Companhia Vale do Rio Doce
Form 6-K
February 26, 2009

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United States
Securities and Exchange Commission
Washington, D.C. 20549
FORM 6-K
Report of Foreign Private Issuer
Pursuant to Rule 13a-16 or 15d-16
of the
Securities Exchange Act of 1934
For the month of
February 2009
Companhia Vale do Rio Doce
Avenida Graça Aranha, No. 26
20030-900 Rio de Janeiro, RJ, Brazil
(Address of principal executive office)

(Indicate by check mark whether the registrant files or will file annual reports under cover of Form 20-F or Form 40-F.)
(Check One) Form 20-F þ Form 40-F o
(Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1))
(Check One) Yes o No þ
(Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7))
(Check One) Yes o No þ
(Indicate by check mark whether the registrant by furnishing the information contained in this Form is also thereby furnishing information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.)
(Check One) Yes o No þ
(If Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b). 82-__________.)

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Stockholders
Companhia Vale do Rio Doce

In our opinion, the accompanying consolidated balance sheets and the related consolidated statements of income, of cash flows and of changes in stockholders equity present fairly, in all material respects, the financial position of Companhia Vale do Rio Doce and its subsidiaries at December 31, 2008 and 2007, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2008 in conformity with accounting principles generally accepted in the United States of America. Also in our opinion, the Company maintained, in all material respects, effective internal control over financial reporting as of December 31, 2008, based on criteria established in *Internal Control Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). The Company s management is responsible for these financial statements, for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management s Report on internal control over financial reporting. Our responsibility is to express opinions on these financial statements and on the Company s internal control over financial reporting based on our integrated audits. We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement and whether effective internal control over financial reporting was maintained in all material respects. Our audits of the financial statements included examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. Our audit of internal control over financial reporting included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, and testing and evaluating the design and operating effectiveness of internal control based on the assessed risk. Our audits also included performing such other procedures as we considered necessary in the circumstances. We believe that our audits provide a reasonable basis for our opinions.

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

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

PricewaterhouseCoopers
Auditores Independentes

Rio de Janeiro, Brazil
February 19, 2009

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Management s Report on Internal Control over Financial Reporting

The management of Companhia Vale do Rio Doce VALE is responsible for establishing and maintaining adequate internal control over financial reporting.

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

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

Vale s management has assessed the effectiveness of the company s internal control over financial reporting as of December 31, 2008 based on the criteria established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission - COSO. Based on such assessment and criteria, Vale s management has concluded that the company s internal control over financial reporting was effective as of December 31, 2008.

The effectiveness of the company s internal control over financial reporting as of December 31, 2008 has been audited by PricewaterhouseCoopers Auditores Independentes, an independent registered public accounting firm, as stated in their report which appears herein.

By:

Name: Roger Agnelli
Title: Chief Executive Officer

By:

Name: Fabio de Oliveira Barbosa
Title: Chief Financial Officer

Date: February 19, 2009

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Consolidated Balance Sheets
Expressed in millions of United States Dollars

	December 31, 2008	December 31, 2007
Assets		
Current assets		
Cash and cash equivalents	10,331	1,046
Short term investments	2,308	
Accounts receivable		
Related parties	137	281
Unrelated parties	3,067	3,671
Loans and advances to related parties	53	64
Inventories	3,896	3,859
Deferred income tax	583	603
Recoverable taxes	1,993	1,159
Other	870	697
	23,238	**11,380**
Property, plant and equipment, net, and intangible assets	**49,329**	**54,625**
Investments in affiliated companies, joint ventures and other investments	**2,408**	**2,922**
Other assets		
Goodwill on acquisition of subsidiaries	1,898	3,791
Loans and advances		
Related parties		3
Unrelated parties	77	127
Prepaid pension cost	622	1,009
Prepaid expenses	223	200
Judicial deposits	1,141	1,124
Advances to suppliers energy	408	574
Recoverable taxes	394	199
Unrealized gains on derivative instruments	32	673
Other	161	90
	4,956	**7,790**
TOTAL	**79,931**	**76,717**

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Consolidated Balance Sheets
Expressed in millions of United States Dollars
(Except number of shares)

	(Continued)	
	December 31, 2008	**December 31, 2007**
Liabilities and stockholders equity		
Current liabilities		
Suppliers	2,261	2,430
Payroll and related charges	591	734
Current portion of long-term debt	633	1,249
Short-term debt		167
Loans from related parties	77	6
Provision for income taxes	502	1,198
Taxes payable and royalties	55	322
Employees postretirement benefits	102	131
Railway sub-concession agreement payable	400	210
Unrealized losses on derivative instruments		346
Provisions for asset retirement obligations	48	64
Minimum mandatory dividends payable	2,068	2,683
Other	500	543
	7,237	**10,083**
Long-term liabilities		
Employees postretirement benefits	1,485	2,204
Long-term debt	17,535	17,608
Provisions for contingencies (Note 20 (b))	1,685	2,453
Unrealized losses on derivative instruments	573	5
Deferred income tax	4,005	5,725
Provisions for asset retirement obligations	839	911
Railway sub-concession agreement payable		210
Other	1,525	1,687
	27,647	**30,803**
Minority interests	**2,491**	**2,555**
Commitments and contingencies (Note 20)		
Stockholders equity		
Preferred class A stock - 7,200,000,000 no-par-value shares authorized and 2,108,579,618 (2007 - 1,919,516,400) issued	9,727	4,953
	15,262	7,742

Common stock - 3,600,000,000 no-par-value shares authorized and 3,256,724,482 (2007 - 2,999,797,716) issued		
Treasury stock - 76,854,304 (2007 - 30,341,144) preferred and 74,937,899 (2007 - 56,582,040) common shares	(1,141)	(389)
Additional paid-in capital	393	498
Mandatorily convertible notes common shares	1,288	1,288
Mandatorily convertible notes preferred shares	581	581
Other cumulative comprehensive income (loss)	(11,510)	1,655
Undistributed retained earnings	18,340	15,317
Unappropriated retained earnings	9,616	1,631
	42,556	**33,276**
TOTAL	**79,931**	**76,717**

The accompanying notes are an integral part of these consolidated financial statements.

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Consolidated Statements of Income
Expressed in millions of United States Dollars
(Except per share amounts)

	Three-month period ended (unaudited)			Year ended of December 31,		
	December 31, 2008	**September 30, 2008**	**December 31, 2007**	**2008**	**2007**	**2006**
Operating revenues, net of discounts, returns and allowances						
Sales of ores and metals	6,052	10,425	7,213	32,779	28,441	16,511
Aluminum products	779	889	672	3,042	2,722	2,381
Revenues from logistic services	310	473	389	1,607	1,525	1,376
Other products and services	301	335	138	1,081	427	95
	7,442	**12,122**	**8,412**	**38,509**	**33,115**	**20,363**
Taxes on revenues	(187)	(383)	(249)	(1,083)	(873)	(712)
Net operating revenues	**7,255**	**11,739**	**8,163**	**37,426**	**32,242**	**19,651**
Operating costs and expenses						
Cost of ores and metals sold	(2,730)	(4,051)	(3,687)	(14,055)	(13,628)	(7,946)
Cost of aluminum products	(529)	(684)	(486)	(2,267)	(1,705)	(1,355)
Cost of logistic services	(190)	(272)	(231)	(930)	(853)	(777)
Other	(71)	(109)	(100)	(389)	(277)	(69)
	(3,520)	**(5,116)**	**(4,504)**	**(17,641)**	**(16,463)**	**(10,147)**
Selling, general and administrative expenses	(708)	(374)	(424)	(1,748)	(1,245)	(816)
Research and development expenses	(295)	(331)	(262)	(1,085)	(733)	(481)
Impairment of goodwill	(950)			(950)		
Other	(719)	(383)	(290)	(1,254)	(607)	(570)
	(6,192)	**(6,204)**	**(5,480)**	**(22,678)**	**(19,048)**	**(12,014)**
Operating income	**1,063**	**5,535**	**2,683**	**14,748**	**13,194**	**7,637**
Non-operating income (expenses)						
Financial income	247	277	58	602	295	327
Financial expenses	(399)	(457)	(554)	(1,765)	(2,517)	(1,222)
Gains (losses) on derivatives, net	(586)	(587)	316	(812)	931	(116)
Foreign exchange and indexation gains (losses), net	(241)	(321)	315	364	2,553	529
Gain on sale of investments				80	777	674
	(979)	**(1,088)**	**135**	**(1,531)**	**2,039**	**192**
	84	**4,447**	**2,818**	**13,217**	**15,233**	**7,829**

Income before income taxes, equity results and minority interests						
Income taxes						
Current	966	(477)	(610)	(1,338)	(3,901)	(1,134)
Deferred	219	621	394	803	700	(298)
	1,185	**144**	**(216)**	**(535)**	**(3,201)**	**(1,432)**
Equity in results of affiliates, joint ventures and other investments	125	290	136	794	595	710
Minority interests	(27)	(60)	(165)	(258)	(802)	(579)
Net income	**1,367**	**4,821**	**2,573**	**13,218**	**11,825**	**6,528**
Basic and diluted earnings per share						
Earnings per preferred share	0.25	0.94	0.52	2.58	2.41	1.35
Earnings per common share	0.25	0.94	0.52	2.58	2.41	1.35
Earnings per prefered share linked to (*)	0.76	1.19	0.79	4.09	3.30	
Earnings per common share linked to (*)	0.81	1.25	0.85	4.29	3.51	

(*) Basic earnings per share only, as dilution assumes conversion.

The accompanying notes are an integral part of these consolidated financial statements.

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Consolidated Statements of Cash Flows
Expressed in millions of United States Dollars

	Three-month period ended (unaudited)			Year ended of December 31,		
	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007	2006
Cash flows from operating activities:						
Net income	1,367	4,821	2,573	13,218	11,825	6,528
Adjustments to reconcile net income to cash from operations:						
Depreciation, depletion and amortization	568	713	737	2,807	2,186	997
Dividends received	116	126	112	513	394	516
Equity in results of affiliates, joint ventures and other investments	(125)	(290)	(136)	(794)	(595)	(710)
Deferred income taxes	(219)	(621)	(394)	(803)	(700)	298
Impairment of goodwill	950			950		
Loss on disposal of property, plant and equipment	10	243	104	376	168	106
Gain on sale of investments				(80)	(777)	(674)
Foreign exchange and indexation losses (gains), net	740	1,133	(266)	451	(2,827)	(917)
Unrealized derivative losses (gains), net	586	587	(326)	812	(917)	116
Minority interests	27	60	165	258	802	579
Unrealized interest (income) expense, net	(3)	83	(23)	116	102	36
Others	17	1	46	(3)	115	(93)
Decrease (increase) in assets:						
Accounts receivable	1,615	(1,481)	135	(466)	235	(438)
Inventories	(43)	(77)	(558)	(467)	(343)	859
Others	(171)	5	80	(242)	(292)	(12)
Increase (decrease) in liabilities:						
Suppliers	200	237	429	703	998	(47)
Payroll and related charges	(25)	97	106	1	170	(86)
Income taxes	119	(291)	(582)	(140)	393	84
Others	564	(14)	260	(96)	75	90
Net cash provided by operating activities	**6,293**	**5,332**	**2,462**	**17,114**	**11,012**	**7,232**
Cash flows from investing activities:						
Short term investments	(1,674)	(634)		(2,308)		
Loans and advances receivable						

Related parties						
Loan proceeds	(3)		(32)	(37)	(33)	(18)
Repayments	18	15		58	10	11
Others	24	(40)	(1)	(15)	1	(16)
Judicial deposits	(71)	(26)	(50)	(133)	(125)	(78)
Investments	(19)	(85)	(230)	(128)	(324)	(107)
Property, plant and equipment	(3,689)	(1,553)	(2,747)	(8,972)	(6,651)	(4,431)
Proceeds from disposal of investments				134	1,042	837
Proceeds from disposals of property, plant and equipment						49
Acquisition of subsidiaries, net of cash acquired					(2,926)	(13,201)
Net cash used in investing activities	**(5,414)**	**(2,323)**	**(3,060)**	**(11,401)**	**(9,006)**	**(16,954)**
Cash flows from financing activities:						
Short-term debt, additions	1	65	2,021	1,076	4,483	4,912
Short-term debt, repayments	(125)	(65)	(1,877)	(1,311)	(5,040)	(4,233)
Loans						
Related parties						
Loan proceeds	33		1	54	259	10
Repayments		(16)	(39)	(20)	(273)	(50)
Issuances of long-term debt						
Related parties						14
Others	253	71	646	1,890	7,212	21,993
Repayments of long-term debt						
Others	(65)	(313)	(114)	(1,130)	(11,130)	(7,635)
Treasury stock	(752)			(752)		(301)
Mandatorily convertible notes					1,869	
Capital increase		12,190		12,190		
Dividends and interest attributed to stockholders	(1,600)		(1,050)	(2,850)	(1,875)	(1,300)
Dividends to minority interest	(56)		(429)	(143)	(714)	(65)
Net cash provided by (used in) financing activities	**(2,311)**	**11,932**	**(841)**	**9,004**	**(5,209)**	**13,345**
Increase (decrease) in cash and cash equivalents	(1,432)	14,941	(1,439)	14,717	(3,203)	3,623
Effect of exchange rate changes on cash and cash equivalents	(2,863)	(2,469)	(23)	(5,432)	(199)	(216)
Cash and cash equivalents, beginning of period	14,626	2,154	2,508	1,046	4,448	1,041
Cash and cash equivalents, end of period	**10,331**	**14,626**	**1,046**	**10,331**	**1,046**	**4,448**

Cash paid during the period for:						
Interest on short-term debt		(1)	(8)	(11)	(49)	(9)
Interest on long-term debt	(314)	(305)	(361)	(1,255)	(1,289)	(565)
Income tax	(149)	(726)	(732)	(2,867)	(3,284)	(586)
Non-cash transactions						
Interest capitalized	185	14	15	230	78	126
Issuance of preferred stock for the acquisition of Caemi, net of cash acquired						2,552

The accompanying notes are an integral part of these consolidated financial statements.

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Consolidated Statements of Changes in Stockholders Equity
Expressed in millions of United States Dollars
(except number of shares and per-share amounts)

	Three-month period ended (unaudited)			Year ended of December 31,		
	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007	2006
Preferred class A stock (including twelve special shares)						
Beginning of the period	9,727	4,953	4,953	4,953	4,702	2,150
Capital increase		4,774		4,774		2,552
Transfer from undistributed retained earnings					251	
End of the period	**9,727**	**9,727**	**4,953**	**9,727**	**4,953**	**4,702**
Common stock						
Beginning of the period	15,262	7,742	7,742	7,742	3,806	3,806
Capital increase		7,520		7,520		
Transfer from undistributed retained earnings					3,936	
End of the period	**15,262**	**15,262**	**7,742**	**15,262**	**7,742**	**3,806**
Treasury stock						
Beginning of the period	(389)	(389)	(389)	(389)	(389)	(301)
Acquisitions	(752)			(752)		(88)
End of the period	**(1,141)**	**(389)**	**(389)**	**(1,141)**	**(389)**	**(389)**
Additional paid-in capital						
Beginning and end of the period	393	498	498	498	498	498
Change in the period		(105)		(105)		
End of the period	**393**	**393**	**498**	**393**	**498**	**498**
Mandatorily convertible notes common shares						

Beginning and end of the period	**1,288**	**1,288**	**1,288**	**1,288**	**1,288**	
Mandatorily convertible notes preferred shares						
Beginning and end of the period	**581**	**581**	**581**	**581**	**581**	
Other cumulative comprehensive income (deficit)						
Cumulative translation adjustments						
Beginning of the period	(3,993)	2,842	1,003	1,340	(1,628)	(2,856)
Change in the period	(7,500)	(6,835)	337	(12,833)	2,968	1,228
End of the period	**(11,493)**	**(3,993)**	**1,340**	**(11,493)**	**1,340**	**(1,628)**
Unrealized gain (loss) available-for-sale securities, net of tax						
Beginning of the period	(79)	111	229	211	271	127
Change in the period	96	(190)	(18)	(194)	(60)	144
End of the period	**17**	**(79)**	**211**	**17**	**211**	**271**
Surplus (deficit) accrued pension plan						
Beginning of the period	(304)	164	540	75	353	460
Change in the period	270	(468)	(465)	(109)	(278)	(107)
End of the period	**(34)**	**(304)**	**75**	**(34)**	**75**	**353**
Cash flow hedge						
Beginning of the period	28	8	23	29		
Change in the period	(28)	20	6	(29)	29	
End of the period		**28**	**29**		**29**	

Total other cumulative comprehensive income (deficit)	**(11,510)**	**(4,348)**	**1,655**	**(11,510)**	**1,655**	**(1,004)**
Undistributed retained earnings						
Beginning of the period	14,183	17,021	6,560	15,317	9,555	4,357
Transfer from/to unappropriated retained earnings	4,157	(2,838)	8,757	3,023	9,949	5,198
Capitalized earnings					(4,187)	
End of the period	**18,340**	**14,183**	**15,317**	**18,340**	**15,317**	**9,555**
Unappropriated retained earnings						
Beginning of the period	14,521	6,886	10,524	1,631	2,505	3,983
Net income	1,367	4,821	2,573	13,218	11,825	6,528
Interest on mandatorily covertible debt						
Preferred class A stock	(15)	(8)	(8)	(46)	(22)	
Common stock	(32)	(16)	(18)	(96)	(45)	
Dividends and interest attributed to stockholders equity						
Preferred class A stock	(806)		(1,049)	(806)	(1,049)	(1,098)
Common stock	(1,262)		(1,634)	(1,262)	(1,634)	(1,710)
Appropriation from/to undistributed retained earnings	(4,157)	2,838	(8,757)	(3,023)	(9,949)	(5,198)
End of the period	**9,616**	**14,521**	**1,631**	**9,616**	**1,631**	**2,505**
Total stockholders equity	**42,556**	**51,218**	**33,276**	**42,556**	**33,276**	**19,673**
Number of shares:						
	2,108,579,618	2,108,579,618	1,919,516,400	2,108,579,618	1,919,516,400	1,919,516,400

Preferred class A stock (including twelve special shares)						
Common stock	3,256,724,482	3,256,724,482	2,999,797,716	3,256,724,482	2,999,797,716	2,999,797,716
Buy-backs						
Beginning of the period	(86,922,944)	(86,923,052)	(86,923,184)	(86,923,184)	(86,927,072)	(56,627,872)
Acquisitions	(64,869,259)			(64,869,259)		(30,299,200)
Sales		108		240	3,888	
End of the period	(151,792,203)	(86,922,944)	(86,923,184)	(151,792,203)	(86,923,184)	(86,927,072)
	5,213,511,897	5,278,381,156	4,832,390,932	5,213,511,897	4,832,390,932	4,832,387,044

The accompanying notes are an integral part of these consolidated financial statements.

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Notes to the Consolidated Financial Statements
Expressed in millions of United States Dollars, unless otherwise stated

1 The Company and its operation

Companhia Vale do Rio Doce (Vale , the Company or we) is a limited liability company incorporated in Brazil. Operations are carried out through Vale and our subsidiary companies, joint ventures and affiliates, and mainly consist of mining, non-ferrous metal production, logistics and steel activities.

At December 31, 2008, our principal consolidated operating subsidiaries are the following:

Subsidiary	% ownership	% voting capital	Head office location	Principal activity
Alumina do Norte do Brasil S.A. Alunorte (Alunorte)	57.03	59.02	Brazil	Alumina
Alumínio Brasileiro S.A. Albras (Albras)	51.00	51.00	Brazil	Aluminum
CADAM S.A (CADAM)	61.48	100.00	Brazil	Kaolin
CVRD Overseas Ltd.	100.00	100.00	Cayman Islands	Trading
Ferrovia Centro-Atlântica S. A.	100.00	100.00	Brazil	Logistics
Minerações Brasileiras Reunidas S.A. MBR	92.99	92.99	Brazil	Iron ore
Pará Pigmentos S.A. (PPSA)	86.17	85.57	Brazil	Kaolin
PT International Nickel Indonesia Tbk (PT Inco)	61.16	61.16	Indonesia	Nickel
Vale Manganês S.A. (formely Rio Doce Manganês S.A.)	100.00	100.00	Brazil	Manganese and Ferroalloys
Vale Manganèse France (formely Rio Doce Manganèse Europe RDME)	100.00	100.00	France	Ferroalloys
Rio Doce Manganese Norway RDMN	100.00	100.00	Norway	Ferroalloys
Vale Australia Pty Ltd.	100.00	100.00	Australia	Coal
Vale Inco Limited	100.00	100.00	Canada	Nickel
Vale International S.A (formerly CVRD International S.A)	100.00	100.00	Swiss	Trading
Valesul Aumínio S.A.	100.00	100.00	Brazil	Aluminum

2 Basis of consolidation

All majority-owned subsidiaries in which we have both share and management control are consolidated. All significant intercompany accounts and transactions are eliminated. Our variable interest entities in which we are the primary beneficiary are consolidated. Investments in unconsolidated affiliates and joint ventures are accounted for under the equity method (Note 12).

We evaluate the carrying value of our equity accounted investments in relation to publicly quoted market prices when available. If the quoted market price is below book value, and such decline is considered other than temporary, we write-down our equity investments to quoted market value.

We define joint ventures as businesses in which we and a small group of other partners each participate actively in the overall entity management, based on a shareholders agreement. We define affiliates as businesses in which we participate as a minority stockholder but with significant influence over the operating and financial policies of

the investee.

Our participation in hydroelectric projects are made via consortium contracts under which we have undivided interests in the assets and are liable for our proportionate share of liabilities and expenses, which are based on our proportionate share of power output. We do not have joint liability for any obligations. No separate legal or tax status is granted to consortia under Brazilian law. Accordingly, we recognize our proportionate share of costs and our undivided interest in assets relating to hydroelectric projects (Note 11).

3 Summary of significant accounting policies

The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Estimates are used for, but not limited to, the selection of useful lives of property, plant and equipment, impairment, provisions necessary for contingent liabilities, fair values assigned to assets and liabilities acquired in business combinations, income tax valuation allowances, employee post retirement benefits and other similar evaluations. Actual results could differ from those estimates.

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(a) Basis of presentation

We have prepared our consolidated financial statements in accordance with United States generally accepted accounting principles (US GAAP), which differ in certain respects from the accounting practices adopted in Brazilian GAAP which are the basis for our statutory financial statements.

In December 2007, significant modifications were made to Brazilian GAAP as part of a convergence project with International Financial Reporting Standards (IFRS). Such changes became effective for the fiscal year ended December 31, 2008, whereas other changes will be introduced subsequently.

Our condensed consolidated interim financial information for the three-month periods ended December 31, 2008, September 30, 2008, and December 31, 2007, presented herein are unaudited. However, in our opinion, such condensed consolidated financial information include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the results for interim periods.

The Brazilian Real is the parent Company s functional currency. We have selected the U.S. Dollar as our reporting currency. The financial statements have been translated in accordance with the criteria set forth in Statement of Financial Accounting Standards No. (SFAS) 52 Foreign Currency Translation .

All assets and liabilities have been translated to U.S. Dollars at the closing rate of exchange at each balance sheet date (or, if unavailable, the first available exchange rate). All statement of income accounts have been translated to U.S. Dollars at the average exchange rates prevailing during the respective periods. Capital accounts are recorded at historical exchange rates. Translation gains and losses are recorded in the Cumulative Translation Adjustments account (CTA) in stockholders equity. The results of operations and financial position of our entities that have a functional currency other than the U.S. Dollar, have been translated in accordance with SFAS 52.

The exchange rates used to translate the assets and liabilities of the Brazilian operations at December 31, 2008 and December 31, 2007, were R$ 2.3370 and R$ 1.7713, respectively.

The net transaction gain (loss) included in our statement of income (Foreign exchange and indexation gains (losses), net) was US$ (1,011), US$ 1,639 and US$ 452 in the year ended December 31, 2008, 2007 and 2006, respectively.

(b) Cash equivalents and short-tem investment

Cash flows from overnight investments and fundings are reported net. Short-term investments that have a ready market and original maturities of 90 days or less are classified as Cash equivalents . The remaining investments, with longer maturities are stated at fair value and presented as Short-term investments .

(c) Long-term

Assets and liabilities that are realizable or due more than 12 months after the balance sheet date are classified as long-term.

(d) Inventories

Inventory is recorded at the average cost of purchase or production, reduced to market value (net realizable value less a reasonable margin) when lower.

We classify proven and probable reserve quantities attributable to stockpiled inventories as inventories and account for them as processed when they are removed from the mine. These reserve quantities are not included in the total proven and probable reserve quantities used in the units of production, depreciation, depletion and amortization calculations.

We periodically assess our inventories to identify obsolescence or slow moving and if needed, we recognize definitive allowances for slow movement or obsolete inventories.

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(e) Removal of waste materials to access mineral deposits

Stripping costs (the costs associated with the removal of overburden and other waste materials) incurred during the development of a mine, before production commences, are capitalized as part of the depreciable cost of developing the property. Such costs are subsequently amortized over the useful life of the mine based on proven and probable reserves.

Post-production stripping costs are included in the cost of the inventory produced (that is extracted), at each mine individually during the period that the stripping cost are incurred.

(f) Property, plant and equipment and Intangible Assets

Property, plant and equipment are recorded at cost, including interest cost incurred during the construction of major new facilities. We compute depreciation on the straight-line basis at annual average rates which take into consideration the useful lives of the assets, as follows: 3.03% for railroads, 3.65% for buildings, 3.78% for installations and 7.30% for other equipment. Expenditures for maintenance and repairs are charged to operating costs and expenses as incurred.

We capitalize the costs of developing major new ore bodies or expanding the capacity of operating mines and amortize these to operations on the unit-of-production method based on the total probable and proven quantity of ore to be recovered. Exploration costs are expensed. Once the economic viability of mining activities is established, subsequent development costs are capitalized.

