

PINNACLE BANKSHARES CORP  
Form 10-K  
March 28, 2012  
Table of Contents

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-K**

(Mark One)

**ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

**For the fiscal year ended December 31, 2011**

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: 000-23909**

**PINNACLE BANKSHARES CORPORATION**

(Exact name of registrant as specified in its charter)

|                                                                                          |                                                              |
|------------------------------------------------------------------------------------------|--------------------------------------------------------------|
| <b>Virginia</b><br>(State or other jurisdiction of<br>incorporation or organization)     | <b>54-1832714</b><br>(I.R.S. Employer<br>Identification No.) |
| <b>622 Broad Street, Altavista, Virginia</b><br>(Address of principal executive offices) | <b>24517-1830</b><br>(Zip Code)                              |
| <b>Registrant's telephone number, including area code (434) 369-3000</b>                 |                                                              |

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

| <b>Title of each class</b> | <b>Name of each exchange on which registered</b> |
|----------------------------|--------------------------------------------------|
| n/a                        | n/a                                              |

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

**Common stock, par value \$3.00**

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

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

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

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§ 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  No

## Edgar Filing: PINNACLE BANKSHARES CORP - Form 10-K

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 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.

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.

Large accelerated filer

Accelerated filer

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

Smaller reporting company

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

The aggregate market value of the issuer's common stock held by non-affiliates as of June 30, 2011 was \$10,101,976.

There were 1,496,589 shares of common stock of the issuer outstanding as of March 27, 2012.

### DOCUMENTS INCORPORATED BY REFERENCE

Portions of the 2011 Annual Report to Shareholders, which is attached hereto as Exhibit 13, are incorporated by reference in Part II of this report. Portions of the Proxy Statement for the Company's Annual Meeting of Shareholders to be held on April 10, 2012 are incorporated by reference in Part III of this report.

**Table of Contents**

**PINNACLE BANKSHARES CORPORATION**

**2011 FORM 10-K ANNUAL REPORT**

**TABLE OF CONTENTS**

**PART I**

|          |                                             |    |
|----------|---------------------------------------------|----|
| Item 1.  | <u>Business</u>                             | 3  |
|          | <u>General Development of Business</u>      |    |
|          | <u>Competition</u>                          |    |
|          | <u>Regulation and Supervision</u>           |    |
|          | <u>Employees</u>                            |    |
|          | <u>Executive Officers of the Registrant</u> |    |
| Item 1A. | <u>Risk Factors</u>                         | 15 |
| Item 1B. | <u>Unresolved Staff Comments</u>            | 15 |
| Item 2.  | <u>Properties</u>                           | 15 |
| Item 3.  | <u>Legal Proceedings</u>                    | 15 |
| Item 4.  | <u>Mine Safety Disclosures</u>              | 15 |

**PART II**

|          |                                                                                                                     |    |
|----------|---------------------------------------------------------------------------------------------------------------------|----|
| Item 5.  | <u>Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u> | 16 |
| Item 6.  | <u>Selected Financial Data</u>                                                                                      | 16 |
| Item 7.  | <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                        | 16 |
| Item 7A. | <u>Quantitative and Qualitative Disclosures about Market Risk</u>                                                   | 16 |
| Item 8.  | <u>Financial Statements and Supplementary Data</u>                                                                  | 16 |
| Item 9.  | <u>Changes In and Disagreements With Accountants on Accounting and Financial Disclosure</u>                         | 16 |
| Item 9A. | <u>Controls and Procedures</u>                                                                                      | 16 |
| Item 9B. | <u>Other Information</u>                                                                                            | 17 |

**PART III**

|          |                                                                                                       |    |
|----------|-------------------------------------------------------------------------------------------------------|----|
| Item 10. | <u>Directors, Executive Officers and Corporate Governance</u>                                         | 17 |
| Item 11. | <u>Executive Compensation</u>                                                                         | 17 |
| Item 12. | <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u> | 18 |
| Item 13. | <u>Certain Relationships and Related Transactions, and Director Independence</u>                      | 18 |
| Item 14. | <u>Principal Accountant Fees and Services</u>                                                         | 18 |

**PART IV**

|          |                                                |    |
|----------|------------------------------------------------|----|
| Item 15. | <u>Exhibits, Financial Statement Schedules</u> | 18 |
|          | <u>SIGNATURES</u>                              | 21 |

**Table of Contents**

**PART I**

**Item 1. Business.**  
**General Development of Business**

Pinnacle Bankshares Corporation, a Virginia corporation (the Company), was organized in 1997 and is registered as a bank holding company under the Bank Holding Company Act of 1956, as amended. The Company is headquartered in Altavista, Virginia. The Company conducts all of its business activities through the branch offices of its wholly-owned subsidiary bank, First National Bank (the Bank). The Company exists primarily for the purpose of holding the stock of its subsidiary, the Bank, and of such other subsidiaries as it may acquire or establish. The Company's administrative offices are located at 622 Broad Street, Altavista, Virginia.

The Bank was organized as a national bank in 1908 and commenced general banking operations in December of that year, providing services to commercial and agricultural businesses and individuals in the Altavista area. With an emphasis on personal service, the Bank today offers a broad range of commercial and retail banking products and services including checking, savings and time deposits, individual retirement accounts, merchant bankcard processing, residential and commercial mortgages, home equity loans, consumer installment loans, agricultural loans, investment loans, small business loans, commercial lines of credit and letters of credit. The Bank also offers a full range of investment, insurance and annuity products through its association with Infinex Investments, Inc. and Banker's Insurance, LLC.

The Bank serves a trade area consisting primarily of Campbell County, northern Pittsylvania County, eastern Bedford County, Amherst County and the city of Lynchburg from facilities located in Campbell County, Bedford County, the town of Altavista, the town of Amherst, the town of Rustburg and the city of Lynchburg, Virginia. In June 1999 the Company opened the Airport facility, located just outside the Lynchburg city limits, and in August 2000, opened the Old Forest Road facility, located on Old Forest Road in Lynchburg, and the Brookville Plaza facility, located on Timberlake Road in Lynchburg. In August 2004 the Company opened the Forest facility, located in Forest, Bedford County, Virginia. In July 2005 the Company opened the Smith Mountain Lake loan production facility, located in Moneta, Franklin County, Virginia and closed the facility in May 2011. In May 2006 the Company relocated the Brookville Plaza facility to Timberlake Road in Campbell County. In November 2006, the Company opened a temporary Amherst facility located in the town of Amherst. The Company opened a permanent Amherst facility on South Main Street in Amherst in March 2008. In February 2009, the Company opened the Rustburg facility, located on Village Highway in the Rustburg Marketplace Shopping Center, which further increases our presence in Campbell County.

The Bank has two wholly-owned subsidiaries. FNB Property Corp., which is a Virginia corporation, was formed to hold title to Bank premises real estate. FNB Property Corp. sold land held for sale in 2003 and purchased land in Forest, Virginia that was used to build the Forest facility. First Properties, Inc., also a Virginia corporation, was formed to hold title to other real estate owned. Eight properties valued at \$645,000 are being held in other real estate owned as of December 31, 2011.

**Competition**

The banking business in central Virginia is highly competitive with respect to both loans and deposits and is dominated by a number of major banks that have offices operating throughout the state and in the Company's market area. The Company actively competes for all types of deposits and loans with other banks and with nonbank financial institutions, including savings and loan associations, finance companies, credit unions, mortgage companies, insurance companies and other lending institutions.

Institutions such as brokerage firms, credit card companies and even retail establishments offer alternative investment vehicles such as money market funds as well as traditional banking services. Other entities (both public and private) seeking to raise capital through the issuance and sale of debt or equity securities also represent a source of competition for the Company with respect to the acquisition of deposits. Among the

## **Table of Contents**

advantages that the major banks have over the Company is their ability to finance extensive advertising campaigns and to allocate their investment assets to regions of highest yield and demand over a more diverse geographic area. Although major banks have these competitive advantages over small independent banks, the Company actively tries to turn the loss of local independent banks to its competitive advantage by soliciting customers who prefer the personal service offered by a small independent bank.

