First Resource Bank

# 2016 ANNUAL REPORT

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## FIRST RESOURCE EXECUTIVE MANAGEMENT

**Glenn B. Marshall**
President & Chief Executive Officer

**Lauren C. Ranalli**
Executive Vice President & Chief Financial Officer

**Natalie M. Carrozza**
Executive Vice President & Chief Operating Officer

**Lisa A. Donnon**
Executive Vice President & Chief Lending Officer

**John A. Durso Jr.**
Senior Vice President & Chief Retail Banking Officer


Where Customer Satisfaction
comes FIRST

Dear First Resource Bank Shareholder:

**The Bank achieved tremendous growth in 2016 which translated into a record high Net Income to Common Shareholders for the year ended December 31, 2016 of $1,278,656; this represents bottom line growth of 12% year over year.** This record profit was the result of the following highlights for 2016:

- Achieved record net income, <u>8%</u> higher than 2015.
- Total interest income grew <u>16%</u> over the prior year.
- Deposits grew <u>22%</u>, to end the year at a record high, $202.7 million.
- Loans outstanding grew <u>12%</u>, to end the year at a record high, $197.8 million.
- Total assets grew <u>16%</u>, to end the year at a record high, $240.9 million.
- Asset quality improved significantly, with nonperforming assets to total assets declining from 1.17% at December 31, 2015 to <u>0.63%</u> at December 31, 2016.
- Redeemed the remaining 25% of the Bank's Small Business Lending Fund preferred stock.
- Issued a 5% stock dividend.
- Experienced a 19% increase in our common stock price.

In 2014 the Bank set out to grow deposits by developing specific strategies: create a recognizable brand in the marketplace, relocate the branch in Exton to build the prototype brand, build a new branch in West Chester to replicate the brand, and hire quality retail staff to proclaim the Bank's mission and gather deposits from the community. Through the implementation of these strategies, we not only grew deposits by over 22% in 2016, but we converted the deposit mix to achieve a lower cost of funds. The Bank continues to see growth in the use of our electronic deposit functions such as our remote scanners (FRed), and deposits through smart phones, with electronic banking being an average of 47% of the Bank's daily deposits. The Bank is properly positioned to take advantage of our strengthened retail deposit system to substantially reduce the need for wholesale funding on our balance sheet and continually improve our cost of funds.

First Resource Bank has carefully grown total loans and improved credit quality, while increasing our yield on loans. The 2016 performance marks the third year in a row of 12% loan growth for the Bank. This loan growth produced a 16% surge in total interest income in 2016 as compared to 2015. This achievement was accomplished amidst tremendous market disruption with larger banks reaching down to the community market place and offering competitive pricing and loan structures that tightened margins for longer durations. Yet First Resource Bank continues to navigate through rocky waters as a stabilizing force in the community, with reasonable loan rates, lower fees, and superior customer service.

Gains on sales of SBA loans remain volatile, with gains in the years ended December 31, 2014, 2015 and 2016 being $104 thousand, $389 thousand and $55 thousand, respectively. Each year had only one loan sold which produced gains related to each loan's size. The Bank continues to forge organic loan growth while seizing opportunities for SBA loans as they present. Despite the decline in gains on sale of SBA loans in 2016, net income increased 8% over 2015 as a result of the organic expansion. Our experience with SBA loans continues to deepen and we expect to augment our organic loan growth with additional SBA loan transactions in the coming year.

Our common stock closed the year trading at $8.20 per share on December 31, 2016, a 19% increase over the $6.90 closing stock price at December 31, 2015. We continue to see shareholder benefits from our move to the OTCQX marketplace.

Please visit the Bank's website to listen to our Virtual Investor presentations for 2015, 2016 and 2017 which were presented in cooperation with OTCQX. The presentations describe our Hybrid Community Bank principles. Our philosophy defines the future of community banking, with a strategic number of well positioned retail locations featuring friendly, community banking staff who are *high touch*, in combination with the best e-banking technology available for all of our customers. This *high touch*, *high tech* combination to customer service is a pillar of First Resource Bank. The Bank currently processes an average of 47% of its daily deposits through one of our electronic banking channels. These technologies are available to every customer, at their home, office, or in the palm of their hand through their smart phone 24/7. Additionally, our friendly, courteous customer service staff continue to support the Bank's deposit growth in our high visibility retail locations. This Hybrid Community Bank approach eliminates the need for excessive retail locations and the overhead that accompanies physical facilities. This *high touch* and *high tech* formula is key to the future success of our community banking model.

We would like to thank you, our shareholders and our customers, for your continued support and patronage. We also thank the Board of Directors and the First Resource Bank team for their service and hard work in 2016. If you have any questions about First Resource Bank or any of our available bank services, please feel free to contact Glenn on his cell at 610.996.6661.

Sincerely,

**Glenn B. Marshall**
President & CEO

**James B. Griffin**
Chairman of the Board

First
Resource
Bank

# First Resource Bank

Financial Statements

December 31, 2016 and 2015

# First Resource Bank

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1801 Market Street, Suite 1700
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Philadelphia, PA 19103

## Independent Auditor's Report

Board of Directors
First Resource Bank
Exton, Pennsylvania

We have audited the accompanying financial statements of First Resource Bank, which comprise the balance sheets as of December 31, 2016 and 2015, and the related statements of income, comprehensive income, shareholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

### *Management's Responsibility for the Financial Statements*

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### *Auditor's Responsibility*

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

*Opinion*

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of First Resource Bank as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BDO USA, LLP

