<u>SOUTHEAST COMMUNITY CAPITAL CORPORATION</u>

<u>REPORT ON APPLICATION OF ACCOUNTING PRINCIPLES TO SPECIFIED TRANSACTIONS</u>

<u>MAY 22, 2007</u>

Board of Directors
Southeast Community Capital Corporation
Nashville, Tennessee

We have been engaged to report on the appropriate application of accounting principles generally accepted in the United States of America to the specific transactions described below. This report is being issued to Southeast Community Capital Corporation for assistance in evaluating accounting principles applicable to participating Tennessee financial institutions for the specific transactions, as described below. Our engagement has been conducted in accordance with standards established by the American Institute of Certified Public Accountants.

DESCRIPTION OF TRANSACTIONS

The facts, circumstances and assumptions relevant to the specific transactions, as provided to us by management of Southeast Community Capital Corporation (the "Corporation"), are as follows:

> The Corporation is a not-for-profit corporation exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code. The Corporation has developed the Tennessee Rural Opportunity Fund (the "Fund") to create a permanent $10,000,000 loan fund targeted to assist disadvantaged small businesses in rural areas of Tennessee. In order to provide the capital for this Fund, the Corporation will seek below-market rate loans from participating Tennessee financial institutions. Based on anticipated future state tax legislation designed as an incentive for Tennessee financial institutions to participate in such programs, an investing bank will receive a Tennessee Franchise and Excise tax credit each year for the next ten years, in the amount of 10% of the amount of qualifying loans made and outstanding. Each such loan will bear interest at the rate of 3% per annum, payable quarterly. At the end of 10 years, the investing bank may make a charitable donation to the Corporation in the form of forgiveness of the loan(s), thereby creating a potential federal income tax deduction for the bank. The state tax legislation is further anticipated to provide that, should the investing bank elect not to forgive the loan, the bank would forfeit and be liable for repayment of all such previously claimed state tax credits, plus applicable penalties and interest, to the State of Tennessee.

The Corporation has requested guidance on the appropriate application of accounting principles generally accepted in the United States of America to account for the above transactions by an investing bank (the "Bank") that elects to participate in the Fund.

APPLICATION OF CURRENT ACCOUNTING PRINCIPLES, GUIDANCE AND STANDARDS

The Financial Accounting Standards Board ("FASB") issued Concept Statement 1 - *Objectives of Financial Reporting by Business Enterprises* in November 1978, Concept Statement 5 - *Recognition and Measurement in Financial Statements of Business Enterprises* in December 1984, and Concept Statement 6 - *Elements of Financial Statements* in December 1985. These Statements of Financial Accounting Concepts are a series of publications in the FASB's conceptual framework for financial accounting and reporting. Statements in the series are intended to set forth objectives and fundamentals as the basis for development of financial accounting and reporting standards. The objectives identify the goals and purposes of financial reporting. The fundamentals are the underlying concepts of financial accounting that guide the selection of transactions, events, and circumstances to be accounted for; their recognition and measurement; and the means of summarizing and communicating them to interested parties. These statements were referred to and relied upon, in part, in reaching the following conclusions:

LOAN AND INTEREST INCOME RECOGNITION

Concept Statement 6, paragraphs 25-26, state *Assets are probable future economic benefits obtained or controlled by a particular entity as a result of past transactions or events.* Therefore, at the time a Bank makes a loan to the Corporation as funding for the Tennessee Rural Opportunity Fund, an unsecured loan should be recorded by the Bank that will accrue interest at the agreed-upon fixed rate of 3% per annum, payable quarterly.

Concept Statement 6, paragraph 78 states, *Revenues are inflows or other enhancements of assets of an entity or settlements of its liabilities (or a combination of both) from delivering or producing goods, rendering services, or other activities that constitute the entity's ongoing major or central operations.* Accordingly, the Bank should recognize interest income in accordance with Concept Statement 5, paragraph 83, in the period realized or realizable and earned.