The Company does not depend upon a single customer or industry, the loss of which would have a material adverse effect on the Company's financial condition. The Company is located in a market rich in industrial and retail diversification.

The Company believes that its prompt response to lending requests is a key factor to the Company's competitive position in its primary service area. In addition, local decision-making and the accessibility of senior management to customers also distinguish the Company from other area financial institutions.

In order to compete with the other financial institutions in its primary service area, the Company relies principally upon local promotional activities, personal contact by its officers, directors, employees and stockholders and its ability to offer specialized services to customers. The Company's promotional activities emphasize the advantages of dealing with a local bank attuned to the particular needs of the community.

## **Regulation and Supervision**

Set forth below is a brief description of the material laws and regulations that affect the Company. The description of these statutes and regulations is only a summary and does not purport to be complete. This discussion is qualified in its entirety by reference to the statutes and regulations summarized below. No assurance can be given that these statutes or regulations will not change in the future.

**General.** The Company is subject to the periodic reporting requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), which include, but are not limited to, the filing of annual, quarterly and other reports with the Securities and Exchange Commission (the SEC). As an Exchange Act reporting company, the Company is directly affected by the Sarbanes-Oxley Act of 2002 (the SOX), which is aimed at improving corporate governance and reporting procedures and requires additional corporate governance measures and expanded disclosure with respect to the Company's corporate operations and internal controls. The Company is complying with the SEC and other rules and regulations implemented pursuant to the SOX and intends to comply with any applicable rules and regulations implemented in the future. Although the Company has incurred and will continue to incur additional expense in complying with the provisions of the SOX and the resulting regulations, this compliance has not had, and is not expected to have, a material impact on the Company's financial condition or results of operations.

When enacted in 2002, Section 404(a) of the SOX required public companies to include in their annual reports on Form 10-K an assessment from management of the effectiveness of the company's internal control over financial reporting, and Section 404(b) of the SOX required the company's auditor to attest to and report on management's assessment. From 2002 through 2012, the SEC had delayed implementation of Section 404(b) of the SOX for public companies with a public float below \$75 million (i.e. companies that are smaller reporting companies or non-accelerated filers). In July 2010, the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act) permanently exempted smaller reporting companies and non-accelerated filers from Section 404(b) of the SOX, and the SEC made conforming amendments to certain of its rules and forms in September 2010.

The Company is a bank holding company within the meaning of the Bank Holding Company Act of 1956 (the BHCA), and is registered as such with, and subject to the supervision of, the Board of Governors of the Federal Reserve System (the FRB). Generally, a bank holding company is required to obtain the approval of the FRB before it may acquire all or substantially all of the assets of any bank, and before it may acquire ownership or control of the voting shares of any bank if, after giving effect to the acquisition, the bank holding company would own or control more than 5% of the voting shares of such bank. The FRB's approval is also required for the merger or consolidation of bank holding companies. The Dodd-Frank Act amended provisions of the BHCA (and corresponding provisions of the Federal Deposit Insurance Act (the FDIA)) to require that a bank holding company be well capitalized and well managed before the FRB will approve an interstate bank acquisition or merger. Also as a result of the Dodd-Frank Act, banks also are able to branch across state lines, provided that the law of the state in

**Table of Contents**

which the branch is to be located would permit establishment of the branch if the bank were a state bank chartered by such state. Additionally, the FRB has the power to order any bank holding company or its subsidiaries to terminate any activity or to terminate its ownership or control of any subsidiary when the FRB has reasonable grounds to believe that continuation of such activity or ownership constitutes a serious risk to the financial soundness, safety or stability of any bank subsidiary of the bank holding company.

The Company is required to file periodic reports with the FRB and provide any additional information the FRB may require. The FRB also has the authority to examine the Company and the Bank, as well as any arrangements between the Company and the Bank, with the cost of any such examinations to be borne by the Company.

Banking subsidiaries of bank holding companies are also subject to certain restrictions imposed by Federal law in dealings with their holding companies and other affiliates. Subject to certain restrictions set forth in the Federal Reserve Act, a bank can loan or extend credit to an affiliate, purchase or invest in the securities of an affiliate, purchase assets from an affiliate or issue a guarantee, acceptance or letter of credit on behalf of an affiliate, as long as the aggregate amount of such transactions of a bank and its subsidiaries with its affiliates does not exceed 10% of the capital stock and surplus of the bank on a per affiliate basis or 20% of the capital stock and surplus of the bank on an aggregate affiliate basis. In addition, such transactions must be on terms and conditions that are consistent with safe and sound banking practices. In particular, a bank and its subsidiaries generally may not purchase from an affiliate a low-quality asset, as defined in the Federal Reserve Act. These restrictions also prevent a bank holding company and its other affiliates from borrowing from a banking subsidiary of the bank holding company unless the loans are secured by marketable collateral of designated amounts. Additionally, the Company and the Bank are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit, sale or lease of property or furnishing of services.

A bank holding company is also prohibited from engaging in or acquiring direct or indirect ownership or control of more than 5% of the voting shares of any company engaged in nonbanking activities. A bank holding company may, however, engage in or acquire an interest in a company that engages in activities which the FRB has determined by regulation or order are so closely related to banking as to be a proper incident to banking. In making these determinations, the FRB considers whether the performance of such activities by a bank holding company would offer advantages to the public that outweigh possible adverse effects.

As a national bank, the Bank is also subject to regulation, supervision and regular examination by the Office of the Comptroller of the Currency (the Comptroller). Each depositor's account with the Bank is insured by the Federal Deposit Insurance Corporation (the FDIC) to the maximum amount permitted by law, which is currently \$250,000 for each depositor for interest bearing accounts. For non-interest-bearing accounts the Bank is insured by the FDIC to the maximum amount permitted by law which is currently unlimited. The Bank is also subject to certain regulations promulgated by the FRB and applicable provisions of Virginia law, insofar as they do not conflict with or are not preempted by Federal banking law.

The regulations of the FDIC, the Comptroller and the FRB govern most aspects of the Company's business, including deposit reserve requirements, investments, loans, certain check clearing activities, issuance of securities, payment of dividends, branching, deposit interest rate ceilings and numerous other matters. As a consequence of the extensive regulation of commercial banking activities in the United States, the Company's business is particularly susceptible to changes in state and Federal legislation and regulations, which may have the effect of increasing the cost of doing business, limiting permissible activities or increasing competition.

***Governmental Policies and Legislation.*** Banking is a business that depends primarily on interest rate differentials. In general, the difference between the interest rates paid by the Company on its deposits and its other borrowings and the interest rates received by the Company on loans extended to its customers and securities held in its portfolio comprise the major portion of the Company's earnings. These rates are highly sensitive to many factors that are beyond the Company's control. Accordingly, the Company's growth and earnings are subject to the influence of domestic and foreign economic conditions, including inflation, recession and unemployment.

## Table of Contents

The commercial banking business is affected not only by general economic conditions, but is also influenced by the monetary and fiscal policies of the Federal government and the policies of its regulatory agencies, particularly the FRB. The FRB implements national monetary policies (with objectives such as curbing inflation and combating recession) by its open-market operations in U.S. Government securities, and, at times, other securities, by adjusting the required level of reserves for financial institutions subject to its reserve requirements and by varying the discount rates applicable to borrowings by depository institutions. The actions of the FRB in these areas influence the growth of bank loans, investments and deposits, and also affect interest rates charged on loans and paid on deposits. The nature and impact of any future changes in monetary policies cannot be predicted.

From time to time, legislation is enacted which has the effect of increasing the cost of doing business, limiting or expanding permissible activities or affecting the competitive balance between banks and other financial institutions. Proposals to change the laws and regulations governing the operations and taxation of bank holding companies, banks and other financial institutions are frequently made in Congress, in the Virginia legislature and brought before various bank holding company and bank regulatory agencies. The likelihood of any major changes and the impact such changes might have are impossible to predict.