Philadelphia, Pennsylvania
February 15, 2017

# Financial Statements

# First Resource Bank

## Balance Sheets

| *December 31,* | | **2016** | | 2015 |
|---|---|---|---|---|
| **Assets** | | | | |
| Cash and due from banks | $ | **3,210,601** | $ | 1,254,982 |
| Time deposits at other banks | | **599,000** | | 250,000 |
| Securities available-for-sale, at fair value | | **23,829,613** | | 16,020,725 |
| Securities held-to-maturity (fair value of $4,423,079 at December 31, 2016 and $3,326,334 at December 31, 2015) | | **4,530,983** | | 3,272,823 |
| Loans receivable, net of allowance for loan losses of $1,579,068 at December 31, 2016 and $1,450,836 at December 31, 2015 | | **196,259,780** | | 174,651,631 |
| Restricted investment in bank stock | | **837,400** | | 929,400 |
| Bank premises and equipment, net | | **5,955,748** | | 6,223,326 |
| Accrued interest receivable | | **564,658** | | 470,770 |
| Bank owned life insurance | | **4,278,309** | | 4,161,041 |
| Other assets | | **849,938** | | 817,339 |
| **Total Assets** | $ | **240,916,030** | $ | 208,052,037 |
| **Liabilities and Shareholders' Equity** | | | | |
| **Liabilities** | | | | |
| Deposits: | | | | |
| Noninterest-bearing | $ | **18,849,933** | $ | 14,200,995 |
| Interest-bearing | | **183,805,218** | | 151,782,566 |
| Total deposits | | **202,655,151** | | 165,983,561 |
| Short-term borrowings | | **-** | | 10,177,000 |
| Long-term borrowings | | **15,607,500** | | 9,409,500 |
| Subordinated debt | | **3,969,108** | | 3,960,615 |
| Accrued interest payable | | **172,202** | | 138,260 |
| Other liabilities | | **893,330** | | 827,869 |
| **Total Liabilities** | | **223,297,291** | | 190,496,805 |
| **Shareholders' Equity** | | | | |
| Preferred stock, Series 2011A; authorized 489,769 shares; $1,000 liquidation preference per share, 0 shares issued and outstanding at December 31, 2016; 1,271 shares issued and outstanding at December 31, 2015 | | **-** | | 1,271,000 |
| Common stock, $1 par value; authorized 20,000,000 shares; 2,100,299 shares issued and outstanding at December 31, 2016; 1,977,328 shares issued and outstanding at December 31, 2015 | | **2,100,299** | | 1,977,328 |
| Surplus | | **12,136,088** | | 11,484,125 |
| Accumulated other comprehensive (loss) income | | **(73,849)** | | 32,207 |
| Retained earnings | | **3,456,201** | | 2,790,572 |
| **Total Shareholders' Equity** | | **17,618,739** | | 17,555,232 |
| **Total Liabilities and Shareholders' Equity** | $ | **240,916,030** | $ | 208,052,037 |

*See accompanying notes to financial statements.*

# First Resource Bank

## Statements of Income

| *Years Ended December 31,* | 2016 | 2015 |
|---|---|---|
| **Interest Income** | | |
| Loans, including fees | $ 9,380,456 | $ 8,117,987 |
| Securities | 264,890 | 197,691 |
| Other | 24,333 | 13,815 |
| **Total Interest Income** | 9,669,679 | 8,329,493 |
| **Interest Expense** | | |
| Deposits | 1,525,936 | 1,403,124 |
| Borrowings | 479,772 | 210,926 |
| **Total Interest Expense** | 2,005,708 | 1,614,050 |
| Net interest income | 7,663,971 | 6,715,443 |
| **Provision for Loan Losses** | 223,784 | 282,375 |
| **Net Interest Income After Provision for Loan Losses** | 7,440,187 | 6,433,068 |
| **Other Income** | | |
| Service charges and other fees | 153,484 | 135,983 |
| Bank owned life insurance income | 117,268 | 120,060 |
| Gain on sale of SBA loans | 54,708 | 389,160 |
| Gain on sale of securities available-for-sale | - | 15,641 |
| Other | 45,437 | 42,060 |
| **Total Other Income** | 370,897 | 702,904 |
| **Other Expenses** | | |
| Salaries and employee benefits | 3,314,002 | 2,771,624 |
| Occupancy and equipment | 771,798 | 708,421 |
| Professional fees | 315,594 | 319,443 |
| Advertising and promotion | 139,461 | 156,800 |
| Data processing | 354,761 | 319,899 |
| FDIC premium expense | 156,315 | 127,203 |
| Loan expenses | 115,878 | 96,505 |
| Other | 764,319 | 762,834 |
| **Total Other Expenses** | 5,932,128 | 5,262,729 |
| Income before federal income tax expense | 1,878,956 | 1,873,243 |
| **Federal Income Tax Expense** | 597,723 | 687,474 |
| **Net Income** | 1,281,233 | 1,185,769 |
| **Preferred Stock Dividends** | (2,577) | (46,171) |
| **Net Income Available to Common Shareholders** | $ 1,278,656 | $ 1,139,598 |

*See accompanying notes to financial statements.*

# First Resource Bank

## Statements of Comprehensive Income

| *Years Ended December 31,* | **2016** | 2015 |
|---|---|---|
| **Net Income** | **$ 1,281,233** | $ 1,185,769 |
| **Other Comprehensive Loss** | | |
| Unrealized holding losses on available-for-sale securities | **(160,692)** | (74,312) |
| Less reclassification adjustment for realized gains included in net income [1] | **-** | (15,641) |
| Tax effect [2] | **54,636** | 30,583 |
| Total other comprehensive loss | **(106,056)** | (59,370) |
| **Total Comprehensive Income** | **$ 1,175,177** | $ 1,126,399 |

(1) Amounts are included in gain on sale of securities available-for-sale on the statements of income in total other income.
(2) Amounts are included in federal income tax expense on the statements of income.

*See accompanying notes to financial statements.*

# First Resource Bank

## Statements of Shareholders' Equity

| | Preferred Stock | Common Stock | Surplus | Accumulated Other Comprehensive Income (Loss) | Retained Earnings | Total |
|---|---|---|---|---|---|---|
| **Balance, January 1, 2015** | $ 5,083,000 | $ 1,612,283 | $ 9,523,083 | $ 91,577 | $ 1,715,494 | $ 18,025,437 |
| Net income | - | - | - | - | 1,185,769 | 1,185,769 |
| Other comprehensive loss | - | - | - | (59,370) | - | (59,370) |
| Cash dividend | - | - | - | - | (64,520) | (64,520) |
| Sale of common stock (365,045 shares) | - | 365,045 | 1,961,042 | - | - | 2,326,087 |
| Preferred stock dividends | - | - | - | - | (46,171) | (46,171) |
| Preferred stock redemption (3,812 shares) | (3,812,000) | - | - | - | - | (3,812,000) |
| **Balance, December 31, 2015** | 1,271,000 | 1,977,328 | 11,484,125 | 32,207 | 2,790,572 | 17,555,232 |
| Net income | **-** | **-** | **-** | **-** | **1,281,233** | **1,281,233** |
| Other comprehensive loss | **-** | **-** | **-** | **(106,056)** | **-** | **(106,056)** |
| 5% stock dividend | **-** | **98,918** | **513,432** | **-** | **(612,350)** | **-** |
| Cash in lieu of fractional shares on 5% stock dividend | **-** | **-** | **-** | **-** | **(677)** | **(677)** |
| Sale of common stock (8,739 shares) | **-** | **8,739** | **48,791** | **-** | **-** | **57,530** |
| Exercise of stock options (15,314 shares) | **-** | **15,314** | **89,740** | **-** | **-** | **105,054** |
| Preferred stock dividends | **-** | **-** | **-** | **-** | **(2,577)** | **(2,577)** |
| Preferred stock redemption (1,271 shares) | **(1,271,000)** | **-** | **-** | **-** | **-** | **(1,271,000)** |
| **Balance, December 31, 2016** | **$ -** | **$ 2,100,299** | **$ 12,136,088** | **$ (73,849)** | **$ 3,456,201** | **$ 17,618,739** |