Separately acquired intangible assets are shown at historical cost. Intangible assets acquired in a business combination are recognized at fair value at the acquisition date. All our intangible assets have definite useful lives and are carried at cost less accumulated amortization, which is calculated using the straight-line method over their estimated useful lives.

(g) Business combinations

We adopt SFAS 141 Business Combinations to record acquisitions of interests in other companies. This purchase method , requires that we reasonably determine the fair value of the identifiable tangible and intangible assets and liabilities of acquired companies and segregate goodwill as an intangible asset.

We assign goodwill to reporting units and test each reporting unit s goodwill for impairment at least annually, and whenever circumstance indicating that recognized goodwill may not be fully recovered are identified. We perform the annual goodwill impairment tests during the last quarter of the year using September 30 as our base date.

Goodwill is reviewed for impairment utilizing a two step process. In the first step, we compare a reporting unit s fair value with its carrying amount to identify any potential goodwill impairment loss. If the carrying amount of a reporting unit exceeds the unit s fair value, based on a discounted cash flow analysis, we carry out the second step of the impairment test, measuring and recording the amount, if any, of the unit s goodwill impairment loss.

(h) Impairment of long-lived assets

All long-lived assets, are tested to determine if they are recoverable from operating earnings on an undiscounted cash flow basis over their useful lives whenever events or changes in circumstance indicate that the carrying value may not be recoverable.

When we determine that the carrying value of long-lived assets and definite-life intangible assets may not be recoverable, we measure any impairment loss based on a projected discounted cash flow method using a discount rate determined to be commensurate with the risk inherent in our current business model.

(i) Available-for-sale equity securities

Equity securities classified as available-for-sale are recorded pursuant to SFAS 115 Accounting for Certain Investments in Debt and Equity Securities . Accordingly, we classify unrealized holding gains and losses, net of taxes, as a separate component of stockholders equity until realized.

(j) Compensated absences

The liability for future compensation for employee vacations is fully accrued as earned.

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(k) Derivatives and hedging activities

We apply SFAS 133 Accounting for Derivative Financial Instruments and Hedging Activities , as amended. This standard requires that we recognize all derivative financial instruments as either assets or liabilities on our balance sheet and measure such instruments at fair value. Changes in the fair value of derivatives are recorded in each period in current earnings or in other comprehensive income, in the latter case depending on whether a transaction is designated as an effective hedge and has been effective during the period.

(l) Asset retirement obligations

Our retirement obligations consist primarily of estimated closure costs, the initial measurement of which is recognized as a liability discounted to present value and subsequently accreted through earnings. An asset retirement cost equal to the initial liability is capitalized as part of the related asset s carrying value and depreciated over the asset s useful life.

(m) Revenues and expenses

Revenues are recognized when title is transferred to the customer or services are rendered. Revenue from exported products is recognized when such products are loaded on board the ship. Revenue from products sold in the domestic market is recognized when delivery is made to the customer. Revenue from logistic services is recognized when the service order has been fulfilled. Expenses and costs are recognized on the accrual basis.

(n) Income taxes

The deferred tax effects of tax loss carryforwards and temporary differences are recognized pursuant to SFAS 109 Accounting for Income Taxes . A valuation allowance is made when we believe that it is more likely than not that tax assets will not be fully recovered in the future.

(o) Earnings per share

Earnings per share are computed by dividing net income by the weighted average number of common and preferred shares outstanding during the period.

(p) Interest attributed to stockholders equity (dividend)

Brazilian corporations are permitted to distribute interest attributable to stockholders equity. The calculation is based on the stockholders equity amounts as stated in the statutory accounting records and the interest rate applied may not exceed the long-term interest rate (TJLP) determined by the Brazilian Central Bank. Also, such interest may not exceed 50% of net income for the year nor 50% of retained earnings plus revenue reserves as determined by Brazilian GAAP .

As the notional interest charge is tax deductible in Brazil, the benefit to us, as opposed to making a dividend payment, is a reduction in our income tax charge. Income tax of 15% is withheld on behalf of the stockholders relative to the interest distribution. Under Brazilian law, interest attributed to stockholders equity is considered as part of the annual minimum mandatory dividend (Note 16). This notional interest distribution is treated for accounting purposes as a deduction from stockholders equity in a manner similar to a dividend and the tax credit recorded in income.

(q) Comprehensive income

We present comprehensive income as part of the Statement of Changes in Stockholders Equity, in compliance with SFAS 130 Reporting Comprehensive Income , net of taxes.

(r) Pension and other post retirement benefits

We sponsor private pension and other post retirement benefits for our employees which are actuarially determined and recognized as an asset or liability or both depending on the funded or unfunded status of each plan in accordance with SFAS 158 Employees Accounting for Defined Benefit Pension and Other Post retirement Plans . The cost of our defined benefit and prior service costs or credits that arise during the period and are not components of net periodic benefit costs are recorded in other cumulative comprehensive income (deficit).

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4 Recently-issued accounting pronouncements

In January 2009, the Financial Accounting Standards Board (FASB) issued EITF 99-20-1 Amendments to the Impairment Guidance of EITF Issue No. 99-20 , to achieve more consistent determination of whether an other-than-temporary impairment has occurred. It is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. We are currently studying the effects of this pronouncement.

In December 2008, the FASB issued Staff Position No. FAS 132(R)-1, Employers Disclosures about Post Retirement Benefit Plan Assets . It is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2009. We are currently studying the effects of this pronouncement.

In November 2008, the FASB issued EITF 08-08, Accounting for an Instrument (or an Embedded Feature) with a Settlement Amount That Is Based on the Stock of an Entity s Consolidated Subsidiary , which addresses the fair value of an outstanding instrument and its presentation. It is effective for fiscal years and interim periods beginning after December 15, 2008. We are currently studying the effects of this pronouncement.

In November 2008, the FASB issued EITF 08-06, Equity Method Investment Accounting Considerations , which clarifies the accounting for certain transactions and impairment considerations involving equity method investments. It is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. We are currently studying the effects of this pronouncement.

In October 2008, the FASB issued Staff Position No. FAS 157-3, Determining the Fair Value of a Financial Asset in a Market That Is Not Active (FSP 157-3), which clarifies the application of SFAS 157 when the market for a financial asset is inactive. Specifically, FSP 157-3 clarifies how (1) management s internal assumptions should be considered in measuring fair value when observable data are not present, (2) observable market information from an inactive market should be taken into account, and (3) the use of broker quotes or pricing services should be considered in assessing the relevance of observable and unobservable data to measure fair value. The guidance in FSP 157-3 was effective immediately upon issuance and did not generate impact on our Financial Statements.

In June 2008, the FASB issued FSP EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions are Participating Securities . The FSP provides that instruments granted in share-based payment transactions that contain nonforfeitable rights to dividends or dividend equivalents (whether paid or unpaid) are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share (EPS) under the two-class method described in paragraphs 60 and 61 of FASB Statement No. 128, Earnings per Share. It is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early application is not permitted. We are currently studying the effects of this pronouncement.

In May 2008, the FASB issued FSP APB 14-1, Accounting for Convertible Debt Instruments That May Be Settled in Cash upon Conversion (Including Partial Cash Settlement) . According to this FSP these debt instruments are not addressed by paragraph 12 of APB Opinion No. 14, Accounting for Convertible Debt and Debt Issued with Stock Purchase Warrants. Additionally, it specifies that issuers of such instruments should separately account for the liability and equity components in a manner that will reflect the entity s nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. This FSP is effective for financial statements issued for fiscal years beginning after December 15, 2008. We are currently studying the effects of this pronouncement.

In May 2008, the FASB issued FAS 162, The Hierarchy of Generally Accepted Accounting Principles . The objective of this Statement is to identify the sources of accounting principles and the framework for selecting the

principles used in the preparation of financial statements of nongovernmental entities that are presented in conformity with US GAAP (the GAAP hierarchy). This Statement shall be effective 60 days following the SEC s approval of the Public Company Accounting Oversight Board (PCAOB) amendments to AU Section 411, The Meaning of Present Fairly in Conformity With Generally Accepted Accounting Principles. There are no specific disclosure requirements with this statement. We are currently assessing the effects of this Statement and believe that it will not have a material impact on our Consolidation Financial Statements.

In April 2008, the FASB issued FSP FAS 142-3, Determination of the Useful Life of Intangible Assets . The objective of this FSP is to address situations of renewing or extending the useful life of a recognized intangible asset. It is effective for financial statements issued for fiscal years and interim periods beginning after December 15, 2008. Early application is not permitted. We are currently studying the effects of this pronouncement.

In December 2007, the FASB issued SFAS 160, which clarifies that a no controlling interest in a subsidiary is an ownership interest in the consolidated entity that should be reported as equity in the consolidated financial statements. SFAS 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008 (that is, in the case of Vale, January 1, 2009).

In December 2007, the FASB issued SFAS 141(R), that applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008 (that is, in the case of Vale, January 1, 2009).

5 Major acquisitions and disposals

In February 2008, we sold our interest in Jubilee Mines N.L. (held through Vale Inco), representing 4.83% of its common shares, for US$134 generating a gain of US$80.

In October, 2007 we were awarded, in a public auction, a 30-year sub-concession agreement to operate the Ferrovia Norte Sul S.A. FNS railway for R$1,482 million equivalent to US$837 at the exchange rate in effect on that date, payable in three installments. The first installment, equivalent to US$412 and corresponding to 50% was paid in December 2007. The second and third installments, each representing 25% of the total amount, are to be paid upon the completion of the railroad. The outstanding installments are indexed to the general price index (IGP-DI) and accrue interest of 12% p.a. This sub-concession right has been accounted for as an intangible asset (Note 11).

In July 2007, we sold our interest in Lion Ore Mining International Ltd. (held through Vale Inco), representing 1.80% of its common shares for US$105, generating a gain of US$80.

In June 2007, we sold 25,213,664 common shares, representing 57.84% of the total capital of our subsidiary Log-In Logística Intermodal S.A. (Log-In) for US$179, recording a gain of US$155. In July 2007, we sold an additional 5.10% stake in Log-In for US$24 recording a gain of US$21. At December 31, 2008, we held 31.33% of the voting and total capital of this entity, which is accounted for under the equity method.

In May 2007, we sold part (12.43%) of our stockholding in Usinas Siderúrgicas de Minas Gerais S.A. USIMINAS, an available-for-sale investee, for US$728, recording a gain of US$456. We have retained 5.89% of the ordinary shares the minimum number of shares required to participate in the current shareholders agreement of the investee, representing 2.93% of the total capital.

In May 2007, we acquired a further 6.25% of the total share capital of Empreendimentos Brasileiros de Mineração S.A. EBM, which main asset is its interest in MBR, for US$231 and as a result, our direct and indirect stake in MBR increased to 92.99% of total and voting capital. We simultaneously entered into an usufruct agreement with minority shareholders whereby they transferred to us all rights and obligations with respect to their shares, including rights to dividends for the next 30 years, for which we will make an initial payment of US$61 plus an annual fee of US$48 for each of the next 29 years. The present value of the future obligation is recorded as a liability and the corresponding charge recorded to minority interests in the balance sheet.

In April 2007, we concluded the acquisition of 100% of Vale Australia (formerly AMCI Holdings Australia Pty AMCI HA), a private company based in Australia, which owns and operates coal mines in that country, for US$656.

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6 Income taxes

Income taxes in Brazil comprise federal income tax and social contribution, which is an additional federal tax. The statutory composite enacted tax rate applicable in the periods presented is 34%. In other countries where we have operations, the applicable tax rates vary from 1.67% to 40%.

The amount reported as income tax expense in our consolidated financial statements is reconciled to the statutory rates as follows:

	Three-month period ended (unaudited)								
	December 31, 2008			September 30, 2008			December 31, 2007		
	Brazil	**Foreign**	**Total**	**Brazil**	**Foreign**	**Total**	**Brazil**	**Foreign**	**Total**
Income before income taxes, equity results and minority interests	**(2,489)**	**2,573**	**84**	**334**	**4,113**	**4,447**	**1,299**	**1,519**	**2,818**
Tax at Brazilian composite rate	846	(875)	(29)	(114)	(1,398)	(1,512)	(442)	(516)	(958)
Adjustments to derive effective tax rate:									
Tax benefit on interest attributed to stockholders	238		238	278		278	129		129
Difference on tax rates of foreign income		347	347		808	808		777	777
Exchange variation not taxable		667	667		633	633		(101)	(101)
Tax incentives	(48)		(48)	14		14	7		7
Other non-taxable gains (losses)	(68)	78	10	57	(134)	(77)	(12)	(58)	(70)
Income taxes per consolidated statements of income	**968**	**217**	**1,185**	**235**	**(91)**	**144**	**(318)**	**102**	**(216)**

	Year ended of December 31,						
		2008			2007		2006
	Brazil	**Foreign**	**Total**	**Brazil**	**Foreign**	**Total**	**Total**
Income before income taxes, equity results and minority interests	**2,434**	**10,783**	**13,217**	**7,769**	**7,464**	**15,233**	**7,829**
Tax at Brazilian composite rate	(828)	(3,667)	(4,495)	(2,641)	(2,538)	(5,179)	(2,662)
Adjustments to derive effective tax rate:							

Tax benefit on interest attributed to stockholders	692		692	474		474	343
Difference on tax rates of foreign income		1,728	1,728		1,729	1,729	1,129
Exchange variation not taxable		982	982		(290)	(290)	(125)
Tax incentives	53		53	173		173	194
Valuation allowance reversal (provision)				16		16	(21)
Other non-taxable gains (losses)	287	218	505	64	(188)	(124)	(290)
Income taxes per consolidated statements of income	**204**	**(739)**	**(535)**	**(1,914)**	**(1,287)**	**(3,201)**	**(1,432)**

We have certain Brazilian income tax incentives relating to our manganese operations in Carajás, our potash operations in Rosario do Catete, our alumina and aluminum operations in Barcarena and our kaolin operations in Ipixuna and Mazagão. The incentives relating to manganese, aluminum and kaolin comprise partial exemption up to 2013. The incentive relating to alumina and potash comprise full income tax exemption on defined production levels, which expires in 2009 and 2013, respectively. An amount equal to the tax saving is appropriated from retained earnings to a reserve account within stockholders equity and may not be distributed in the form of cash dividends.

We also have income tax incentives related to our Goro Project under development in New Caledonia (The Goro Project). These incentives include an income tax holiday during the construction phase of the project and throughout a 15-year period commencing in the first year in which commercial production, as defined by the applicable legislation, is achieved followed by a five-year, 50 per cent income tax holiday. The Goro Project also qualifies for certain exemptions from indirect taxes such as import duties during the construction phase and throughout the commercial life of the project. Certain of these tax benefits, including the income tax holiday, are subject to an earlier phase out should the project achieve a specified cumulative rate of return. We are subject to a branch profit tax commencing in the first year in which commercial production is achieved, as defined by the applicable legislation. To date, we have not recorded any taxable income for New Caledonian tax purposes. The benefits of this legislation are expected to apply with respect to taxes payable once the Goro project is in operation.

We are subject to examination by the tax authorities for up to five years regarding our operations in Brazil, ten years for Indonesia, and five and six years for Canada, except for Newfoundland which has no limit.

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Brazilian tax loss carryforwards have no expiration date though offset is restricted to 30% of annual taxable income. Effective January 1, 2007, the Company adopted the provisions of FASB Interpretation No. 48, Accounting for Uncertainty in Income Taxes .

The reconciliation of the beginning and ending amounts of unrecognized tax benefits is as follows:

	As of December 31,	
	2008	2007
Beginning of the period	**1,046**	**663**
Increase resulting from tax positions taken	103	264
Decrease resulting from tax positions taken	(261)	(47)
Changes in tax legislation	2	29
Cumulative translation adjustments	(233)	137
End of the period	**657**	**1,046**

Recognized deferred income tax assets and liabilities are composed as follows:

	As of December 31,	
	2008	2007
Current deferred tax assets		
Accrued expenses deductible only when disbursed	**583**	**603**
Long-term deferred tax assets and liabilities		
Assets		
Employee postretirement benefits provision	171	461
Tax loss carryforwards	119	348
Other temporary differences	548	
Asset retirement obligation	207	195
	1,045	**1,004**
Liabilities		
Fair value of financial instruments	(326)	(173)
Unrealized tax indexation effects	(108)	(138)
Property, plant and equipment	(47)	(150)
Prepaid retirement benefit	(199)	(203)
Fair value adjustments in business combinations	(4,446)	(5,770)
Other temporary differences	198	(191)
	(4,928)	**(6,625)**
Valuation allowance		

Beginning balance	(104)	(113)
Translation adjustments	18	(20)
Change in allowance	(36)	29
Ending balance	**(122)**	**(104)**
Net long-term deferred tax liabilities	**(4,005)**	**(5,725)**

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7 Cash and cash equivalents

	As of December 31,	
	2008	2007
Cash	767	424
Short-term investments denominated in Brazilian Reais	7,548	123
Short-term investments denominated in other currencies, mainly U.S. dollars	2,016	499
	10,331	**1,046**

The increase in cash and cash equivalents corresponds mainly to the proceeds received from the Global equity offering (Note 16).

8 Accounts receivable

	As of December 31,	
	2008	2007
Customers		
Denominated in Brazilian Reais	461	750
Denominated in other curriencies, mainly U.S. Dollars	2,828	3,311
	3,289	**4,061**
Allowance for doubtful accounts	(85)	(100)
Allowance for ore weight credits		(9)
Total	**3,204**	**3,952**

Accounts receivable from customers in the steel industry represent 47% of receivables at December 31, 2008.

No single customer accounted for more than 10% of total revenues.

Additional allowances for doubtful accounts charged to the statement of income as expenses in 2008 and 2007 totaled US$ 9 and US$ 31, respectively. We wrote-off US$ nil in 2008 and US$ 6 in 2007.

9 Inventories

	As of December 31,	
	2008	2007
Finished products		
Nickel (co-products and by-products)	1,514	1,812
Iron ore and pellets	728	588
Manganese and ferroalloys	199	176
Aluminum products	150	106
Kaolin	40	42
Copper concentrate	26	15
Coal	43	38
Others	80	36
Spare parts and maintenance supplies	1,116	1,046

	3,896	**3,859**

At December 31, 2008, we recorded an adjustment of US$ 77, to reduce nickel inventory to its market value (nil in 2007 and 2006).

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10 Recoverable taxes

	As of December 31, 2008	As of December 31, 2007
Income tax	1,646	643
Value-added tax ICMS	258	294
PIS and COFINS	380	354
Others	103	67
Total	**2,387**	**1,358**
Current	1,993	1,159
Non-current	394	199
	2,387	**1,358**

11 Property, plant and equipment and intangible assets

By type of assets:

	As of December 31, 2008			As of December 31, 2007		
	Cost	Accumulated depreciation	Net	Cost	Accumulated depreciation	Net
Land	182		182	110		110
Buildings	3,742	905	2,837	4,086	842	3,244
Installations	9,990	2,748	7,242	10,974	2,889	8,085
Equipment	5,391	1,626	3,765	5,703	1,709	3,994
Railroads	5,830	1,358	4,472	5,819	1,614	4,205
Mine development costs	15,976	2,062	13,914	19,270	1,632	17,638
Others	4,974	1,639	3,335	7,146	1,813	5,333
	46,085	**10,338**	**35,747**	**53,108**	**10,499**	**42,609**
Construction in progress	13,582		13,582	12,016		12,016
Total	**59,667**	**10,338**	**49,329**	**65,124**	**10,499**	**54,625**

Losses on disposal of property, plant and equipment totaled US$ 376, US$ 168 and US$ 106 in 2008, 2007 and 2006, respectively. Mainly relate to losses on sales of ships and trucks, locomotives and other equipment, which were replaced in the normal course of business.

Assets given in guarantee of judicial processes totaled US$ 141.

Hydroelectric assets

We participate in several jointly-owned hydroelectric plants, already in operation or under construction, in which we record our undivided interest in these assets as Property, plant and equipment.

At December 31, 2008 the cost of hydroelectric plants in service totals US$ 1,162 (2007 US$ 803) and the related depreciation in the year was US$ 304 (2007 US$ 68). The cost of hydroelectric plant under construction at

December 31, 2008 totals US$ 206 (2007 US$ 735). Income and operating expenses for such plants are not material

Intangibles

All of the intangible assets recognized in our financial statements were acquired from third parties, either directly or through a business combination and have definite useful lives from 6 to 30 years.

At December 31, 2008 the intangibles amount to US$ 875 (December 31, 2007 US$ 1,113), and are comprised of rights granted by the government North-South Railroald of US$ 671 and off take-agreements of US$ 204.

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12 Investments in affiliated companies and joint ventures

	2008				Investments		Equity in earnings (losses) of investee adjustments						Dividends received				
							Three-month period ended (unaudited)			As of December 31,			Three-month period ended (unaudited)			As of Dece[r] 31,	
	Participation in capital (%)		Net equity	Net income (loss) for the year	December 31, 2008	December 31, 2007	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007	2006	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007
	Voting	Total															
us																	
anhia Brasileira de ação ASCO (1)	51.11	51.00	215	166	110	61	18	36	2	84	12	18					
anhia no-Brasileira otização ANOBRÁS	51.00	50.89	143	117	73	43	7	17	(3)	59	9	15		6		6	16
anhia no-Brasileira otização ASCO (1)	50.00	50.00	109	88	55	45	4	19	4	44	19	17	13		21	13	21
anhia rasileira de ação RASCO (1)	51.00	50.90	114	66	58	46	14	18		34	10	12					8
da Serra S.A. MSG	50.00	50.00	42	3	21	30	(1)	1	1	1	3	2					
ARCO ação S.A. ARCO (2)	50.00	50.00	732	629	412	546	37	82	56	315	242	229	50	112	25	300	150
					26	30	1	2	3	6	6	19					
					755	**801**	**80**	**175**	**63**	**543**	**301**	**312**	**63**	**118**	**46**	**319**	**195**
ics																	
N Logística odal S.A. (3)	31.33	31.33	282	37	94	107	6	3	6	20	8					3	
Logística S.A	37.86	41.50	786	273	326	342	87	44	34	113	117	95			24	34	51
					420	**449**	**93**	**47**	**40**	**133**	**125**	**95**			**24**	**37**	**51**
ngs																	

rnia Steel ries Inc. CSI	50.00	50.00	320	21	160	163	(35)	18	(7)	11	(1)	54	13			13	11
SENKRUPP Companhia rgica (Cost ble-for-sale	10.46	10.46			443	388											
rgicas de Gerais S.A. NAS (cost - ble-for-sale					164	465		8		18	31	147		8		18	31
					767	**1,016**	**(35)**	**26**	**(7)**	**29**	**30**	**201**	**13**	**8**		**31**	**42**
te																	
ção Rio do S.A. MRN	40.00	40.00	347	156	140	184	22	18	21	62	84	64	13			99	64
l Alumínio VALESUL	100.00	100.00										12					
					140	**184**	**22**	**18**	**21**	**62**	**84**	**76**	**13**			**99**	**64**
Longyu rces Co. Ltd.	25.00	25.00	703	315	176	115	15	28	12	79	46	31	27		42	27	42
ong ang ational any Ltd.	25.00	25.00	44	(66)	11	23	(17)		2	(17)		(5)					
					187	**138**	**(2)**	**28**	**14**	**62**	**46**	**26**	**27**		**42**	**27**	**42**
Resources st $25) ble-for-sale					2	34											
Mines N.L 5) (4) ble-for-sale						126											
ela Nickel ost $24) ble-for-sale					8	72											
y Minerals 31) available e					9												
Nickel Corp					21												
Resources (6)						44	(38)			(38)							

	13	23	4		5	4	9						
	53	**299**	**(34)**		**5**	**(34)**	**9**						
affiliates int ventures													
	86	**35**	**1**	**(4)**		**(1)**							
	86	**35**	**1**	**(4)**		**(1)**							
	1,233	**1,672**	**(48)**	**68**	**33**	**118**	**169**	**303**	**53**	**8**	**42**	**157**	**148**
	2,408	**2,922**	**125**	**290**	**136**	**794**	**595**	**710**	**116**	**126**	**112**	**513**	**394**

(1) Although Vale held a majority of the voting interest of investees accounted for under the equity method, existing veto rights held by minority shareholders under shareholder agreements preclude consolidation;

(2) Investment includes goodwill of US$ 46 in 2008 and US$ 61 in 2007;

(3) Consolidation discontinued from June, 2007; (4) Sold in February, 2008 (Note 5);

(5) Equity in results of affilites refers to dividends received.

(6)

Losses
considered other
than temporary.

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13 Impairment of goodwill

As described on note 3 (g), we test goodwill and long-lived assets for impairment at least annually, or more frequently when events or changes in circumstances indicate that they might be impaired. For impairment test purposes goodwill is allocated to reporting units.

Following the downturn in the economy, which contributed to the decline in the prices of certain commodities produced by us during the last quarter of 2008, we updated our impairment test based on forecasted discounted cash flows. As a result, we determined that the goodwill associated with the acquisition of Vale Inco, included within the reportable segment Non-ferrous nickel was partially impaired. In the case of Vale Inco, goodwill has been allocated by us to the finished products and intermediate products reporting units. The impairment charge recorded in operating results in the fourth quarter of 2008 was US$950.

Management determined discounted cash flows based on approved financial budgets. Gross margin projections were based on past performance and management s expectations of market developments. Information about sales prices are consistent with the forecasts included in industry reports, considering quoted prices when available and when appropriate. The discount rates used reflect specific risks relating to the relevant assets in each reporting unit, depending on their composition and location.

Recognition of additional goodwill impairment charges in the future would depend on several estimates including market conditions, recent actual results and management s forecasts. This information shall be obtained at the time when our assessment is to be updated. It is not possible at this time to determine if any such future impairment charge would result or, if it does, whether such charge would be material.