**Dividends.** There are regulatory restrictions on dividend payments by both the Bank and the Company that may affect the Company's ability to pay dividends on its common stock. See Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities.

**Capital Requirements.** The FRB, the Comptroller and the FDIC have adopted risk-based capital adequacy guidelines for bank holding companies and banks. These capital adequacy regulations are based upon a risk-based capital determination, whereby a bank holding company's capital adequacy is determined in light of the risk, both on- and off-balance sheet, contained in the company's assets. Different categories of assets are assigned risk weightings and are counted as a percentage of their book value.

The regulations divide capital between Tier 1 capital (core capital) and Tier 2 capital. For a bank holding company, Tier 1 capital consists primarily of common stock, related surplus, noncumulative perpetual preferred stock, minority interests in consolidated subsidiaries and a limited amount of qualifying cumulative preferred securities. Goodwill and certain other intangibles are excluded from Tier 1 capital. Tier 2 capital consists of an amount equal to the allowance for loan losses up to a maximum of 1.25% of risk weighted assets, limited other types of preferred stock not included in Tier 1 capital, hybrid capital instruments and term subordinated debt. Investments in and loans to unconsolidated banking and finance subsidiaries that constitute capital of those subsidiaries are excluded from capital. The sum of Tier 1 and Tier 2 capital constitutes qualifying total capital. The guidelines generally require banks to maintain a total qualifying capital to weighted risk assets ratio of 8% (the Risk-based Capital Ratio). At least 4% of the total qualifying capital to weighted risk assets (the Tier 1 Risk-based Capital Ratio) must be Tier 1 capital.

The FRB, the Comptroller and the FDIC have adopted leverage requirements that apply in addition to the risk-based capital requirements. Banks and bank holding companies are required to maintain a minimum leverage ratio of Tier 1 capital to average total consolidated assets (the Leverage Ratio) of at least 3.0% for the most highly-rated, financially sound banks and bank holding companies and a minimum Leverage Ratio of at least 4.0% for all other banks. The FDIC and the FRB define Tier 1 capital for banks in the same manner for both the Leverage Ratio and the Risk-based Capital Ratio. However, the FRB defines Tier 1 capital for bank holding companies in a slightly different manner. An institution may be required to maintain Tier 1 capital of at least 4% or 5%, or possibly higher, depending upon the activities, risks, rate of growth, and other factors deemed material by regulatory authorities.

As of December 31, 2011, the Company and Bank both met all applicable capital requirements imposed by regulation. At December 31, 2011, the Risk-based Capital Ratios of the Company and the Bank were 11.24 percent and 11.79 percent, respectively. At December 31, 2011, the Tier 1 Risk-based Capital Ratios of the Company and the Bank were 9.99 percent and 10.53 percent, respectively. At December 31, 2011, the Leverage Ratios of the Company and the Bank were 8.12 percent and 8.56 percent, respectively.

---

## **Table of Contents**

***Federal Deposit Insurance Corporation Improvement Act of 1991.*** There are five capital categories applicable to insured institutions, each with specific regulatory consequences. If the appropriate Federal banking agency determines, after notice and an opportunity for hearing, that an insured institution is in an unsafe or unsound condition, it may reclassify the institution to the next lower capital category (other than critically undercapitalized) and require the submission of a plan to correct the unsafe or unsound condition. The Comptroller has issued regulations to implement these provisions.

Under these regulations, the categories are:

- a. **Well Capitalized** The institution exceeds the required minimum level for each relevant capital measure. A well capitalized institution is one (i) having a Risk-based Capital Ratio of 10% or greater, (ii) having a Tier 1 Risk-based Capital Ratio of 6% or greater, (iii) having a Leverage Ratio of 5% or greater and (iv) that is not subject to any order or written directive to meet and maintain a specific capital level for any capital measure.
- b. **Adequately Capitalized** The institution meets the required minimum level for each relevant capital measure. No capital distribution may be made that would result in the institution becoming undercapitalized. An adequately capitalized institution is one (i) having a Risk-based Capital Ratio of 8% or greater, (ii) having a Tier 1 Risk-based Capital Ratio of 4% or greater and (iii) having a Leverage Ratio of 4% or greater or a Leverage Ratio of 3% or greater if the institution is rated composite 1 under the CAMELS (Capital, Assets, Management, Earnings, Liquidity and Sensitivity to market risk) rating system.
- c. **Undercapitalized** The institution fails to meet the required minimum level for any relevant capital measure. An undercapitalized institution is one (i) having a Risk-based Capital Ratio of less than 8% or (ii) having a Tier 1 Risk-based Capital Ratio of less than 4% or (iii) having a Leverage Ratio of less than 4%, or if the institution is rated a composite 1 under the CAMEL rating system, a Leverage Ratio of less than 3%.
- d. **Significantly Undercapitalized** The institution is significantly below the required minimum level for any relevant capital measure. A significantly undercapitalized institution is one (i) having a Risk-based Capital Ratio of less than 6% or (ii) having a Tier 1 Risk-based Capital Ratio of less than 3% or (iii) having a Leverage Ratio of less than 3%.
- e. **Critically Undercapitalized** The institution fails to meet a critical capital level set by the appropriate Federal banking agency. A critically undercapitalized institution is one having a ratio of tangible equity to total assets that is equal to or less than 2%.

An institution which is less than adequately capitalized must adopt an acceptable capital restoration plan, is subject to increased regulatory oversight, and is increasingly restricted in the scope of its permissible activities. Each company having control over an undercapitalized institution must provide a limited guarantee that the institution will comply with its capital restoration plan. Except under limited circumstances consistent with an accepted capital restoration plan, an undercapitalized institution may not grow. An undercapitalized institution may not acquire another institution, establish additional branch offices or engage in any new line of business unless determined by the appropriate Federal banking agency to be consistent with an accepted capital restoration plan, or unless the FDIC determines that the proposed action will further the purpose of prompt corrective action. The appropriate Federal banking agency may take any action authorized for a significantly undercapitalized institution if an undercapitalized institution fails to submit an acceptable capital restoration plan or fails in any material respect to implement a plan accepted by the agency. A critically undercapitalized institution is subject to having a receiver or conservator appointed to manage its affairs and for loss of its charter to conduct banking activities.

An insured depository institution may not pay a management fee to a bank holding company controlling that institution or any other person having control of the institution if, after making the payment, the institution would be undercapitalized. In addition, an institution cannot make a capital distribution, such as a dividend or other distribution that is in substance a distribution of capital to the owners of the institution, if following such a distribution the institution would be undercapitalized. Thus, if payment of such a management fee or the making of such would cause the Bank to become undercapitalized, it could not pay a management fee or dividend to the Company.

---

## Table of Contents

As of December 31, 2011, both the Company and the Bank were considered well capitalized.

**Basel III Capital Framework.** In December 2010, the Basel Committee on Banking Supervision (the Basel Committee) released its final framework for strengthening international capital and liquidity regulation, now officially identified by the Basel Committee as Basel III. Basel III, when implemented by the U.S. banking agencies and fully phased-in, will require bank holding companies and their bank subsidiaries to maintain substantially more capital, with a greater emphasis on common equity. Implementation is presently scheduled to be phased in between 2014 and 2019, although it is possible that implementation may be delayed as a result of multiple factors including the current condition of the banking industry within the U.S. and abroad.

The Basel III final capital framework, among other things, (i) introduces as a new capital measure Common Equity Tier 1 (CET1), (ii) specifies that Tier 1 capital consists of CET1 and Additional Tier 1 capital instruments meeting specified requirements, (iii) defines CET1 narrowly by requiring that most adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expands the scope of the adjustments as compared to existing regulations.

