

1ST SOURCE CORP
Form 10-Q
July 25, 2013
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For the quarterly period ended June 30, 2013

OR

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

For the transition period from _____ to _____

Commission file number 0-6233

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(Exact name of registrant as specified in its charter)

INDIANA

(State or other jurisdiction of incorporation or organization)

**100 North Michigan Street
South Bend, IN**

(Address of principal executive offices)

35-1068133

(I.R.S. Employer Identification No.)

46601

(Zip Code)

(574) 235-2000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

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

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

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller reporting company

(Do not check if a smaller reporting company)

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

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Number of shares of common stock outstanding as of July 12, 2013 24,375,595 shares

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	June 30, 2013	December 31, 2012
<u>ASSETS</u>		
Cash and due from banks	\$ 64,850	\$ 83,232
Federal funds sold and interest bearing deposits with other banks	3,171	702
Investment securities available-for-sale (amortized cost of \$815,626 and \$849,139 at June 30, 2013 and December 31, 2012, respectively)	828,312	880,764
Other investments	22,409	22,609
Trading account securities	166	146
Mortgages held for sale	10,849	10,879
Loans and leases - net of unearned discount		
Commercial and agricultural loans	660,380	639,069
Auto, light truck and environmental equipment	510,562	438,147
Medium and heavy duty truck	178,594	172,002
Aircraft financing	677,510	696,479
Construction equipment financing	311,135	278,974
Commercial real estate	576,810	554,968
Residential real estate	454,983	438,641
Consumer loans	123,411	109,273
Total loans and leases	3,493,385	3,327,553
Reserve for loan and lease losses	(85,690)	(83,311)
Net loans and leases	3,407,695	3,244,242
Equipment owned under operating leases, net	52,856	52,173
Net premises and equipment	46,027	45,016
Goodwill and intangible assets	86,915	87,502
Accrued income and other assets	115,561	123,428
Total assets	\$ 4,638,811	\$ 4,550,693
<u>LIABILITIES</u>		
Deposits:		
Noninterest bearing	\$ 698,389	\$ 646,380
Interest bearing	3,002,410	2,977,967
Total deposits	3,700,799	3,624,347
Short-term borrowings:		
Federal funds purchased and securities sold under agreements to repurchase	162,778	158,680
Other short-term borrowings	39,126	10,508
Total short-term borrowings	201,904	169,188
Long-term debt and mandatorily redeemable securities	58,216	71,021
Subordinated notes	58,764	58,764
Accrued expenses and other liabilities	51,375	68,718
Total liabilities	4,071,058	3,992,038
<u>SHAREHOLDERS' EQUITY</u>		
Preferred stock; no par value		
Authorized 10,000,000 shares; none issued or outstanding		
Common stock; no par value		
Authorized 40,000,000 shares; issued 25,641,887 at June 30, 2013 and December 31, 2012	346,535	346,535
Retained earnings	241,401	223,715

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Cost of common stock in treasury (1,269,292 shares at June 30, 2013 and 1,399,261 shares at December 31, 2012)	(28,021)	(31,134)
Accumulated other comprehensive income	7,838	19,539
Total shareholders equity	567,753	558,655
Total liabilities and shareholders equity	\$ 4,638,811	\$ 4,550,693

The accompanying notes are a part of the consolidated financial statements.