14 Short-term debt

Short-term borrowings outstanding on December 31, 2007, mainly from commercial banks for export financing denominated in U.S. Dollars, with average annual interest rates of 5.5%.

15 Long-term debt

	Current liabilities		**Long-term liabilities**	
	2008	**2007**	**2008**	**2007**
Foreign debt				
Loans and financing denominated in the following currencies:				
U.S. Dollars	210	212	5,905	5,927
Others	23	64	167	214
Fixed Rate Notes US Dollar denominated			6,510	6,680
Debt securities export sales (*) US Dollar denominated	55	53	149	205
Perpetual notes			83	87
Accrued charges	217	282		
	505	**611**	**12,814**	**13,113**
Brazilian debt				

Brazilian Reais indexed to Long-Term Interest Rate TJLP/CDI	33	586	1,989	1,148
Brazilian Reais indexed to General Price Index-Market (IGPM)		1	1	1
Basket of currencies	1	2	4	6
Non-convertible debentures			2,562	3,340
U.S. Dollars Denominated			165	
Accrued charges	94	49		
	128	**638**	**4,721**	**4,495**
Total	**633**	**1,249**	**17,535**	**17,608**

(*) Secured by receivables from future export sales.

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The long-term portion at December 31, 2008 falls due as follows:

2010	2,304
2011	2,618
2012	1,137
2013	2,556
2014 and thereafter	8,628
No due date (Perpetual notes and non-convertible debentures)	292
	17,535

At December 31, 2008 annual interest rates on long-term debt were as follows:

Up to 3%	690
3.1% to 5%	5,845
5.1% to 7% (*)	5,596
7.1% to 9% (*)	2,136
9.1% to 11%	87
Over 11% (*)	3,729
Variable (Perpetual notes)	85
	18,168

(*) Includes non-convertible debentures and other Brazilian Reais-denominated debt that bear interest at CDI (Brazilian interbank certificate of deposit) and TJLP (Brazilian government long-term interest) rates plus a spread. For these operations we have entered into derivative transactions to mitigate our exposure on the floating rate debt denominated in Brazilian Reais, totaling US$ 4,169

wich US$ 3,522 has original interest rate above 11%. The average cost after taking into account the derivative transactions is 4.9%.

The indexation indices/ rates applied to our debt were as follows (unaudited):

	Three-month period ended			Year ended of December 31,	
	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007
TJLP Long-Term Interest Rate (effective rate)	1.5	1.5	1.5	6.3	6.4
IGP-M General Price Index Market	1.2	1.6	3.5	9.8	7.8
Appreciation (Devaluation) of Real against U.S. Dollar	(18.1)	(16.8)	3.8	(24.2)	20.7

In January 2008 we entered into a trade finance agreement with a Brazilian bank in the amount of US$ 1,100 with final maturity in 2018.

During 2008, we entered into agreements with Banco Nacional de Desenvolvimento Econômico e Social BNDES, (the Brazilian National Development Bank) and with long-term Japanese financing agencies, Japan Bank for International Cooperation JBIC and Nippon Export and Investment Insurance NEXI related to future lines of credit to finance mining, logistics and power generation projects as part of our investment program for 2008-2012.

Additionally, we have revolving credit lines available under which amounts can be drawn down and repaid at the option of the borrower. At December 31, 2008, the total amount available under revolving credit lines was of US$1,900, of which US$ 1,150 was granted to Vale International and the balance to Vale Inco. As of December 31, 2008, neither Vale International nor Vale Inco had drawn any amounts under these facilities.

Vale Inco had drawn down US$ 101 by way of letters of credit.

At December 31, 2008 the US Dollar denominated Fixed Rate Notes of US$ 6,510 (December 31, 2007 US$ 6,680) and other debt of US$ 11,102 (December 31, 2007 US$ 11,511) are unsecured. The export securitization of US$ 204 (December 31, 2007 US$ 258) represents debt securities collateralized by receivables from future export sales of CVRD Overseas Ltd.. Loans from international lenders of US$ 57 (December 31, 2007 US$ 82) are guaranteed by the Brazilian Federal Government, to which we have provided like counter guarantees. The remaining long-term debt of US$ 295 (December 31, 2007 US$ 326) is collateralized mainly by receivables.

Our principal covenants require us to maintain certain ratios, such as debt to EBITDA and interest coverage. We were in full compliance with our financial covenants as of December 31, 2008 and 2007.

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16 Stockholders equity

Each holder of common and preferred class A stock is entitled to one vote for each share on all matters brought before stockholders meetings, except for the election of the Board of Directors, which is restricted to the holders of common stock. The Brazilian Government holds twelve preferred special shares which confer permanent veto rights over certain matters.

Both common and preferred stockholders are entitled to receive a mandatory minimum dividend of 25% of annual adjusted net income under Brazilian GAAP, once declared at the annual stockholders meeting. In the case of preferred stockholders, this dividend cannot be less than 6% of the preferred capital as stated in the statutory accounting records or, if greater, 3% of the Brazilian GAAP equity value per share. For the year ended December 31, 2008, this dividends corresponds to US$2,068, provided against stockholders equity.

In July 2008, we issued 80,079,223 common ADS, 176,847,543 common shares, 63,506,751 preferred ADS and 100,896,048 preferred shares through a Global equity offering. Our capital increased by US$11,666, upon subscription of preferred stock of US$4,146 corresponding to 164,402,799 shares and common stock of US$7,520 corresponding to 256,926,766 shares. In August, 2008, we issued an additional 24,660,419 preferred shares, representing an increase of US$628. After the closing of the operation, our capital stock increased by US$12,294 in 2008; the transaction costs of US$105 were recorded as a reduction of the additional paid-in capital account.

In September 2007, a stock split was effected whereby each existing common and preferred share was split into two shares. After the split our capital comprises 4,919,314,116 shares, of which 1,919,516,400 are preferred class A shares and 2,999,797,716 are common shares, including twelve special class shares without par value (Golden Shares). All references to numbers of share and per share amounts included herein reflect retroactive application of the stock split.
In June 2007, we issued US$ 1,880 Mandatorily Convertible Notes due June 15, 2010 for total proceeds of US$ 1,869, net of commissions. The Notes bear interest at 5.50% per year payable quarterly and additional interest which will be payable based on the net amount of cash distribution paid to ADS holders. A tranche of US$ 1,296 Notes are mandatorily convertible into an aggregate maximum of 56,582,040 common shares and a tranche of US$ 584 Notes are mandatorily convertible into an aggregate maximum of 30,295,456 preferred class A shares. On the maturity date (whether at stated maturity or upon acceleration following an event of default), the Series RIO Notes will automatically convert into ADSs, each ADS representing one common share of Vale, and the Series RIO P Notes will automatically convert into ADSs, each ADS representing one preferred class A share of Vale. We currently hold the shares to be issued on conversion in treasury. The Notes are not repayable in cash. Holders of notes will have no voting rights. We will pay to the holders of our Series RIO Notes or RIO P Notes additional interest in the event that Vale makes cash distributions to all holders of RIO ADSs or RIO P ADSs, respectively. We determined, using a statistical model, that the potential variability in the number of shares to be converted is not a predominant feature of this hybrid financial instrument and thus classified it as an equity instrument within stockholders equity. Other than during the cash acquisition conversion period, holders of the notes have the right to convert their notes, in whole or in part, at any time prior to maturity in the case of the Series RIO Notes, into RIO ADSs at the minimum conversion rate of 0.8664 RIO ADSs per Series RIO Note, and in the case of Series RIO P Notes, into RIO P ADSs at the minimum conversion rate of 1.0283 RIO P ADSs per Series RIO P Note.

In April 2007, at an Extraordinary Shareholders ´ Meeting, paid-up capital was increased by US$ 4,187 through transfer of reserves, without issuance of shares, to US$ 12,695.

Brazilian law permits the payment of cash dividends only from retained earnings as stated in the BR GAAP statutory records and such payments are made in Brazilian Reais. Pursuant to the Company s statutory books,

undistributed retained earnings at December 31, 2008 total US$ 16,854, comprising the unrealized income and expansion reserves, which could be freely transferred to retained earnings and paid as dividends, if approved by the stockholders, after deducting of the minimum annual mandatory dividend.

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No withholding tax is payable on distribution of profits earned except for distributions in the form of interest attributed to stockholders equity (Note 3 (p)).

Brazilian laws and our By-laws require that certain appropriations be made from retained earnings to reserve accounts on an annual basis, all determined in accordance with amounts stated in the statutory accounting records, as detailed below:

	Three-month period ended (unaudited)			Year ended of December 31,		
	December 31, 2008	**September 30, 2008**	**December 31, 2007**	**2008**	**2007**	**2006**
Undistributed retained earnings						
Unrealized income reserve						
Beginning of the period	67	73	105	73	57	101
Transfer from (to) retained earnings	(22)	(6)	(32)	(28)	16	(44)
End of the period	**45**	**67**	**73**	**45**	**73**	**57**
Expansion reserve						
Beginning of the period	12,857	13,881	5,726	13,881	8,485	3,621
Transfer to capital stock					(3,776)	
Transfer from (to) retained earnings	3,952	(1,024)	8,155	2,928	9,172	4,864
End of the period	**16,809**	**12,857**	**13,881**	**16,809**	**13,881**	**8,485**
Legal reserve						
Beginning of the period	1,212	1,310	724	1,310	970	599
Transfer to capital stock					(370)	
Transfer from (to) retained earnings	236	(98)	586	138	710	371
End of the period	**1,448**	**1,212**	**1,310**	**1,448**	**1,310**	**970**
Fiscal incentive investment reserve						
Beginning of the period	47	53	5	53	43	36
Transfer to capital stock					(41)	
Transfer from (to) retained earnings	(9)	(6)	48	(15)	51	7
End of the period	**38**	**47**	**53**	**38**	**53**	**43**
Total undistributed retained earnings	**18,340**	**14,183**	**15,317**	**18,340**	**15,317**	**9,555**

The purpose and basis of appropriation to such reserves is described below:

Unrealized income reserve this represents principally our share of the earnings of affiliates and joint ventures, not yet received in the form of cash dividends.

Expansion reserve this is a general reserve for expansion of our activities.

Legal reserve   this reserve is a requirement for all Brazilian corporations and represents the appropriation of 5% of annual net income up to a limit of 20% of capital stock all determined under Brazilian GAAP.

Fiscal incentive investment reserve   this reserve results from an option to designate a portion of income tax otherwise payable for investment in government approved projects and is recorded in the year following that in which the taxable income was earned. As from 2000, this reserve basically contemplates income tax incentives (Note 6).

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Basic and diluted earnings per share

Basic and diluted earnings per share amounts have been calculated as follows:

	Three-month period ended (unaudited)			As of December 31,		
	December 31, 2008	**September 30, 2008**	**December 31, 2007**	**2008**	**2007**	**2006**
Net income for the period	**1,367**	**4,821**	**2,573**	**13,218**	**11,825**	**6,528**
Interest attributed to preferred convertible notes	(15)	(8)	(8)	(46)	(16)	
Interest attributed to common convertible notes	(32)	(16)	(18)	(96)	(37)	
Net income for the period adjusted	1,320	4,797	2,547	13,076	11,772	6,528
Basic and diluted earnings per share						
Income available to preferred stockholders	507	1,850	978	5,027	4,552	2,568
Income available to common stockholders	791	2,866	1,524	7,823	7,092	3,960
Income available to convertible notes linked to preferred shares	8	28	16	78	45	
Income available to convertible notes linked to common shares	14	53	29	148	83	
Weighted average number of shares outstanding (thousands of shares) preferred shares	2,042,341	1,976,727	1,889,175	1,946,454	1,889,171	1,908,852
Weighted average number of shares outstanding (thousands of shares) common shares	3,185,750	3,063,752	2,943,216	3,028,817	2,943,216	2,943,216
Treasury preferred shares linked to mandatorily convertible notes	30,295	30,295	30,295	30,295	18,478	
Treasury common shares linked to mandatorily convertible notes	56,582	56,582	56,582	56,582	34,510	
Total	**5,314,968**	**5,127,356**	**4,919,268**	**5,062,148**	**4,885,375**	**4,852,068**

Earnings per preferred share	0.25	0.94	0.52	2.58	2.41	1.35
Earnings per common share	0.25	0.94	0.52	2.58	2.41	1.35
Earnings per convertible notes linked to preferred share (*)	0.76	1.19	0.79	4.09	3.30	
Earnings per convertible notes linked to common share (*)	0.81	1.25	0.85	4.29	3.51	

(*) Basic earnings per share only, as dilution assumes conversion.

Had the conversion of the convertible notes been included in the calculation of diluted earnings per share they would have generated the following dilutive effect as shown below:

	Three-month period ended (unaudited)			As of December 31,		
	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007	2006
Income available to preferred stockholders	530	1,885	1,002	5,151	4,613	
Income available to common stockholders	837	2,936	1,571	8,067	7,212	
Weighted average number of shares outstanding (thousands of shares) preferred shares	2,072,636	2,007,022	1,919,470	1,976,749	1,907,649	
Weighted average number of shares outstanding (thousands of shares) common shares	3,242,332	3,120,334	2,999,798	3,085,399	2,977,726	
Earnings per preferred share	0.26	0.94	0.52	2.61	2.42	
Earnings per common share	0.26	0.94	0.52	2.61	2.42	

17 Other cumulative comprehensive income (deficit)

	Three-month period ended (unaudited)			As of December 31,		
	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007	2006
Comprehensive income (deficit) is comprised as follows:						
Net income	1,367	4,821	2,573	13,218	11,825	6,528
Cumulative translation adjustments	(7,500)	(6,835)	337	(12,833)	2,968	1,228
	96	(190)	(18)	(194)	(60)	144

Unrealized gain (loss) available-for-sale securities, net of tax						
Surplus (deficit) accrued pension plan	270	(468)	(465)	(109)	(278)	(107)
Cash flow hedge	(28)	20	6	(29)	29	
Total comprehensive income (deficit)	**(5,795)**	**(2,652)**	**2,433**	**53**	**14,484**	**7,793**
Tax effect on other comprehensive income allocated to each component						
Unrealized gain (loss) available-for-sale securities, net of tax						
Gross balance as of the period end	42	(105)	271	42	271	395
Tax (expense) benefit	(25)	26	(60)	(25)	(60)	(124)
Net balance as of the period end	17	(79)	211	17	211	271
Surplus accrued pension plan						
Gross balance as of the period end	(63)	(415)	134	(63)	134	540
Tax (expense) benefit	29	111	(59)	29	(59)	(187)
Net balance as of the period end	(34)	(304)	75	(34)	75	353

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18 Pension plans

Since 1973 we sponsor a supplementary social security plan with characteristics of a defined benefit plan (the Old Plan) covering substantially all Brazilian employees, with benefits calculated based on years of service, age, contribution salary and supplementary social security benefits. This plan is administered by Fundação Vale do Rio Doce de Seguridade Social VALIA and was funded by monthly contributions made by us and our employees, calculated based on periodic actuarial appraisals.

In May 2000, we implemented a new supplementary social security plan with characteristics of defined contribution, which complements the earnings of programmed retirements. The plan offers benefits to cover death, physical invalidity, and sickness, with defined benefit characteristics. Brazilian employees could opt to migrate to the New Plan (a Benefit Mix Plan Vale Mais) which was taken up by over 98% of our employees. The Old Plan will continue in existence, covering almost exclusively retired participants and their beneficiaries.

Additionally we provide supplementary payments to a specific group of former Brazilian employees, in addition to the regular benefits from Valia. The plan provides represents a postretirement health care, dental and pharmaceutical benefits.

Upon the acquisition of Inco, we assumed benefits through defined benefit pension plans that cover essentially all its employees and post retirement benefits other than pensions that also provide certain health care and life insurance benefits for retired employees.

The following information details the status of the defined benefit elements of all plans in accordance with SFAS 132 Employers Disclosure about Pensions and Other Post retirement Benefits and SFAS 158 Employers Accounting for Defined Benefit Pension and Other Postretirement Plans , as amended.

(a) Change in benefit obligation

	As of December 31,					
	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Benefit obligation at beginning of year	3,178	4,436	1,671	2,531	3,743	1,287
Liability recognized upon consolidation of Inco					100	213
Service cost	11	60	25	9	61	20
Interest cost	309	245	85	306	229	78
Plan amendment		16			4	
Benefits paid	(283)	(291)	(70)	(301)	(279)	(63)
Effect of exchange rate changes	(779)	(775)	(272)	526	607	215
Actuarial loss (gain)	(12)	(660)	(370)	107	(29)	(79)
Benefit obligation at end of year	**2,424**	**3,031**	**1,069**	**3,178**	**4,436**	**1,671**

We use a measurement date of December 31 for our pension and post retirement benefit plans

(b) Change in plan assets

	As of December 31,					
	2008			2007		
	Overfunded pension plans	**Underfunded pension plans**	**Underfunded other benefits**	**Overfunded pension plans**	**Underfunded pension plans**	**Underfunded other benefits**
Fair value of plan assets at beginning of year	4,187	3,762	10	3,508	3,078	4
Actual return on plan assets	57	(603)	1	250	85	1
Employer contributions	41	272	70	33	372	67
Benefits paid	(283)	(291)	(70)	(301)	(279)	(63)
Effect of exchange rate changes	(959)	(633)	(2)	697	506	1
Fair value of plan assets at end of year	**3,043**	**2,507**	**9**	**4,187**	**3,762**	**10**

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Plan assets at December 31, 2008 include US$ 188 (US$ 693 at December 31, 2007) and US$ 53 (US$ 73 at December 31, 2007) of portfolio investments in our own shares and debentures, respectively, and US$ 44 (US$ 48 at December 31, 2007) and US$ nil (US$ nil at December 31, 2007) of shares of related parties and debentures, as well. They also include US$ 2,472 of Brazilian Federal Government securities (US$ 1,116 at December 31, 2007) and US$ 347 of Canada Federal Government securities (US$ 475 at December 31, 2007).

(c) Funded Status and Financial Position

	As of December 31,					
	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Other assets	619		3	1,009		
Current liabilities		38	64		54	77
Long-term liabilities		486	999		620	1,584
Funded status	**619**	**524**	**1,060**	**1,009**	**674**	**1,661**

(d) Assumptions used (nominal terms)

	Brazil					
	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Discount rate	11.28% p.a.	11.28% p.a.	11.28% p.a.	10.24% p.a.	10.24% p.a.	10.24% p.a.
Expected return on plan assets	12.22% p.a.	13.00% p.a.		12.78% p.a.	11.70% p.a.	
Rate of compensation increase up to 47 years	7.12% p.a.			7.12% p.a.		
Rate of compensation increase over 47 years	4.00% p.a.			4.00% p.a.		
Inflation	4.00% p.a.	4.00% p.a.	4.00% p.a.	4.00% p.a.	4.00% p.a.	4.00% p.a.
Health care cost trend rate			7.12% p.a.			7.64% p.a.

	Foreign					
	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Discount rate		5.58% p.a.	7.32% p.a.		5.21% p.a.	5.55% p.a.
Expected return on plan assets		6.99% p.a.	7.35% p.a.		7.18% p.a.	7.50% p.a.

Rate of compensation increase up to 47 years	4.12% p.a.	3.58% p.a.	4.01% p.a.	3.58% p.a.
Rate of compensation increase over 47 years	4.12% p.a.	3.58% p.a.	4.01% p.a.	3.58% p.a.
Inflation	2.00% p.a.	2.00% p.a.	2.00% p.a.	2.00% p.a.
Health care cost trend rate		6.19% p.a.		6.35% p.a.

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(e) Investment targets and composition of plan assets

Overfunded pension plans

The fair value of the Brazil overfunded pension plan assets is US$3,043 and US$4,187 at December 31, 2008 and 2007, respectively. There are no foreign overfunded pension plans assets at the period end. The asset allocation for these plans at December 31, 2008 and 2007, and the target allocation for 2009, by asset category, follows:

	Percentage of plan assets Brazil		
	Target for 2009 (Unaudited)	At December 31, 2008	At December 31, 2007
Equity securities	26%	20%	29%
Real estate	6%	4%	4%
Loans	7%	6%	4%
Fixed Income	61%	70%	63%
Total	**100%**	**100%**	**100%**

Underfunded pension plans

The fair value of the underfunded pension plan assets is US$146 and US$146 at the end of 2008 and 2007, respectively, for Brazilian plans and US$2,361 and US$3,616 at the end of 2008 and 2007, respectively, for foreign plans. The asset allocation for these plans at the end of 2008 (Brazil and foreign) and 2007 (Brazil and foreign), and the target allocation for 2009, by asset category, follows:

	Percentage of plan assets Brazil		
	Target for 2009 (Unaudited)	At December 31, 2008	At December 31, 2007
Loans	0%	0%	5%
Fixed Income	100%	100%	95%
Total	**100%**	**100%**	**100%**

	Percentage of plan assets Foreign		
	Target for 2009	At December 31, 2008	At December 31, 2007
Equity securities	61%	54%	61%
Fixed Income	39%	46%	39%
Total	**100%**	**100%**	**100%**

The asset allocation policy follows the asset class targets determined by our ALM Asset Allocation Modelling. The fixed income asset allocation target for the Brazilian plans was established in order to surpass the benefit obligation and to be used for the payment of short-term plans. The proposal for 2009 is to increase the investments in inflation-indexed bonds.

The target for equity securities of these plans reflects the expected appreciation of the Brazilian stock markets and its expected long term return.

The asset allocation policy for the foreign plans of 39% fixed income and 61% equity securities, approximates the policy mix through a rebalancing policy.

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Underfunded other benefits

The fair value of the foreign underfunded other benefit assets is US$9 and US$10 at the end of 2008 and 2007, respectively. There are no Brazilian underfunded other benefit assets in our postretirement benefit other than pensions at the period end.

The asset allocation for these benefits at the end of 2008 and target allocation for 2009, by asset category, follows:

	Percentage of plan assets Foreign		
	Target for 2009 (Unaudited)	At December 31, 2008	2007
Equity securities			
Fixed Income	61%	61%	61%
Total	39%	39%	39%
	100%	**100%**	**100%**

The asset allocation policy is the same for the foreign underfunded pension plan.

(f) Pension costs

	Three-month period ended (unaudited) December 31, 2008		
	Overfunded pension plans	**Underfunded pension plans**	**Underfunded other benefits**
Service cost benefits earned during the period	3	13	5
Interest cost on projected benefit obligation	86	53	21
Expected return on assets	(143)	(57)	(5)
Amortization of initial transition obligation	4	(2)	6
Net deferral	(1)	11	(2)
Net periodic pension cost	**(51)**	**18**	**25**

	Three-month period ended (unaudited) September 30, 2008		
	Overfunded pension plans	**Underfunded pension plans**	**Underfunded other benefits**
Service cost benefits earned during the period	3	15	6
Interest cost on projected benefit obligation	87	66	21
Expected return on assets	(145)	(63)	
Amortization of initial transition obligation	4	2	(2)
Net deferral	(2)		
Net periodic pension cost	**(53)**	**20**	**25**

Three-month period ended (unaudited)

	December 31, 2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Service cost benefits earned during the period	3	18	6
Interest cost on projected benefit obligation	110	76	26
Expected return on assets	(205)	(73)	(4)
Amortization of initial transition obligation	5		
Net deferral	(6)		
Net periodic pension cost	**(93)**	**21**	**28**

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	As of December 31,					
	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Service cost benefits earned during the period	11	60	25	9	61	20
Interest cost on projected benefit obligation	309	245	85	306	229	78
Expected return on assets	(515)	(253)	(5)	(570)	(247)	(4)
Amortization of initial transition obligation	15			14		
Net deferral	(5)	11	(2)	(17)		
Net periodic pension cost	**(185)**	**63**	**103**	**(258)**	**43**	**94**

(g) Expected contributions and benefits

Employer contributions expected for 2009 are US$338.

The benefit payments, which reflect future service, are expected to be made as follows:

	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Total
2009	195	262	68	525
2010	197	263	72	532
2011	199	261	76	536
2012	200	260	79	539
2013	201	256	82	539
2014 and thereafter	1,011	1,265	412	2,688

(h) Accumulated benefit obligation

	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Accumulated benefit obligation	2,415	2,955	1,069	3,166	4,293	1,671
Projected benefit obligation	2,424	3,031	1,069	3,178	4,436	1,671
Fair value of plan assets	(3,043)	(2,507)	(9)	(4,187)	(3,762)	(10)

(i) Impact of 1% variation in assumed health care cost trend rate

	1% increase		1% decrease	
	2008	2007	2008	2007

Accumulated postretirement benefit obligation (APBO)	134	261	(110)	(201)
Interest and service costs	18	15	(14)	(12)

(j) Other Cumulative Comprehensive Income (Deficit)

	As of December 31,					
	2008			2007		
	Overfunded pension plans	**Underfunded pension plans**	**Underfunded other benefits**	**Overfunded pension plans**	**Underfunded pension plans**	**Underfunded other benefits**
Net transition assets	(16)			(24)		
Net actuarial loss / (gain)	(240)	(206)	282	(6)	(34)	97
Effect of exchange rate changes	(18)	10	3	94	(7)	(2)
Deferred income tax	94	83	(106)	(22)	14	(35)
Amounts recognized in other cumulative comprehensive income (deficit)	**(180)**	**(113)**	**179**	**42**	**(27)**	**60**

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(k) Change in Other Cumulative Comprehensive Income (Deficit)

	As of December 31,					
	2008			2007		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Net transition obligation / (asset) not yet recognized in NPPC at beginning of period	(31)			(38)		
Net actuarial loss / (gain) not yet recognized in NPPC at beginning of period	94	(41)	(14)	491	(33)	(11)
Deferred income tax at beginning of period	(21)	14	5	(154)	11	4
Effect of initial recognition of cumulative comprehensive Income (deficit)	42	(27)	(9)	299	(22)	(7)
Change in the period						
Amortization of net transition obligation / (asset)	15			14		
Amortization of net actuarial loss / (gain)	(6)			(17)		
Total net actuarial loss / (gain) arising during period	(328)	(165)	296	(480)	(1)	108
Effect of exchange rate changes	(18)	10	3	94	(7)	(2)
Deferred income tax	115	69	(111)	132	3	(39)
Total recognized in other cumulative comprehensive income (deficit)	**(180)**	**(113)**	**179**	**42**	**(27)**	**60**

(l) Net periodic pension cost for 2009

	As of December 31, 2009		
	Overfunded pension plans	Underfunded pension plans	Underfunded other benefits
Service cost	9	41	17
Interest cost	263	240	85
Expected return on plan assets	(362)	(195)	(1)
Net transition obligation / (asset) amortization	12		

Net prior service cost / (credit) amortization		3	
Net actuarial loss / (gain) amortization		1	(23)
	(78)	**90**	**78**

19 Long-term incentive compensation plan

In 2008, the Board of Directors approved a long-term incentive compensation plan, which was implemented in April 2008, over a three-year cycle (2008 to 2010).