When fully phased in on January 1, 2019, Basel III requires banks to maintain, (i) as a newly adopted international standard, a minimum ratio of CET1 to risk-weighted assets of at least 4.5%, plus a 2.5% capital conservation buffer (which is added to the 4.5% CET1 ratio as that buffer is phased in, effectively resulting in a minimum ratio of CET1 to risk-weighted assets of at least 7%), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio as that buffer is phased in, effectively resulting in a minimum Tier 1 capital ratio of 8.5% upon full implementation), (iii) a minimum ratio of Total (that is, Tier 1 plus Tier 2) capital to risk-weighted assets of at least 8.0%, plus the capital conservation buffer (which is added to the 8.0% total capital ratio as that buffer is phased in, effectively resulting in a minimum total capital ratio of 10.5% upon full implementation) and (iv) as a newly adopted international standard, a minimum leverage ratio of 3%, calculated as the ratio of Tier 1 capital to balance sheet exposures plus certain off-balance sheet exposures (computed as the average for each quarter of the month-end ratios for the quarter).

Basel III also provides for a countercyclical capital buffer, generally to be imposed when national regulators determine that excess aggregate credit growth becomes associated with a buildup of systemic risk, that would be a CET1 add-on to the capital conservation buffer in the range of 0% to 2.5% when fully implemented (potentially resulting in total buffers of between 2.5% and 5%).

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of CET1 to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases and compensation based on the amount of the shortfall.

The implementation of the Basel III final framework will commence January 1, 2013. On that date, banking institutions will be required to meet the following minimum capital ratios:

3.5% CET1 to risk-weighted assets.

4.5% Tier 1 capital to risk-weighted assets.

8.0% Total capital to risk-weighted assets.

The Basel III final framework provides for a number of new deductions from and adjustments to CET1. These include, for example, the requirement that mortgage servicing rights, deferred tax assets dependent upon future taxable income and significant investments in non-consolidated financial entities be deducted from CET1 to the extent that any one such category exceeds 10% of CET1 or all such categories in the aggregate exceed 15% of CET1.

Implementation of the deductions and other adjustments to CET1 will begin on January 1, 2014 and will be phased-in over a five-year period (20% per year). The implementation of the capital conservation buffer will begin on January 1, 2016 at 0.625% and be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019).



## Table of Contents

The U.S. banking agencies have indicated informally that they expect to propose regulations implementing Basel III in mid-2012. Notwithstanding its release of the Basel III framework as a final framework, the Basel Committee is considering further amendments to Basel III, including the imposition of additional capital surcharges on globally systemically important financial institutions. In addition to Basel III, the Dodd-Frank Act requires or permits the Federal banking agencies to adopt regulations affecting banking institutions' capital requirements in a number of respects, including potentially more stringent capital requirements for systemically important financial institutions. Accordingly, the regulations ultimately applicable to the Company may be substantially different from the Basel III final framework as published in December 2010.

Requirements to maintain higher levels of capital or to maintain higher levels of liquid assets could adversely impact the Company's net income and return on equity.

**The Dodd-Frank Act.** On July 21, 2010, the Dodd-Frank Act was signed into law. The Dodd-Frank Act implemented far-reaching changes across the financial regulatory landscape, including changes that will affect all bank holding companies and banks, including the Company and the Bank, including the following provisions affecting the business of the Company and the Bank:

*Insurance of Deposit Accounts.* The Dodd-Frank Act changed the assessment base for federal deposit insurance from the amount of insured deposits to consolidated assets less tangible capital, eliminated the ceiling on the size of the Deposit Insurance Fund ( DIF ) and increased the floor applicable to the size of the DIF. The Dodd-Frank Act also made permanent the \$250,000 limit for federal deposit insurance and increased the cash limit of Securities Investor Protection Corporation protection from \$100,000 to \$250,000 and provides unlimited federal deposit insurance until December 31, 2012 for non-interest bearing demand transaction accounts at all insured depository institutions.

*Payment of Interest on Demand Deposits.* The Dodd-Frank Act repealed the federal prohibitions on the payment of interest and demand deposits, thereby permitting depository institutions to pay interest on business transaction and other accounts.

*Creation of the Consumer Financial Protection Bureau.* The Dodd-Frank Act centralized significant aspects of consumer financial protection by creating a new agency, the Consumer Financial Protection Bureau (the CFPB ), responsible for implementing, examining and enforcing compliance with Federal consumer financial laws for institutions with more than \$10 billion of assets and, to a lesser extent, smaller institutions. As a smaller institution, most consumer protection aspects of the Dodd-Frank Act will continue to be applied to the Company by the FRB and to the Bank by the Comptroller.

*Debit Card Interchange Fees.* The Dodd-Frank Act amended the Electronic Fund Transfer Act to, among other things, require that debit card interchange fees must be reasonable and proportional to the actual cost incurred by the issuer with respect to the transaction. In June 2011, the FRB adopted regulations setting the maximum permissible interchange fee as the sum of 21 cents per transaction and 5 basis points multiplied by the value of the transaction, with an additional adjustment of up to one cent per transaction if the issuer implements additional fraud-prevention standards. Although issuers that have assets of less than \$10 billion are exempt from the FRB's regulations that set maximum interchange fees, these regulations are expected to significantly impact the interchange fees that financial institutions with less than \$10 billion in assets are able to collect.

In addition, the Dodd-Frank Act implemented other far-reaching changes to the financial regulatory landscape, including provisions that:

Restrict the preemption of state law by Federal law and disallow subsidiaries and affiliates of national banks, such as subsidiaries and affiliates of the Bank, from availing themselves of such preemption.

Apply the same leverage and risk-based capital requirements that apply to insured depository institutions to most bank holding companies.

Edgar Filing: PINNACLE BANKSHARES CORP - Form 10-K

Require bank holding companies and banks to be both well capitalized and well managed in order to acquire banks located outside their home state.

---

**Table of Contents**

Impose comprehensive regulation of the over-the-counter derivatives market, which would include certain provisions that would effectively prohibit insured depository institutions from conducting certain derivatives businesses in the institution itself.

Require large, publicly traded bank holding companies to create a risk committee responsible for the oversight of enterprise risk management.

Implement corporate governance revisions, including with regard to executive compensation and proxy access by shareholders, that apply to all public companies, not just financial institutions.

Many aspects of the Dodd-Frank Act remain subject to rulemaking and will take effect over several years, making it difficult to anticipate the overall financial impact on the Company and the Bank or their customers or the financial industry more generally. Provisions in the legislation that affect the payment of interest on demand deposits and interchange fees are likely to increase the costs associated with deposits as well as place limitations on certain revenues those deposits may generate. Provisions in the legislation that require revisions to the capital requirements of the Company and the Bank could impact the Company's and the Bank's future raising activities. Although the Company and Bank have not issued trust preferred securities, provisions in the legislation that revoke the Tier 1 capital treatment of trust preferred securities could cause the Company and the Bank to seek other sources of capital in the future. Some of the rules that have been proposed and, in some cases, adopted to comply with the Dodd-Frank Act's mandates are discussed further below.

***Insurance of Accounts, Assessments and Regulation by the FDIC.*** The Bank's deposits are insured up to applicable limits by the DIF of the FDIC. In July 2010, the Dodd-Frank Act permanently raised the basic limit on federal deposit insurance coverage to \$250,000 per depositor, but did not change FDIC deposit insurance coverage for retirement accounts, which remains \$250,000 per depositor. In November 2010, the FDIC issued a final rule to implement provisions of the Dodd-Frank Act that provide for temporary unlimited deposit insurance coverage for noninterest-bearing transaction accounts. For purposes of this extension, the definition of noninterest-bearing transaction accounts includes traditional checking accounts or demand deposit accounts on which no interest is paid and Interest on Lawyer Trust Accounts (IOLTAs), and excludes negotiable order of withdrawal consumer checking accounts (NOW accounts) and money-market deposit accounts. The extended program is not optional and will no longer be funded by separate premiums. This temporary unlimited deposit insurance coverage became effective on December 31, 2010 and terminates on December 31, 2012.

Under the FDIA, the FDIC may terminate deposit insurance upon a finding that the institution has engaged in unsafe and unsound practices, is in an unsafe or unsound condition to continue operations, or has violated any applicable law, regulation, rule, order or condition imposed by the FDIC, subject to administrative and potential judicial hearing and review processes.