*See accompanying notes to financial statements.*

# First Resource Bank

## Statements of Cash Flows

| *Years Ended December 31,* | **2016** | 2015 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $ **1,281,233** | $ 1,185,769 |
| Adjustments to reconcile change in net income to net cash provided by operating activities: | | |
| Provision for loan losses | **223,784** | 282,375 |
| Depreciation | **396,215** | 355,868 |
| Net amortization on securities | **72,439** | 56,152 |
| Net amortization of subordinated debt issuance costs | **8,493** | 3,086 |
| Net accretion of deferred loan origination fees | **(133,395)** | (107,027) |
| Deferred tax (benefit) expense | **(20,090)** | 45,091 |
| Loss (gain) recorded on other real estate owned | **8,174** | (359) |
| Gain on sale of securities available-for-sale | **-** | (15,641) |
| Bank owned life insurance income | **(117,268)** | (120,060) |
| Proceeds from sales of SBA loans originated for sale | **591,146** | 3,405,754 |
| SBA loans originated for sale | **(536,438)** | (3,016,594) |
| Gains on sales of SBA loans originated for sale | **(54,708)** | (389,160) |
| Increase in accrued interest receivable | **(93,888)** | (47,014) |
| (Increase) decrease in other assets | **(20,679)** | 155,196 |
| Increase in accrued interest payable | **33,942** | 65,244 |
| Increase in other liabilities | **65,461** | 246,146 |
| **Net Cash Provided by Operating Activities** | **1,704,421** | 2,104,826 |
| **Cash Flows from Investing Activities** | | |
| Net increase in loans | **(21,698,538)** | (18,987,341) |
| Purchases of securities available-for-sale | **(18,799,408)** | (12,945,960) |
| Purchases of securities held-to-maturity | **(1,615,752)** | (1,682,609) |
| Proceeds from sales of securities available-for-sale | **-** | 343,136 |
| Maturities and principal repayments of securities available-for-sale | **10,762,972** | 6,275,598 |
| Maturities and principal repayment of securities held-to-maturity | **352,009** | 47,460 |
| Purchase of time deposits at other banks | **(349,000)** | - |
| Redemption (purchase) of restricted bank stock | **92,000** | (47,000) |
| Proceeds from sale of other real estate owned | **54,632** | 308,165 |
| Purchases of premises and equipment | **(128,637)** | (1,061,942) |
| **Net Cash Used in Investing Activities** | **(31,329,722)** | (27,750,493) |
| **Cash Flows from Financing Activities** | | |
| Net increase in deposits | **36,671,590** | 22,635,198 |
| Net change in short-term borrowings | **(10,177,000)** | (1,823,000) |
| Proceeds from long-term borrowings | **6,198,000** | 4,000,000 |
| Repayment of long-term borrowings | **-** | (1,089,500) |
| Proceeds from issuance of subordinated debt, net | **-** | 3,957,529 |
| Preferred stock dividends | **(2,577)** | (46,171) |
| Redemption of preferred stock | **(1,271,000)** | (3,812,000) |
| Cash dividends on common stock | **-** | (64,520) |
| Cash in lieu of fractional shares on 5% stock dividend | **(677)** | - |
| Sale of common stock | **57,530** | 2,326,087 |
| Proceeds from the exercise of stock options | **105,054** | - |
| **Net Cash Provided by Financing Activities** | **31,580,920** | 26,083,623 |
| Net increase in cash and cash equivalents | **1,955,619** | 437,956 |
| **Cash and Cash Equivalents, Beginning of Year** | **1,254,982** | 817,026 |
| **Cash and Cash Equivalents, End of Year** | $ **3,210,601** | $ 1,254,982 |
| **Supplementary Cash Flows Information** | | |
| Interest paid | $ **1,971,766** | $ 1,548,806 |
| Federal income taxes paid | $ **745,148** | $ 335,000 |
| Other real estate acquired in settlement of loans | $ **-** | $ 169,167 |

*See accompanying notes to financial statements.*

## 1. Summary of Significant Accounting Policies

### *Organization and Nature of Operations*

First Resource Bank (the "Bank") is incorporated under the laws of the Commonwealth of Pennsylvania and is a Pennsylvania state chartered bank. The Bank is a full service bank providing personal and business lending and deposit services. As a state chartered bank, the Bank is subject to regulation of the Pennsylvania Department of Banking and Securities and the Federal Deposit Insurance Corporation. The region served by the Bank is the southeastern area of Pennsylvania.

### *Estimates*

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America ("U.S. GAAP") 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. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the valuation of deferred tax assets.

### *Significant Group Concentrations of Credit Risk*

Most of the Bank's activities are with customers located within Chester County, Pennsylvania. Note 3 discusses the types of lending that the Bank engages in. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy. The Bank does not have any significant concentrations to any one industry or customer.

### *Presentation of Cash Flows*

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold. Generally, federal funds are sold for one day periods. As of December 31, 2016 and 2015, the Bank had no federal funds sold.

The Bank maintains cash deposits in other depository institutions that occasionally exceed the amount of deposit insurance available. Management periodically assesses the financial condition of these institutions and believes that the risk of any possible credit loss is minimal.

### *Comprehensive Income*

Accounting principles generally recognized in the United States of America require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on securities available-for-sale, are reported as a separate component of the shareholders' equity section of the balance sheet, such items, along with net income, are components of comprehensive income (loss).

### *Securities*

Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each balance sheet date.

Securities classified as available-for-sale are those securities that the Bank intends to hold for an indefinite period of time but not necessarily to maturity. Securities available-for-sale are carried at fair value. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movement in interest rates, changes in maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations and other similar factors. Unrealized gains and losses are reported as increases or decreases in other comprehensive income, net of the deferred tax effect. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings. Premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Securities classified as held-to-maturity are those debt securities the Bank has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in general economic conditions. These securities are carried at cost adjusted for the amortization of premium and accretion of discount, computed by using the interest method over the terms of the securities.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement, and 2) OTTI related to other factors, which is recognized in other comprehensive income (loss). The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

### *Loans Receivable*

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Bank is generally amortizing these amounts over the contractual life of the loan. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

The loans receivable portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following classes: commercial, commercial real estate and commercial construction. Consumer loans consist of the following classes: home equity loans and other consumer loans.

For all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

***Allowance for Loan Losses***

The allowance for loan losses represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. Non-residential consumer loans are generally charged off no later than 120 days past due on a contractual basis, earlier in the event of bankruptcy, or if there is an amount deemed uncollectible. Because all identified losses are immediately charged off, no portion of the allowance for loan losses is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific and general components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as home equity loans and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

1. Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.

2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.

3. Nature and volume of the portfolio and terms of loans.

4. Experience, ability, and depth of lending management and staff.

5. Volume and severity of past due, classified and nonaccrual loans and other loan modifications.

6. Quality of the Bank's loan review system, and the degree of oversight by the Bank's Board of Directors.

7. Existence and effect of any concentrations of credit and changes in the level of such concentrations.

8. Effect of external factors, such as competition and legal and regulatory requirements.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

A majority of the Bank's loans are loans to business owners of many types. The Bank makes commercial loans for real estate development, equipment financing, accounts receivable and inventory financing and other purposes as required by the customer base.