Table of Contents**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF INCOME***(Unaudited - Dollars in thousands, except per share amounts)*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Interest income:				
Loans and leases	\$ 40,112	\$ 40,318	\$ 79,282	\$ 80,214
Investment securities, taxable	3,498	4,334	7,193	8,661
Investment securities, tax-exempt	760	848	1,531	1,700
Other	241	231	483	457
Total interest income	44,611	45,731	88,489	91,032
Interest expense:				
Deposits	4,412	5,704	8,954	11,449
Short-term borrowings	45	47	77	100
Subordinated notes	1,055	1,648	2,110	3,295
Long-term debt and mandatorily redeemable securities	228	357	723	828
Total interest expense	5,740	7,756	11,864	15,672
Net interest income	38,871	37,975	76,625	75,360
Provision for loan and lease losses	1,293	2,055	2,050	4,309
Net interest income after provision for loan and lease losses	37,578	35,920	74,575	71,051
Noninterest income:				
Trust fees	4,439	4,379	8,540	8,352
Service charges on deposit accounts	2,325	2,621	4,564	5,059
Debit card income	2,344	2,194	4,409	4,261
Mortgage banking income	1,936	1,502	3,564	3,444
Insurance commissions	1,393	1,211	2,839	2,568
Equipment rental income	4,086	4,666	8,098	10,016
Investment securities and other investment gains	38	8	211	403
Other income	3,560	3,209	6,844	6,210
Total noninterest income	20,121	19,790	39,069	40,313
Noninterest expense:				
Salaries and employee benefits	19,176	20,370	39,112	40,686
Net occupancy expense	2,147	1,848	4,354	4,008
Furniture and equipment expense	3,909	3,831	7,808	7,338
Depreciation - leased equipment	3,274	3,803	6,499	8,114
Professional fees	1,310	1,449	2,665	2,847
Supplies and communication	1,499	1,385	3,035	2,778
FDIC and other insurance	927	854	1,805	1,803
Business development and marketing expense	932	1,050	1,705	1,917
Loan and lease collection and repossession expense	1,095	979	1,852	2,480
Other expense	1,475	1,009	3,459	2,655
Total noninterest expense	35,744	36,578	72,294	74,626

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Income before income taxes	21,955	19,132	41,350	36,738
Income tax expense	8,013	6,565	15,004	12,456
Net income	\$ 13,942	\$ 12,567	\$ 26,346	\$ 24,282
Per common share:				
Basic net income per common share	\$ 0.56	\$ 0.51	\$ 1.07	\$ 0.99
Diluted net income per common share	\$ 0.56	\$ 0.51	\$ 1.07	\$ 0.99
Dividends	\$ 0.17	\$ 0.16	\$ 0.34	\$ 0.32
Basic weighted average common shares outstanding	24,367,529	24,263,881	24,344,882	24,261,649
Diluted weighted average common shares outstanding	24,368,973	24,273,898	24,346,053	24,272,423

The accompanying notes are a part of the consolidated financial statements.

Table of Contents**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME***(Unaudited - Dollars in thousands)*

	Three Months Ended June 30,		Six Months Ended June 30,	
	2013	2012	2013	2012
Net income	\$ 13,942	\$ 12,567	\$ 26,346	\$ 24,282
Other comprehensive (loss) income, net of tax:				
Change in unrealized (depreciation) appreciation of available-for-sale securities, net of tax	(10,495)	1,449	(11,701)	1,047
Reclassification adjustment for gains included in net income, net of tax				(171)
Other comprehensive (loss) income	(10,495)	1,449	(11,701)	876
Comprehensive income	\$ 3,447	\$ 14,016	\$ 14,645	\$ 25,158

The accompanying notes are a part of the consolidated financial statements.

1st SOURCE CORPORATION**CONSOLIDATED STATEMENTS OF SHAREHOLDERS EQUITY***(Unaudited - Dollars in thousands, except per share amounts)*

	Total	Preferred Stock	Common Stock	Retained Earnings	Cost of Common Stock in Treasury	Accumulated Other Comprehensive Income (Loss), Net
Balance at January 1, 2012	\$ 523,918	\$	\$ 346,535	\$ 190,261	\$ (31,389)	\$ 18,511
Net income	24,282			24,282		
Other comprehensive income	876					876
Issuance of 165,460 common shares under stock based compensation awards, including related tax effects	3,644			85	3,559	
Cost of 104,471 shares of common stock acquired for treasury	(2,617)				(2,617)	
Common stock dividend (\$0.32 per share)	(7,839)			(7,839)		
Balance at June 30, 2012	\$ 542,264	\$	\$ 346,535	\$ 206,789	\$ (30,447)	\$ 19,387

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Balance at January 1, 2013	\$	558,655	\$		\$	346,535	\$	223,715	\$	(31,134)	\$	19,539
Net income		26,346						26,346				
Other comprehensive loss		(11,701)										(11,701)
Issuance of 157,032 common shares under stock based compensation awards, including related tax effects		3,419						(313)		3,732		
Cost of 27,063 shares of common stock acquired for treasury		(619)								(619)		
Common stock dividend (\$0.34 per share)		(8,347)						(8,347)				
Balance at June 30, 2013	\$	567,753	\$		\$	346,535	\$	241,401	\$	(28,021)	\$	7,838

The accompanying notes are a part of the consolidated financial statements.