***Deposit Insurance Assessments.*** The Bank's deposits are insured up to applicable limits by the FDIC. Under the risk-based assessment system, insured institutions are assigned to one of four risk categories based on supervisory evaluations, regulatory capital levels and certain other factors. An institution's assessment rate depends upon the category to which it is assigned. Unlike the other categories as applied to small institutions, Risk Category 1, which contains the least risky depository institutions, contains further risk differentiation based on the FDIC's analysis of financial ratios, examination component ratings (CAMELS components) and other information. Assessment rates are determined by the FDIC and, beginning April 1, 2011, initial base assessment rates ranged from 2.5 to 45 basis points. The FDIC may make the following further adjustments to an institution's initial base assessment rates: decreases for long-term unsecured debt, including most senior unsecured debt and subordinated debt; increases for holding long-term unsecured debt or subordinated debt issued by other insured depository institutions; and increases for broker deposits in excess of 10 percent of domestic deposits for insurances not well rated and well capitalized. The Dodd-Frank Act transferred to the FDIC increased discretion with regard to managing the required amount of reserves for the DIF, or the designated reserve ratio. Among other changes, the Dodd-Frank Act (i) raised the minimum designated reserve ratio to 1.35 percent and removed the upper limit on the designated reserve ratio, (ii) requires that the designated reserve ratio reach 1.35 percent by September 2020, and (iii) requires the FDIC to offset the effect on

---

**Table of Contents**

institutions with total consolidated assets of less than \$10 billion of increasing of raising the designated reserve ratio from 1.15 percent to 1.35 percent. The FDIA requires that the FDIC consider the appropriate level for the designated reserve ratio on at least an annual basis.

In an effort to restore capitalization levels and to ensure the DIF will adequately cover projected losses from future bank failures, the FDIC, in October 2008, proposed a rule to alter the way in which it differentiates for risk in the risk-based assessment system and to revise deposit insurance assessment rates, including base assessment rates. The FDIC also introduced three adjustments that could be made to an institution's initial base assessment rate, as well as a uniform 7 basis point increase in rates for the first quarter of 2009. The rule for first quarter 2009 assessment rates was adopted as a final rule in December 2008, resulting in annualized assessment rates for Risk Category 1 institutions ranging from 12 to 14 basis points. A final rule related to the rest of the proposal was adopted on March 4, 2009 and became effective on April 1, 2009, applying to assessments for the second quarter of 2009 and thereafter. The new rule provides for initial base assessment rates for Risk Category 1 institutions of 12 to 16 basis points, subject to potential base-rate adjustments, including (i) a potential decrease of up to 5 basis points for long-term unsecured debt, including senior and subordinated debt, (ii) a potential increase for secured liabilities in excess of 25% of domestic deposits and (iii) for non-Risk Category 1 institutions, a potential increase for brokered deposits in excess of 10% of domestic deposits. Taking into account these potential base-rate adjustments, the annualized assessment rate for Risk Category 1 institutions would range from 7 to 24 basis points.

In May 2009, the FDIC adopted a final rule imposing a five basis point special assessment on each insured depository institution's assets minus Tier 1 capital as of June 30, 2009. The assessment was part of the FDIC's efforts to rebuild the DIF and help maintain public confidence in the banking system. The company was assessed \$149,486, all of which was expensed in 2009.

In November 2009, the FDIC adopted a final rule requiring insured depository institutions to prepay their estimated quarterly risk-based assessments for the fourth quarter of 2009, and for all of 2010, 2011 and 2012, on December 31, 2009, along with each institution's risk-based deposit insurance assessment for the third quarter of 2009. The prepayment was based on an institution's assessment rate and assessment base for the third quarter of 2009, assuming a five percent annual growth in deposits each year. While the FDIC plan would maintain current assessment rates through 2010, effective January 1, 2011, the rates would increase by three basis points across the board. The FDIC has elected to forgo this increase under a new DIF restoration plan adopted in October 2010 as discussed below. On December 30, 2009, the Company prepaid \$1,841,966 of FDIC assessments.

In October 2010, the FDIC adopted a new DIF restoration plan to ensure that the fund reserve ratio reaches 1.35 percent by September 30, 2020, as required by the Dodd-Frank Act. The restoration plan requires the FDIC to update its loss and income projections for the DIF at least semiannually, and if needed the FDIC may increase or decrease assessment rates, following a notice-and-comment rulemaking.

In November 2010, the FDIC issued a final rule to implement provisions of the Dodd-Frank Act that provide for temporary unlimited coverage for noninterest-bearing transaction accounts beginning January 1, 2011 and continuing through December 2012. For purposes of this extension, the definition of noninterest-bearing transaction accounts excludes negotiable order of withdrawal consumer checking accounts (or NOW accounts). The extended program is not optional and will no longer be funded by separate premiums.

In February 2011, the FDIC approved a final rule that changed the assessment base from domestic deposits to average consolidated total assets minus average tangible equity (defined as Tier 1 capital); adopted a new large-bank pricing assessment scheme; and set a target designated reserve ratio for the DIF. The rule, as mandated by the Dodd-Frank Act, finalizes a target size for the DIF at 2 percent of insured deposits. It also implements a lower assessment rate schedule when the fund reaches 1.15 percent and, in lieu of dividends, provides for a lower rate schedule when the reserve ratio reaches 2 percent and 2.5 percent. The changes went into effect beginning with the second quarter of 2011, and began affecting premiums payable at the end of September 2011.

***Mortgage Banking Regulation.*** The Bank's mortgage banking operation is subject to the rules and regulations of, and examination by the U.S. Department of Housing and Urban Development, the Federal Housing Administration, the Veterans Administration and state

## Table of Contents

regulatory authorities with respect to originating, processing and selling mortgage loans. Those rules and regulations, among other things, establish standards for loan origination, prohibit discrimination, provide for inspections and appraisals of property, require credit reports on prospective borrowers and, in some cases, restrict certain loan features, and fix maximum interest rates and fees. In addition to other Federal laws, mortgage origination activities are subject to the Equal Credit Opportunity Act, Truth-in-Lending Act, Home Mortgage Disclosure Act, the Real Estate Settlement Procedures Act, and the Home Ownership Equity Protection Act, and the regulations promulgated thereunder. These laws prohibit discrimination, require the disclosure of certain basic information to mortgagors concerning credit and settlement costs, limit payment for settlement services to the reasonable value of the services rendered and require the maintenance and disclosure of information regarding the disposition of mortgage applications based on race, gender, geographical distribution and income level.

**Gramm-Leach-Bliley Act of 1999.** The Gramm-Leach-Bliley Act of 1999 (the GLBA ) implemented major changes to the statutory framework for providing banking and other financial services in the United States. The GLBA, among other things, eliminated many of the restrictions on affiliations among banks and securities firms, insurance firms and other financial service providers. A bank holding company that qualifies and elects to be a financial holding company will be permitted to engage in activities that are financial in nature or incidental or complimentary to financial activities. The activities that the GLBA expressly lists as financial in nature include insurance underwriting, sales and brokerage activities, providing financial and investment advisory services, underwriting services and limited merchant banking activities.

To become eligible for these expanded activities, a bank holding company must qualify and elect to be a financial holding company. To qualify as a financial holding company, each insured depository institution controlled by the bank holding company must be well-capitalized, well-managed and have at least a satisfactory rating under the CRA (discussed below). In addition, the bank holding company must file with the FRB a declaration of its intention to become a financial holding company. While the Company satisfies these requirements, the Company has not elected for various reasons to be treated as a financial holding company under the GLBA.

The GLBA has not had a material adverse impact on the Company's or the Bank's operations. To the extent that it allows banks, securities firms and insurance firms to affiliate, the financial services industry has experienced further consolidation. The GLBA probably has the result of increasing competition that we face from larger institutions and other companies offering financial products and services, many of which may have substantially greater financial resources.