Under the terms of the plan, the participants, restricted to certain executives, may elect to allocate part of their annual bonus to the plan. The allocation is applied to purchase preferred shares of Vale, through a predefined financial institution, at market conditions and with no benefit provided by Vale.

The shares purchased by each executive are unrestricted and may, at the participant s discretion, be sold at any time. However, the shares must be held for a three-year period and the executive must be continually employed by Vale during that period. The participant then becomes entitled to receive from Vale, a cash payment equivalent to the total amount of shares held, based on market rates.

We account for the compensation cost provided to our executives under this long-term incentive compensation plan, following the requirements of FAS 123(R) Accounting for Stock-Based Compensation . Liabilities are measured at each reporting date at fair value, based on market rates. Compensation costs incurred are recognized, over the defined three-year vesting period. At December, 2008, we recognized a long-term liability of US$7, relating to 711,005 shares, through the Statements of Income.

20 Commitments and contingencies

(a) We provided certain guarantees on behalf of the Goro Project pursuant to which we guaranteed payments due from Goro of up to a maximum amount of US$100 (Maximum Amount) in connection with an indemnity. We also provided additional guarantees covering the amounts payable by Goro regarding (a) amounts exceeding the Maximum Amount in connection with the indemnity and (b) certain other amounts under lease agreements.

Sumic Nickel Netherlands B.V. Sumic, a 21% shareholder of Goro, has a put option to sell to Vale Inco 25%, 50%, or 100% of its share in Goro. The put option can be exercised if the defined cost of the initial Goro project exceeds US$4,200 at project rates and an agreement cannot be reached on how to proceed with the project.

We provided guarantees covering certain termination payments by Goro to a supplier under an electricity supply agreement (ESA) entered into in October 2004 for the Goro nickel-cobalt project. The amount of the termination payments guaranteed depends upon a number of factors, including whether any termination of the ESA occurs as a result of a default by Goro and the date of such early termination. If Goro defaults under the ESA prior to the anticipated start date for electricity supply, the termination payment, which currently is at its maximum amount, would be $145 million. Once the supply of electricity under the ESA to the project begins, the guaranteed amounts will decrease over the life of the ESA.

(b) We and our subsidiaries are defendants in numerous legal actions in the normal course of business. Based on the advice of our legal counsel, management believes that the amounts recognized are sufficient to cover probable losses in connection with such actions.

The provision for contingencies and the related judicial deposits are composed as follows:

	December 31, 2008		December 31, 2007	
	Provision for contingencies	**Judicial deposits**	**Provision for contingencies**	**Judicial deposits**
Labor and social security claims	458	378	519	372
Civil claims	386	242	311	135
Tax related actions	828	518	1,605	613
Others	13	3	18	4
	1,685	**1,141**	**2,453**	**1,124**

Labor and social security related actions principally comprise claims by Brazilian employees and former employees for (i) payment of time spent traveling from their residences to the work-place, (ii) additional health and safety related payments and (iii) various other matters, often in connection with disputes about the amount of indemnities paid upon dismissal and the one-third extra holiday pay.

Civil actions principally related to claims made against us by contractors in Brazil in connection with losses alleged to have been incurred by them as a result of various past Government economic plans during which full inflation indexation of contracts was not permitted, as well, as for accidents and land appropriations disputes.

Tax tax-related actions principally comprise challenges initiated by us, on certain taxes on revenues and value added taxes and uncertain tax positions. We continue to vigorously pursue our interests in all the above actions but recognize that we probably will incur some losses in the final instance, for which we have made provisions.

Judicial deposits are made by us following the court requirements, in order to be entitled to either initiate or continue a legal action. These amounts are released to us, upon receipt of a final favorable outcome from the legal action; in the case of an unfavorable outcome, the deposits are transferred to the prevailing party.

Contingencies settled in 2008, 2007 and 2006 totaled US$148, US$331, US$424, respectively. Provisions recognized in the years ended December 31, 2008, 2007 and 2006, totaled US$213, US$364, US$439, respectively, classified as

other operating expenses. During 2008, we reversed a provision of US$300 previously recognized, in connection with a favorable decision obtained for a process regarding income tax.

In addition to the contingencies for which we have made provisions we are defendants in claims where in our opinion, and based on the advice of our legal counsel, the likelihood of loss is possible but not probable, in the total amount of US$2,476 at December 31, 2008, and for which no provision has been made (2007 US$2,381).

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(c) At the time of our privatization in 1997, we issued shareholder revenue interest instruments known in Brazil as debentures participativas (debentures) to our then-existing shareholders, including the Brazilian Government. The terms of the debentures, were set to ensure that our pre-privatization shareholders, including the Brazilian Government, would participate alongside us in potential future financial benefits that we could be able to derive from exploiting our mineral resources.

In preparation for the issuance of the debentures, we issued series B preferred shares on a one-for-one basis to all holders of our common shares and series A preferred shares. We then exchanged all of the series B shares for the debentures at par value. The debentures are not redeemable or convertible, and do not trade on a stapled basis or otherwise with our common or preferred shares. During 2002 we registered the debentures with the Brazilian Securities Commissions (CVM) in order to permit trading.

Under the terms of the debentures, holders will have the right to receive semi-annual payments equal to an agreed percentage of our net revenues (revenues less value added tax) from certain identified mineral resources that we owned as of May 1997, to the extent that we exceed defined threshold production volumes of these resources, and from the sale of mineral rights that we owned as of May 1997. Our obligation to make payments to the holders will cease when the relevant mineral resources are exhausted at which time we are required to repay the original par value plus accrued interest. Based on current production levels, and estimates for new projects, we began payments relating to copper resources in 2004 and expect to start payments relating to iron ore resources from approximately 2013 for our Northern System and 2018 for our South steam System in Brazil, and payments related to other mineral resources at the end of the current decade.

The table below summarizes the amounts we will be required to pay under the debentures based on the net revenues we earn from the identified mineral resources and the sale of mineral rights.

Area	Mineral	Required Payments by CVRD
South steam System	Iron ore	1.8% of net revenue, after total sales from May 1997 exceeds 1.7 billion tons.
Northern System	Iron ore	1.8% of net revenue, after total sales from May 1997 exceeds 1.2 billion tons.
Pojuca, Andorinhas, Liberdade and Sossego	Gold and copper	2.5% of net revenue from the beginning of commercialization.
Igarapé Bahia and Alemão	Gold and copper	2.5% of net revenue, after total sales from May 1997 exceeds 70 tons of gold.
Other areas, excluding Carajás / Serra Leste	Gold	2.5% of net revenue.
Other areas owned as of May 1997	Other minerals	1% of net revenue, 4 years after the beginning of the commercialization.
All areas	Sale of mineral rights owned as of May 1997	1% of the sales price.

In September 2008 and April 2008 we paid remuneration on these debentures of US$6 and US$5, respectively. During 2007 we paid a total of US$11.

(d) We are committed under a take-or-pay agreement to purchase approximately 32,300 thousand metric tons of bauxite from Mineração Rio do Norte S.A. MRN at a formula driven price, calculated based on the current London Metal Exchange LME quotation for aluminum. Based on a market price of US$32,26 per metric ton as of December 31, 2008, this arrangement represents the following total commitment per metric ton as of December 31, 2008:

2009	281
2010	191
2011	187
2012	190
2013	192
	1,041

(e) Description of Leasing Arrangements

Part of our railroad operations include leased facilities. The 30-year lease, renewable for a further 30 years, expires in August, 2026 and is classified as an operating lease. At the end of the lease term, we are required to return the concession and the lease assets. In most cases, management expects that in the normal course of business, leases will be renewed.

The following is a schedule by year of future minimum rental payments required under the railroad operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2008:

Year ending December 31:	
2009	53
2010	53
2011	53
2012	54
2013 thereafter	714
Total minimum payments required	**927**

The total expenses of operating leases for the years ended December 31, 2008, 2007 and 2006 was US$53, US$62 and US$48, respectively.

During 2008, we entered into operating lease agreements with our joint ventures Nibrasco, Itabrasco and Kobrasco, under wich we leased four pellet plants. The lease terms are from 5 to 30 years.

The following is a schedule by year of future minimum rental payments required under the pellet plants operating leases that have initial or remaining non-cancelable lease terms in excess of one year as of December 31, 2008:

Year ending December 31:	
2009	81
2010	81
2011	81
2012	81
2013 thereafter	987

Total	**1,311**

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(f) Asset retirement obligations:

We use various judgments and assumptions when measuring our asset retirement obligations.

Changes in circumstances, law or technology may affect our estimates and we periodically review the amounts accrued and adjust them as necessary. Our accruals do not reflect unasserted claims because we are currently not aware of any such issues. Also the amounts provided are not reduced by any potential recoveries under cost sharing, insurance or indemnification arrangements because such recoveries are considered uncertain.

The changes in the provisions for asset retirement obligations are as follows:

	Three-month period ended (unaudited)			As of December 31,	
	December 31, 2008	September 30, 2008	December 31, 2007	2008	2007
Beginning of period	**1,000**	**1,101**	**859**	**975**	**676**
Accretion expense	50	45	23	164	84
Liabilities settled in the current period	(2)	(1)	(8)	(7)	(15)
Revisions in estimated cash flows	(45)		83	(47)	83
Cumulative translation adjustment	(116)	(145)	18	(198)	147
End of period	**887**	**1,000**	**975**	**887**	**975**

21 Other expenses

The line item Other operating expenses totaled US$1,254 in 2008 (US$607 in 2007). During the last quarter of 2008 we recognized certain expenses considered to be one off events which substantially caused the increase in 2008 as compared to 2007. The most significant items recognized during the last quarter of 2008 in this respect were: (i) a US$204 expense relating to additional payment relating to tax assessments on transportation services, (ii) inventory market value write-down of US$77, and (iii) write-off of intangible asset (patent right) in the amount of US$65.

22 Fair Value disclosure of Financial Assets and Liabilities

In September 2006, the FASB issued SFAS N. 157, Fair Value Measurements , which defines fair value, establishes a framework for measuring fair value and expands disclosures about fair value measurements. SFAS 157 does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information.

In February 2007, the FASB issued SFAS N. 159, The Fair Value Option for Financial Assets and Financial Liabilities Including an amendment of FASB Statement N. 115 . SFAS N. 159 permits the choice of measuring financial instruments and certain other items at fair value. SFAS N. 159 is effective for financial statements issued for fiscal years beginning after November 15, 2007.

On January 1, 2008, the Company adopted SFAS N. 159 and elected not to apply the provisions of SFAS No. 159 to its eligible financial assets and financial liabilities on the date of adoption. Accordingly, the initial application of both SFAS N. 157 and SFAS N. 159 had no effect on the Company.

Under SFAS N. 157, the inputs used to measure fair value must be classified into one of three level as follows:

Level 1 Quoted prices in an active market for identical assets or liabilities;

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Level 2 Observable inputs other than Level 1, quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets and liabilities in markets that are not active, and model-derived prices whose inputs are observable or whose significant value drivers are observable; and
Level 3 Assets and liabilities whose significant value drivers are unobservable.
The valuation of assets measured at fair value in the Company s Consolidated Balance Sheet at December 31, 2008 is summarized below:

		Fair Value Measurements		
	Fair value December 31, 2008	Quoted prices in active markets for identical assets or liabilities, (Level 1)	Significant Other Observable Inputs (Level 2)	Significant unobservable inputs (Level 3)
Available-for-sale securities	2,408	2,408		
Unrealized losses on derivatives	(539)		(539)	
Other financial liabilities	(380)		(380)	

Our long-term debt is reported at amortized costs, however its fair value measurements at December 31, 2008 are as follows:

	Carrying amount	Fair Value	Level 1	Level 2	Level 3
Long-term debt (less interests)	17,857	16,635	7,833	8,802	

The carrying amount of our current financial instruments generally approximates fair market value because of the short-term maturity or frequent repricing of these instruments.
The market value of our listed long-term investments, where available, is disclosed in Note 12.

23 Segment and geographical information

We adopt SFAS 131 Disclosures about Segments of an Enterprise and Related Information with respect to the information we present about our operating segments. SFAS 131 introduced a management approach concept for reporting segment information, whereby such information is required to be reported on the basis that the chief decision-maker uses internally for evaluating segment performance and deciding how to allocate resources to segments. We analyze our segment information on aggregated and disaggregated basis as follows:
Ferrous products comprises iron ore mining and pellet production, as well as our Brazilian Northern and Southern transportation systems, including railroads, ports and terminals, as they pertain to mining operations. Manganese mining and ferroalloys are also included in this segment.
Non-ferrous comprises the production of non-ferrous minerals, including nickel (co-products and by-products), potash, kaolin, copper and aluminum comprises aluminum trading activities, alumina refining and aluminum metal smelting and investments in joint ventures and affiliates engaged in bauxite mining.
Logistics comprises our transportation systems as they pertain to the operation of our ships, ports and railroads for third-party cargos.
Others comprises our investments in joint ventures and affiliates engaged in other businesses.
Information presented to senior management with respect to the performance of each segment is generally derived directly from the accounting records maintained in accordance with accounting practices adopted in Brazil together with certain minor inter-segment allocations.

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Consolidated net income and principal assets are reconciled as follows:

Results by segment before eliminations (Aggregated)

Three-month period ended (unaudited)															
December 31, 2008						**September 30, 2008**							**Dece**		
) **n ous**	**Aluminum**	**Logistics**	**Others**	**Eliminations**	**Consolidated**	**Ferrous**	(*) **Non ferrous**	**Aluminum**	**Logistics**	**Others**	**Eliminations**	**Consolidated**	**Ferrous**	(*) **Non ferrous**	**Alumin**
416	1,001	6	212	(3,848)	6,327	11,577	2,536	1,122	14	203	(5,615)	9,837	5,904	2,978	84
71	179	303	53	(176)	1,115	1,601	133	261	491	66	(267)	2,285	1,116	113	21
515)	(929)	(217)	(165)	4,024	(4,566)	(8,202)	(1,567)	(1,143)	(328)	(185)	5,882	(5,543)	(4,895)	(1,795)	(90
12)		(17)	(59)		(295)	(92)	(122)		(31)	(86)		(331)	(84)	(92)	
318)	(38)	(26)	(15)		(568)	(270)	(353)	(47)	(34)	(9)		(713)	(262)	(404)	(3
950)					(950)										
408)	**213**	**49**	**26**		**1,063**	**4,614**	**627**	**193**	**112**	**(11)**		**5,535**	**1,779**	**800**	**11**
54	10	3	1	(804)	247	923	201	12	3		(862)	277	653	227	
609)	(18)	(10)	(41)	804	(399)	(954)	(360)	(11)	(1)	7	862	(457)	(906)	(462)	(3
(15)	64				(586)	(639)	16	36				(587)	149	110	6
25	(206)	12	(107)		(241)	(102)	4	(185)	(41)	3		(321)	246	70	3
(38)	22	93	(32)		125	175		18	47	50		290	63	5	2
203	12	4	(2)		1,185	190	(74)	9	19			144	(298)	104	(3
(6)	(20)		5		(27)	(14)	(38)	(20)		12		(60)	4	(86)	(7
394)	**77**	**151**	**(150)**		**1,367**	**4,193**	**376**	**52**	**139**	**61**		**4,821**	**1,690**	**768**	**10**
16	348			(271)	528	601	216	322			(432)	707	417	468	13

259	108		9	(70)	350	313	406	93			(155)	657	102	517	14
64	353	(2)		(1,639)	1,891	3,714	735	478	12	8	(1,933)	3,014	1,949	636	37
15	50		54	(304)	358	605	56	58		61	(303)	477	204	134	4
230	142		74	(703)	1,352	1,304	323	158		98	(573)	1,310	551	392	13
27		8		(420)	955	3,926	223	13	2	4	(1,686)	2,482	1,958	400	
205			75	(441)	893	1,114	577			32	(533)	1,190	723	431	
416	**1,001**	**6**	**212**	**(3,848)**	**6,327**	**11,577**	**2,536**	**1,122**	**14**	**203**	**(5,615)**	**9,837**	**5,904**	**2,978**	**84**
71	179	303	53	(176)	1,115	1,601	133	261	491	66	(267)	2,285	1,116	113	21
487	**1,180**	**309**	**265**	**(4,024)**	**7,442**	**13,178**	**2,669**	**1,383**	**505**	**269**	**(5,882)**	**12,122**	**7,020**	**3,091**	**1,05**

(*) Other than Aluminum.

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Operating segment after eliminations (Disaggregated)

As of and for the three-month period ended (unaudited) December 31, 2008

	Revenues												
	Foreign	Domestic	Total	Value added tax	Net revenues	Cost and expenses	Net	Depreciation, depletion and amortization	Impairment	Operating income	Property, Plant and Equipment, Net and Intangible Assets	Addition to Property, Plant and Equipment and Intangible	Investments
Ferrous													
Iron ore	3,105	431	3,536	(64)	3,472	(1,497)	1,975	(147)		1,828	14,595	1,360	47
Pellets	914	114	1,028	(25)	1,003	(522)	481	(19)		462	645	76	708
Manganese	19	5	24	(4)	20	(17)	3			3	18	1	
Ferroalloys	92	83	175	(21)	154	(69)	85	(3)		82	166	18	
Pig iron											144	116	
	4,130	**633**	**4,763**	**(114)**	**4,649**	**(2,105)**	**2,544**	**(169)**		**2,375**	**15,568**	**1,571**	**755**
Non ferrous													
Nickel and other products (*)	1,111	7	1,118		1,118	(1,298)	(180)	(295)	(950)	(1,425)	21,729	1,233	53
Potash		23	23	(2)	21	(15)	6	(1)		5	159	35	
Kaolin	35	10	45	(2)	43	(40)	3	(5)		(2)	199	2	
Copper concentrate	73	30	103	(6)	97	(285)	(188)	(17)		(205)	3,543	89	
Aluminum products	713	66	779	(3)	776	(543)	233	(38)		195	3,831	115	140
	1,932	**136**	**2,068**	**(13)**	**2,055**	**(2,181)**	**(126)**	**(356)**	**(950)**	**(1,432)**	**29,461**	**1,474**	**193**
Logistics													
Railroads		240	240	(40)	200	(152)	48	(22)		26	1,431	10	326
Ports		70	70	(10)	60	(41)	19	(4)		15	1,441	113	
Ships											374	342	94
		310	**310**	**(50)**	**260**	**(193)**	**67**	**(26)**		**41**	**3,246**	**465**	**420**
Others	265	36	301	(10)	291	(195)	96	(17)		79	1,054	179	1,040
	6,327	**1,115**	**7,442**	**(187)**	**7,255**	**(4,674)**	**2,581**	**(568)**	**(950)**	**1,063**	**49,329**	**3,689**	**2,408**

(*) Includes nickel co-products and by-products (copper, precious metals, cobalt and others).

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Operating segment after eliminations (Disaggregated)

	As of and for the three-month period ended (unaudited) September 30, 2008											
	Revenues											
	Foreign	Domestic	Total	Value added tax	Net revenues	Cost and expenses	Net	Depreciation, depletion and amortization	Operating income	Property, Plant and Equipment, Net and Intangible Assets	Addition to Property, Plant and Equipment and Intangible	Investments
Ferrous												
Iron ore	5,149	1,026	6,175	(142)	6,033	(2,075)	3,958	(239)	3,719	16,139	708	56
Pellets	1,095	317	1,412	(75)	1,337	(746)	591	(25)	566	1,273	(2)	848
Manganese	101	18	119	(6)	113	(20)	93	(1)	92	79	1	
Ferroalloys	212	152	364	(39)	325	(141)	184	(4)	180	137	11	
Pig iron	60		60		60	(21)	39		39	176	5	
	6,617	**1,513**	**8,130**	**(262)**	**7,868**	**(3,003)**	**4,865**	**(269)**	**4,596**	**17,804**	**723**	**904**
Non ferrous												
Nickel and other products (*)	1,933	12	1,945		1,945	(1,107)	838	(314)	524	23,355	555	93
Potash		103	103	(5)	98	(36)	62	(5)	57	130	2	
Kaolin	46	11	57	(2)	55	(56)	(1)	(11)	(12)	232	(5)	
Copper concentrate	244	6	250	(1)	249	(153)	96	(22)	74	1,838	73	
Aluminum products	767	122	889	(25)	864	(675)	189	(49)	140	4,391	24	126
	2,990	**254**	**3,244**	**(33)**	**3,211**	**(2,027)**	**1,184**	**(401)**	**783**	**29,946**	**649**	**219**
Logistics												
Railroads		386	386	(64)	322	(207)	115	(26)	89	1,696	75	289
Ports		87	87	(14)	73	(65)	8	(9)	(1)	1,637	44	
Ships										33	1	109
		473	**473**	**(78)**	**395**	**(272)**	**123**	**(35)**	**88**	**3,366**	**120**	**398**
Others	230	45	275	(10)	265	(189)	76	(8)	68	3,346	61	1,152
	9,837	**2,285**	**12,122**	**(383)**	**11,739**	**(5,491)**	**6,248**	**(713)**	**5,535**	**54,462**	**1,553**	**2,673**

(*) Includes nickel co-products and by-products (copper, precious metals, cobalt and others).

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Operating segment after eliminations (Disaggregated)

	As of and for the three-month period ended (unaudited) December 31, 2007											
	Revenues											
	Foreign	Domestic	Total	Value added tax	Net revenues	Cost and expenses	Net	Depreciation, depletion and amortization	Operating income	Property, Plant and Equipment, Net and Intangible Assets	Addition to Property, Plant and Equipment and Intangible	Investments
Ferrous												
Iron ore	2,818	531	3,349	(74)	3,275	(1,522)	1,753	(222)	1,531	17,031	958	60
Pellets	524	202	726	(46)	680	(490)	190	(26)	164	754	31	741
Manganese	21	8	29	(1)	28	(21)	7	(2)	5	79	1	
Ferroalloys	181	102	283	(26)	257	(137)	120	(8)	112	168	12	
Pig iron	24		24		24	(22)	2		2	198	6	
	3,568	**843**	**4,411**	**(147)**	**4,264**	**(2,192)**	**2,072**	**(258)**	**1,814**	**18,230**	**1,008**	**801**
Non ferrous												
Nickel and other products (*)	2,480	11	2,491		2,491	(1,398)	1,093	(370)	723	23,668	705	299
Potash		58	58	(3)	55	(35)	20	(7)	13	218	6	
Kaolin	62	12	74	(2)	72	(40)	32	(10)	22	295	2	
Copper concentrate	175	28	203	(6)	197	(146)	51	(21)	30	1,841	86	
Aluminum products	586	86	672	(24)	648	(492)	156	(37)	119	4,448	281	184
	3,303	**195**	**3,498**	**(35)**	**3,463**	**(2,111)**	**1,352**	**(445)**	**907**	**30,470**	**1,080**	**483**
Logistics												
Railroads		322	322	(52)	270	(194)	76	(23)	53	1,735	462	342
Ports	11	56	67	(9)	58	(52)	6	(6)		1,371	58	
Ships										36		107
	11	**378**	**389**	**(61)**	**328**	**(246)**	**82**	**(29)**	**53**	**3,142**	**520**	**449**
Others	87	27	114	(6)	108	(194)	(86)	(5)	(91)	2,783	139	1,189
	6,969	**1,443**	**8,412**	**(249)**	**8,163**	**(4,743)**	**3,420**	**(737)**	**2,683**	**54,625**	**2,747**	**2,922**

(*) Includes nickel co-products and by-products (copper, precious metals, cobalt and others).