The Bank's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and finished inventory or raw material. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or the term of the loan.

The evaluation of the adequacy of the allowance is based on an analysis which categorizes the entire loan portfolio by certain risk characteristics. The loan portfolio is segmented into the following loan classes, where the risk level for each class is analyzed when determining the allowance for loan losses.

1. Commercial loans are made to entrepreneurs, proprietors, professionals, partnerships, LLP's, LLC's and corporations. The assets financed are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets, such as accounts receivable and inventory, to cash. These loans can be affected by economic conditions. Commercial term loans may have maturities up to 10 years and generally have fixed interest rates for up to five years. Commercial lines of credit are renewed annually and generally carry variable interest rates. Typical collateral for commercial loans include the borrower's accounts receivable, inventory and machinery and equipment.

2. Commercial real estate loans include long-term loans financing commercial properties, either owner occupied or rental properties. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale of or lease of the subject property. These loans can be affected by economic conditions and the value of the underlying properties. Commercial real estate loans require a loan to value ratio of not greater than 80%. Loan amortizations vary from one year to twenty-five years and terms typically do not exceed 10 years. Interest rates can be either floating or adjustable periods of up to five years with either a rate reset provision or a balloon payment.

3. Commercial construction loans include loans to finance the construction or rehabilitation of either commercial properties or 1 to 4 family residential structures. The vast majority of the commercial construction portfolio finances 1 to 4 family residential properties. Construction loans generally are considered to involve a higher degree of risk of loss than occupied real estate due to uncertainty of construction costs. Inspections are performed prior to disbursement of loan proceeds as construction progress to mitigate these risks. These loans can also be affected by economic conditions. The commercial construction portfolio is focused on small spot lot builders and smaller building companies. These loans carry variable interest rates and are usually interest only loans with maturities ranging from one year to three years.

4. Home equity loans, home equity lines of credit, residential mortgages and residential construction loans are secured by the borrower's residential real estate in either a first or second lien position. These loans can be affected by economic conditions and the value of the underlying property. The risk is considered low on loans in these categories that are secured by first liens. The credit risk is considered slightly higher on loans in these categories with second liens as these loans are dependent on the value of the underlying properties and have the added risk of the subordinate collateral positions. Home equity loans require a loan to value ratio of not greater than 85% with limited exceptions. Home equity lines of credit have variable rates. Closed end home equity loans have maturities up to fifteen years and carry fixed interest rates. Residential mortgages have adjustable rates and terms up to thirty years.

5. Other consumer loans include installment loans, car loans and overdraft lines of credit. The majority of these loans are unsecured and therefore are considered to involve a higher risk of loss.

6. Cash collateralized loans consist of loans secured by deposit accounts. These loans have low credit risk as they are fully secured by their collateral.

The vast majority of the commercial and consumer loans are located in Chester County, Pennsylvania.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial loans, commercial real estate loans and commercial construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate or the fair value of the collateral if the loan is collateral dependent.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value, or the amount by which its carrying value exceeds its estimated fair value is charged-off. The estimated carrying values of the Bank's impaired loans are measured based on the estimated fair value of the loan's collateral or the present value of expected future cash flows.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Loans whose terms are modified are classified as troubled debt restructurings if the Bank grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate, to a below market rate for a loan with similar credit risk, or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans criticized special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses and may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

***U.S. Small Business Association (SBA) Lending Activities***

The Bank originates loans to customers in its primary market area under an SBA program that generally provides for SBA guarantees of up to 90 percent of each loan. The Bank generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. When the guaranteed portion of an SBA loan is sold, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income.

SBA servicing assets are recognized separately when rights are acquired through the sale of the SBA guaranteed portion. These servicing rights are initially measured at fair value at the date of sale and included in the gain on sale. To determine the fair value of servicing rights, the Bank uses market prices for comparable mortgage servicing contracts, when available, or alternatively, uses a valuation model that calculates the present value of estimated future net servicing income. In using this valuation method, the Bank incorporates assumptions that market participants would use in estimating future net servicing income, which includes estimates of the cost to service, the discount rate, custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, default rates, late fees and losses. Servicing rights were not material at December 31, 2016 or 2015.

Servicing rights are amortized in proportion to, and over the period of, the estimated net servicing income or net servicing loss and measured for impairment based on fair value at each reporting date. The amortization of the servicing rights is analyzed periodically and is adjusted to reflect changes in prepayment rates and other estimates.

Serviced loans sold to others are not included in the accompanying balance sheets. Income (losses) and fees collected for loan servicing are included within other income on the statements of income.

### *Transfers of Financial Assets*

Transfers of financial assets, including loan and loan participation sales, are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### *Bank Owned Life Insurance*

The Bank invests in bank owned life insurance (“BOLI”) as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by the Bank on a chosen group of officers. The Bank is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies. Increases in cash surrender value are recorded in other income.

### *Restricted Investment in Bank Stock*

Restricted stock at December 31, 2016 and 2015 is comprised of stock in the Federal Home Loan Bank of Pittsburgh (“FHLB”) in the amount of $787,400 and $879,400, respectively, and in Atlantic Community Bankers Bank (“ACBB”) in the amount of $50,000 for both years. Federal law requires a member institution of the Federal Home Loan Bank to hold stock according to a predetermined formula. All restricted stock is recorded at cost.

### *Other Real Estate Owned*

Other real estate owned (“OREO”) is comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure and loans classified as in-substance foreclosure. A loan is classified as in-substance foreclosure when the Bank has taken possession of the collateral regardless of whether formal proceedings take place. OREO initially is recorded at fair value, net of estimated selling costs, at the date of foreclosure establishing a new cost basis. Any write-downs based on fair value at the date of foreclosure are charged to the allowance for loan losses. If an increase in cost basis results, it is classified as non-interest income unless there has been a prior charge-off, in which case a recovery to the allowance for loan losses is recorded. After foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell. Revenues and expenses from operations and write-downs are included in other expenses. In addition, any gain or loss realized upon disposal is included in other expense. The Bank had OREO of $54,426 and $117,232 at December 31, 2016 and 2015, respectively. Such assets are recorded in other assets in the accompanying balance sheets.

### *Bank Premises and Equipment*

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the related assets. Leasehold improvements are depreciated over the lesser of the useful life, or term of the lease, including renewal options, if reasonably assured, on a straight-line basis. Fixed assets in process represent assets that were not placed in service as of the balance sheet dates.

### *Advertising Costs*

The Bank follows the policy of charging the costs of advertising to expense as incurred.