The GLBA and other regulations issued by Federal banking agencies also provide protections against the transfer and use by financial institutions of consumer nonpublic personal information. A financial institution must provide to its customers, at the beginning of the customer relationship and annually thereafter, the institution's policies and procedures regarding the handling of customers' nonpublic personal financial information. These privacy provisions generally prohibit a financial institution from providing a customer's personal financial information to unaffiliated third parties unless the institution discloses to the customer that the information may be so provided and the customer is given the opportunity to opt out of such disclosure.

**Community Reinvestment Act.** The Bank is subject to the requirements of the Community Reinvestment Act (the CRA ). The CRA imposes on financial institutions an affirmative and ongoing obligation to meet the credit needs of their local communities, including low and moderate-income neighborhoods, consistent with the safe and sound operation of those institutions. A financial institution's efforts in meeting community credit needs is evaluated as part of the examination process pursuant to twelve assessment factors and then given a rating of Outstanding, Satisfactory, Needs to improve or Substantial noncompliance. These factors also are considered in evaluating mergers, acquisitions and applications to open a branch or facility. The Bank received a rating of Satisfactory in its most recent CRA performance evaluation as of September 30, 2010.

**USA PATRIOT Act.** The USA PATRIOT Act became effective on October 26, 2001 and provides for the facilitation of information sharing among governmental entities and financial institutions for the purpose of combating terrorism and money laundering. Among other provisions, the USA PATRIOT Act permits financial institutions, upon providing notice to the United States Treasury, to share information with one another in order to better identify and report to the Federal government concerning activities that may

## Table of Contents

involve money laundering or terrorists' activities. The USA PATRIOT Act is considered a significant banking law in terms of information disclosure regarding certain customer transactions. Certain provisions of the USA Patriot Act impose the obligation to establish anti-money laundering programs, including the development of a customer identification program, and the screening of all customers against any government lists of known or suspected terrorists. Although it created a reporting obligation, the USA PATRIOT Act has not materially affected and is not expected to materially affect the Bank's products, services or other business activities.

**Reporting Terrorist Activities.** The Federal Bureau of Investigation (FBI) has sent, and will send, our banking regulatory agencies lists of the names of persons suspected of involvement in terrorism. The Bank has been requested, and will be requested, to search its records for any relationships or transactions with persons on those lists. If the Bank finds any relationships or transactions, it must file a suspicious activity report and contact the FBI.

The Office of Foreign Assets Control (OFAC), which is a division of the Department of the Treasury, is responsible for helping to insure that United States entities do not engage in transactions with enemies of the United States, as defined by various Executive Orders and Acts of Congress. OFAC has sent, and will send, our banking regulatory agencies lists of names of persons and organizations suspected of aiding, harboring or engaging in terrorist acts, and publicly releases information on designations of persons and organizations suspected of engaging in these activities. If the Bank finds a name on any transaction, account or wire transfer that is on an OFAC list, it must freeze such account, file a suspicious activity report and notify the FBI. The Bank has appointed an OFAC compliance officer to oversee the inspection of its accounts and the filing of any notifications. The Bank actively checks high-risk OFAC areas such as new accounts, wire transfers and customer files. The Bank performs these checks utilizing software, which is updated each time a modification is made to the lists provided by OFAC and other agencies of Specially Designated Nationals and Blocked Persons.

**Consumer Laws and Regulations.** The Bank is also subject to certain consumer laws and regulations that are designed to protect consumers in transactions with banks. While the list set forth herein is not exhaustive, these laws and regulations include the Truth in Lending Act, the Truth in Savings Act, the Electronic Funds Transfer Act, the Expedited Funds Availability Act, the Equal Credit Opportunity Act, the Fair Credit Reporting Act and the Fair Housing Act, among others. These laws and regulations mandate certain disclosure requirements and regulate the manner in which financial institutions transact business with customers. The Bank must comply with the applicable provisions of these consumer protection laws and regulations as part of its ongoing customer relations.

The Dodd-Frank Act created the CFPB, a federal regulatory agency that is responsible for implementing, examining and enforcing compliance with federal consumer financial laws for institutions with more than \$10 billion of assets and, to a lesser extent, smaller institutions. The Dodd-Frank Act gives the CFPB authority to supervise and regulate providers of consumer financial products and services, and establishes the CFPB's power to act against unfair, deceptive or abusive practices. The CFPB has stated that it will focus on (i) risks to consumers and compliance with federal consumer financial laws, (ii) the markets in which firms operate and risks to consumers posed by activities in those markets, (iii) depository institutions that offer a wide variety of consumer financial products and services, and depository institutions with a more specialized focus, and (iv) non-depository companies that offer one or more consumer financial products or services.

As a smaller institution (i.e., with assets of \$10 billion or less), most consumer protection aspects of the Dodd-Frank Act will continue to be applied to the Company by the FRB and to the Bank by the Comptroller. However, the CFPB may include its own examiners in regulatory examinations by a smaller institution's prudential regulators and may require smaller institutions to comply with certain CFPB reporting requirements. In addition, regulatory positions taken by the CFPB and administrative and legal precedents established by CFPB enforcement activities could influence how the FRB and Comptroller apply consumer protection laws and regulations to financial institutions that are not directly supervised by the CFPB. The precise impact of the CFPB's consumer protection activities cannot be forecast.

**Incentive Compensation.** In June 2010, the FRB, the Comptroller and the FDIC issued comprehensive final guidance on incentive compensation policies intended to ensure that the incentive compensation policies of banking organizations do not undermine the safety and soundness of such organizations by encouraging excessive risk-taking. Banking

**Table of Contents**

organizations are instructed to review their incentive compensation policies to ensure that they do not encourage excessive risk-taking and implement corrective programs as needed. The Federal Reserve Board will review, as part of the regular, risk-focused examination process, the incentive compensation arrangements of banking organizations, such as the Bank, that are not large, complex banking organizations. These reviews will be tailored to each organization based on the scope and complexity of the organization's activities and the prevalence of incentive compensation arrangements. The findings of the supervisory initiatives will be included in reports of examination. Deficiencies will be incorporated into the organization's supervisory ratings, which can affect the organization's ability to make acquisitions and take other actions. Enforcement actions may be taken against a banking organization if its incentive compensation arrangements, or related risk-management control or governance processes, pose a risk to the organization's safety and soundness and the organization is not taking prompt and effective measures to correct the deficiencies.

**Future Regulation.** From time to time, various legislative and regulatory initiatives are introduced in Congress and state legislatures, as well as by regulatory agencies. Such initiatives may include proposals to expand or contract the powers of bank holding companies and depository institutions or proposals to substantially change the financial institution regulatory system. Such legislation could change banking statutes and the operating environment of the Company in substantial and unpredictable ways. If enacted, such legislation could increase or decrease the cost of doing business, limit or expand permissible activities or affect the competitive balance among banks, savings associations, credit unions, and other financial institutions. The Company cannot predict whether any such legislation will be enacted, and, if enacted, the effect that it, or any implementing regulations, would have on the financial condition or results of operations of the Company. A change in statutes, regulations or regulatory policies applicable to the Company or the Bank, or any of its subsidiaries, could have a material effect on the business of the Company.

**Employees**

As of December 31, 2011, the Company had 105 full-time and part-time employees. The Company's management believes that its employee relations are good.

**Executive Officers of the Registrant**

| <b>Name (Age)</b>        | <b>Principal Occupation During Past Five Years</b>                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|--------------------------|----------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Aubrey H. Hall, III (41) | President & Chief Executive Officer of Pinnacle Bankshares Corporation and Chief Executive Officer and Trust Officer of First National Bank since July 2011; Director, Pinnacle Bankshares Corporation and First National Bank since 2011. Previously, Executive Vice President of Pinnacle Bankshares Corporation and President and Chief Operating Officer of First National Bank from January 2011 to July 2011 and Chief Lending Officer of First National Bank from 2007 to 2011. |
| Carroll E. Shelton (61)  | Vice President of Pinnacle Bankshares Corporation and Senior Vice President and Chief Credit Officer of First National Bank since 1990; Director, Pinnacle Bankshares Corporation since 1990.                                                                                                                                                                                                                                                                                          |
| Bryan M. Lemley (40)     | Secretary, Treasurer and Chief Financial Officer of Pinnacle Bankshares Corporation since 2000 and Senior Vice President of First National Bank since April 2010, Cashier and Chief Financial Officer of First National Bank since June 2000.                                                                                                                                                                                                                                          |

**Table of Contents**

**Item 1A. Risk Factors.**

Not required.