Table of Contents**1st SOURCE CORPORATION****CONSOLIDATED STATEMENTS OF CASH FLOWS***(Unaudited - Dollars in thousands)*

	Six Months Ended June 30,	
	2013	2012
Operating activities:		
Net income	\$ 26,346	\$ 24,282
Adjustments to reconcile net income to net cash provided (used) by operating activities:		
Provision for loan and lease losses	2,050	4,309
Depreciation of premises and equipment	2,331	2,094
Depreciation of equipment owned and leased to others	6,499	8,114
Amortization of investment security premiums and accretion of discounts, net	1,929	1,999
Amortization of mortgage servicing rights	937	1,528
Mortgage servicing asset recoveries		(147)
Deferred income taxes	(2,020)	(3,996)
Investment securities and other investment gains	(211)	(403)
Originations of loans held for sale, net of principal collected	(59,773)	(96,948)
Proceeds from the sales of loans held for sale	62,295	94,491
Net gain on sale of loans held for sale	(2,492)	(2,736)
Change in trading account securities	(20)	(6)
Change in interest receivable	(912)	(312)
Change in interest payable	1,041	1,702
Change in other assets	10,939	7,894
Change in other liabilities	(7,795)	(4,542)
Other	341	586
Net change in operating activities	41,485	37,909
Investing activities:		
Proceeds from sales of investment securities		40,236
Proceeds from maturities of investment securities	112,836	159,553
Purchases of investment securities	(81,041)	(169,504)
Net change in other investments	200	(960)
Loans sold or participated to others	19,819	15,494
Net change in loans and leases	(187,832)	(199,988)
Net change in equipment owned under operating leases	(7,182)	3,173
Purchases of premises and equipment	(3,361)	(3,082)
Net change in investing activities	(146,561)	(155,078)
Financing activities:		
Net change in demand deposits, NOW accounts and savings accounts	61,457	92,814
Net change in certificates of deposit	14,995	(26,938)
Net change in short-term borrowings	32,716	8,694
Proceeds from issuance of long-term debt	12,035	25,600
Payments on long-term debt	(26,296)	(268)
Net proceeds from issuance of treasury stock	3,419	3,644
Acquisition of treasury stock	(619)	(2,617)
Cash dividends paid on common stock	(8,544)	(8,007)
Net change in financing activities	89,163	92,922
Net change in cash and cash equivalents	(15,913)	(24,247)

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Cash and cash equivalents, beginning of year	83,934	114,327
Cash and cash equivalents, end of period	\$ 68,021	\$ 90,080

Supplemental Information:

Non-cash transactions:

Loans transferred to other real estate and repossessed assets	\$ 2,510	\$ 1,791
Common stock matching contribution to Employee Stock Ownership and Profit Sharing Plan	2,801	2,643

The accompanying notes are a part of the consolidated financial statements.

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1ST SOURCE CORPORATION

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1. Basis of Presentation

1st Source Corporation is a bank holding company headquartered in South Bend, Indiana that provides, through its subsidiaries (collectively referred to as 1st Source or the Company), a broad array of financial products and services. The accompanying unaudited consolidated financial statements reflect all adjustments (all of which are normal and recurring in nature) which are, in the opinion of management, necessary for a fair presentation of the consolidated financial position, the results of operations, changes in comprehensive income, changes in shareholders' equity, and cash flows for the periods presented. These unaudited consolidated financial statements have been prepared according to the rules and regulations of the Securities and Exchange Commission (SEC) and, therefore, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles (GAAP) have been omitted.