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Operating segment after eliminations (Disaggregated)

					As of and for the year ended December 31,								
2008					2007								
uminum	Logistics	Others	Eliminations	Consolidated	Ferrous	(*) Non ferrous	Aluminum	Logistics	Others	Eliminations	Consolidated	Ferrous	(*) Non ferrous
3,916	51	588	(15,842)	31,834	21,126	13,338	3,506	61	242	(10,437)	27,836	15,729	4,199
850	1,640	234	(882)	6,675	3,865	487	751	1,519	1	(1,344)	5,279	2,738	277
(3,948)	(1,097)	(617)	16,724	(18,919)	(16,882)	(7,301)	(3,307)	(983)	(310)	11,781	(17,002)	(12,004)	(3,301)
	(101)	(266)		(1,085)	(175)	(329)		(39)	(190)		(733)	(123)	(166)
(171)	(128)	(35)		(2,807)	(917)	(1,039)	(110)	(103)	(17)		(2,186)	(632)	(219)
				(950)									
647	**365**	**(96)**		**14,748**	**7,017**	**5,156**	**840**	**455**	**(274)**		**13,194**	**5,708**	**790**
30	10	1	(3,255)	602	2,514	578	17	9	25	(2,848)	295	789	97
(59)	(15)	(36)	3,255	(1,765)	(4,008)	(1,152)	(166)	(17)	(14)	2,848	(2,509)	(1,526)	(172)
(22)				(812)	854	(90)	153				917	(15)	86
(275)	(32)	(106)		364	2,302	93	181	(15)	(2)		2,559	206	214
				80		81		237	459		777	443	
62	133	94		794	301	9	84	125	76		595	312	
(71)	23	9		(535)	(1,959)	(1,005)	(231)	(16)	10		(3,201)	(976)	(250)
(105)		6		(258)	(31)	(444)	(326)	(1)			(802)	(157)	(190)
207	**484**	**(128)**		**13,218**	**6,990**	**3,226**	**552**	**777**	**280**		**11,825**	**4,784**	**575**
1,164	1		(1,201)	2,820	1,449	1,555	850	23		(1,026)	2,851	1,249	438
412	1	9	(392)	2,467	432	2,462	308		81	(318)	2,965	506	450
1,534	26	9	(5,933)	9,449	6,823	2,589	1,606	33		(3,716)	7,335	5,465	1,020
174		154	(952)	1,500	827	396	142		161	(412)	1,114	767	218

600	1	245	(1,918)	4,737	2,131	2,041	584			(929)	3,827	1,779	523
23	21	4	(3,949)	6,706	7,570	1,457		4		(3,168)	5,863	4,781	499
9	1	167	(1,497)	4,155	1,894	2,838	16	1		(868)	3,881	1,182	1,050
3,916	**51**	**588**	**(15,842)**	**31,834**	**21,126**	**13,338**	**3,506**	**61**	**242**	**(10,437)**	**27,836**	**15,729**	**4,198**
850	1,640	234	(882)	6,675	3,865	487	751	1,519	1	(1,344)	5,279	2,738	277
4,766	**1,691**	**822**	**(16,724)**	**38,509**	**24,991**	**13,825**	**4,257**	**1,580**	**243**	**(11,781)**	**33,115**	**18,467**	**4,475**

(*) Other than Aluminum.

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Operating segment after eliminations (Disaggregated)

As of and for the year ended December 31, 2008

	Revenues												
	Foreign	**Domestic**	**Total**	**Value added tax**	**Net revenues**	**Cost and expenses**	**Net**	**Depreciation, depletion and amortization**	**Impairment**	**Operating income**	**Property, Plant and Equipment, Net and Intangible Assets**	**Addition to Property, Plant and Equipment and Intangible**	**Investment**
Ferrous													
Iron ore	15,102	2,673	17,775	(364)	17,411	(6,547)	10,864	(876)		9,988	14,595	3,645	47
Pellets	3,481	820	4,301	(189)	4,112	(2,394)	1,718	(112)		1,606	645	127	708
Manganese	221	45	266	(15)	251	(77)	174	(5)		169	18	3	
Ferroalloys	704	507	1,211	(128)	1,083	(457)	626	(22)		604	166	32	
Pig iron	146		146		146	(67)	79	(3)		76	144	122	
	19,654	**4,045**	**23,699**	**(696)**	**23,003**	**(9,542)**	**13,461**	**(1,018)**		**12,443**	**15,568**	**3,929**	**755**
Non ferrous													
Nickel and other products (*)	7,785	44	7,829		7,829	(4,425)	3,404	(1,323)	(950)	1,131	21,729	2,813	53
Potash		295	295	(16)	279	(120)	159	(19)		140	159	43	
Kaolin	167	42	209	(9)	200	(213)	(13)	(32)		(45)	199	6	
Copper concentrate	787	106	893	(22)	871	(683)	188	(77)		111	3,543	283	
Aluminum products	2,681	361	3,042	(66)	2,976	(2,288)	688	(172)		516	3,831	440	140
	11,420	**848**	**12,268**	**(113)**	**12,155**	**(7,729)**	**4,426**	**(1,623)**	**(950)**	**1,853**	**29,461**	**3,585**	**193**
Logistics													
Railroads		1,303	1,303	(205)	1,098	(749)	349	(103)		246	1,431	121	326
Ports	11	293	304	(39)	265	(198)	67	(26)		41	1,441	242	
Ships											374	343	94
	11	**1,596**	**1,607**	**(244)**	**1,363**	**(947)**	**416**	**(129)**		**287**	**3,246**	**706**	**420**
Others	749	186	935	(30)	905	(703)	202	(37)		165	1,054	752	1,040
	31,834	**6,675**	**38,509**	**(1,083)**	**37,426**	**(18,921)**	**18,505**	**(2,807)**	**(950)**	**14,748**	**49,329**	**8,972**	**2,408**

(*) Includes nickel co-products and by-products (copper, precious metals, cobalt and others).

Operating segment after eliminations (Disaggregated)

	Revenues											
	As of and for the year ended December 31, 2007											
	Foreign	**Domestic**	**Total**	**Value added tax**	**Net revenues**	**Cost and expenses**	**Net**	**Depreciation, depletion and amortization**	**Operating income**	**Property, Plant and Equipment, Net and Intangible Assets**	**Intangible**	**Addition to Property, Plant and Equipment and Investments**
Ferrous												
Iron ore	9,873	2,035	11,908	(286)	11,622	(4,520)	7,102	(777)	6,325	17,031	2,496	60
Pellets	2,151	587	2,738	(132)	2,606	(1,860)	746	(87)	659	754	92	741
Manganese	48	21	69	(5)	64	(66)	(2)	(7)	(9)	79	2	
Ferroalloys	445	274	719	(70)	649	(442)	207	(25)	182	168	22	
Pig iron	81		81		81	(57)	24	(5)	19	198	34	
	12,598	**2,917**	**15,515**	**(493)**	**15,022**	**(6,945)**	**8,077**	**(901)**	**7,176**	**18,230**	**2,646**	**801**
Non ferrous												
Nickel and other products (*)	11,664	125	11,789		11,789	(6,077)	5,712	(927)	4,785	23,668	2,088	299
Potash		178	178	(10)	168	(108)	60	(23)	37	218	19	
Kaolin	202	36	238	(9)	229	(228)	1	(33)	(32)	295	33	
Copper concentrate	663	139	802	(30)	772	(456)	316	(64)	252	1,841	197	
Aluminum products	2,418	304	2,722	(66)	2,656	(1,717)	939	(111)	828	4,448	856	184
	14,947	**782**	**15,729**	**(115)**	**15,614**	**(8,586)**	**7,028**	**(1,158)**	**5,870**	**30,470**	**3,193**	**483**
Logistics												
Railroads		1,220	1,220	(199)	1,021	(636)	385	(88)	297	1,735	491	342
Ports	13	254	267	(46)	221	(177)	44	(22)	22	1,371	102	
Ships	17	21	38	(3)	35	(44)	(9)	(3)	(12)	36	12	107
	30	**1,495**	**1,525**	**(248)**	**1,277**	**(857)**	**420**	**(113)**	**307**	**3,142**	**605**	**449**
Others	261	85	346	(17)	329	(474)	(145)	(14)	(159)	2,783	207	1,189
	27,836	**5,279**	**33,115**	**(873)**	**32,242**	**(16,862)**	**15,380**	**(2,186)**	**13,194**	**54,625**	**6,651**	**2,922**

(*) Includes nickel co-products and by-products (copper, precious metals, cobalt and others).

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Operating segment after eliminations (Disaggregated)

As of and for the year ended December 31, 2006

	Revenues			**Value added**	**Net**	**Cost and**		**Depreciation, depletion and**	**Operating**	**Property, Plant and Equipment,**	**Addition to Property, Plant and**	
	Foreign	**Domestic**	**Total**	**tax**	**revenues**	**expenses**	**Net**	**Amortization**	**income**	**Net**	**Equipment**	**Investments**
Ferrous												
Iron ore	8,167	1,860	10,027	(271)	9,756	(4,060)	5,696	(528)	5,168	13,235	2,616	48
Pellets	1,590	389	1,979	(86)	1,893	(1,210)	683	(53)	630	593	110	529
Manganese	39	16	55	(3)	52	(97)	(45)	(4)	(49)	65	19	
Ferroalloys	342	166	508	(43)	465	(443)	22	(19)	3	186	34	
	10,138	**2,431**	**12,569**	**(403)**	**12,166**	**(5,810)**	**6,356**	**(604)**	**5,752**	**14,079**	**2,779**	**577**
Non ferrous												
Nickel and other products (*)	2,786	16	2,802		2,802	(2,267)	535	(124)	411	17,193	483	222
Potash		143	143	(8)	135	(84)	51	(23)	28	178	16	
Kaolin	188	30	218	(9)	209	(182)	27	(27)		249	19	
Copper concentrate	690	89	779	(20)	759	(246)	513	(49)	464	1,386	150	
Aluminum products	2,220	161	2,381	(37)	2,344	(1,354)	990	(65)	925	2,829	749	164

					Total past due	Current	Total loans
SBA loans held for investment	$860	$—	$—	$933	$1,793	$40,941	$42,734
SBA 504 loans	—	—	—	—	—	21,565	21,565
Commercial loans							
Commercial other	—	22	—	—	22	92,881	92,903
Commercial real estate	1,786	174	—	1,069	3,029	461,523	464,552
Commercial real estate construction	—	—	—	—	—	57,664	57,664
Residential mortgage	5,837	293	—	1,952	8,082	372,775	380,857

loans							
Consumer loans							
Home equity	—	201	—	323	524	57,332	57,856
Consumer other	—	—	—	—	—	55,400	55,400
Total loans held for investment	$8,483	$690	$—	$4,277	$13,450	$1,160,081	$1,173,531
SBA loans held for sale	—	—	—	—	—	21,579	21,579
Total loans	$8,483	$690	$—	$4,277	$13,450	$1,181,660	$1,195,110

(1) At March 31, 2018, nonaccrual loans included $27 thousand of loans guaranteed by the SBA.

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	December 31, 2017						
(In thousands)	30-59 days past due	60-89 days past due	90+ days and still accruing	Nonaccrual (1)	Total past due	Current	Total loans
SBA loans held for investment	$240	$313	$ —	$ 632	$1,185	$42,814	$43,999
SBA 504 loans	—	—	—	—	—	21,871	21,871
Commercial loans							
Commercial other	23	—	60	25	108	82,717	82,825
Commercial real estate	558	1,073	—	43	1,674	468,022	469,696
Commercial real estate construction	—	—	—	—	—	54,473	54,473
Residential mortgage loans	1,830	958	—	1,669	4,457	360,688	365,145
Consumer loans							
Home equity	51	205	—	625	881	54,936	55,817
Consumer other	3	—	—	—	3	54,035	54,038
Total loans held for investment	$2,705	$2,549	$ 60	$ 2,994	$8,308	$1,139,556	$1,147,864
SBA loans held for sale	—	—	—	—	—	22,810	22,810
Total loans	$2,705	$2,549	$ 60	$ 2,994	$8,308	$1,162,366	$1,170,674

(1) At December 31, 2017, nonaccrual loans included $27 thousand of loans guaranteed by the SBA.

Impaired Loans

The Company has defined impaired loans to be all nonperforming loans individually evaluated for impairment and TDRs. Management considers a loan impaired when, based on current information and events, it is determined that the Company will not be able to collect all amounts due according to the loan contract. Impairment is evaluated on an individual basis for SBA, SBA 504, and commercial loans.

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The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of March 31, 2018:

	March 31, 2018		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$439	$ 357	$ —
Commercial loans			
Commercial real estate	1,069	1,069	—
Total commercial loans	1,069	1,069	—
Total impaired loans with no related allowance	1,508	1,426	—
With an allowance:			
SBA loans held for investment (1)	638	549	279
Commercial loans			
Commercial real estate	774	774	126
Total commercial loans	774	774	126
Total impaired loans with a related allowance	1,412	1,323	405
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	1,077	906	279
Commercial loans			
Commercial real estate	1,843	1,843	126
Total commercial loans	1,843	1,843	126
Total individually evaluated impaired loans	$2,920	$ 2,749	$ 405

(1) Balances are reduced by amount guaranteed by the SBA of $27 thousand at March 31, 2018.

The following table provides detail on the Company's impaired loans that are individually evaluated for impairment with the associated allowance amount, if applicable, as of December 31, 2017:

	December 31, 2017		
(In thousands)	Unpaid principal balance	Recorded investment	Specific reserves
With no related allowance:			
SBA loans held for investment (1)	$135	$ 52	$ —
SBA 504 loans	—	—	—
Commercial loans			
Commercial other	25	25	—
Commercial real estate	43	43	—
Total commercial loans	68	68	—
Total impaired loans with no related allowance	203	120	—
With an allowance:			
SBA loans held for investment (1)	748	553	194
Commercial loans			
Commercial other	—	—	—
Commercial real estate	786	786	138
Total commercial loans	786	786	138
Total impaired loans with a related allowance	1,534	1,339	332
Total individually evaluated impaired loans:			
SBA loans held for investment (1)	883	605	194
SBA 504 loans	—	—	—
Commercial loans			
Commercial other	25	25	—
Commercial real estate	829	829	138
Total commercial loans	854	854	138
Total individually evaluated impaired loans	$1,737	$ 1,459	$ 332

(1) Balances are reduced by amount guaranteed by the SBA of $27 thousand at December 31, 2017.

Impaired loans increased $1.2 million at March 31, 2018 compared to December 31, 2017. The increase in impaired loans was primarily due to the downgrade of one commercial loan totaling $1.1 million and one SBA loan totaling $307 thousand. Both loans were put on to nonaccrual in the first quarter of 2018.

The following table presents the average recorded investments in impaired loans and the related amount of interest recognized during the time period in which the loans were impaired for the three months ended March 31, 2018 and 2017. The average balances are calculated based on the month-end balances of impaired loans. When the ultimate collectability of the total principal of an impaired loan is in doubt and the loan is on nonaccrual status, all payments are applied to principal under the cost recovery method, and therefore no interest income is recognized. The interest income recognized on impaired loans noted below represents primarily accruing TDRs and nominal amounts of income recognized on a cash basis for well-collateralized impaired loans.

	For the three months ended March 31,			
	2018		2017	
(In thousands)	Average recorded investment	Interest income recognized on impaired loans	Average recorded investment	Interest income recognized on impaired loans
SBA loans held for investment (1)	$658	$ (2)	$998	$ (6)
SBA 504 loans	—	—	329	—
Commercial loans				
Commercial other	—	—	25	—
Commercial real estate	1,495	15	1,133	22
Total	$2,153	$ 13	$2,485	$ 16

(1) Balances are reduced by the average amount guaranteed by the SBA of $30 thousand and $248 thousand for the three months ended March 31, 2018 and 2017, respectively.

TDRs

The Company's loan portfolio also includes certain loans that have been modified as TDRs. TDRs occur when a creditor, for economic or legal reasons related to a debtor’s financial condition, grants a concession to the debtor that it would not otherwise consider, unless it results in a delay in payment that is insignificant. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. When the Company modifies a loan, management evaluates for any possible impairment using either the discounted cash flows method, where the value of the modified loan is based on the present value of expected cash flows, discounted at the contractual interest rate of the original loan agreement, or by using the fair value of the collateral less selling costs if the loan is collateral-dependent. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through an allowance estimate or charge-off to the allowance. This process is used, regardless of loan type, and for loans modified as TDRs that subsequently default on their modified terms.

The Company had one performing TDR with a balance of $774 thousand and $786 thousand as of March 31, 2018 and December 31, 2017, respectively, which was included in the impaired loan numbers as of such dates. At March 31, 2018 and December 31, 2017, there were specific reserves of $126 thousand and $138 thousand, respectively, on the performing TDR. The loan remains in accrual status since it continues to perform in accordance with the restructured terms.

To date, the Company’s TDRs consisted of interest rate reductions, interest only periods, principal balance reductions, and maturity extensions. There were no loans modified during the three months ended March 31, 2018 and 2017 that were deemed to be TDRs. There were no loans modified as a TDR within the previous 12 months that subsequently defaulted at some point during the three months ended March 31, 2018. In this case, the subsequent default is defined as 90 days past due or transferred to nonaccrual status.

NOTE 9. Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

Allowance for Loan Losses

The Company has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. At a minimum, the adequacy of the allowance for loan losses is reviewed by management on a quarterly basis. For purposes of determining the allowance for loan losses, the Company has segmented the loans in its portfolio by loan type. Loans are segmented into the following pools: SBA 7(a), SBA 504, commercial, residential mortgages, and consumer loans. Certain portfolio segments are further broken down into classes based on the associated risks within those segments and the type of collateral underlying each loan. Commercial loans are divided into the following four classes: commercial real estate, commercial real estate construction, unsecured business line of credit and commercial other. Consumer loans are divided into two classes as follows: Home equity and other.

The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. The same standard methodology is used, regardless of loan type. Specific reserves are made to individual impaired loans and TDRs (see Note 1 for additional information on this term). The general reserve is set based upon a representative average historical net charge-off rate adjusted for the following environmental factors: delinquency and impairment trends, charge-off and recovery trends, changes in the volume of restructured loans, volume and loan term trends, changes in risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes. Within the five-year historical net charge-off rate, the Company weights the past three years more heavily as it believes it is more indicative of future charge-offs. All of the environmental factors are ranked and assigned a basis points value based on the following scale: low, low moderate, moderate, high moderate and high risk. Each environmental factor is evaluated separately for each class of loans and risk weighted based on its individual characteristics.

- For SBA 7(a), SBA 504 and commercial loans, the estimate of loss based on pools of loans with similar characteristics is made through the use of a standardized loan grading system that is applied on an individual loan level and updated on a continuous basis. The loan grading system incorporates reviews of the financial performance of the borrower, including cash flow, debt-service coverage ratio, earnings power, debt level and equity position, in conjunction with an assessment of the borrower's industry and future prospects. It also incorporates analysis of the type of collateral and the relative loan to value ratio.
- For residential mortgage and consumer loans, the estimate of loss is based on pools of loans with similar characteristics. Factors such as credit score, delinquency status and type of collateral are evaluated. Factors are updated frequently to capture the recent behavioral characteristics of the subject portfolios, as well as any changes in loss mitigation or credit origination strategies, and adjustments to the reserve factors are made as needed.

According to the Company's policy, a loss ("charge-off") is to be recognized and charged to the allowance for loan losses as soon as a loan is recognized as uncollectable. All credits which are 90 days past due must be analyzed for the Company's ability to collect on the credit. Once a loss is known to exist, the charge-off approval process is immediately expedited. This charge-off policy is followed for all loan types.

The allocated allowance is the total of identified specific and general reserves by loan category. The allocation is not necessarily indicative of the categories in which future losses may occur. The total allowance is available to absorb losses from any segment of the portfolio. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in methodologies for estimating allocated and general reserves in the portfolio.

The following tables detail the activity in the allowance for loan losses by portfolio segment for the three months ended March 31, 2018 and 2017:

	For the three months ended March 31, 2018						
(In thousands)	SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$1,471	$430	$ 7,395	$ 3,130	$ 1,130	$ —	$13,556
Charge-offs	(81)	—	—	—	(6)	—	(87)
Recoveries	64	—	16	13	134	—	227
Net (charge-offs) recoveries	(17)	—	16	13	128	—	140
Provision for (credit to) loan losses charged to expense	50	(100)	398	287	(135)	—	500
Balance, end of period	$1,504	$330	$ 7,809	$ 3,430	$ 1,123	$ —	$14,196

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(In thousands)	For the three months ended March 31, 2017 SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Balance, beginning of period	$1,576	$573	$ 6,729	$ 2,593	$ 925	$ 183	$12,579
Charge-offs	(109)	—	(76)	—	(66)	—	(251)
Recoveries	37	—	53	12	1	—	103
Net (charge-offs) recoveries	(72)	—	(23)	12	(65)	—	(148)
Provision for (credit to) loan losses charged to expense	149	27	(173)	264	166	(183)	250
Balance, end of period	$1,653	$600	$ 6,533	$ 2,869	$ 1,026	$ —	$12,681

The following tables present loans and their related allowance for loan losses, by portfolio segment, as of March 31, 2018 and December 31, 2017:

(In thousands)	March 31, 2018 SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$279	$—	$ 126	$—	$—	$ —	$405
Collectively evaluated for impairment	1,225	330	7,683	3,430	1,123	—	13,791
Total	$1,504	$330	$ 7,809	$ 3,430	$ 1,123	$ —	$14,196
Loan ending balances:							
Individually evaluated for impairment	$906	$—	$ 1,843	$—	$—	$ —	$2,749
Collectively evaluated for impairment	41,828	21,565	613,276	380,857	113,256	—	1,170,782
Total	$42,734	$21,565	$ 615,119	$ 380,857	$ 113,256	$ —	$1,173,531

(In thousands)	December 31, 2017 SBA held for investment	SBA 504	Commercial	Residential	Consumer	Unallocated	Total
Allowance for loan losses ending balance:							
Individually evaluated for impairment	$194	$—	$ 138	$—	$—	$ —	$332
Collectively evaluated for impairment	1,277	430	7,257	3,130	1,130	—	13,224
Total	$1,471	$430	$ 7,395	$ 3,130	$ 1,130	$ —	$13,556
Loan ending balances:							
Individually evaluated for impairment	$605	$—	$ 854	$—	$—	$ —	$1,459
Collectively evaluated for impairment	43,394	21,871	606,140	365,145	109,855	—	1,146,405
Total	$43,999	$21,871	$ 606,994	$ 365,145	$ 109,855	$ —	$1,147,864

Changes in Methodology

The Company did not make any changes to its allowance for loan losses methodology in the current period.

Reserve for Unfunded Loan Commitments

In addition to the allowance for loan losses, the Company maintains a reserve for unfunded loan commitments at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the reserve are made through other expense and applied to the reserve which is classified as other liabilities. At March 31, 2018, a $286 thousand commitment reserve was reported on the balance sheet as an "other liability", compared to a $292 thousand commitment reserve at December 31, 2017, due to a larger loan portfolio requiring a larger general reserve.

NOTE 10. New Accounting Pronouncements

ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." ASU 2014-09 replaced almost all existing revenue recognition guidance in current U.S. GAAP. The Company's main source of revenue is comprised of net interest income on interest earning assets and liabilities and non-interest income. The scope of the guidance explicitly excludes net interest income as well as many other revenues for financial assets and liabilities including loans, leases, securities, and derivatives. As such, the Company does not expect the guidance to have a material impact on its financial statements.

Under current U.S. GAAP, when full consideration is not expected and financing is required by the buyer to purchase the property, there are very prescriptive requirements in determining when foreclosed real estate property sold by an institution should be derecognized and a gain or loss be recognized. The new guidance that will be applied to these sales is more principles based. For example, as it pertains to the criteria for determining how a contract should be accounted for under the new guidance, judgment will need to be exercised in evaluating if: (a) a commitment on the buyer's part exists, (b) collection is probable in circumstances where the initial investment is minimal and (c) the buyer has obtained control of the asset, including the significant risks and rewards of the ownership. If there is no commitment on the buyer's part, collection is not probable or the buyer has not obtained control of the asset, then a gain cannot be recognized under the new guidance. The initial investment requirement for the buyer along with the various methods for profit recognition are no longer applicable when the new guidance goes into effect. The Company will revise its current policy on the recognition and measurement of gain on sale of other real estate owned to be consistent with the new guidance, but does not expect the new guidance to have a significant impact on the consolidated financial statements of the Company when adopted.

For deposit-related fees, considering the straightforward nature of the arrangements with the Company's deposits customers, the Company does not expect the recognition and measurement outcomes of deposit-related fees to be significant differently under the new guidance compared to current U.S. GAAP.

ASU 2014-09 was to be effective for interim and annual periods beginning after December 15, 2016 and was to be applied on either a modified retrospective or full retrospective basis. In August 2015, the FASB issued ASU 2015-14 which defers the original effective date for all entities by one year. Public business entities should apply the guidance in ASU 2015-14 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. Earlier application is permitted only as of annual reporting periods beginning after December 15, 2016, including interim reporting periods within that reporting period. The Company has applied this change and the impact of the adoption of ASU 2014-09 on its consolidated financial statements was immaterial.

ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities." ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. This eliminates the available for sale classification of accounting for equity securities and adjusts the fair value disclosures for financial instruments carried at amortized cost such that the disclosed fair values represent an exit price as opposed to an entry price. This update requires that equity securities be carried at fair value on the balance sheet and any periodic changes in value will be adjusted through the income

statement. A practical expedient is provided for equity securities without a readily determinable fair value, such that these securities can be carried at cost less any impairment. For public business entities, the amendments in this update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company has adopted this standard as of January 1, 2018. As of March 31, 2018, $15 thousand in unrealized losses on equity securities were reclassified to net income.

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ASU 2016-02, “Leases (Topic 842)”. ASU 2016-02 was issued in three parts: (a) Section A, “Leases: Amendments to the FASB Accounting Standards Codification®,” (b) Section B, “Conforming Amendments Related to Leases: Amendments to the FASB Accounting Standards Codification®,” and (c) Section C, “Background Information and Basis for Conclusions.” While both lessees and lessors are affected by the new guidance, the effects on lessees are much more significant. The update states that a lessee should recognize the assets and liabilities that arise from all leases with a term greater than 12 months. The core principle requires the lessee to recognize a liability to make lease payments and a "right-of-use" asset. The accounting applied by the lessor is relatively unchanged as the majority of operating leases should remain classified as operating leases and the income from them recognized, generally, on a straight-line basis over the lease term. The standards update also requires expanded qualitative and quantitative disclosures. For public business entities, ASC 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018. ASC 2016-02 mandates a modified retrospective transition for all entities. In January 2018, FASB issued ASU 2018-01, " Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842." ASU 2018-01 was issued to facilitate the implementation of ASU 2016-02. ASU 2018-01 would give entities the option to apply ASC 842 as of the effective date, rather than as of the beginning of the earliest period presented. Under this additional optional transition method, a cumulative-effect adjustment would be recognized in the opening balance of retained earnings in the period of adoption. Lessors would be able to apply a practical expedient under which they could elect, by class of underlying assets, to not separate nonlease components from the related lease components and account for the components as a single lease component if the timing and pattern of revenue recognition for the lease and nonlease components are the same, and the combined single lease component is classified as an operating lease. The effective date and transition requirements for the amendment are the same as the effective date and transition requirements in ASU 2016-02. The Company is currently evaluating the impact of the adoption of ASC 2016-02 and ASU 2018-01 on its consolidated financial statements. As of March 31, 2018, the Company had minimum noncancelable net operating lease payments of $1.7 million that are being evaluated. The implementation team is working on gathering all key lease data elements to meet the requirements of the new guidance.