### *Employee Benefit Plans*

The Bank has established a 401(k) Plan (the "Plan"). All employees are eligible to participate after they have attained the age of 18. The employees may contribute up to the maximum percentage allowable by law of their compensation to the Plan. During 2016 and 2015, the Bank has elected to make a 3% safe harbor contribution for all employees. This contribution is vested immediately. The Bank's contribution to the Plan for the years ended December 31, 2016 and 2015 was $79,816 and $70,970, respectively.

The Bank has implemented non-qualified Supplemental Executive Retirement Plans for certain executive officers that provide for payments upon retirement, death or disability. As of December 31, 2016 and 2015, other liabilities include $194,627 and $147,496 accrued under these plans, respectively. For the years ended December 31, 2016 and 2015, salaries and employee benefits expense includes $47,131 and $43,005 expensed under these plans, respectively.

### *Income Taxes*

Deferred income taxes are provided on the balance sheet method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment.

### *Stock-Based Compensation*

The Bank recognizes the cost of employee services received in exchange for an award of stock options based on the grant date fair value of the award. The cost is recognized over the vesting period.

For the years ended December 31, 2016 and 2015, there was no stock-based compensation expense recognized.

### *Off-Balance Sheet Financial Instruments*

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and letters of credit. Such financial instruments are recorded in the balance sheets when they are funded.

### *Reclassifications*

Certain amounts in the prior year's financial statements have been reclassified to conform with the current year's presentation. These reclassifications did not have any impact on shareholders' equity or net income.

### *Subsequent Events*

The Bank has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2016 for items that should potentially be recognized or disclosed in these financial statements. The evaluation was conducted through February 15, 2017, the date these financial statements were available to be issued.

## 2. Securities

The amortized cost and fair value of securities available-for-sale and held-to-maturity at December 31, 2016 and 2015 are summarized as follows:

| *December 31, 2016* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| Available-for-sale: | | | | |
| U. S. government securities | $ 9,999,538 | $ - | $ (938) | $ 9,998,600 |
| U. S. government mortgage-backed securities - residential | 13,941,967 | 53,697 | (164,651) | 13,831,013 |
| | $ 23,941,505 | $ 53,697 | $ (165,589) | $ 23,829,613 |
| Held-to-maturity: | | | | |
| U. S. government mortgage-backed securities - residential | $ 127,127 | $ 5,632 | $ - | $ 132,759 |
| Corporate bonds | 500,000 | 16,230 | - | 516,230 |
| Municipal bonds | 3,903,856 | 1,116 | (130,882) | 3,774,090 |
| | $ 4,530,983 | $ 22,978 | $ (130,882) | $ 4,423,079 |

| *December 31, 2015* | | Amortized Cost | | Gross Unrealized Gains | | Gross Unrealized Losses | | Fair Value |
|---|---|---|---|---|---|---|---|---|
| Available-for-sale: | | | | | | | | |
| U. S. government securities | $ | 8,999,965 | $ | 35 | $ | - | $ | 9,000,000 |
| U. S. government mortgage-backed securities - residential | | 6,971,960 | | 72,017 | | (23,252) | | 7,020,725 |
| | $ | 15,971,925 | $ | 72,052 | $ | (23,252) | $ | 16,020,725 |
| Held-to-maturity: | | | | | | | | |
| U. S. government mortgage-backed securities - residential | $ | 164,872 | $ | 9,482 | $ | - | $ | 174,354 |
| Corporate bonds | | 500,000 | | 23,960 | | - | | 523,960 |
| Municipal bonds | | 2,607,951 | | 20,069 | | - | | 2,628,020 |
| | $ | 3,272,823 | $ | 53,511 | $ | - | $ | 3,326,334 |

The following tables show the investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2016 and 2015.

| *December 31, 2016* | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Securities available-for-sale: | | | | | | |
| U. S. government securities | **$ 9,998,600** | **$ (938)** | **$ -** | **$ -** | **$ 9,998,600** | **$ (938)** |
| U. S. government mortgage-backed securities - residential | **11,480,635** | **(164,651)** | **-** | **-** | **11,480,635** | **(164,651)** |
| | **$ 21,479,235** | **$ (165,589)** | **$ -** | **$ -** | **$ 21,479,235** | **$ (165,589)** |
| Securities held-to-maturity: | | | | | | |
| Municipal bonds | **$ 3,162,894** | **$ (130,882)** | **$ -** | **$ -** | **$ 3,162,894** | **$ (130,882)** |

| *December 31, 2015* | Less than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Securities available-for-sale: | | | | | | |
| U. S. government mortgage-backed securities - residential | $ 4,811,054 | $ (23,252) | $ - | $ - | $ 4,811,054 | $ (23,252) |

As of December 31, 2016, twenty-four securities were in unrealized loss positions for less than twelve months due to interest rate fluctuations. As of December 31, 2015, seven securities were in unrealized loss positions for less than twelve months due to interest rate fluctuations. No securities were deemed to be other-than-temporarily impaired.

The amortized cost and fair value of securities as of December 31, 2016, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because the securities may be called without any penalties.

| *December 31, 2016* | Available-for-Sale | | Held-to-Maturity | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due less than one year | **$ 9,999,538** | **$ 9,998,600** | **$ 610,079** | **$ 611,196** |
| Due after one year through five years | **-** | **-** | **1,176,698** | **1,185,945** |
| Due after five years through ten years | **-** | **-** | **1,389,336** | **1,352,644** |
| Due over 10 years | **-** | **-** | **1,227,743** | **1,140,535** |
| | **9,999,538** | **9,998,600** | **4,403,856** | **4,290,320** |
| U.S. government mortgage-backed securities - residential | **13,941,967** | **13,831,013** | **127,127** | **132,759** |
| | **$ 23,941,505** | **$ 23,829,613** | **$ 4,530,983** | **$ 4,423,079** |

Securities with a carrying value of $3,412,000 and $3,077,000 at December 31, 2016 and 2015, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

During the year ended December 31, 2016, there were no securities sold by the Bank. Proceeds from the sale of securities available-for-sale amounted to $343,136 for the year ended December 31, 2015, which included gross realized gains of $15,641.

## 3. Loans Receivable

The composition of loans receivable at December 31, 2016 and 2015 is as follows:

| | **2016** | 2015 |
|---|---|---|
| Commercial | **$ 26,377,274** | $ 18,596,898 |
| Commercial real estate | **130,510,262** | 115,998,415 |
| Commercial construction | **17,120,600** | 16,781,853 |
| Home equity | **23,585,090** | 24,046,023 |
| Consumer, other | **480,210** | 841,906 |
| Total loans | **198,073,436** | 176,265,095 |
| Unearned net loan origination fees and costs | **(234,588)** | (162,628) |
| Allowance for loan losses | **(1,579,068)** | (1,450,836) |
| **Net Loans** | **$196,259,780** | $ 174,651,631 |

***Loan Sales***

The Bank originates and sells loans secured by the SBA. The Bank retains the unguaranteed portion of the loan and the servicing on the loans sold and receives a fee based upon the principal balance outstanding.