The Notes to the Consolidated Financial Statements appearing in 1st Source Corporation's Annual Report on Form 10-K (2012 Annual Report), which include descriptions of significant accounting policies, should be read in conjunction with these interim financial statements. The Consolidated Statement of Financial Condition at December 31, 2012 has been derived from the audited financial statements at that date but does not include all of the information and footnotes required by U.S. generally accepted accounting principles for complete financial statements. Certain amounts in the prior period consolidated financial statements have been reclassified to conform to the current year presentation.

Note 2. Recent Accounting Pronouncements

Comprehensive Income: In February 2013, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2013-02 *Comprehensive Income (Topic 220) Reporting of Amounts Reclassified Out of Accumulated Other Comprehensive Income*. ASU 2013-02 requires an entity to provide information about the amounts reclassified out of accumulated other comprehensive income by component. ASU 2013-02 is effective prospectively during interim and annual periods beginning after December 15, 2012. The Company has adopted the standard as required, however the effect of applying this standard is not reflected in the June 30, 2013 Form 10Q as the Company did not have amounts reclassified out of Accumulated Other Comprehensive Income during the three or six months ended June 30, 2013. Amounts in future periods, when they occur, will be reflected in the investment securities and other investment gains and the income tax expense line items in the Consolidated Statements of Income.

Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities: In January 2013, the FASB issued ASU No. 2013-01 *Balance Sheet (Topic 210) Clarifying the Scope of Disclosures about Offsetting Assets and Liabilities*. ASU 2013-01 clarifies that ordinary trade receivables and receivables are not in the scope of ASU 2011-11. ASU 2011-11 applies only to derivatives, repurchase agreements, and securities borrowing and securities lending transactions that are either offset in accordance with specific criteria in the Accounting Standards Codification or subject to a master netting arrangement or similar agreement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The effect of applying this standard is reflected in Note 8 - Derivative Financial Instruments.

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Offsetting Assets and Liabilities: In December 2011, the FASB issued ASU No. 2011-11 *Balance Sheet (Topic 210) - Disclosures about Offsetting Assets and Liabilities*. ASU 2011-11 requires an entity to disclose both gross information and net information about both instruments and transactions eligible for offset in the statement of financial position and instruments and transactions subject to an agreement similar to a master netting arrangement. ASU 2011-11 is effective for annual reporting periods beginning on or after January 1, 2013, and interim periods within those annual periods. Retrospective disclosure is required for all comparative periods presented. The effect of applying this standard is reflected in Note 8 Derivative Financial Instruments.

Note 3. Investment Securities

Investment securities available-for-sale were as follows:

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2013				
U.S. Treasury and Federal agencies securities	\$ 391,452	\$ 6,545	\$ (5,357)	\$ 392,640
U.S. States and political subdivisions securities	103,875	3,949	(1,186)	106,638
Mortgage-backed securities Federal agencies	287,099	6,749	(2,626)	291,222
Corporate debt securities	28,133	216	(18)	28,331
Foreign government and other securities	2,700	9	(1)	2,708
Total debt securities	813,259	17,468	(9,188)	821,539
Marketable equity securities	2,367	4,409	(3)	6,773
Total investment securities available-for-sale	\$ 815,626	\$ 21,877	\$ (9,191)	\$ 828,312
December 31, 2012				
U.S. Treasury and Federal agencies securities	\$ 410,983	\$ 11,353	\$ (83)	\$ 422,253
U.S. States and political subdivisions securities	100,055	5,864	(482)	105,437
Mortgage-backed securities Federal agencies	301,136	11,296	(25)	312,407
Corporate debt securities	30,897	445	(94)	31,248
Foreign government and other securities	3,700	26		3,726
Total debt securities	846,771	28,984	(684)	875,071
Marketable equity securities	2,368	3,329	(4)	5,693
Total investment securities available-for-sale	\$ 849,139	\$ 32,313	\$ (688)	\$ 880,764

At June 30, 2013 and December 31, 2012, the residential mortgage-backed securities held by the Company consisted primarily of GNMA, FNMA and FHLMC pass-through certificates which are guaranteed by those respective agencies of the United States government (Government Sponsored Enterprise, GSEs).