ASU 2016-13, "Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." ASU 2016-13 was issued to replace the incurred loss impairment methodology in current GAAP with an expected credit loss methodology and requires consideration of a broader range of information to determine credit loss estimates. Financial assets measured at amortized cost will be presented at the net amount expected to be collected by using an allowance for credit losses. Purchased credit impaired loans will receive an allowance account at the acquisition date that represents a component of the purchase price allocation. Credit losses relating to available-for-sale debt securities will be recorded through an allowance for credit losses, with such allowance limited to the amount by which fair value is below amortized cost. For public business entities, ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019. The Company is currently evaluating the impact of the adoption of ASU 2016-13 on its consolidated financial statements.

ASU 2016-15, "Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 was issued to address diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows under Topic 230, Statement of Cash Flows, and other Topics. This update addresses eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments in this update provide guidance on the following eight specific cash flow issues:

- Debt Prepayment or Debt Extinguishment Costs
- Settlement of Zero-Coupon Debt Instruments or Other Debt Instruments with Coupon Interest Rates That Are Insignificant in Relation to the Effective Interest Rate of the Borrowing
- Contingent Consideration Payments Made after a Business Combination
- Proceeds from the Settlement of Insurance Claims
- Proceeds from the Settlement of Corporate-Owned Life Insurance Policies, include Bank-Owned Life Insurance Policies

- Distributions Received from Equity Method Investees
- Beneficial Interest in Securitization Transactions
- Separately Identifiable Cash Flows and Application of the Predominance Principle

The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company has applied this change and the impact of the adoption of ASU 2016-15 on its consolidated financial statements was immaterial.

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ASU 2016-18, "Statement of Cash Flows (Topic 230): Restricted Cash." ASU 2016-18 was issued to address divergence in the way restricted cash is classified and presented. The amendments in the update require that a statement of cash flows explain the change during a reporting period in the total of cash, cash equivalents, and amounts generally described as restricted cash and restricted cash equivalents. The amendments in this update apply to entities that have restricted cash or restricted cash equivalents and are required to present a statement of cash flows under Topic 230. The amendment says that transfers between cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents are not part of the entity's operating, investing, and financing activities. For public business entities, ASU 2016-18 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The Company has applied this change and the impact of the adoption of ASU 2016-18 on its consolidated financial statements was immaterial.

ASU 2017-04, "Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment." ASU 2017-04 was issued in an effort to simplify accounting in a new standard. The amendments in this update require that an entity perform its annual or interim goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. The amendment states that an entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, but the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. For public business entities, ASU 2017-04 is effective for fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performing on testing dates after January 1, 2017. The Company does not expect this ASU to have a material impact on the Company's consolidated financial statements since the fair values of our reporting units were not lower than their respective carrying amounts at the time of our goodwill impairment analysis for 2017.

ASU 2017-07, "Compensation - Retirement Benefits (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost" ASU 2017-07 was issued to provide guidance on the presentation of defined benefit costs in the income statement. The amendments in this update requires that an entity report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The amendment states that other components of net benefit cost be separate from the service cost component in the income statement. For public business entities, ASU 2017-07 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. ASU 2017-07 is not expected to have a significant impact on the presentation of the Company's consolidated financial statements.

ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities." ASU 2017-08 was issued to enhance the accounting for the amortization of premiums for purchased callable debt securities. This amendment requires that the amortization premium be shortened to the earliest call date. For public business entities, ASU 2017-08 is effective for fiscal years after December 15, 2018, and interim periods within those fiscal years. The Company has applied this change and the impact of the adoption of ASU 2017-08 on its consolidated financial statements was immaterial.

ASU 2017-12, "Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 was issued to ease the burden associated with assessing hedge effectiveness and to promote better financial statement alignment of the recognition and presentation of the effects of the hedging instrument and the hedged item. This guidance requires entities to present the earnings effect of the hedging instrument in the same income statement line item with the earnings effect on the hedged item. For public business entities, ASU 2017-12 is effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. ASU 2017-12 is not expected to have a significant impact on the consolidated financial statements.

ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." ASU 2018-02 allows a reclassification from accumulated other comprehensive income (loss) ("AOCI") to retained earnings for the stranded tax effects caused by the

revaluation of deferred taxes resulting from the newly enacted corporate tax rate in the Tax Cuts and Jobs Act. The ASU is effective in years beginning after December 15, 2018, but permits early adoption in a period for which financial statements have not yet been issued. The Company has elected to early adopt the ASU as of January 1, 2018. The adoption of the guidance resulted in a $66 thousand cumulative-effect adjustment that increased retained earnings and decreased AOCI in the first quarter of 2018.

NOTE 11. Derivative Financial Instruments and Hedging Activities

Derivative Financial Instruments

The Company has derivative financial instruments in the form of interest rate swap agreements, which derive their value from underlying interest rates. These transactions involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivatives are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instrument, is reflected on the Company's balance sheet as other assets or other liabilities.

The Company is exposed to credit-related losses in the event of nonperformance by the counterparties to any derivative agreement. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations. The Company deals only with primary dealers.

Derivative instruments are generally either negotiated OTC contracts or standardized contracts executed on a recognized exchange. Negotiated OTC derivative contracts are generally entered into between two counterparties that negotiate specific agreement terms, including the underlying instrument, amount, exercise prices and maturity.

Risk Management Policies – Hedging Instruments

The primary focus of the Company's asset/liability management program is to monitor the sensitivity of the Company's net portfolio value and net income under varying interest rate scenarios to take steps to control its risks. On a quarterly basis, the Company evaluates the effectiveness of entering into any derivative agreement by measuring the cost of such an agreement in relation to the reduction in net portfolio value and net income volatility within an assumed range of interest rates.

Interest Rate Risk Management – Cash Flow Hedging Instruments

The Company has variable rate debt as a source of funds for use in the Company's lending and investment activities and for other general business purposes. These debt obligations expose the Company to variability in interest payments due to changes in interest rates. If interest rates increase, interest expense increases. Conversely, if interest rates decrease, interest expense decreases. Management believes it is prudent to limit the variability of a portion of its interest payments and, therefore hedges its variable-rate interest payments. To meet this objective, management enters into interest rate swap agreements whereby the Company receives variable interest rate payments and makes fixed interest rate payments during the contract period.

During the three months ended March 31, 2018, the Company received variable rate London Interbank Offered Rate ("LIBOR") payments from and paid fixed rates in accordance with its interest rate swap agreements. A summary of the Company's outstanding interest rate swap agreements used to hedge variable rate debt at March 31, 2018 and 2017, respectively is as follows:

	For the three months ended March 31,			
(In thousands, except percentages and years)	2018		2017	
Notional amount	$60,000		$60,000	
Weighted average pay rate	1.26	%	1.26	%
Weighted average receive rate	1.39	%	0.97	%

Weighted average maturity in years	2.74	3.61
Unrealized gain relating to interest rate swaps	$583	$81

At March 31, 2018 and 2017, the unrealized gain relating to interest rate swaps was recorded as a derivative asset. Changes in the fair value of the interest rate swaps designated as hedging instruments of the variability of cash flows associated with long-term debt are reported in other comprehensive income.

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NOTE 12. Employee Benefit Plans

Stock Option Plans

The Company has incentive and nonqualified option plans, which allow for the grant of options to officers, employees and members of the Board of Directors. Transactions under the Company's stock option plans for the three months ended March 31, 2018 are summarized in the following table:

	Shares	Weighted average exercise price	Weighted average remaining contractual life in years	Aggregate intrinsic value
Outstanding at December 31, 2017	504,573	$ 8.31	5.7	$5,772,843
Options granted	114,500	20.24		
Options exercised	(55,007)	5.28		
Options forfeited	(4,433)	12.57		
Options expired	—	—		
Outstanding at March 31, 2018	559,633	$ 11.01	6.7	$6,148,159
Exercisable at March 31, 2018	357,672	$ 7.52	5.3	$5,179,996

Grants under the Company's incentive and nonqualified option plans generally vest over 3 years and must be exercised within 10 years of the date of grant. The exercise price of each option is the market price on the date of grant. As of March 31, 2018, 2,462,585 shares have been reserved for issuance upon the exercise of options, 559,633 option grants are outstanding, and 1,630,647 option grants have been exercised, forfeited or expired, leaving 272,305 shares available for grant.

The fair values of the options granted during the three months ended March 31, 2018 and 2017 were estimated on the date of grant using the Black-Scholes option-pricing model with the following weighted average assumptions:

	For the three months ended March 31,	
	2018	2017
Number of options granted	114,500	47,100
Weighted average exercise price	$20.24	$ 16.37
Weighted average fair value of options	$5.97	$ 4.64
Expected life in years (1)	6.3497716895	P6Y6M26D
Expected volatility (2)	26.40 %	28.12 %
Risk-free interest rate (3)	2.48 %	2.18 %
Dividend yield (4)	1.14 %	1.15 %

(1) The expected life of the options was estimated based on historical employee behavior and represents the period of time that options granted are expected to be outstanding.
(2) The expected volatility of the Company's stock price was based on the historical volatility over the period commensurate with the expected life of the options.
(3) The risk-free interest rate is the U.S. Treasury rate commensurate with the expected life of the options on the date of grant.
(4) The expected dividend yield is the projected annual yield based on the grant date stock price.

Upon exercise, the Company issues shares from its authorized but unissued common stock to satisfy the options. The following table presents information about options exercised during the three months ended March 31, 2018 and 2017:

	For the three months ended March 31,	
	2018	2017
Number of options exercised	55,007	17,064
Total intrinsic value of options exercised	$825,653	$147,690
Cash received from options exercised	$290,357	$134,955
Tax deduction realized from options	$232,091	$60,331

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The following table summarizes information about stock options outstanding and exercisable at March 31, 2018:

	Options outstanding			Options exercisable	
Range of exercise prices	Options outstanding	Weighted average remaining contractual life (in years)	Weighted average exercise price	Options exercisable	Weighted average exercise price
$0.00 - 4.00	39,600	1.0	$ 3.55	39,600	$ 3.55
4.01 - 8.00	177,100	4.5	6.16	177,100	6.16
8.01 - 12.00	154,367	7.5	9.41	116,963	9.24
12.01 - 16.00	44,066	8.7	14.96	14,007	14.93
16.01 - 20.00	104,500	9.5	18.89	10,002	16.75
20.01 - 24.00	40,000	10.0	21.15	—	—
Total	559,633	6.7	$ 11.01	357,672	$ 7.52

Financial Accounting Standards Board Accounting Standards Codification ("FASB ASC") Topic 718, “Compensation - Stock Compensation,” requires an entity to recognize the fair value of equity awards as compensation expense over the period during which an employee is required to provide service in exchange for such an award (vesting period). Compensation expense related to stock options and the related income tax benefit for the three months ended March 31, 2018 and 2017 are detailed in the following table:

	For the three months ended March 31,	
	2018	2017
Compensation expense	$123,460	$69,817
Income tax benefit	$34,705	$28,520

As of March 31, 2018, unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Company’s stock option plans totaled approximately $945 thousand. That cost is expected to be recognized over a weighted average period of 2.4 years.

Restricted Stock Awards

Restricted stock is issued under the stock bonus program to reward employees and directors and to retain them by distributing stock over a period of time. The following table summarizes nonvested restricted stock activity for the three months ended March 31, 2018:

	Shares	Average grant date fair value
Nonvested restricted stock at December 31, 2017	94,003	$ 12.53
Granted	38,300	20.64
Cancelled	—	—
Vested	(28,866)	11.34
Nonvested restricted stock at March 31, 2018	103,437	$ 15.86

Restricted stock awards granted to date vest over a period of 4 years and are recognized as compensation to the recipient over the vesting period. The awards are recorded at fair market value at the time of grant and amortized into

salary expense on a straight line basis over the vesting period. As of March 31, 2018, 518,157 shares of restricted stock were reserved for issuance, of which 73,104 shares are available for grant.

Restricted stock awards granted during the three months ended March 31, 2018 and 2017 were as follows:

	For the three months ended March 31,	
	2018	2017
Number of shares granted	38,300	38,400
Average grant date fair value	$20.64	$16.36

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Compensation expense related to restricted stock for the three months ended March 31, 2018 and 2017 is detailed in the following table:

	For the three months ended March 31,	
	2018	2017
Compensation expense	$141,297	$141,804
Income tax benefit	$39,719	$57,927

As of March 31, 2018, there was approximately $1.5 million of unrecognized compensation cost related to nonvested restricted stock awards granted under the Company's stock incentive plans. That cost is expected to be recognized over a weighted average period of 3.1 years.

401(k) Savings Plan

The Bank has a 401(k) savings plan covering substantially all employees. Under the Plan, an employee can contribute up to 80 percent of their salary on a tax deferred basis. The Bank may also make discretionary contributions to the Plan. The Bank contributed $136 thousand and $119 thousand to the Plan during the three months ended March 31, 2018 and 2017, respectively.

Deferred Fee Plan

The Company has a deferred fee plan for Directors and executive management. Directors of the Company have the option to elect to defer up to 100 percent of their respective retainer and Board of Director fees, and each member of executive management has the option to elect to defer up to 100 percent of their year end cash bonuses. Director and executive deferred fees totaled $250 thousand and $120 thousand during the three months ended March 31, 2018 and 2017, respectively. The interest paid on the deferred balances totaled $15 thousand and $10 thousand during the three months ended March 31, 2018 and 2017, respectively. The fees distributed on the deferred balances totaled $3 thousand in 2018. No fees were distributed in 2017.

Benefit Plans

In addition to the 401(k) savings plan which covers substantially all employees, in 2015 the Company established an unfunded supplemental defined benefit plan to provide additional retirement benefits for the President and Chief Executive Officer ("CEO") and certain key executives.

On June 4, 2015, the Company approved the Supplemental Executive Retirement Plan ("SERP") pursuant to which the President and CEO is entitled to receive certain supplemental nonqualified retirement benefits. On November 21, 2016 the Company approved a change in calculation of the Retirement Benefit payable under the Plan so that the Retirement Benefit shall be an amount equal to forty percent (40%) of the average of Executive's base salary for the thirty-six (36) months immediately preceding executive's separation from service after age 66, adjusted annually thereafter by two 2 percent. The total benefit is to be made payable in fifteen annual installments. The future payments are estimated to total $3.4 million. A discount rate of 4.00% was used to calculate the present value of the benefit obligation.

The President and CEO commenced vesting in this retirement benefit on January 1, 2014, and vests an additional 3 percent each year until fully vested on January 1, 2024. In the event that the President and CEO's separation from service from the company were to occur prior to full vesting, the President and CEO would be entitled to and shall be paid the vested portion of the retirement benefit calculated as of the date of separation from service. Notwithstanding the foregoing, upon a Change in Control, and provided that within 6 months following the Change in Control the President and CEO is involuntarily terminated for reasons other than "cause" or the President and CEO resigns for "good reason," as such is defined in the SERP, or the President and CEO voluntarily terminates his employment after being

offered continued employment in a position that is not a "Comparable Position," as such is also defined in the SERP, the President and CEO shall become one hundred percent 100% vested in the full retirement benefit.

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No contributions or payments have been made during the three months ended March 31, 2018. The following table summarizes the components of the net periodic pension cost of the defined benefit plan recognized during the three months ended March 31, 2018 and 2017:

	For the three months ended March 31,	
(In thousands)	2018	2017
Service cost	$112	$ 16
Interest cost	13	10
Amortization of prior service cost	21	21
Net periodic benefit cost	$146	$ 47

The following table summarizes the changes in benefit obligations of the defined benefit plan during the three months ended March 31, 2018 and 2017:

	For the three months ended March 31,	
(In thousands)	2018	2017
Benefit obligation, beginning of year	$1,187	$1,023
Service cost	112	16
Interest cost	13	10
Benefit obligation, end of period	$1,312	$1,049

On October 22, 2015, the Company entered into an Executive Incentive Retirement Plan (the "Plan") with certain key executive officers. The Plan has an effective date of January 1, 2015.

The Plan is an unfunded, nonqualified deferred compensation plan. For any Plan Year, a guaranteed annual Deferral Award percentage of seven and one half percent (7.5%) of the participant's annual base salary will be credited to each Participant's Deferred Benefit Account. A discretionary annual Deferral Award equal to seven and one half percent (7.5%) of the participant's annual base salary may be credited to the Participant's account in addition to the guaranteed Deferral Award, if the Bank exceeds the benchmarks set forth in the Annual Executive Bonus Matrix. The total Deferral Award shall never exceed fifteen percent (15%) of the participant's base salary for any given Plan Year. Each Participant shall be one hundred percent 100% vested in all Deferral Awards as of the date they are awarded.

As of March 31, 2018, the Company had total year to date expenses of $21 thousand related to the Plan. The Plan is reflected on the Company's balance sheet as accrued expenses.

Certain members of management are also enrolled in a split-dollar life insurance plan with a post retirement death benefit of $250 thousand. Total expenses related to this plan were $1 thousand for the three months ended March 31, 2018 and 2017.

13. Regulatory Capital

A significant measure of the strength of a financial institution is its capital base. Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for common stock, qualifying preferred stock and certain qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, subject to limitations, certain qualifying long-term debt, preferred stock and hybrid instruments, which do not qualify for tier 1 capital. The Parent Company and its subsidiary Bank are subject to various regulatory capital requirements administered by banking regulators. Quantitative measures of capital adequacy include the leverage ratio (tier 1 capital as a percentage of tangible assets), tier 1 risk-based capital ratio (tier 1 capital as a percent of risk-weighted assets), total risk-based capital ratio (total risk-based capital as a percent of total risk-weighted assets), and common equity tier 1 capital ratio.

Minimum capital levels are regulated by risk-based capital adequacy guidelines, which require the Company and the Bank to maintain certain capital as a percentage of assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-weighted assets). Failure to meet minimum capital requirements can initiate certain mandatory and possibly discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action applicable to banks, the Company and the Bank must meet specific capital guidelines. Prompt corrective action provisions are not applicable to bank holding companies.

In September 2010, the Group of Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, adopted Basel III, which constitutes a set of capital reform measures designed to strengthen the regulation, supervision and risk management of banking organizations worldwide. In order to implement Basel III and certain additional capital changes required by the Dodd-Frank Act, the FDIC approved, as an interim final rule in July 2013, the regulatory capital requirements substantially similar to final rules issued by the Board of Governors of the Federal Reserve System ("Federal Reserve") for U.S. state nonmember banks and the Office of the Comptroller of the Currency for national banks.

The interim final rule includes new risk-based capital and leverage ratios that will be phased-in from 2015 to 2019 for most state nonmember banks. The rule includes a new common equity Tier 1 capital ("CET1") to risk-weighted assets ratio of 4.5% and a common equity Tier 1 capital conservation buffer of 2.5% of risk-weighted assets, which is in addition to the Tier 1 and Total risk-based capital requirements. The interim final rule also raises the minimum ratio of Tier 1 capital to risk-weighted assets from 4.0% to 6.0% and requires a minimum leverage ratio of 4.0%. The required minimum ratio of total capital to risk-weighted assets will remain 8.0%. The new risk-based capital requirements (except for the capital conservation buffer) became effective for the Company and the Bank on January 1, 2015.

The new rules also include a one-time opportunity to opt-out of the changes to treatment of accumulated other comprehensive income ("AOCI") components. By making the election to opt-out, the institution may continue treating AOCI items in a manner consistent with risk-based capital rules in place prior to January 2015. The Bank and the Company have made the election to opt out of the treatment of AOCI on the appropriate March 31, 2015 filings.

The following table summarizes the Company's and the Bank's regulatory capital ratios at March 31, 2018 and December 31, 2017, as well as the minimum regulatory capital ratios required for the Bank to be deemed "well-capitalized."

	At March 31, 2018		Required for capital adequacy purposes effective		To be well-capitalized under prompt corrective action regulations
	Company	Bank	January 1, 2018	January 1, 2019	Bank
Leverage ratio	9.46 %	9.12 %	4.000 %	4.00 %	5.00 %
CET1	11.14 %	11.60 %	6.375 % (1)	7.00 % (2)	6.50 %
Tier I risk-based capital ratio	12.07 %	11.60 %	7.875 % (1)	8.50 % (2)	8.00 %
Total risk-based capital ratio	13.24 %	12.81 %	9.875 % (1)	10.50 % (2)	10.00 %

(1) Includes 1.875% capital conservation buffer.
(2) Includes 2.5% capital conservation buffer.

	At December 31, 2017	Required for capital	To be well-capitalized

			adequacy purposes effective		under prompt corrective action regulations
	Company	Bank	January 1, 2017	January 1, 2019	Bank
Leverage ratio	9.37 %	9.03 %	4.000 %	4.00 %	5.00 %
CET1	10.81 %	11.33 %	5.750 % (3)	7.00 % (4)	6.50 %
Tier I risk-based capital ratio	11.75 %	11.33 %	7.250 % (3)	8.50 % (4)	8.00 %
Total risk-based capital ratio	12.87 %	12.50 %	9.250 % (3)	10.50 % (4)	10.00 %

(3) Includes 1.25% capital conservation buffer.
(4) Includes 2.5% capital conservation buffer.

ITEM 2 Management's Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the 2017 consolidated audited financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2017. When necessary, reclassifications have been made to prior period data throughout the following discussion and analysis for purposes of comparability. This Quarterly Report on Form 10-Q contains certain "forward looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995, which may be identified by the use of such words as "believe", "expect", "anticipate", "should", "planned", "estimated" "potential". Examples of forward looking statements include, but are not limited to, estimates with respect to the financial condition, results of operations and business of Unity Bancorp, Inc. that are subject to various factors which could cause actual results to differ materially from these estimates. These factors include, in addition to those items contained in the Company's Annual Report on Form 10-K under Item IA-Risk Factors, as updated by our subsequent Quarterly Reports on Form 10-Q, the following: changes in general, economic, and market conditions, legislative and regulatory conditions, or the development of an interest rate environment that adversely affects Unity Bancorp, Inc.'s interest rate spread or other income anticipated from operations and investments.

Overview

Unity Bancorp, Inc. (the "Parent Company") is a bank holding company incorporated in New Jersey and registered under the Bank Holding Company Act of 1956, as amended. Its wholly-owned subsidiary, Unity Bank (the "Bank" or, when consolidated with the Parent Company, the "Company") is chartered by the New Jersey Department of Banking and Insurance and commenced operations on September 13, 1991. The Bank provides a full range of commercial and retail banking services through the internet and it's eighteen branch offices located in Bergen, Hunterdon, Middlesex, Somerset, Union and Warren counties in New Jersey, and Northampton County in Pennsylvania as well as a loan production office in Bergen County, New Jersey. These services include the acceptance of demand, savings, and time deposits and the extension of consumer, real estate, SBA and other commercial credits. The Bank has multiple subsidiaries used to hold part of its investment and loan portfolios and OREO properties.

The Company has two other wholly-owned subsidiaries: Unity (NJ) Statutory Trust II and Unity Risk Management, Inc. On July 24, 2006, the Trust issued $10.0 million of trust preferred securities to investors. These floating rate securities are treated as subordinated debentures on the Company's financial statements. However, they qualify as Tier I Capital for regulatory capital compliance purposes, subject to certain limitations. Unity Risk Management, Inc. is the Company's captive insurance company that insures risks to the Bank not covered by the traditional commercial insurance market. The Company does not consolidate the accounts and related activity of Unity (NJ) Statutory Trust II, but it does consolidate the accounts of Unity Risk Management, Inc.

Earnings Summary

Net income totaled $5.2 million, or $0.48 per diluted share for the quarter ended March 31, 2018, compared to $3.2 million, or $0.30 per diluted share for the same period a year ago. Return on average assets and average common equity for the quarter were 1.53% and 17.69%, respectively, compared to 1.07 % and 12.02% for the same period a year ago.

First quarter highlights include:

- Net interest income increased 23.9% compared to the prior year's quarter due to strong loan growth and the increase in interest rate environment.
- Net interest margin equaled 3.99% this quarter compared to 3.70% in the prior years' quarter. Higher yields on our earning assets such as loans offset the rising costs of deposits.
- Noninterest income increased 3.7% compared to the prior year's quarter due to increased loan payoff fees, gains on the sales of SBA loans and bank owned life insurance ("BOLI") income.
- Noninterest expense increased 10.1% compared to the prior year's quarter due to growth of our retail branch and lending networks.
- The effective tax rate declined to 19.1% as a result of the "Tax Cuts and Jobs Act," which was enacted December 22, 2017 and lowered the corporate tax rate.
- Residential mortgage, consumer and commercial loans increased 4.3%, 3.1% and 1.3%, respectively, while total loans increased 2.1% since year end 2017.
- Time, noninterest-bearing demand and savings deposits rose 24.7%, 3.6% and 2.9%, respectively, while total deposits increased 7.1% since year-end 2017.

The Company's quarterly performance ratios may be found in the table below.

	For the three months ended March 31,	
	2018	2017
Net income per common share - Basic (1)	$0.49	$0.30
Net income per common share - Diluted (2)	$0.48	$0.30
Return on average assets	1.53 %	1.07 %
Return on average equity (3)	17.69 %	12.02 %
Efficiency ratio (4)	54.00 %	59.08 %

(1) Defined as net income divided by weighted average shares outstanding.
(2) Defined as net income divided by the sum of the weighted average shares and the potential dilutive impact of the exercise of outstanding options.
(3) Defined as net income divided by average shareholders' equity.
(4) Defined as noninterest expense divided by the sum of the net interest income plus noninterest income less any gains or losses on securities.

