OTHER INFORMATION

None.

PART III

Item 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

The information required by this Item 10, with respect to our executive officers, is included in Part I of the Annual Report on Form 10-K. The other information required by this Item 10 is incorporated by reference to the Company's 2014 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 11. EXECUTIVE COMPENSATION

Information required under this Item is incorporated by reference to the Company's 2014 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

Information required under this Item is incorporated by reference to the Company's 2014 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

Information required under this Item is incorporated by reference to the Company's 2014 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

Item 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

Information required under this Item is incorporated by reference to the Company's 2014 Proxy Statement to be filed with the SEC within 120 days from fiscal year end.

PART IV

Item 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

The following documents are filed as part of this report:

1. Financial Statements — See Index to Consolidated Financial Statements at Item 8 of the Annual Report on Form 10-K.
2. Financial Statement Schedules — Supplemental schedules are not provided because of the absence of conditions under which they are required or because the required information is given in the financial statements or notes thereto
3. Exhibits — The following exhibits are filed as part of, or incorporated by reference into, this Annual Report on Form 10-K.

EXHIBITS TO THE 10-K

Exhibit No.	Description
3.1	Certificate of Incorporation of the Registrant, as amended, July 12, 1999 (incorporated by reference to exhibit of the same number contained in the Company's Form 8-K dated September 21, 1999)
3.2	Certificate of Amendment of the Certificate of Incorporation of the Registrant, dated October 31, 2003 (incorporated by reference to exhibit of the same number contained in the Company's Form 8-K dated November 4, 2003)
3.3	Certificate of Amendment of the Certificate of Incorporation of the Registrant (incorporated by reference to exhibit 3.3 of the Company's Form 10-K dated January 14, 2013).
3.4	Amended and Restated By-Laws of the Registrant, dated December 15 , 2011 (incorporated by reference to exhibit 3.1.1 of the same number contained in the Company's Form 8-K dated December 21, 2011)
4	Specimen of Common Share Certificate (incorporated by reference to exhibit of the same number contained in the Company's Annual Report on Form 10K/A for fiscal year ended October 31, 1999)
4.2	Schedule A to Articles of Amendment of FuelCell Energy, Ltd., setting forth the rights, privileges, restrictions and conditions of Class A Cumulative Redeemable Exchangeable Preferred Shares (incorporated by reference to exhibit of the same number contained in the Company's Form 10-Q for the period ended January 31, 2009).
4.3	Certificate of Designation for the 5% Series B Cumulative Convertible Perpetual Preferred Stock (Liquidation Preference $1,000) (incorporated by reference to Exhibit 3.1 contained in the Company's Form 8-K, dated November 22, 2004).
10.1	** Alliance Agreement between FuelCell Energy, Inc. and POSCO Energy, dated as of February 7, 2007 (incorporated by reference to exhibit of the same number contained in the Company's Form 10-Q/A for the period ended January 31, 2009).
10.2	** Technology Transfer, License and Distribution Agreement between FuelCell Energy, Inc. and POSCO Energy, dated as of February 7, 2007 (incorporated by reference to exhibit of the same number contained in the Company's Form 10-Q/A for the period ended January 31, 2009).
10.3	Loan agreement, dated April 29, 2008, between the Company and the Connecticut Development Authority (incorporated by reference to exhibit of the same number contained in the Company's Form 10-Q for the period ended January 31, 2009).
10.4	**Stack Technology Transfer and License Agreement dated as of October 27, 2009, by and between FuelCell Energy, Inc. and POSCO Energy (incorporated by reference to exhibit 10.1 of the Company's Form 8-K, dated November 2, 2009).
10.5	**Contract for the Supply of DFC Modules and DFC Components dated as of June 9, 2009, by and between FuelCell Energy, Inc. and POSCO Energy (incorporated by reference to exhibit 10.2 of the Company's Form 8-K, dated November 2, 2009).