During the years ended December 31, 2016 and 2015, the Bank sold SBA loans originated for sale for total proceeds of $591,146 and $3,405,754, respectively. The loan sales resulted in realized gains of $54,708 and $389,160 for the years ended December 31, 2016 and 2015, respectively. There were no SBA loans originated for sale held at December 31, 2016 and 2015.

Loans serviced for others are not included in the accompanying balance sheets. The unpaid principal balances of loans serviced for others were $4,241,664 and $3,777,089 at December 31, 2016 and 2015, respectively.

## 4. Allowance for Loan Losses

The following tables summarize the activity in the allowance for loan losses by loan class for the years ended December 31, 2016 and 2015, and information in regards to the allowance for loan losses and the recorded investment in loans receivable by loan class as of December 31, 2016 and 2015:

*2016* — Allowance for Loan Losses

| | Beginning Balance | Charge-offs | Recoveries | Provisions | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
|---|---|---|---|---|---|---|---|
| Commercial | **$ 177,109** | **$ -** | **$ 1,275** | **$ 50,692** | **$ 229,076** | **$ -** | **$ 229,076** |
| Commercial real estate | **802,105** | **(29,000)** | **4,962** | **92,714** | **870,781** | **-** | **870,781** |
| Commercial construction | **210,277** | **-** | **4,300** | **17,308** | **231,885** | **-** | **231,885** |
| Home equity | **245,251** | **(83,321)** | **1,606** | **77,286** | **240,822** | **-** | **240,822** |
| Consumer, other | **16,094** | **-** | **4,626** | **(14,216)** | **6,504** | **-** | **6,504** |
| | **$ 1,450,836** | **$ (112,321)** | **$ 16,769** | **$ 223,784** | **$ 1,579,068** | **$ -** | **$ 1,579,068** |

*2016* — Loans Receivable

| | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
|---|---|---|---|
| Commercial | **$ 26,377,274** | **$ 1,334,293** | **$ 25,042,981** |
| Commercial real estate | **130,510,262** | **5,168,895** | **125,341,367** |
| Commercial construction | **17,120,600** | **70,241** | **17,050,359** |
| Home equity | **23,585,090** | **623,131** | **22,961,959** |
| Consumer, other | **480,210** | **92,682** | **387,528** |
| | **$ 198,073,436** | **$ 7,289,242** | **$ 190,784,194** |

*2015* — Allowance for Loan Losses

| | Beginning Balance | Charge-offs | Recoveries | Provisions | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
|---|---|---|---|---|---|---|---|
| Commercial | $ 154,413 | $ (30,759) | $ 810 | $ 52,645 | $ 177,109 | $ - | $ 177,109 |
| Commercial real estate | 667,785 | (55,878) | 23,104 | 167,094 | 802,105 | - | 802,105 |
| Commercial construction | 72,258 | (50,123) | 22,482 | 165,660 | 210,277 | - | 210,277 |
| Home equity | 400,088 | (88,160) | 25,539 | (92,216) | 245,251 | - | 245,251 |
| Consumer, other | 22,819 | - | 4,083 | (10,808) | 16,094 | - | 16,094 |
| | $ 1,317,363 | $ (224,920) | $ 76,018 | $ 282,375 | $ 1,450,836 | $ - | $ 1,450,836 |

| *2015* | Loans Receivable | | |
|---|---|---|---|
| | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
| Commercial | $ 18,596,898 | $ 1,485,629 | $ 17,111,269 |
| Commercial real estate | 115,998,415 | 4,345,290 | 111,653,125 |
| Commercial construction | 16,781,853 | 181,500 | 16,600,353 |
| Home equity | 24,046,023 | 475,290 | 23,570,733 |
| Consumer, other | 841,906 | 95,371 | 746,535 |
| | $ 176,265,095 | $ 6,583,080 | $ 169,682,015 |

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Bank's internal risk rating system as of December 31, 2016 and 2015:

| *December 31, 2016* | Commercial | Commercial Real Estate | Commercial Construction | Home Equity | Consumer, Other | Total |
|---|---|---|---|---|---|---|
| Pass | **$ 25,042,981** | **$ 126,177,750** | **$ 17,050,359** | **$ 23,134,883** | **$ 480,210** | **$191,886,183** |
| Special mention | - | - | - | - | - | - |
| Substandard | **1,334,293** | **4,332,512** | **70,241** | **450,207** | - | **6,187,253** |
| Doubtful | - | - | - | - | - | - |
| | **$ 26,377,274** | **$ 130,510,262** | **$ 17,120,600** | **$ 23,585,090** | **$ 480,210** | **$198,073,436** |

| *December 31, 2015* | Commercial | Commercial Real Estate | Commercial Construction | Home Equity | Consumer, Other | Total |
|---|---|---|---|---|---|---|
| Pass | $ 17,111,269 | $ 112,429,892 | $ 16,600,353 | $ 23,862,111 | $ 841,906 | $ 170,845,531 |
| Special mention | - | - | - | - | - | - |
| Substandard | 1,485,629 | 3,568,523 | 181,500 | 183,912 | - | 5,419,564 |
| Doubtful | - | - | - | - | - | - |
| | $ 18,596,898 | $ 115,998,415 | $ 16,781,853 | $ 24,046,023 | $ 841,906 | $ 176,265,095 |

The following tables summarize information in regards to impaired loans by loan portfolio class as of and for the years ended December 31, 2016 and 2015:

| *December 31, 2016* | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial | **$ 1,334,293** | **$ 1,334,293** | **$ -** | **$ 1,467,070** | **$ 80,917** |
| Commercial real estate | **5,168,895** | **5,335,380** | **-** | **5,168,609** | **227,758** |
| Commercial construction | **70,241** | **104,243** | **-** | **122,175** | **-** |
| Home equity | **623,131** | **623,131** | **-** | **704,043** | **33,537** |
| Consumer - other | **92,682** | **145,871** | **-** | **94,114** | **3,066** |
| With an allowance recorded: | | | | | |
| Commercial | **$ -** | **$ -** | **$ -** | **$ -** | **$ -** |
| Commercial real estate | **-** | **-** | **-** | **-** | **-** |
| Commercial construction | **-** | **-** | **-** | **-** | **-** |
| Home equity | **-** | **-** | **-** | **-** | **-** |
| Consumer - other | **-** | **-** | **-** | **-** | **-** |
| Total: | | | | | |
| Commercial | **$ 1,334,293** | **$ 1,334,293** | **$ -** | **$ 1,467,070** | **$ 80,917** |
| Commercial real estate | **5,168,895** | **5,335,380** | **-** | **5,168,609** | **227,758** |
| Commercial construction | **70,241** | **104,243** | **-** | **122,175** | **-** |
| Home equity | **623,131** | **623,131** | **-** | **704,043** | **33,537** |
| Consumer, other | **92,682** | **145,871** | **-** | **94,114** | **3,066** |