Net Interest Income

The primary source of the Company's operating income is net interest income, which is the difference between interest and dividends earned on earning assets and fees earned on loans, and interest paid on interest-bearing liabilities. Earning assets include loans to individuals and businesses, investment securities, interest-earning deposits and federal funds sold. Interest-bearing liabilities include interest-bearing demand, savings and time deposits, FHLB advances and other borrowings. Net interest income is determined by the difference between the yields earned on earning assets and the rates paid on interest-bearing liabilities ("net interest spread") and the relative amounts of earning assets and interest-bearing liabilities. The Company's net interest spread is affected by regulatory, economic and competitive factors that influence interest rates, loan demand, deposit flows and general levels of nonperforming

assets.

During the quarter ended March 31, 2018, tax-equivalent net interest income amounted to $12.9 million, an increase of $2.5 million or 23.7 percent when compared to the same period in 2017. The net interest margin increased 29 basis points to 3.99 percent for the quarter ended March 31, 2018, compared to 3.70 percent for the same period in 2017. The net interest spread was 3.73 percent for the first quarter of 2018, a 27 basis point increase compared to the same period in 2017. This was due to strong loan growth, the rising interest rate environment and a stable cost of funds.

During the quarter ended March 31, 2018, tax-equivalent interest income was $15.6 million, an increase of $3.0 million or 24.0 percent when compared to the same period in the prior year. This increase was mainly driven by the increase in the balance of average loans, partially offset by a decrease in the balance of average securities, federal funds sold, interest-bearing deposits and repos.

- Of the $3.0 million net increase in interest income on a tax-equivalent basis, $2.4 million of the increase was due to increased average earning assets, and $678 thousand was due to increased yields on the earning assets.
- The average volume of interest-earning assets increased $166.0 million to $1.3 billion for the first quarter of 2018 compared to $1.1 billion for the same period in 2017. This was due primarily to a $194.8 million increase in average loans, primarily commercial, residential mortgage and consumer loans, partially offset by a $29.0 million decrease in federal funds sold, interest-bearing deposits and repos and a $1.8 million decrease in investment securities.

- The yield on total interest-earning assets increased 37 basis points to 4.85 percent for the three months ended March 31, 2018 when compared to the same period in 2017. The yield on the loan portfolio increased 21 basis points to 5.07 percent.

Total interest expense was $2.8 million for the three months ended March 31, 2018, an increase of $564 thousand or 25.6 percent compared to the same period in 2017. This increase was driven by the increased rate and volume of interest-bearing deposits and the increased volume of borrowed funds and subordinated debentures, partially offset by the decreased rate on the borrowed funds and subordinated debentures compared to a year ago:

- Of the $564 thousand increase in interest expense, $278 thousand was due to increased rates on interest-bearing deposits, $204 thousand was due to an increase in the volume of borrowed funds and subordinated debentures and $182 thousand was due to an increase in the volume of interest-bearing deposits, partially offset by $100 thousand due to reduced rates paid on borrowed funds and subordinated debentures.
- Interest-bearing liabilities averaged $1.0 billion for the first quarter of 2018, an increase of $122.4 million or 13.9 percent compared to the prior year's quarter. The increase in interest-bearing liabilities was due to an increase in interest-bearing deposits and borrowed funds and subordinated debentures.
- The average cost of total interest-bearing liabilities increased 10 basis points to 1.12 percent. While the cost of interest-bearing deposits increased 14 basis points to 0.97 percent for the first quarter of 2018, the cost of borrowed funds and subordinated debentures decreased 29 basis points to 1.86 percent due to the use of derivative instruments to hedge interest risk. The increase in the cost of deposits was primarily driven by a promotional savings and time product.

The following table reflects the components of net interest income, setting forth for the periods presented herein: (1) average assets, liabilities and shareholders' equity, (2) interest income earned on interest-earning assets and interest expense paid on interest-bearing liabilities, (3) average yields earned on interest-earning assets and average rates paid on interest-bearing liabilities, (4) net interest spread, and (5) net interest income/margin on average earning assets. Rates/Yields are computed on a fully tax-equivalent basis, assuming a federal income tax rate of 21 percent in 2018 and 35 percent in 2017.

Consolidated Average Balance Sheets
(Dollar amounts in thousands, interest amounts and interest rates/yields on a fully tax-equivalent basis)

	For the three months ended					
	March 31, 2018			March 31, 2017		
	Average Balance	Interest	Rate/Yield	Average Balance	Interest	Rate/Yield
ASSETS						
Interest-earning assets:						
Federal funds sold, interest-bearing deposits and repos	$48,936	$205	1.70 %	$77,943	$129	0.67 %
FHLB stock	7,799	134	6.97	5,776	93	6.53
Securities:						
Taxable	63,393	492	3.15	64,148	491	3.10
Tax-exempt	5,349	38	2.88	6,443	67	4.22
Total securities (A)	68,742	530	3.13	70,591	558	3.21
Loans:						
SBA loans	68,376	1,183	7.02	57,960	854	5.98
SBA 504 loans	21,689	274	5.12	26,050	301	4.69
Commercial loans	610,720	7,452	4.95	512,543	6,166	4.88
Residential mortgage loans	371,061	4,340	4.74	297,203	3,384	4.62
Consumer loans	110,947	1,529	5.59	94,217	1,132	4.87
Total loans (B)	1,182,793	14,778	5.07	987,973	11,837	4.86
Total interest-earning assets	$1,308,270	$15,647	4.85 %	$1,142,283	$12,617	4.48 %
Noninterest-earning assets:						
Cash and due from banks	23,244			23,578		
Allowance for loan losses	(13,949)			(12,785)		
Other assets	65,686			55,493		
Total noninterest-earning assets	74,981			66,286		
Total assets	$1,383,251			$1,208,569		
LIABILITIES AND SHAREHOLDERS' EQUITY						
Interest-bearing liabilities:						
Total interest-bearing demand deposits	$178,385	$224	0.51 %	$152,392	$153	0.41 %
Total savings deposits	403,222	776	0.78	378,439	583	0.62
Total time deposits	252,000	1,000	1.61	222,307	804	1.47
Total interest-bearing deposits	833,607	2,000	0.97	753,138	1,540	0.83
Borrowed funds and subordinated debentures	167,458	768	1.86	125,499	664	2.15
Total interest-bearing liabilities	$1,001,065	$2,768	1.12 %	$878,637	$2,204	1.02 %
Noninterest-bearing liabilities:						
Noninterest-bearing demand deposits	252,128			215,405		
Other liabilities	10,165			6,792		
Total noninterest-bearing liabilities	262,293			222,197		
Total shareholders' equity	119,893			107,735		
Total liabilities and shareholders' equity	$1,383,251			$1,208,569		
Net interest spread		$12,879	3.73 %		$10,413	3.46 %
Tax-equivalent basis adjustment		(7)			(23)	
Net interest income		$12,872			$10,390	

Net interest margin	3.99	%	3.70	%

(A) Yields related to securities exempt from federal and state income taxes are stated on a fully tax-equivalent basis. They are reduced by the nondeductible portion of interest expense, assuming a federal tax rate of 21 percent in 2018 and 35 percent in 2017, as well as all applicable state rates.

(B) The loan averages are stated net of unearned income, and the averages include loans on which the accrual of interest has been discontinued.

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The rate volume table below presents an analysis of the impact on interest income and expense resulting from changes in average volume and rates over the periods presented. Changes that are not due to volume or rate variances have been allocated proportionally to both, based on their relative absolute values. Amounts have been computed on a tax-equivalent basis, assuming a federal income tax rate of 21 percent in 2018 and 35 percent in 2017.

	For the three months ended March 31, 2018 versus March 31, 2017 Increase (decrease) due to change in:		
(In thousands on a tax-equivalent basis)	Volume	Rate	Net
Interest income:			
Federal funds sold, interest-bearing deposits and repos	$(62)	$138	$76
FHLB stock	35	6	41
Securities	(16)	(12)	(28)
Loans	2,395	546	2,941
Total interest income	$2,352	$678	$3,030
Interest expense:			
Demand deposits	$29	$42	$71
Savings deposits	39	154	193
Time deposits	114	82	196
Total interest-bearing deposits	182	278	460
Borrowed funds and subordinated debentures	204	(100)	104
Total interest expense	386	178	564
Net interest income - fully tax-equivalent	$1,966	$500	$2,466
Decrease in tax-equivalent adjustment			16
Net interest income			$2,482

Provision for Loan Losses

The provision for loan losses totaled $500 thousand for the three months ended March 31, 2018, compared to $250 thousand for the three months ended March 31, 2017. Each period's loan loss provision is the result of management's analysis of the loan portfolio and reflects changes in the size and composition of the portfolio, the level of net charge-offs, delinquencies, current economic conditions and other internal and external factors impacting the risk within the loan portfolio. Additional information may be found under the captions "Financial Condition - Asset Quality" and "Financial Condition - Allowance for Loan Losses and Reserve for Unfunded Loan Commitments." The current provision is considered appropriate under management's assessment of the adequacy of the allowance for loan losses.

Noninterest Income

The following table shows the components of noninterest income for the three months ended March 31, 2018 and 2017:

	For the three months ended March 31,	
(In thousands)	2018	2017
Branch fee income	$330	$331
Service and loan fee income	564	512

Gain on sale of SBA loans held for sale, net	547	485
Gain on sale of mortgage loans, net	424	532
BOLI income	171	88
Net security losses	(15)	—
Other income	265	256
Total noninterest income	$2,286	$2,204

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For the three months ended March 31, 2018, noninterest income increased $82 thousand to $2.3 million, compared to the same period last year. Quarterly noninterest income increased primarily due to higher service and loan fee income, gains on the sale of SBA loans and bank owned life insurance ("BOLI") income.

Changes in our noninterest income for the three months ended March 31, 2018 vs. 2017 reflect:

- Branch fee income remained relatively flat for the three months ended March 31, 2018 when compared to the same period in the prior year.
- Service and loan fee income increased primarily due to higher loan payoff fees.
- SBA loan sales during the first quarter of 2018 totaled $5.8 million with a net gain of $547 thousand, compared to $6.0 million in sales with a net gain of $485 thousand in the prior year's quarter.
- During the quarter, $20.1 million in residential mortgage loans were sold at a gain of $424 thousand, compared to $25.7 million in loans sold at a gain of $532 thousand during the prior year's quarter. Residential mortgage loans are sold as a tool to manage liquidity needs within the bank.
- Bank owned life insurance ("BOLI") income increased $83 thousand for the three months ended March 31, 2018 when compared to the same period in the prior year primarily due to the purchase of a $10.0 million Separate Account BOLI policy.
- There were no gains on the sale of securities for the three months ended March 31, 2018 or 2017. Due to the adoption of ASU 2016-01 in January of 2018, there was a $15 thousand adjustment to net income in the first quarter of 2018 resulting from unrealized losses on equity securities.
- Other income increased in the quarterly period primarily due to increased service charges on Visa check cards.

Noninterest Expense

The following table presents a breakdown of noninterest expense for the three months ended March 31, 2018 and 2017:

	For the three months ended March 31,	
(In thousands)	2018	2017
Compensation and benefits	$4,834	$4,095
Occupancy	690	600
Processing and communications	689	604
Furniture and equipment	536	511
Professional services	251	226
Loan collection and OREO expenses	6	341
Other loan expenses	33	83
Deposit insurance	186	76
Advertising	319	236
Director fees	162	197
Other expenses	488	471
Total noninterest expense	$8,194	$7,440

Noninterest expense increased $754 thousand to $8.2 million for the three months ended March 31, 2018.

Changes in noninterest expense for the three months ended March 31, 2018 versus 2017 reflect:

- Compensation and benefits expense, the largest component of noninterest expense, increased $739 thousand for the three months ended March 31, 2018, when compared to 2017. Expenses have risen as we expanded our branch network, lending and support staff. This additional headcount has resulted in higher salary, commission and benefit expenses such as medical insurance, retirement and 401(k) plan benefits.
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Due to expansion, occupancy expense increased $90 thousand for the three months ended March 31, 2018. Rental and utilities expense as well as seasonal snow removal also increased compared to the same period last year.

- Processing and communications expenses increased $85 thousand for the three months ended March 31, 2018, primarily due to increased armored car expense from the addition of new branches.
- Furniture and equipment expense increased $25 thousand during the first quarter of 2018, primarily due to investment in our technology infrastructure through equipment, network and software upgrades that will improve our efficiency and help to keep our data secure.

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- Professional service fees increased $25 thousand for the three months ended March 30, 2018, primarily due to higher legal expenses.
- Loan collection and OREO costs decreased $335 thousand compared to the prior year's quarter due to a loss of $253 thousand on the sale of an OREO property in the first quarter of 2017.
- Other loan expenses decreased $50 thousand for the three months ended March 31, 2018, compared to the prior year's quarter, primarily due to a decrease in loan appraisal expenses.
- Deposit insurance expense increased $110 thousand for the three months ended March 31, 2018.
- Advertising expense increased $83 thousand compared to the prior year's quarter in support of our retail and lending staff as well as branch expansions and retail promotions.
- Director fees decreased $35 thousand for the three months ended March 31, 2018.
- Other expenses increased $17 thousand for the three months ended March 31, 2018, primarily due to higher officer and employee training expenses.

Income Tax Expense

For the quarter ended March 31, 2018, the Company reported income tax expense of $1.2 million for an effective tax rate of 19.1 percent, compared to income tax expense of $1.7 million and an effective tax rate of 34.9 percent for the prior year’s quarter. The decrease in the effective tax rate was due to the "Tax Cuts and Jobs Act", which lowered the corporate tax rate from 35% to 21% starting in 2018. For additional information on income taxes, see Note 4 to the Consolidated Financial Statements.

Financial Condition at March 31, 2018

Total assets decreased $15.6 million or 1.1 percent, to $1.4 billion at March 31, 2018, when compared to year end 2017. This decrease was due to decreases of $34.0 million in cash and cash equivalents and $2.3 million in securities, partially offset by an increase of $23.8 million in net loans.

Total deposits increased $74.4 million, due to increases of $55.6 million in time deposits, $11.7 million in savings deposits and $9.2 million in noninterest-bearing demand deposits, partially offset by a decrease of $2.1 million in interest-bearing demand deposits. Borrowed funds decreased $94.0 million due to a reduction in overnight borrowings.

Total shareholders’ equity increased $5.0 million over year end 2017, primarily due to earnings and an increase in common stock, partially offset by dividends paid during the three months ended March 31, 2018.

These fluctuations are discussed in further detail in the paragraphs that follow.

Securities Portfolio

The Company’s securities portfolio consists of AFS, HTM and equity investments. Management determines the appropriate security classification of AFS and HTM at the time of purchase. The investment securities portfolio is maintained for asset-liability management purposes, as well as for liquidity and earnings purposes.

AFS securities are investments carried at fair value that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk, to take advantage of market conditions that create economically attractive returns and as an additional source of earnings. AFS securities consist primarily of obligations of U.S. Government sponsored entities, obligations of state and political subdivisions, mortgage-backed securities, and corporate and other securities.

AFS securities totaled $50.2 million at March 31, 2018, a decrease of $2.1 million or 4.0 percent, compared to $52.3 million at December 31, 2017. This net decrease was the result of:

- $1.3 million in principal payments and maturities,
- $806 thousand of depreciation in the market value of the portfolio. At March 31, 2018, the portfolio had a net unrealized loss of $1.3 million compared to a net unrealized loss of $476 thousand at December 31, 2017. These net unrealized losses are reflected net of tax in net income, and
- $46 thousand in net amortization of premiums.

The weighted average life of AFS securities, adjusted for prepayments, amounted to 6.2 years at March 31, 2018 and December 31, 2017.

Equity securities are investments carried at fair value that may be sold in response to changing market and interest rate conditions or for other business purposes. Activity in this portfolio is undertaken primarily to manage liquidity and interest rate risk, to take advantage of market conditions that create economically attractive returns and as an additional source of earnings. Equity securities consist of Community Reinvestment Act ("CRA") investments and the Company's current other equity holdings. These securities were transferred from available for sale and reclassified into equity securities on the balance sheet as a result of the adoption of ASU 2016-01 in January 2018.

Equity securities totaled $1.2 million as of March 31, 2018 and December 31, 2017. As of March 31, 2018, $15 thousand in unrealized losses in equity securities were reclassified to net income.

HTM securities, which are carried at amortized cost, are investments for which there is the positive intent and ability to hold to maturity. The portfolio is comprised primarily of U.S. Government sponsored entities, obligations of state and political subdivisions, mortgage-backed securities, and corporate and other securities.

HTM securities were $16.2 million at March 31, 2018, a decrease of $139 thousand or 0.9 percent, from year end 2017. This decrease was the result of:
- $132 thousand in principal payments and maturities and
- $7 thousand in net amortization of premiums.

The weighted average life of HTM securities, adjusted for prepayments, amounted to 6.0 years and 5.9 years at March 31, 2018 and December 31, 2017, respectively. As of March 31, 2018 and December 31, 2017, the fair value of HTM securities was $16.2 million and $16.3 million, respectively.

The average balance of taxable securities amounted to $63.4 million for the three months ended March 31, 2018, compared to $64.1 million for the same period in 2017. The average yield earned on taxable securities increased 5 basis points, to 3.15 percent for the three months ended March 31, 2018, from 3.10 percent for the same period in the prior year. The average balance of tax-exempt securities amounted to $5.3 million for the three months ended March 31, 2018, compared to $6.4 million for the same period in 2017. The average yield earned on tax-exempt securities decreased 134 basis points, to 2.88 percent for the three months ended March 31, 2018, from 4.22 percent for the same period in 2017.

Securities with a carrying value of $3.9 million and $20.8 million at March 31, 2018 and December 31, 2017, respectively, were pledged to secure Government deposits, secure other borrowings and for other purposes required or permitted by law.

Approximately 81 percent of the total investment portfolio had a fixed rate of interest at March 31, 2018.

See Note 7 to the accompanying Consolidated Financial Statements for more information regarding Securities.

Loan Portfolio

The loan portfolio, which represents the Company’s largest asset group, is a significant source of both interest and fee income. The portfolio consists of SBA, SBA 504, commercial, residential mortgage and consumer loans. Each of these segments is subject to differing levels of credit and interest rate risk.

Total loans increased $24.4 million or 2.1 percent to $1.2 billion at March 31, 2018, compared to year end 2017. Residential mortgage, commercial and consumer loans increased $15.7 million, $8.1 million, and $3.4 million, respectively, partially offset by a decrease of $2.5 million and $306 thousand in SBA and SBA 504 loans, respectively.

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The following table sets forth the classification of loans by major category, including unearned fees and deferred costs and excluding the allowance for loan losses as of March 31, 2018 and December 31, 2017:

	March 31, 2018		December 31, 2017	
(In thousands, except percentages)	Amount	% of total	Amount	% of total
SBA loans held for investment	$42,734	3.6 %	$43,999	3.8 %
SBA 504 loans	21,565	1.8	21,871	1.9
Commercial loans	615,119	51.4	606,994	51.8
Residential mortgage loans	380,857	31.9	365,145	31.2
Consumer loans	113,256	9.5	109,855	9.4
Total loans held for investment	1,173,531	98.2	1,147,864	98.1
SBA loans held for sale	21,579	1.8	22,810	1.9
Total loans	$1,195,110	100.0%	$1,170,674	100.0%

Average loans increased $194.8 million or 19.7 percent to $1.2 billion for the three months ended March 31, 2018 from $988.0 million for the same period in 2017. The increase in average loans was due to increases in commercial, residential mortgages, consumer, and SBA 7(a) loans, partially offset by a decline in SBA 504 loans. The yield on the overall loan portfolio increased 21 basis points to 5.07 percent for the three months ended March 31, 2018 when compared to the same period in the prior year.

SBA 7(a) loans, on which the SBA historically has provided guarantees of up to 90 percent of the principal balance, are considered a higher risk loan product for the Company than its other loan products. These loans are made for the purposes of providing working capital or financing the purchase of equipment, inventory or commercial real estate. Generally, an SBA 7(a) loan has a deficiency in its credit profile that would not allow the borrower to qualify for a traditional commercial loan, which is why the SBA provides the guarantee. The deficiency may be a higher loan to value (“LTV”) ratio, lower debt service coverage (“DSC”) ratio or weak personal financial guarantees. In addition, many SBA 7(a) loans are for start up businesses where there is no history or financial information. Finally, many SBA borrowers do not have an ongoing and continuous banking relationship with the Bank, but merely work with the Bank on a single transaction. The guaranteed portion of the Company’s SBA loans are generally sold in the secondary market with the nonguaranteed portion held in the portfolio as a loan held for investment.

SBA 7(a) loans held for sale, carried at the lower of cost or market, amounted to $21.6 million at March 31, 2018, a decrease of $1.2 million from $22.8 million at December 31, 2017. SBA 7(a) loans held to maturity amounted to $42.7 million at March 31, 2018, a decrease of $1.3 million from $44.0 million at December 31, 2017. The yield on SBA loans, which are generally floating and adjust quarterly to the Prime rate, was 7.02 percent for the three months ended March 31, 2018, compared to 5.98 percent in the prior year.

The guarantee rates on SBA 7(a) loans range from 50 percent to 90 percent, with the majority of the portfolio having a guarantee rate of 75 percent at origination. The guarantee rates are determined by the SBA and can vary from year to year depending on government funding and the goals of the SBA program. The carrying value of SBA loans held for sale represents the guaranteed portion to be sold into the secondary market. The carrying value of SBA loans held to maturity represents the unguaranteed portion, which is the Company's portion of SBA loans originated, reduced by the guaranteed portion that is sold into the secondary market. Approximately $96.6 million and $97.5 million in SBA loans were sold but serviced by the Company at March 31, 2018 and December 31, 2017, respectively, and are not included on the Company’s balance sheet. There is no relationship or correlation between the guarantee percentages and the level of charge-offs and recoveries on the Company’s SBA 7(a) loans. Charge-offs taken on SBA 7(a) loans effect the unguaranteed portion of the loan. SBA loans are underwritten to the same credit standards irrespective of the guarantee percentage.

The SBA 504 program consists of real estate backed commercial mortgages where the Company has the first mortgage and the SBA has the second mortgage on the property. Generally, the Company has a 50 percent LTV ratio on SBA 504 program loans at origination. At March 31, 2018, SBA 504 loans totaled $21.6 million, a decrease of $306 thousand from $21.9 million at December 31, 2017. The yield on SBA 504 loans increased 43 basis points to 5.12 percent for the three months ended March 31, 2018, from 4.69 percent for the same period in 2017.

Commercial loans are generally made in the Company’s marketplace for the purpose of providing working capital, financing the purchase of equipment, inventory or commercial real estate and for other business purposes. These loans amounted to $615.1 million at March 31, 2018, an increase of $8.1 million from year end 2017. The yield on commercial loans was 4.95 percent for the three months ended March 31, 2018, compared to 4.88 percent for the same period in 2017.

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Residential mortgage loans consist of loans secured by 1 to 4 family residential properties. These loans amounted to $380.9 million at March 31, 2018, an increase of $15.7 million from year end 2017. Sales of mortgage loans totaled $20.1 million for the three months ended March 31, 2018. Approximately $2.7 million of the loans sold were from portfolio, with the remainder consisting of new production. The yield on residential mortgages was 4.74 percent for the three months ended March 31, 2018, compared to 4.62 percent in the 2017 period. Residential mortgage loans maintained in portfolio are generally to individuals that do not qualify for conventional financing. In extending credit to this category of borrowers, the Bank considers other mitigating factors such as credit history, equity and liquid reserves of the borrower. As a result, the residential mortgage loan portfolio of the Bank includes adjustable rate mortgages with rates that exceed the rates on conventional fixed-rate mortgage loan products but which are not considered high priced mortgages.

Consumer loans consist of home equity loans, construction loans and loans for the purpose of financing the purchase of consumer goods, home improvements, and other personal needs, and are generally secured by the personal property being purchased. These loans amounted to $113.3 million, an increase of $3.4 million from year end 2017 primarily related to consumer construction loans. The yield on consumer loans was 5.59 percent for the three months ended March 31, 2018, compared to 4.87 percent for the same period in 2017.

There are no concentrations of loans to any borrowers or group of borrowers exceeding 10 percent of the total loan portfolio and no foreign loans in the portfolio.

In the normal course of business, the Company may originate loan products whose terms could give rise to additional credit risk. Interest-only loans, loans with high LTV or debt service ratios, construction loans with payments made from interest reserves and multiple loans supported by the same collateral (e.g. home equity loans) are examples of such products. However, these products are not material to the Company’s financial position and are closely managed via credit controls that mitigate their additional inherent risk. Management does not believe that these products create a concentration of credit risk in the Company’s loan portfolio. The Company does not have any option adjustable rate mortgage loans.

The majority of the Company’s loans are secured by real estate. Declines in the market values of real estate in the Company’s trade area impact the value of the collateral securing its loans. This could lead to greater losses in the event of defaults on loans secured by real estate. At March 31, 2018 and December 31, 2017, approximately 94 percent of the Company’s loan portfolio was secured by real estate.

TDRs

TDRs occur when a creditor, for economic or legal reasons related to a debtor’s financial condition, grants a concession to the debtor that it would not otherwise consider. These concessions typically include reductions in interest rate, extending the maturity of a loan, or a combination of both. When the Company modifies a loan, management evaluates for any possible impairment using either the discounted cash flows method, where the value of the modified loan is based on the present value of expected cash flows, discounted at the contractual interest rate of the original loan agreement, or by using the fair value of the collateral less selling costs. If management determines that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized by segment or class of loan, as applicable, through an allowance estimate or charge-off to the allowance. This process is used, regardless of loan type, and for loans modified as TDRs that subsequently default on their modified terms.