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Exhibit No.	Description
10.36	*The FuelCell Energy, Inc. Section 423 Stock Purchase Plan (incorporated by reference to exhibit of the same number contained in the Company's 10-KSB for fiscal year ended October 31, 1994 dated January 18, 1995)
10.37	*Amendment to the The FuelCell Energy, Inc. Section 423 Stock Purchase Plan (incorporated by reference to Annex A contained in the Company's DEF 14A dated February 23, 2011)
10.54	*The FuelCell Energy, Inc. 1998 Equity Incentive Plan (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 1998)
10.55	Lease agreement, dated March 8, 2000, between the Company and Technology Park Associates, L.L.C. (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended April 30, 2000)
10.56	Security agreement, dated June 30, 2000, between the Company and the Connecticut Development Authority (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 2000)
10.57	Loan agreement, dated June 30, 2000, between the Company and the Connecticut Development Authority (incorporated by reference to exhibit of the same number contained in the Company's 10-Q for the period ended July 31, 2000)
10.58	*The FuelCell Energy, Inc. 2006 Equity Incentive Plan (incorporated by reference to the Company's S-8 filing on January 23, 2007)
10.59	*Amended and Restated 2010 Equity Incentive Plan (incorporated by reference to the exhibit of the same number contained in the Company's Form 8-K dated March 21, 2012).
10.63	Intracreditor Subordination and Confirmation Agreement made and effective as of January 4, 2011 by JPMorgan Chase Bank, N.A. (incorporated by reference to exhibit of the same number contained in the Company's 10-K for the period ended October 31, 2010 dated January 14, 2011)

Exhibit No.	Description
10.65	*Employment Agreement, dated January 28, 2010 between FuelCell Energy, Inc. and Arthur Bottone, Senior Vice President, Chief Commercial Officer (incorporated by reference to exhibit of the same number contained in the Company’s 10-K for the period ended October 31, 2010 dated January 14, 2011).
10.66	*First Amendment to Employment Agreement, dated December 19, 2011 and effective as of January 1, 2012 between FuelCell Energy, Inc. and Arthur Bottone, President and Chief Executive Officer (incorporated by reference to exhibit 10.3 of the Company’s Form 8-K dated December 23, 2011).
10.67	*Employment Agreement, dated March 21, 2012 and effective as of January 1, 2012 between FuelCell Energy, Inc. and Anthony Rauseo, Chief Operating Officer (incorporated by reference to the exhibit of the same number contained in the Company’s Form 8-K, dated March 31, 2012).
10.68	*Employment Agreement, dated March 21, 2012 and effective as of January 1, 2012 between FuelCell Energy, Inc. and Michael Bishop, Chief Financial Officer (incorporated by reference to the exhibit of the same number contained in the Company's Form 8-K, dated March 21, 2012).
10.69	Letter Agreement dated March 31, 2011, Guarantee dated April 1, 2011 by and between the Company and Enbridge, Inc. and Revised Special Rights and Restrictions attributable to the Class A Preferred Stock of FuelCell Energy, Ltd. for each (incorporated by reference to the Company’s Form 8-K dated April 6, 2011).
10.70	Second Amendment dated January 4, 2012 to the Export loan agreement dated January 4, 2012, between the Company and JPMorgan Chase Bank, N.A. (incorporated by reference to the exhibit of the same number contained in the Company's 10-K for the year ended October 31, 2011).
10.71	Securities Exchange Agreement dated December 20, 2012 by and among the Company and Versa Power Systems Inc., and the stockholders of Versa Power Systems Inc., (incorporated by reference to the Company's Form 8-K dated December 20, 2012).
10.72	Purchase and Sale Contract dated October 31, 2012 by and between POSCO Energy Co., LTD. and the Company (incorporated by reference to the Company's Form 8-K dated as of October 31, 2012).
10.73	Cell Technology Transfer and License Agreement dated October 31, 2012 by and between the Company and POSCO Energy, Co., LTD (incorporated by reference to the Company's Form 8-K dated as of October 31, 2012 and the Company's Form 8-K/A dated as of January 7, 2013).