The contractual maturities of investments in debt securities available-for-sale at June 30, 2013 are shown below. Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

Amortized Cost	Fair Value
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Due in one year or less	\$	123,887	\$	123,155
Due after one year through five years		330,448		336,000
Due after five years through ten years		70,565		69,983
Due after ten years		1,260		1,179
Mortgage-backed securities		287,099		291,222
Total debt securities available-for-sale	\$	813,259	\$	821,539

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The following table shows the gross realized gains and losses on sale of securities from the securities available-for-sale portfolio, including marketable equity securities. Realized gains and losses on the sales of all securities are computed using the specific identification cost basis. There were no other-than-temporary-impairment (OTTI) write-downs in 2013 or 2012.

(Dollars in thousands)	Three Months Ended June 30,		Six Months Ended June 30,		
	2013	2012	2013	2012	
Gross realized gains	\$	\$	\$	\$	275
Gross realized losses					
Net realized gains	\$	\$	\$	\$	275

The following table summarizes gross unrealized losses and fair value by investment category and age.

(Dollars in thousands)	Less than 12 Months		12 months or Longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
June 30, 2013						
U.S. Treasury and Federal agencies securities	\$ 186,172	\$ (5,185)	\$ 15,069	\$ (172)	\$ 201,241	\$ (5,357)
U.S. States and political subdivisions securities	29,755	(875)	2,343	(311)	32,098	(1,186)
Mortgage-backed securities - Federal agencies	70,652	(2,625)	52	(1)	70,704	(2,626)
Corporate debt securities			4,507	(18)	4,507	(18)
Foreign government and other securities	199	(1)			199	(1)
Total debt securities	286,778	(8,686)	21,971	(502)	308,749	(9,188)
Marketable equity securities			5	(3)	5	(3)
Total investment securities available-for-sale	\$ 286,778	\$ (8,686)	\$ 21,976	\$ (505)	\$ 308,754	\$ (9,191)
December 31, 2012						
U.S. Treasury and Federal agencies securities	\$ 37,316	\$ (83)	\$	\$	\$ 37,316	\$ (83)
U.S. States and political subdivisions securities	7,730	(46)	3,364	(436)	11,094	(482)
Mortgage-backed securities - Federal agencies	6,264	(24)	60	(1)	6,324	(25)
Corporate debt securities			4,431	(94)	4,431	(94)
Foreign government and other securities	100				100	
Total debt securities	51,410	(153)	7,855	(531)	59,265	(684)
Marketable equity securities			5	(4)	5	(4)
	\$ 51,410	\$ (153)	\$ 7,860	\$ (535)	\$ 59,270	\$ (688)

Total investment
securities
available-for-sale

The initial indication of OTTI for both debt and equity securities is a decline in fair value below amortized cost. Quarterly, the impaired securities are analyzed on a qualitative and quantitative basis in determining OTTI. Declines in the fair value of available-for-sale debt securities below their cost that are deemed to be other-than-temporary are reflected in earnings as realized losses to the extent the impairment is related to credit losses. The amount of impairment related to other factors is recognized in other comprehensive income. In estimating OTTI impairment losses, the Company considers among other things, (i) the length of time and the extent to which fair value has been less than cost, (ii) the financial condition and near-term prospects of the issuer, and (iii) whether it is more likely than not that the Company will not have to sell any such securities before a recovery of cost.

At June 30, 2013, the Company does not have the intent to sell any of the available-for-sale securities in the table above and believes that it is more likely than not, that it will not have to sell any such securities before an anticipated recovery of cost. Primarily the unrealized losses on debt securities are due to market volatility and market illiquidity on auction rate securities which are reflected in U.S. States and political subdivisions. The fair value is expected to recover on all debt securities as they approach their maturity date or re-pricing date or if market yields for such investments decline. The Company does not believe any of the securities are impaired due to reasons of credit quality.

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At June 30, 2013 and December 31, 2012, investment securities with carrying values of \$234.05