**Item 1B. Unresolved Staff Comments.**

Not required.

**Item 2. Properties.**

The Company's main office and corporate headquarters, located at 622 Broad Street in downtown Altavista, Virginia, is owned and principally occupied by the Bank.

The Vista Office, located at 1301 N. Main Street in Altavista, Virginia, consists of a single-story building owned by the Bank.

The Airport Office, located at 14580 Wards Road in Campbell County, Virginia, consists of a single-story building owned by the Bank.

The Old Forest Road Office, located at 3309 Old Forest Road in Lynchburg, Virginia, consists of a single-story building owned by the Bank.

The Timberlake Office, located at 20865 Timberlake Road in Campbell County, Virginia, consists of a single-story building leased for \$4,282 per month through April 2012.

The Forest Office, located at 14417 Forest Road in Forest, Virginia, consists of a single-story building owned by the Bank.

The Amherst Office, located at 130 South Main Street in Amherst, Virginia, consists of a single-story building leased for \$10,878 per month through March 2013.

The Rustburg Office, located at 1033 Village Highway in Rustburg, Virginia, consists of a single-story building owned by the Bank.

The Wyndhurst Administrative and Training Office, located at 201 Archway Court in Lynchburg, Virginia, consists of a single-story building leased for \$3,846 per month through January 2013.

The Company believes all of these properties are in good operating condition and are adequate for the Company's present and anticipated future needs. The Company maintains comprehensive general liability and casualty loss insurance covering its properties and activities conducted in or about its properties. The Company believes this insurance provides adequate protection for liabilities or losses that might arise out of the ownership and use of such properties.

**Item 3. Legal Proceedings.**

Neither the Company nor the Bank nor any of their properties is involved in any pending legal proceedings, nor are any such proceedings threatened, other than nonmaterial proceedings arising in the ordinary course of the Company's and the Bank's business.

**Item 4. Mine Safety Disclosures**

None.

**Table of Contents**

**PART II**

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

The information contained on the inside back cover of the 2011 Annual Report to Shareholders, under the caption "Market for Common Equity and Related Stockholder Matters" is incorporated herein by reference.

**Item 6. Selected Financial Data.**

The information presented under the caption "Selected Consolidated Financial Information" on page 6 of the 2011 Annual Report to Shareholders is incorporated herein by reference.

**Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations.**

The information presented under the caption "Management's Discussion and Analysis of Financial Condition and Results of Operations" on pages 7 through 26 of the 2011 Annual Report to Shareholders is incorporated herein by reference.

**Item 7A. Quantitative and Qualitative Disclosures about Market Risk.**

Not required.

**Item 8. Financial Statements and Supplementary Data.**

The consolidated financial statements of the Company and its subsidiary, including the accompanying notes, and independent auditors' report thereon, contained on pages 27 through 65 of the 2011 Annual Report to Shareholders, are incorporated herein by reference.

**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's management evaluated, with the participation of the Chief Executive Officer and Chief Financial Officer, the effectiveness of the Company's disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this report. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective as of the end of the period covered by this report to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act 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 the Company's management, including the Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

Because of the inherent limitations in all control systems, no evaluation of controls can provide absolute assurance that the Company's disclosure controls and procedures will detect or uncover every situation involving the failure of persons within the Company to disclose material information required to be set forth in the Company's periodic reports.

## Edgar Filing: PINNACLE BANKSHARES CORP - Form 10-K

***Management's Report on Internal Control over Financial Reporting.*** The Company's management is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Exchange Act.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the Company's internal control over financial reporting as of December 31, 2011. In making this assessment, management used

---

**Table of Contents**

the criteria set forth by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in *Internal Control - Integrated Framework*. Based on this assessment, the Company's management concluded that, as of December 31, 2011, the Company's internal control over financial reporting was effective based on those criteria.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to rules of the SEC that permit the Company to provide only management's report in this annual report.

**Changes in Internal Controls.** No changes in the Company's internal control over financial reporting occurred during the quarter ended December 31, 2011 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

**Item 9B. Other Information.**

None

**PART III**

Except as otherwise indicated, information called for by the following items under Part III is contained in the Proxy Statement for the Company's 2012 Annual Meeting of Shareholders ( 2012 Proxy Statement ) to be held on April 10, 2012.

**Item 10. Directors, Executive Officers and Corporate Governance.**

The information with respect to the directors of the Company required by this item is contained on pages 5 through 10 of the 2012 Proxy Statement under the caption Election of Directors, and is incorporated herein by reference. The information regarding the Section 16(a) reporting requirements of the directors and executive officers is contained on page 19 of the 2012 Proxy Statement under the caption Section 16(a) Beneficial Ownership Reporting Compliance, and is incorporated herein by reference. The information concerning the executive officers of the Company required by this item is included in Part I of this Form 10-K under the caption Executive Officers of the Registrant. The information regarding the Company's Audit Committee required by this item is contained on page 11 of the 2012 Proxy Statement under the caption Committees of the Board of Directors-Audit Committee, and is incorporated herein by reference. The information regarding the Company's Nominating Committee required by this item is contained on pages 12 and 13 of the 2012 Proxy Statement under the caption Committees of the Board of Directors-Nominating Committee and is incorporated herein by reference.

The Company has adopted a Code of Conduct and Conflict of Interest Policy that applies to the directors, executives and employees of the Company and the Bank, including the Company's Chief Executive Officer, Chief Financial Officer, Controller and other persons performing similar functions. We have posted this Code on our internet website at [www.1stnatbk.com](http://www.1stnatbk.com) under Investor Relations . We intend to provide any required disclosure of any amendment to or waiver from the Code that applies to our Chief Executive Officer, Chief Financial Officer, Controller, or persons performing similar functions, on [www.1stnatbk.com](http://www.1stnatbk.com) Investor Relations promptly following the amendment or waiver. We may elect to disclose any such amendment or waiver in a report on Form 8-K filed with the SEC either in addition to or in lieu of the website disclosure. The information contained on or connected to our internet website is not incorporated by reference into this report and should not be considered part of this or any other report that we file with or furnish to the SEC.

**Item 11. Executive Compensation.**

The information on Executive Compensation required by this item is contained on pages 14 through 19 of the 2012 Proxy Statement under the caption Executive Compensation and is incorporated herein by reference. Information on compensation of directors is contained on page 13 of the 2012 Proxy Statement under the caption Director Compensation and is incorporated herein by reference.

**Table of Contents****Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters.**

The information on security ownership of certain beneficial owners and management required by this item is contained on page 4 of the 2012 Proxy Statement under the caption "Security Ownership of Certain Beneficial Owners and Management" and is incorporated herein by reference.

The following table sets forth information as of December 31, 2011 with respect to certain compensation plans under which equity securities of the Company are authorized for issuance.

**Equity Compensation Plan Information**

| Plan Category                                          | Number of securities to be issued upon exercise of outstanding options, warrants and rights | Weighted-average exercise price of outstanding options, warrants and rights | Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in column 1) |
|--------------------------------------------------------|---------------------------------------------------------------------------------------------|-----------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------|
| Equity compensation plans approved by shareholders     | 45,000(1)                                                                                   | \$ 9.96                                                                     | 55,000(2)                                                                                                                                 |
| Equity compensation plans not approved by shareholders |                                                                                             |                                                                             |                                                                                                                                           |
| <b>Total</b>                                           | <b>45,000</b>                                                                               | <b>\$ 9.96</b>                                                              | <b>55,000</b>                                                                                                                             |

- (1) Reflects shares to be issued pursuant to outstanding options granted under the Company's 1997 Incentive Stock Plan and 2004 Incentive Stock Plan.
- (2) Reflects shares available to be granted in the form of options, restricted stock or stock appreciation rights under the Company's 2004 Incentive Stock Plan.