Exhibit No.	Description
10.74	Amendment to Technology Transfer Distribution and Licensing Agreement dated as of February 7, 2007 and the Stack Technology Transfer License Agreement dated as of October 27, 2009, each by and between the Company and POSCO Energy, Co., LTD (incorporated by reference to the Company's Form 8-K dated as of October 31, 2012).
10.75	Underwriting Agreement, dated as of March 22, 2012, among the Company, Lazard Capital Markets LLC, Stifel, Nicolaus & Company, Incorporated and FBR Capital Markets & Co. (incorporated by reference to exhibit 1.1 of the Company's Form 8-K dated March 22, 2012).
10.76	Securities Purchase Agreement, dated April 30, 2012, by and between the Company and POSCO Energy Co., Ltd, dated April 30, 2012 (incorporated by reference to exhibit 10.1 of the Company's Form 8-K dated April 30, 2012).
10.77	Underwriting Agreement, dated as of June 19, 2013, between the Company and Lazard Capital Markets LLC as representative of the several underwriters named therein (incorporated by reference to Exhibit 10.1 of the Company’s Form 8-K, dated June 20, 2013).
10.78	Export Loan Agreement, dated as of August 1, 2014, between the Company and JPMorgan Chase Bank, N.A. (incorporated by reference to Exhibit 10.61 of the Company’s Form 8-K, dated August 1, 2014).
10.79	Promissory Note of the Company, dated August 1, 2014, to JPMorgan Chase Bank, N.A. (incorporated by reference to Exhibit 10.64 of the Company’s Form 8-K, dated August 1, 2014).
10.80	Loan Agreement, dated as of March 5, 2013, between Clean Energy Finance and Investment Authority, as Lender, and the Company, as Borrower (incorporated by reference to Exhibit 10.69 of the Company’s Form 8-K, dated March 12, 2013).
10.81	Security Agreement, dated March 5, 2013, by the Company in favor of the Clean Energy Finance and Investment Authority (incorporated by reference to Exhibit 10.70 of the Company’s Form 8-K, dated March 12, 2013).
10.82	Securities Purchase Agreement, dated July 30, 2014, between the Company and NRG Energy, Inc. (incorporated by reference to Exhibit 10.82 of the Company's Form 10-Q for the quarter ended July 31, 2014).
10.83	Loan Agreement, dated July 20, 2014, between FuelCell Energy Finance, LLC and NRG Energy (incorporated by reference to Exhibit 10.83 of the Company's Form 10-Q for the quarter ended July 31, 2014).
14	Code of Ethics applicable to the Company’s principal executive officer, principal financial officer and principal accounting officer. (incorporated by reference to exhibit of the same number contained in the Company’s 10-K for the year ended October 31, 2003)
21	Subsidiaries of the Registrant
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Certification of Chief Executive Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002

31.2	Certification of Chief Financial Officer pursuant to Section 302 of the Sarbanes Oxley Act of 2002

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Exhibit No.	Description
32.1	Certification of Chief Executive Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002
32.2	Certification of Chief Financial Officer pursuant to Section 906 of the Sarbanes Oxley Act of 2002
101.SCH#	XBRL Schema Document
101.INS#	XBRL Instance Document
101.CAL#	XBRL Calculation Linkbase Document
101.LAB#	XBRL Labels Linkbase Document
101.PRE#	XBRL Presentation Linkbase Document
101.DEF#	XBRL Definition Linkebase Document

The exhibits marked with the section symbol (#) are interactive data files. Pursuant to Rule 406T of Regulation S-T, these interactive data files (i) are not deemed filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, are not deemed filed for purposes of Section 18 of the Securities Exchange Act of 1934, irrespective of any general incorporation language included in any such filings, and otherwise are not subject to liability under these sections; and (ii) are deemed to have complied with Rule 405 of Regulation S-T ("Rule 405") and are not subject to liability under the anti-fraud provisions of the Section 17(a)(1) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 or under any other liability provision if we have made a good faith attempt to comply with Rule 405 and, after we become aware that the interactive data files fail to comply with Rule 405, we promptly amend the interactive data files.

* Management Contract or Compensatory Plan or Arrangement

** Confidential Treatment has been granted for portions of this document

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized on January 9, 2015.

FUELCELL ENERGY, INC.

/s/ Arthur A. Bottone Arthur A. Bottone President, Chief Executive Officer and Director	Dated: January 9, 2015

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

Signature	Capacity	Date
/s/ Arthur A. Bottone Arthur A. Bottone	President, Chief Executive Officer and Director (Principal Executive Officer)	January 9, 2015
/s/ Michael S. Bishop Michael S. Bishop	Senior Vice President, Chief Financial Officer, Treasurer and Corporate Secretary (Principal Accounting and Financial Officer)	January 9, 2015
/s/ Richard A. Bromley Richard A. Bromley	Director	January 6, 2015
/s/ James H. England James H. England	Director	January 6, 2015
/s/ William A. Lawson William A. Lawson	Director	January 8, 2015
/s/ John A. Rolls John A. Rolls	Director - Chairman of the Board	January 7, 2015
/s/ Christopher S. Sotos Christopher S. Sotos	Director	January 8, 2015
/s/ Togo Dennis West Jr. Togo Dennis West Jr.	Director	January 6, 2015

INDEX OF EXHIBITS

Exhibit 21	Subsidiaries of the Registrant
Exhibit 23.1	Consent of Independent Registered Public Accounting Firm
Exhibit 31.1	CEO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 31.2	CFO Certification pursuant to Section 302 of the Sarbanes-Oxley Act of 2002
Exhibit 32.1	CEO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
Exhibit 32.2	CFO Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002
101.INS	XBRL Instance Document
101.SCH	XBRL Schema Document
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101.LAB	XBRL Labels Linkbase Document
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