| *December 31, 2015* | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial | $ 1,485,629 | $ 1,485,629 | $ - | $ 1,303,947 | $ 86,689 |
| Commercial real estate | 4,345,290 | 4,522,068 | - | 4,793,007 | 188,976 |
| Commercial construction | 181,500 | 215,502 | - | 361,303 | - |
| Home equity | 475,290 | 491,047 | - | 701,946 | 17,728 |
| Consumer - other | 95,371 | 148,560 | - | 97,785 | 3,180 |
| With an allowance recorded: | | | | | |
| Commercial | $ - | $ - | $ - | $ - | $ - |
| Commercial real estate | - | - | - | - | - |
| Commercial construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer - other | - | - | - | - | - |
| Total: | | | | | |
| Commercial | $ 1,485,629 | $ 1,485,629 | $ - | $ 1,303,947 | $ 86,689 |
| Commercial real estate | 4,345,290 | 4,522,068 | - | 4,793,007 | 188,976 |
| Commercial construction | 181,500 | 215,502 | - | 361,303 | - |
| Home equity | 475,290 | 491,047 | - | 701,946 | 17,728 |
| Consumer, other | 95,371 | 148,560 | - | 97,785 | 3,180 |

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the past due status as of December 31, 2016 and 2015:

| *December 31, 2016* | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans Receivables | Recorded Investment >90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| Commercial | $ - | $ - | $ - | $ - | $ 26,377,274 | $ 26,377,274 | $ - |
| Commercial real estate | 1,215,695 | - | 552,808 | 1,768,503 | 128,741,759 | 130,510,262 | - |
| Commercial construction | - | - | 70,241 | 70,241 | 17,050,359 | 17,120,600 | - |
| Home equity | 105,916 | - | - | 105,916 | 23,479,174 | 23,585,090 | - |
| Consumer, other | - | 100 | - | 100 | 480,110 | 480,210 | - |
| | $1,321,611 | $ 100 | $ 623,049 | $ 1,944,760 | $ 196,128,676 | $ 198,073,436 | $ - |

| *December 31, 2015* | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans Receivables | Recorded Investment >90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| Commercial | $ - | $ - | $ - | $ - | $ 18,596,898 | $ 18,596,898 | $ - |
| Commercial real estate | - | 776,767 | 1,942,315 | 2,719,082 | 113,279,333 | 115,998,415 | - |
| Commercial construction | - | - | 181,500 | 181,500 | 16,600,353 | 16,781,853 | - |
| Home equity | - | - | 183,912 | 183,912 | 23,862,111 | 24,046,023 | - |
| Consumer, other | - | - | - | - | 841,906 | 841,906 | - |
| | $ - | $ 776,767 | $ 2,307,727 | $ 3,084,494 | $ 173,180,601 | $ 176,265,095 | $ - |

The following table presents nonaccrual loans by classes of the loan portfolio as of December 31, 2016 and 2015:

| | **2016** | 2015 |
|---|---|---|
| Commercial | $ - | $ - |
| Commercial real estate | 1,382,392 | 1,942,315 |
| Commercial construction | 70,241 | 181,500 |
| Home equity | - | 183,912 |
| Consumer, other | - | - |
| | $ 1,452,633 | $ 2,307,727 |

The Bank may grant a concession or modification for economic or legal reasons related to a borrower's financial condition that it would not otherwise consider resulting in a modified loan which is then identified as a troubled debt restructuring ("TDR"). Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate, to a below market rate for a loan with similar credit risk, or an extension of a loan's stated maturity date. Loan modifications are intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral.

The Bank identifies loans for potential restructure primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future.

The following tables present the Bank's troubled debt restructurings that occurred during the years ended December 31, 2016 and 2015:

| *2016* | Number of Contracts | Pre-Modification Outstanding Recorded Investments | Post-Modification Outstanding Recorded Investments |
|---|---|---|---|
| Troubled debt restructurings: | | | |
| Commercial | **4** | **$ 1,411,650** | **$ 1,411,650** |
| Commercial real estate | **4** | **2,429,159** | **2,429,159** |

| *2015* | Number of Contracts | Pre-Modification Outstanding Recorded Investments | Post-Modification Outstanding Recorded Investments |
|---|---|---|---|
| Troubled debt restructurings: | | | |
| Commercial | 4 | $ 1,626,931 | $ 1,626,931 |
| Commercial real estate | 1 | 182,074 | 182,074 |

There were no troubled debt restructurings with a payment default, with the payment default occurring within twelve months of the restructure date, during the years ended December 31, 2016 and 2015.

At December 31, 2016 and 2015, the Bank had $54,426 and $117,232, respectively, of residential real estate held in other real estate owned. At December 31, 2016 and 2015, the Bank had initiated foreclosure proceedings on approximately $-0- and $184,000, respectively, of loans secured by residential real estate.

## 5. Bank Premises and Equipment

The components of premises and equipment at December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---|---|---|
| Land | $ 1,760,000 | $ 1,760,000 |
| Land improvements | 395,064 | 395,064 |
| Buildings | 3,222,489 | 3,222,489 |
| Leasehold improvements | 5,273 | 1,123 |
| Furniture, fixtures and equipment | 1,083,678 | 1,037,149 |
| Computer equipment and data processing software | 584,111 | 507,834 |
| Fixed assets in process | 7,550 | 5,869 |
| | 7,058,165 | 6,929,528 |
| Accumulated depreciation | (1,102,417) | (706,202) |
| | $ 5,955,748 | $ 6,223,326 |

Depreciation expense was $396,215 and $355,868 for the years ended December 31, 2016 and 2015, respectively.

## 6. Deposits

The components of deposits at December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---|---|---|
| Demand, non-interest bearing | $ 18,849,933 | $ 14,200,995 |
| Demand, interest-bearing | 8,106,745 | 6,392,765 |
| Money market accounts | 91,971,538 | 60,453,093 |
| Time, $250,000 and over | 7,466,949 | 5,469,669 |
| Time, other | 76,259,986 | 79,467,039 |
| | $ 202,655,151 | $ 165,983,561 |

At December 31, 2016, the scheduled maturities of time deposits are as follows:

| *Year ending December 31,* | |
|---|---|
| 2017 | $ 53,629,460 |
| 2018 | 13,446,504 |
| 2019 | 3,254,476 |
| 2020 | 2,707,570 |
| 2021 | 10,688,925 |
| | $ 83,726,935 |

At December 31, 2016 and 2015, the Bank had brokered deposits of $12,578,860 and $12,576,641, respectively.