DONATION PAYABLE AND EXPENSE RECOGNITION

Concept Statement 5, paragraph 85 states, *Expenses and losses are generally recognized when an entity's economic benefits are used up in delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations or when previously recognized assets are expected to provide reduced or no further benefits.*

Concept Statement 6, paragraph 35 states, *Liabilities are probable future sacrifices of economic benefits arising from present obligations of a particular entity to transfer assets or provide services to other entities in the future as a result of past transactions or events.* Furthermore, Concept Statement 1, paragraph 44 states, *Accrual accounting attempts to record the financial effects on an enterprise of transactions and other events and circumstances that have cash consequences for an enterprise in the periods in which those transactions, events, and circumstances occur rather than only in the periods in which cash is received or paid by the enterprise.*

Under the anticipated future tax legislation referred to above, a participating financial institution would be required to repay all Franchise and Excise tax credits previously claimed under the program, plus applicable penalties and interest, with respect to any program loan(s) it did not forgive at the end of the ten-year term. This consequence would be considered an economic detriment to the Bank. Accordingly, the Bank should accrue a liability for the intended and expected eventual act of making the charitable donation to the Corporation in the form of forgiving the loan(s) it makes under the program. Therefore, on each anniversary date of the loan for ten years, the participating Bank should credit "Accrued donations payable" and debit "Charitable donations expense" in the amount of 10% of the dollar amount of the loan.

At the 10th anniversary, upon forgiveness of the loan by the Bank, the loan should be written off by a credit to "Loans receivable" and debit to "Accrued donations payable."

INCOME TAX CONSEQUENCES

Deferred Taxes:

For federal income tax purposes, charitable donations are generally deductible in the tax year paid, regardless of the donor's accounting method or when the contribution was pledged (IRC Reg. 1.170A-1(a)(1)). A contribution is "paid" (and becomes eligible to be claimed as a charitable donations deduction) when it is unconditionally delivered to the donee (IRC Reg. 1.170A-1(b)). Accordingly, the ten annual charitable donation accruals will not be deductible for tax purposes until the loan is legally forgiven and discharged (as scheduled to occur on the tenth anniversary date of the loan).

As a result, this will create a deductible temporary difference, as defined by Statement of Financial Accounting Standards (SFAS) No. 109, *Accounting for Income Taxes*, paragraph 13, equal to the difference between the expense recognized by the Bank for financial accounting purposes and the deduction claimed for income tax purposes. SFAS 109, paragraphs 16 and 17, prescribes that a deferred tax asset be recognized for financial statement purposes for the tax effect of this temporary difference. This asset should be calculated at the applicable federal and state statutory tax rates applied to the aggregate annual donation accruals at each anniversary date of making the loan. The amount of this deferred tax asset recognized in the financial statements could be limited based on the "more likely than not" criteria as defined in SFAS 109. This "more likely than not" criteria states than an entity should recognize a deferred tax asset only if the likelihood of realizing the future tax benefit is more than 50%. In the year in which the debt is forgiven, a charitable donation deduction will be claimed for tax purposes, subject to limitations described below, and the deferred tax asset for the tax effect of the deduction will be charged to expense.

In the year in which the debt is actually forgiven and discharged, and the charitable donation is deducted on the bank's federal and state income tax returns, the amount of the permitted deduction could be limited, resulting in continued deferral of tax benefits. The charitable donations deduction is limited at the federal level to 10% of (consolidated regular and consolidated alternative minimum) taxable income. This limitation is computed without regard to the (consolidated regular and consolidated AMT) charitable donation deduction and certain other items. Any contributions disallowed for federal tax purposes can be carried forward for five years. There are no such limitations for Tennessee Excise tax purposes.