At March 31, 2018, there was one loan totaling $774 thousand that was classified as a TDR and deemed impaired, compared to one such loan totaling $786 thousand at December 31, 2017. The TDR was a commercial real estate loan which was modified in 2017 to reduce the principal balance. The loan remains in accrual status since it continues to

perform in accordance with the restructured terms. Restructured loans that are placed in nonaccrual status may be removed after six months of contractual payments and the borrower showing the ability to service the debt going forward.

Asset Quality

Inherent in the lending function is credit risk, which is the possibility a borrower may not perform in accordance with the contractual terms of their loan. A borrower's inability to pay their obligations according to the contractual terms can create the risk of past due loans and, ultimately, credit losses, especially on collateral deficient loans. The Company minimizes its credit risk by loan diversification and adhering to strict credit administration policies and procedures. Due diligence on loans begins when we initiate contact regarding a loan with a borrower. Documentation, including a borrower's credit history, materials establishing the value and liquidity of potential collateral, the purpose of the loan, the source of funds for repayment of the loan, and other factors, are analyzed before a loan is submitted for approval. The loan portfolio is then subject to on-going internal reviews for credit quality, as well as independent credit reviews by an outside firm.

The risk of loss is difficult to quantify and is subject to fluctuations in collateral values, general economic conditions and other factors. In some cases, these factors have also resulted in significant impairment to the value of loan collateral. The Company values its collateral through the use of appraisals, broker price opinions, and knowledge of its local market.

Nonperforming assets consist of nonperforming loans and OREO. Nonperforming loans consist of loans that are not accruing interest (nonaccrual loans) as a result of principal or interest being in default for a period of 90 days or more or when the ability to collect principal and interest according to the contractual terms is in doubt. When a loan is classified as nonaccrual, interest accruals discontinue and all past due interest previously recognized as income is reversed and charged against current period income. Generally, until the loan becomes current, any payments received from the borrower are applied to outstanding principal, until such time as management determines that the financial condition of the borrower and other factors merit recognition of a portion of such payments as interest income. Loans past due 90 days or more and still accruing interest are not included in nonperforming loans. Loans past due 90 days or more and still accruing generally represent loans that are well collateralized and in a continuing process that are expected to result in repayment or restoration to current status.

The following table sets forth information concerning nonperforming assets and loans past due 90 days or more and still accruing interest at each of the periods presented:

(In thousands, except percentages)	March 31, 2018	December 31, 2017	March 31, 2017
Nonperforming by category:			
SBA loans held for investment (1)	$933	$ 632	$1,239
SBA 504 loans	—	—	237
Commercial loans	1,069	68	1,499
Residential mortgage loans	1,952	1,669	2,514
Consumer loans	323	625	2,269
Total nonperforming loans (2)	$4,277	$ 2,994	$7,758
OREO	56	426	1,172
Total nonperforming assets	$4,333	$ 3,420	$8,930
Past due 90 days or more and still accruing interest:			
Commercial loans	$—	$ 60	$—
Total past due 90 days or more and still accruing interest	$—	$ 60	$—
Nonperforming loans to total loans	0.36 %	0.26 %	0.78 %
Nonperforming loans and TDRs to total loans (3)	0.42	0.32	0.78
Nonperforming assets to total loans and OREO	0.36	0.29	0.89
Nonperforming assets to total assets	0.30	0.23	0.73

(1) Guaranteed SBA loans included above	$ 27	$ 27	$ 60
(2) Nonperforming TDRs included above	—	—	—
(3) Performing TDRs	774	786	—

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Nonperforming loans were $4.3 million at March 31, 2018, a $1.3 million increase from $3.0 million at year end 2017 and a $3.5 million decrease from $7.8 million at March 31, 2017. Since year end 2017, nonperforming loans in the commercial, SBA, and residential loan segments increased, partially offset by a decrease in the consumer loan segment. Included in nonperforming loans at March 31, 2018 and December 31, 2017 are approximately $27 thousand of loans guaranteed by the SBA, compared to $60 thousand at March 31, 2017. In addition, there were $60 thousand in loans past due 90 days or more and still accruing interest at December 31, 2017, compared to no such loans at March 31, 2018 and 2017, respectively.

OREO properties totaled $56 thousand at March 31, 2018, a decrease of $370 thousand from $426 thousand at year end 2017 and a $1.1 million decrease from $1.2 million at March 31, 2017. During the three months ended March 31, 2018, the Company took title to one new property valued at $106 thousand that resulted in a charge to the allowance of $125 thousand. Two OREO properties were sold, resulting in net recoveries of $24 thousand.

The Company also monitors potential problem loans. Potential problem loans are those loans where information about possible credit problems of borrowers causes management to have doubts as to the ability of such borrowers to comply with loan repayment terms. These loans are not included in nonperforming loans as they continue to perform. Potential problem loans totaled $4.7 million at March 31, 2018, an increase of $749 thousand from $4.0 million at December 31, 2017. The increase is due to the addition of 10 loans totaling $2.2 million, offset by the deletion of four loans totaling $1.4 million.

See Note 8 to the accompanying Consolidated Financial Statements for more information regarding Asset Quality.

Allowance for Loan Losses and Reserve for Unfunded Loan Commitments

Management reviews the level of the allowance for loan losses on a quarterly basis. The standardized methodology used to assess the adequacy of the allowance includes the allocation of specific and general reserves. Specific reserves are made to individual impaired loans, which have been defined to include all nonperforming loans and TDRs. The general reserve is set based upon a representative average historical net charge-off rate adjusted for certain environmental factors such as: delinquency and impairment trends, charge-off and recovery trends, volume and loan term trends, risk and underwriting policy trends, staffing and experience changes, national and local economic trends, industry conditions and credit concentration changes.

When calculating the five-year historical net charge-off rate, the Company weights the past three years more heavily. The Company believes using this approach is more indicative of future charge-offs. All of the environmental factors are ranked and assigned a basis points value based on the following scale: low, low moderate, moderate, high moderate, and high risk. The factors are evaluated separately for each type of loan. For example, commercial loans are broken down further into commercial and industrial loans, commercial mortgages, construction loans, etc. Each type of loan is risk weighted for each environmental factor based on its individual characteristics.

According to the Company’s policy, a loss (“charge-off”) is to be recognized and charged to the allowance for loan losses as soon as a loan is recognized as uncollectable. All credits which are 90 days past due must be analyzed for the Company's ability to collect on the credit. Once a loss is known to exist, the charge-off approval process is immediately expedited.

The allowance for loan losses totaled $14.2 million at March 31, 2018 compared to $13.6 million at December 31, 2017, and $12.7 million at March 31, 2017, with resulting allowance to total loan ratios of 1.19 percent, 1.16 percent, and 1.27 percent, respectively. Net recoveries amounted to $140 thousand for the three months ended March 31, 2018, compared to net charge-offs of $148 thousand for the same period in 2017. Net charge-offs to average loan ratios are shown in the table below for each major loan category.

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(In thousands, except percentages)	For the three months ended March 31, 2018	2017
Balance, beginning of period	$13,556	$12,579
Provision for loan losses charged to expense	500	250
Less: Chargeoffs		
SBA loans held for investment	81	109
Commercial loans	—	76
Consumer loans	6	66
Total chargeoffs	87	251
Add: Recoveries		
SBA loans held for investment	64	37
Commercial loans	16	53
Residential mortgage loans	13	12
Consumer loans	134	1
Total recoveries	227	103
Net (recoveries) charge-offs	(140)	148
Balance, end of period	$14,196	$12,681
Selected loan quality ratios:		
Net chargeoffs (recoveries) to average loans:		
SBA loans held for investment	0.10 %	0.50 %
Commercial loans	(0.01)	0.02
Residential mortgage loans	(0.01)	(0.02)
Consumer loans	(0.47)	0.28
Total loans	(0.05)	0.06
Allowance to total loans	1.19	1.27
Allowance to nonperforming loans	331.91 %	163.46 %

In addition to the allowance for loan losses, the Company maintains a reserve for unfunded loan commitments that is maintained at a level that management believes is adequate to absorb estimated probable losses. Adjustments to the reserve are made through other expense and applied to the reserve which is maintained in other liabilities. At March 31, 2018, a $286 thousand commitment reserve was reported on the balance sheet as an "other liability", compared to a $292 thousand commitment reserve at December 31, 2017.

See Note 9 to the accompanying Consolidated Financial Statements for more information regarding the Allowance for Loan Losses and Reserve for Unfunded Loan Commitments.

Deposits

Deposits, which include noninterest-bearing demand deposits, interest-bearing demand deposits, savings deposits and time deposits, are the primary source of the Company's funds. The Company offers a variety of products designed to attract and retain customers, with primary focus on building and expanding relationships. The Company continues to focus on establishing a comprehensive relationship with business borrowers, seeking deposits as well as lending relationships.

Total deposits increased $74.4 million to $1.1 billion at March 31, 2018, from $1.0 billion at December 31, 2017. This increase in deposits was due to increases of $55.6 million in time deposits, $11.7 million in savings deposits, and $9.2 million in noninterest-bearing demand deposits, partially offset by a decrease of $2.1 million in interest-bearing demand deposits. The increase in time and savings was primarily due to new promotions. The

increase in noninterest-bearing demand deposits is attributable to growth in commercial customer relationships.

The Company’s deposit composition at March 31, 2018, consisted of 36.5 percent savings deposits, 25.2 percent time deposits, 23.7 percent noninterest-bearing demand deposits and 14.6 percent interest-bearing demand deposits.

Borrowed Funds and Subordinated Debentures

Borrowed funds consist primarily of adjustable and fixed rate advances from the Federal Home Loan Bank of New York and repurchase agreements. These borrowings are used as a source of liquidity or to fund asset growth not supported by deposit generation. Residential mortgages and commercial loans collateralize the borrowings from the FHLB, while investment securities are pledged against the repurchase agreements.

Borrowed funds and subordinated debentures totaled $191.3 million and $285.3 million at March 31, 2018 and December 31, 2017, respectively, and are broken down in the following table:

(In thousands)	March 31, 2018	December 31, 2017
FHLB borrowings:		
Fixed rate advances	$40,000	$ 40,000
Adjustable rate advances	50,000	50,000
Overnight advances	91,000	170,000
Other repurchase agreements	—	15,000
Subordinated debentures	10,310	10,310
Total borrowed funds and subordinated debentures	$191,310	$ 285,310

The $94.0 million decrease in total borrowed funds and subordinated debentures was due to a $79.0 million decrease in FHLB overnight borrowings and a $15.0 million decrease in other repurchase agreements. The following transactions impacted borrowed funds and subordinated debentures:

- A $91.0 million FHLB overnight line of credit advance issued on March 30, 2018 was at a rate of 2.00% and was repaid on April 2, 2018.
- A $15.0 million repurchase agreement borrowing with a rate of 3.670% that matured on February 28, 2018.
- A $10.0 million ARC FHLB borrowing with a rate of 1.173% that matured on February 16, 2018. This $10.0 million FHLB advance was renewed for an additional six months at a rate of LIBOR plus 0.105%. A swap instrument was implemented which modified the borrowing to a 5 year fixed rate borrowing at 1.208% that matures on February 16, 2021.
- A $20.0 million ARC FHLB borrowing with a rate of 1.158% that matured on January 5, 2018. This $20.0 million FHLB advance was renewed for an additional six months at a rate of LIBOR plus 0.105%. A swap instrument was implemented which modified the borrowing to a 5 year fixed rate borrowing at 1.153% that matures on July 5, 2021.

In March 2018, the FHLB issued a $12.0 million municipal deposit letter of credit in the name of Unity Bank naming the NJ Department of Banking and Insurance as beneficiary to secure certain municipal deposits held by the Bank.

At March 31, 2018, the Company had $223.0 million of additional credit available at the FHLB. Pledging additional collateral in the form of 1 to 4 family residential mortgages, commercial loans and investment securities can increase the line with the FHLB.

Interest Rate Sensitivity

The principal objectives of the asset and liability management function are to establish prudent risk management guidelines, evaluate and control the level of interest-rate risk in balance sheet accounts, determine the level of appropriate risk given the business focus, operating environment, capital, and liquidity requirements, and actively manage risk within the Board approved guidelines. The Company seeks to reduce the vulnerability of operations to changes in interest rates, and actions in this regard are taken under the guidance of the Asset/Liability Management

Committee ("ALCO") of the Board of Directors. The ALCO reviews the maturities and re-pricing of loans, investments, deposits and borrowings, cash flow needs, current market conditions, and interest rate levels.

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The Company utilizes Modified Duration of Equity and Economic Value of Portfolio Equity ("EVPE") models to measure the impact of longer-term asset and liability mismatches beyond two years. The modified duration of equity measures the potential price risk of equity to changes in interest rates. A longer modified duration of equity indicates a greater degree of risk to rising interest rates. Because of balance sheet optionality, an EVPE analysis is also used to dynamically model the present value of asset and liability cash flows with rate shocks of 200 basis points. The economic value of equity is likely to be different as interest rates change. Results falling outside prescribed ranges require action by the ALCO. The Company's variance in the economic value of equity, as a percentage of assets with rate shocks of 200 basis points at March 31, 2018, is a decline of 0.75 percent in a rising-rate environment and an increase of 0.10 percent in a falling-rate environment. The variances in the EVPE at March 31, 2018 are within the Board-approved guidelines of +/- 3.00 percent. In a falling rate environment with a rate shock of 200 basis points, benchmark interest rates are assumed to have floors of 0.00%. At December 31, 2017, the economic value of equity as a percentage of assets with rate shocks of 200 basis points was a decline of 0.81 percent in a rising-rate environment and a decrease of 0.15 percent in a falling-rate environment.

Liquidity

Consolidated Bank Liquidity

Liquidity measures the ability to satisfy current and future cash flow needs as they become due. A bank's liquidity reflects its ability to meet loan demand, to accommodate possible outflows in deposits and to take advantage of interest rate opportunities in the marketplace. Our liquidity is monitored by management and the Board of Directors through a Risk Management Committee, which reviews historical funding requirements, our current liquidity position, sources and stability of funding, marketability of assets, options for attracting additional funds, and anticipated future funding needs, including the level of unfunded commitments. Our goal is to maintain sufficient asset-based liquidity to cover potential funding requirements in order to minimize our dependence on volatile and potentially unstable funding markets.

The principal sources of funds at the Bank are deposits, scheduled amortization and prepayments of investment and loan principal, sales and maturities of investment securities and funds provided by operations. While scheduled loan payments and maturing investments are relatively predictable sources of funds, deposit inflows and outflows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Consolidated Statement of Cash Flows provides detail on the Company's sources and uses of cash, as well as an indication of the Company's ability to maintain an adequate level of liquidity. At March 31, 2018, the balance of cash and cash equivalents was $116.3 million, a decrease of $34.0 million from December 31, 2017. A discussion of the cash provided by and used in operating, investing and financing activities follows.

Operating activities provided $7.6 million and $6.8 million in net cash for the three months ended March 31, 2018 and 2017, respectively. The primary sources of funds were net income from operations and adjustments to net income, such as the proceeds from the sale of mortgage and SBA loans held for sale, partially offset by originations of mortgage and SBA loans held for sale.

Investing activities used $21.6 million and $43.1 million in net cash for the three months ended March 31, 2018 and 2017, respectively. Cash was primarily used to fund new loans and purchase FHLB stock, partially offset by proceeds from redemption of FHLB stock.

- Securities. The Consolidated Bank's available for sale investment portfolio amounted to $50.2 million and $52.3 million at March 31, 2018 and December 31, 2017, respectively. This excludes the Parent Company's securities discussed under the heading "Parent Company Liquidity" below. Projected cash flows from securities over the next twelve months are $6.7 million.

- Loans. The SBA loans held for sale portfolio amounted to $21.6 million and $22.8 million at March 31, 2018 and December 31, 2017, respectively. Sales of these loans provide an additional source of liquidity for the Company.
- Outstanding Commitments. The Company was committed to advance approximately $286.2 million to its borrowers as of March 31, 2018, compared to $291.9 million at December 31, 2017. At March 31, 2018, $209.6 million of these commitments expire within one year, compared to $209.3 million at December 31, 2017. The Company had $4.4 million and $5.6 million in standby letters of credit at March 31, 2018 and December 31, 2017, respectively, which are included in the commitments amount noted above. The estimated fair value of these guarantees is not significant. The Company believes it has the necessary liquidity to honor all commitments. Many of these commitments will expire and never be funded.

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Financing activities used $20.0 million in net cash for the three months ended March 31, 2018, compared to providing $33.6 million for the same period in the prior year, primarily due to repayments of borrowings, partially offset by proceeds from new borrowings and an increase in the Company's deposits.

- Deposits. As of March 31, 2018, deposits included $87.5 million of Government deposits, as compared to $99.6 million at year end 2017. These deposits are generally short in duration and are very sensitive to price competition. The Company believes that the current level of these types of deposits is appropriate. Included in the portfolio were $80.1 million of deposits from thirteen municipalities with account balances in excess of $1.5 million. The withdrawal of these deposits, in whole or in part, would not create a liquidity shortfall for the Company.
- Borrowed Funds. Total FHLB borrowings amounted to $181.0 million and $260.0 million as of March 31, 2018 and December 31, 2017, respectively. There were no third party repurchase agreements as of March 31, 2018 compared to a total of $15.0 million at December 31, 2017. As a member of the Federal Home Loan Bank of New York, the Company can borrow additional funds based on the market value of collateral pledged. At March 31, 2018, pledging provided an additional $223.0 million in borrowing potential from the FHLB. In addition, the Company can pledge additional collateral in the form of 1 to 4 family residential mortgages, commercial loans or investment securities to increase this line with the FHLB.

Parent Company Liquidity

The Parent Company's cash needs are funded by dividends and rental payments on corporate headquarters paid by the Bank. Other than its investment in the Bank, Unity Risk Management, Inc. and Unity Statutory Trust II, the Parent Company does not actively engage in other transactions or business. Only expenses specifically for the benefit of the Parent Company are paid using its cash, which typically includes the payment of operating expenses, cash dividends on common stock and payments on trust preferred debt.

At March 31, 2018, the Parent Company had $1.9 million in cash and cash equivalents and $279 thousand in investment securities valued at fair market value, compared to $1.6 million and $278 thousand at December 31, 2017.

Regulatory Capital

Federal regulators have classified and defined capital into the following components: (1) tier 1 capital, which includes tangible shareholders' equity for common stock, qualifying preferred stock and certain qualifying hybrid instruments, and (2) tier 2 capital, which includes a portion of the allowance for loan losses, certain qualifying long-term debt, preferred stock and hybrid instruments which do not qualify as tier 1 capital. Minimum capital levels are regulated by risk-based capital adequacy guidelines, which require the Company and the Bank to maintain certain capital as a percent of assets and certain off-balance sheet items adjusted for predefined credit risk factors (risk-weighted assets). A bank is required to maintain, at a minimum, tier 1 capital as a percentage of risk-weighted assets of 4 percent and combined tier 1 and tier 2 capital as a percentage of risk-weighted assets of 8 percent. In addition, banks are required to meet a leverage capital requirement, which measures tier 1 capital against average assets. Banks which are highly rated and not experiencing significant growth are required to maintain a leverage ratio of 3 percent while all other banks are expected to maintain a leverage ratio 1 to 2 percentage points higher. Finally, the Bank is required to maintain a ratio of common equity tier 1 capital, consisting solely of common equity, to risk-weighted assets of at least 4.5%. The Company is subject to similar requirements on a consolidated basis.

The following tables summarize the Company’s and the Bank’s regulatory capital ratios at March 31, 2018 and December 31, 2017, as well as the minimum regulatory capital ratios required for the Bank to be deemed “well-capitalized.” The Company's capital amounts and ratios reflect the capital decreases described above.

	At March 31, 2018		Required for capital adequacy purposes effective		To be well-capitalized under prompt corrective action regulations
	Company	Bank	January 1, 2018	January 1, 2019	Bank
Leverage ratio	9.46 %	9.12 %	4.000 %	4.00 %	5.00 %
CET1	11.14 %	11.60 %	6.375 % (1)	7.00 % (2)	6.50 %
Tier I risk-based capital ratio	12.07 %	11.60 %	7.875 % (1)	8.50 % (2)	8.00 %
Total risk-based capital ratio	13.24 %	12.81 %	9.875 % (1)	10.50 % (2)	10.00 %

(1) Includes 1.875% capital conservation buffer.
(2) Includes 2.5% capital conservation buffer.

	At December 31, 2017		Required for capital adequacy purposes effective		To be well-capitalized under prompt corrective action regulations
	Company	Bank	January 1, 2017	January 1, 2019	Bank
Leverage ratio	9.37 %	9.03 %	4.000 %	4.00 %	5.00 %
CET1	10.81 %	11.33 %	5.750 % (3)	7.00 % (4)	6.50 %
Tier I risk-based capital ratio	11.75 %	11.33 %	7.250 % (3)	8.50 % (4)	8.00 %
Total risk-based capital ratio	12.87 %	12.50 %	9.250 % (3)	10.50 % (4)	10.00 %

(3) Includes 1.25% capital conservation buffer.
(4) Includes 2.5% capital conservation buffer.

For additional information on regulatory capital, see Note 13 to the Consolidated Financial Statements.

Shareholders’ Equity

Shareholders’ equity increased $5.0 million to $123.1 million at March 31, 2018 compared to $118.1 million at December 31, 2017, primarily due to net income of $5.2 million. Other items impacting shareholders’ equity included $619 thousand in dividends paid on common stock, $554 thousand from the issuance of common stock under employee benefit plans, $176 thousand in accumulated other comprehensive loss net of tax, and $11 thousand in tax rate adjustments made to accumulated other comprehensive income. As a result of ASU 2018-02, "Income Statement - Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income", the Company reclassed $66 thousand from accumulated other comprehensive income to retained earnings. As a result of ASU 2016-01, "Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities", the Company reclassed $56 thousand of gains (losses) on available for sale equity securities sitting in accumulated other comprehensive income as of December 31, 2017 to beginning retained earnings as of January 1, 2018. The issuance of common stock under employee benefit plans

includes nonqualified stock options and restricted stock expense related entries, employee option exercises and the tax benefit of options exercised.

Repurchase Plan

On October 21, 2002, the Company authorized the repurchase of up to 10 percent of its outstanding common stock. The amount and timing of purchases is dependent upon a number of factors, including the price and availability of the Company's shares, general market conditions and competing alternate uses of funds. There were no shares repurchased during the three months ended March 31, 2018 or 2017.

Impact of Inflation and Changing Prices

The financial statements and notes thereto, presented elsewhere herein have been prepared in accordance with generally accepted accounting principles, which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time and due to inflation. The impact of inflation is reflected in the increased cost of the operations. Unlike most industrial companies, nearly all the Company's assets and liabilities are monetary. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

ITEM 3 Quantitative and Qualitative Disclosures about Market Risk

During the three months ended March 31, 2018, there have been no significant changes in the Company's assessment of market risk as reported in Item 6 of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. (See Interest Rate Sensitivity in Management's Discussion and Analysis herein.)

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ITEM 4 Controls and Procedures

a) The Company's management, with the participation of the Company's Chief Executive Officer and Chief Financial Officer, has evaluated the effectiveness of the Company's disclosure controls and procedures as of March 31, 2018. Based on this evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures are effective for recording, processing, summarizing and reporting the information the Company is required to disclose in the reports it files under the Securities Exchange Act of 1934, within the time periods specified in the SEC's rules and forms.

b) No significant change in the Company's internal control over financial reporting has occurred during the quarterly period covered by this report that has materially affected, or is reasonably likely to materially affect, the Company's controls over financial reporting.

PART II OTHER INFORMATION

ITEM 1 Legal Proceedings

From time to time, the Company is subject to other legal proceedings and claims in the ordinary course of business. The Company currently is not aware of any such legal proceedings or claims that it believes will have, individually or in the aggregate, a material adverse effect on the business, financial condition, or the results of the operation of the Company.

ITEM 1A Risk Factors

Information regarding this item as of March 31, 2018 appears under the heading, "Risk Factors" within the Company's Form 10-K for the year ended December 31, 2017.

ITEM 2 Unregistered Sales of Equity Securities and Use of Proceeds - None

ITEM 3 Defaults upon Senior Securities - None

ITEM 4 Mine Safety Disclosures - N/A

ITEM 5 Other Information - None

ITEM 6 Exhibits

(a) Exhibits		Description
	Exhibit 3(ii)	By-laws of Unity Bancorp as amended. Incorporated by reference from Exhibit 3.1 of current report on Form 8-K filed February 24, 2017
	Exhibit 31.1	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
	Exhibit 31.2	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
	Exhibit 32.1	Certification of Chief Executive Officer and Chief Financial Officer Pursuant to Rule 13a-14(b) or Rule 15d-14(b) and 18 U.S.C. Section 1350, as Adopted Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002

SIGNATURES

Pursuant to the requirements 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.

		UNITY BANCORP, INC.
Dated:	May 3, 2018	/s/ Alan J. Bedner, Jr.
		Alan J. Bedner, Jr.
		Executive Vice President and Chief Financial Officer

EXHIBIT INDEX

QUARTERLY REPORT ON FORM 10-Q

Exhibit No.	Description
31.1	Exhibit 31.1-Certification of James A. Hughes. Required by Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
31.2	Exhibit 31.2-Certification of Alan J. Bedner, Jr. Required by Rule 13a-14(a) or Rule 15d-14(a) and Section 302 of the Sarbanes-Oxley Act of 2002
32.1	Exhibit 32.1-Certification of James A. Hughes and Alan J. Bedner, Jr. Required by Rule 13a-14(b) or Rule 15d-14(b) and Section 906 of the Sarbanes-Oxley Act of 2002, 18 U.S.C. Section 1350
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema Document
101.CAL	XBRL Taxonomy Extension Calculation Linkbase Document
101.LAB	XBRL Taxonomy Extension Label Linkbase Document
101.PRE	XBRL Taxonomy Extension Presentation Linkbase Document
101.DEF	XBRL Taxonomy Extension Definitions Linkbase Document