**Item 13. Certain Relationships and Related Transactions, and Director Independence.**

The information on the interest of management in certain transactions and certain committees of the board of directors required by this item is contained on pages 11 through 14 of the 2012 Proxy Statement under the captions "Committees of the Board of Directors" and "Interest of Management in Certain Transactions," and is incorporated herein by reference.

**Item 14. Principal Accountant Fees and Services.**

The information contained on page 21 of the 2012 Proxy Statement under the captions "Principal Accountant Fees" and "Pre-Approval Policies" is incorporated herein by reference.

**PART IV****Item 15. Exhibits, Financial Statement Schedules.**

- (a)(1) The response to this portion of Item 15 is included in Item 8 above.
- (a)(2)

Edgar Filing: PINNACLE BANKSHARES CORP - Form 10-K

All schedules are omitted because they are not applicable, or the required information is either not material or is shown in the financial statements or the related notes.

(a)(3) Exhibits

**Table of Contents**

| Exhibit<br>Number | Description                                                                                                                                                                                                                                                                                     |
|-------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 3.1               | Amended and Restated Articles of Incorporation (incorporated by reference to Exhibit 3.1 to registrant's quarterly report on Form 10-Q filed on November 13, 2008)                                                                                                                              |
| 3.1(a)            | Articles of Amendment to the Articles of Incorporation, effective May 1, 2009 (incorporated by reference to Exhibit 3.1(a) to registrant's current report on Form 8-K filed on May 4, 2009)                                                                                                     |
| 3.2               | Bylaws (incorporated by reference to Exhibit 3(ii) to registrant's registration statement on Form S-4 filed on January 24, 1997)                                                                                                                                                                |
| 10.1*             | 1997 Incentive Stock Plan (incorporated by reference to Exhibit 4.3 to registrant's registration statement on Form S-8 filed on September 14, 1998)                                                                                                                                             |
| 10.3*             | VBA Directors' Deferred Compensation Plan for Pinnacle Bankshares Corporation, effective December 1, 1997 (incorporated by reference to Exhibit 10.3 to registrant's annual report on Form 10-KSB filed on March 25, 2003)                                                                      |
| 10.4*             | Pinnacle Bankshares Corporation 2004 Incentive Stock Plan, as amended February 9, 2010 (incorporated by reference to Exhibit 10.4 to registrant's current report on Form 8-K filed on February 16, 2010)                                                                                        |
| 10.5*             | Directors' Annual Compensation                                                                                                                                                                                                                                                                  |
| 10.6*             | Base Salaries of Executive Officers of the Registrant                                                                                                                                                                                                                                           |
| 10.7*             | Amended and Restated Change in Control Agreement between Pinnacle Bankshares Corporation and Bryan M. Lemley, dated December 31, 2008 (incorporated by reference to Exhibit 10.7 to registrant's annual report on Form 10-K filed on March 27, 2009)                                            |
| 10.8*             | Amended and Restated Change in Control Agreement between Pinnacle Bankshares Corporation and Carroll E. Shelton, dated December 31, 2008 (incorporated by reference to Exhibit 10.8 to registrant's annual report on Form 10-K filed on March 27, 2009)                                         |
| 10.9              | Pinnacle Bankshares Corporation Promissory Note, effective December 31, 2008, delivered to Community Bankers' Bank (incorporated by reference to Exhibit 10.9 to registrant's current report on Form 8-K filed on January 7, 2009)                                                              |
| 10.10*            | Form of Restricted Stock Agreement under Pinnacle Bankshares Corporation 2004 Incentive Stock Plan, as amended February 9, 2010 (incorporated by reference to Exhibit 10.10 to registrant's current report on Form 8-K filed on April 19, 2010)                                                 |
| 10.11*            | Form of Restricted Stock Agreement (with non-competition and consulting provision) under Pinnacle Bankshares Corporation 2004 Incentive Stock Plan, as amended February 9, 2010 (incorporated by reference to Exhibit 10.11 to registrant's current report on Form 8-K filed on April 19, 2010) |
| 10.12*            | Form of Incentive Stock Option Agreement with Tandem Stock Appreciation Right under Pinnacle Bankshares Corporation 2004 Incentive Stock Plan, as amended February 9, 2010 (incorporated by reference to Exhibit 10.12 to registrant's current report on Form 8-K filed on April 19, 2010)      |
| 10.13*            | Change in Control Agreement between Pinnacle Bankshares Corporation and Aubrey H. Hall, III, effective July 1, 2011 (incorporated by reference to Exhibit 10.13 to registrant's current report on Form 8-K filed on July 7, 2011)                                                               |
| 13                | 2011 Annual Report to Shareholders                                                                                                                                                                                                                                                              |

**Table of Contents**

|      |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
|------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 21   | Subsidiaries of Registrant                                                                                                                                                                                                                                                                                                                                                                                                                                                          |
| 23.1 | Consent of Cherry, Bekaert & Holland, L.L.P.                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 31.1 | CEO Certification Pursuant to Rule 13a-14(a)                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 31.2 | CFO Certification Pursuant to Rule 13a-14(a)                                                                                                                                                                                                                                                                                                                                                                                                                                        |
| 32.1 | CEO/CFO Certification Pursuant to § 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350)                                                                                                                                                                                                                                                                                                                                                                                        |
| 100  | The following materials from Pinnacle Bankshares Corporation's Annual Report on Form 10-K for the year ended December 31, 2011, formatted in XBRL (Extensible Business Reporting Language), furnished herewith: (i) Consolidated Balance Sheets, (ii) Consolidated Statements of Income, (iii) Consolidated Statements of Changes in Stockholders' Equity and Comprehensive Income, (iv) Consolidated Statements of Cash Flows, and (v) Notes to Consolidated Financial Statements. |

\* Denotes management contract.

(b) Exhibits See exhibit index included in Item 15(a)(3) above.

(c) Financial Statement Schedules See Item 15(a)(2) above.

**Table of Contents****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.

PINNACLE BANKSHARES CORPORATION  
(Registrant)

March 28, 2012

Date

/s/ Aubrey H. Hall, III

Aubrey H. Hall, III, President and Chief Executive Officer

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

| Signature                                        | Title                                                                                            | Date           |
|--------------------------------------------------|--------------------------------------------------------------------------------------------------|----------------|
| /s/ Aubrey H Hall, III<br>Aubrey H. Hall, III    | President, Chief Executive Officer and Director<br>(principal executive officer)                 | March 28, 2012 |
| /s/ Bryan M. Lemley<br>Bryan M. Lemley           | Secretary, Treasurer and Chief Financial Officer<br>(principal financial and accounting officer) | March 28, 2012 |
| /s/ A. Willard Arthur<br>A. Willard Arthur       | Director                                                                                         | March 28, 2012 |
| /s/ James E. Burton, IV<br>James E. Burton, IV   | Director                                                                                         | March 28, 2012 |
| /s/ John P. Erb<br>John P. Erb                   | Director                                                                                         | March 28, 2012 |
| /s/ Thomas F. Hall<br>Thomas F. Hall             | Director                                                                                         | March 28, 2012 |
| /s/ R.B. Hancock, Jr.<br>R.B. Hancock, Jr.       | Director                                                                                         | March 28, 2012 |
| /s/ A. Patricia Merryman<br>A. Patricia Merryman | Director                                                                                         | March 28, 2012 |
| /s/ William F. Overacre<br>William F. Overacre   | Director                                                                                         | March 28, 2012 |
| /s/ Carroll E. Shelton<br>Carroll E. Shelton     | Director                                                                                         | March 28, 2012 |
| /s/ C. Bryan Stott<br>C. Bryan Stott             | Director                                                                                         | March 28, 2012 |
| /s/ John L. Waller<br>John L. Waller             | Director                                                                                         | March 28, 2012 |

/s/ Michael E. Watson  
Michael E. Watson

Director

March 28, 2012