Current Taxes:

Under the anticipated future state tax legislation referred to above, the participating Bank will be eligible to claim a Tennessee Franchise and Excise tax credit, in the amount of 10% of its total investment in the qualifying loan(s), for ten consecutive tax years, starting the year the loan is made. The credit will be a direct, dollar for dollar reduction of Tennessee franchise and excise taxes owed, thereby reducing the Bank's current period state tax expense. This tax credit is not expected to be refundable, nor will there be any carryforward provisions under the anticipated future state tax legislation referred to previously.

The treatment described above assumes the investing Bank is a C-Corporation, and files a Form 1120 corporate federal income tax return. Should the investing Bank be an S-Corporation, all transactions at the federal level would be passed through to the shareholders. The S election would not affect the reporting requirements for Tennessee State tax purposes.

REGULATORY CAPITAL

In addition to the accounting treatment outlined above, the Corporation also requested that we comment on the regulatory capital ramifications of these transactions to a Bank. Pursuant to the "Instructions for Preparation of Consolidated Reports of Condition and Income" (FFIEC 031 and 041), loans made by a participating Bank under this program would be classified as unsecured loans. Unsecured loans fall into the 100% risk weight category for regulatory reporting purposes, thereby requiring a dollar for dollar addition to capital in order to maintain the same capital ratios as before the transaction took place.

CONCLUDING COMMENTS

The ultimate responsibility for the decision on the appropriate application of accounting principles generally accepted in the United States of America for an actual transaction rests with the preparers of financial statements, who should consult with their continuing accountant. Our judgment on the appropriate application of accounting principles generally accepted in the United States of America for the described specific transaction is based solely on the facts provided to us as described above; should these facts and circumstances differ, our conclusion may change.

RESTRICTED USE

This report (including the illustration and sample accounting entries provided in Attachment A) is intended solely for the information and use of the board of directors and management of Southeast Community Capital Corporation, and investing banks that elect to participate in the Fund described above, and is not intended to be and should not be used by anyone other than these specified parties.

Kraft CPAs PLLC

Nashville, Tennessee
May 22, 2007

Southeast Community Capital Corporation
Attachment A
Sample Accounting Entries

The accounting entries set forth below are provided for illustration purposes only, based on the following additional assumptions:

Qualifying Loan Amount by Participating Bank: $100,000

Effective combined federal and state statutory tax rate used for deferred tax asset valuation: 38.29%

Interest receivable is accrued on a monthly basis.

The contribution payable and deferred tax calculation entries are made at year end.

Sample Entries:

Date	**General Ledger Account**	**Debit**	**Credit**
At Inception	Unsecured Loan	$ 100,000	
	Cash		$ 100,000
	To record the loan upon the disbursement of cash.		
Monthly	Accrued Interest Receivable	250	
	Interest Income		250
	To record the accrual of interest income at the rate of 3% per annum.		
Quarterly	Cash	750	
	Accrued Interest Receivable		750
	To record the quarterly interest payments received.		
Annually	Income Taxes Payable	10,000	
	Income Tax Expense		10,000
	To record the 10% Tennessee Franchise and Excise tax credit.		
Annually	Deferred Tax Asset	3,829	
	Deferred Income Tax Expense/Benefit		3,829
	To record the deferred tax asset arising from the deductible temporary difference relating to the charitable donation.		

Southeast Community Capital Corporation
Attachment A
Sample Accounting Entries
(Continued)

Date	General Ledger Account	Debit	Credit
Annually	Charitable Donation Expense	10,000	
	Accrued Donations Payable		10,000
	To record the accrued donation expense equal to 1/10 of the loan balance to be forgiven.		
At Forgiveness	Charitable Donation Payable	100,000	
	Unsecured Loan		100,000
	To record the forgiveness and formal discharge of the loan at the end of the 10-year period.		
At Forgiveness	Deferred Income Tax Expense	38,290	
	Deferred Tax Asset		38,290
	To record the utilization of the deferred tax asset upon forgiveness of the loan, thereby creating a charitable donation deduction for tax purposes.		