## 7. Borrowings

Short-term borrowings at December 31, 2015 consisted of an advance from the Federal Home Loan Bank (FHLB) of $10,177,000, due January 4, 2016 with interest at 0.51%. These borrowings matured and were repaid on January 4, 2016. There were no short-term borrowings outstanding at December 31, 2016. The Bank utilizes overnight borrowings from the FHLB for cash flow needs.

Long-term borrowings at December 31, 2016 and 2015 consisted of FHLB borrowings with the following maturity dates and interest rates:

| | **2016** | 2015 |
|---|---|---|
| Fixed note at 1.290%, maturing on January 3, 2017 | **$ 920,000** | $ 920,000 |
| Fixed note at 1.194%, maturing on February 23, 2017 | **1,300,000** | 1,300,000 |
| Fixed note at 1.011%, maturing on July 10, 2017 | **900,000** | 900,000 |
| Fixed note at 0.913%, maturing on August 23, 2017 | **1,200,000** | 1,200,000 |
| Fixed note at 1.102%, maturing on March 30, 2018 | **1,450,000** | 1,450,000 |
| Fixed note at 1.429%, maturing on April 1, 2019 | **850,000** | 850,000 |
| Fixed note at 1.617%, maturing on March 30, 2020 | **850,000** | 850,000 |
| Fixed note at 1.235%, maturing on June 3, 2020 | **2,000,000** | - |
| Fixed note at 2.077%, maturing on June 17, 2020 | **437,500** | 437,500 |
| Fixed note at 2.712%, maturing on August 27, 2020 | **652,000** | 652,000 |
| Fixed note at 1.545%, maturing on January 21, 2021 | **2,198,000** | - |
| Fixed note at 1.854%, maturing on March 30, 2021 | **850,000** | 850,000 |
| Fixed note at 1.562%, maturing on June 3, 2022 | **2,000,000** | - |
| | **$ 15,607,500** | $ 9,409,500 |

Borrowings from the FHLB are secured by a blanket lien on the Bank's assets. The Bank has a maximum borrowing capacity with the FHLB of approximately $97,286,000 at December 31, 2016, of which $15,607,500 was outstanding.

The Bank also has access to borrowings from the Federal Reserve Bank Discount Window. All borrowings through this facility are secured by specific pledge of investments. There were no borrowings outstanding under this facility at December 31, 2016 and 2015.

## 8. Subordinated Debt

On July 31, 2015, the Bank issued $2 million in subordinated notes. These notes have a maturity date of September 15, 2025, and bear interest at a fixed rate of 6.50%. The Bank may, at its option, at any time on an interest payment date on or after September 15, 2020, redeem the notes, in whole or in part, at par plus accrued interest to the date of redemption.

On October 15, 2015, the Bank issued another $2 million in subordinated notes. These notes have a maturity date of October 1, 2025, and bear interest at a fixed rate of 6.50%. The Bank may, at its option, at any time on an interest payment date on or after October 15, 2020, redeem the notes, in whole or in part, at par plus accrued interest to the date of redemption.

The principal and unamortized debt issuance costs of subordinated debt at December 31, 2016 are as follows:

| *December 31, 2016* | Principal | Unamortized Debt Issuance Costs | Net |
|---|---|---|---|
| 6.5% subordinated notes, due September 15, 2025 | **$ 2,000,000** | **$ 20,676** | **$ 1,979,324** |
| 6.5% subordinated notes, due October 1, 2025 | **2,000,000** | **10,216** | **1,989,784** |
| | **$ 4,000,000** | **$ 30,892** | **$ 3,969,108** |

The principal and unamortized debt issuance costs of subordinated debt at December 31, 2015 are as follows:

| *December 31, 2015* | Principal | Unamortized Debt Issuance Costs | Net |
|---|---|---|---|
| 6.5% subordinated notes, due September 15, 2025 | $ 2,000,000 | $ 26,445 | $ 1,973,555 |
| 6.5% subordinated notes, due October 1, 2025 | 2,000,000 | 12,940 | 1,987,060 |
| | $ 4,000,000 | $ 39,385 | $ 3,960,615 |

All subordinated notes are not subject to repayment at the option of the noteholders. These notes are all unsecured and rank junior in right of payment to the Bank's obligations to its general creditors and qualify as Tier 2 capital for regulatory purposes.

## 9. Lease Commitments

The Bank had an operating lease agreement with a related party for office space for the operations department. The lease commenced on February 1, 2008 and had a seven year term. The lease expired on January 31, 2015 and was not renewed. Rent expense for the years ended December 31, 2016 and 2015 was $-0- and $5,288, respectively.

In 2013, the Bank entered into an operating lease agreement for its corporate office. This lease commenced in May 2014 and has a ten year and seven month term with two additional five year option periods. Rent expense for the years ended December 31, 2016 and 2015 was $138,636 and $138,636, respectively.

Future minimum lease payments by year and in the aggregate, under this noncancellable lease agreement, are as follows:

| *Year ending December 31,* | |
|---|---|
| 2017 | $ 137,746 |
| 2018 | 141,461 |
| 2019 | 145,175 |
| 2020 | 148,890 |
| 2021 | 152,604 |
| Thereafter | 466,170 |
| | $ 1,192,046 |

## 10. Employment Agreements

The Bank has employment agreements with its chief executive officer and chief financial officer. The agreements include minimum annual salary commitments and change of control provisions. The Bank also has a change of control agreement with its chief operating officer. The change in control provisions in these agreements provide that upon resignation after a change in the control of the Bank, as defined in the agreement, the individual will receive monetary compensation in the amount set forth in the agreement.

## 11. Shareholders' Equity

On September 15, 2011, the Bank entered into a Securities Purchase Agreement (the "Purchase Agreement") with the Secretary of the Treasury (the "Treasury"), pursuant to which the Bank issued and sold to the Treasury 5,083 shares of its Senior Non-Cumulative Perpetual Preferred Stock, Series 2011A (the "Series 2011A Preferred Stock"), having a liquidation preference of $1,000 per share (the "Liquidation Amount"), for proceeds of $5,083,000. The Purchase Agreement was entered into, and the Series 2011A Preferred Stock was issued, pursuant to the Treasury's Small Business Lending Fund ('SBLF") program, a $30 billion fund established under the Small Business Jobs Act of 2010 that encourages lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion. The proceeds were used to partially redeem $5,147,000 of the Series 2009A, 2009B and 2009C preferred stock previously issued to the Treasury under its Capital Purchase Program.

The Series 2011A Preferred Stock qualifies as Tier 1 capital for the Bank. Non-cumulative dividends are payable quarterly on the Series 2011A Preferred Stock, beginning January 1, 2012. The dividend rate is calculated as a percentage of the aggregate Liquidation Amount of the outstanding Series 2011A Preferred Stock and is based on changes in the level of "Qualified Small Business Lending" or "QSBL" (as defined in the Purchase Agreement) by the Bank. During 2016 and 2015, the annual dividend rate was set at 1.0%.

The Series 2011A Preferred Stock shares are non-voting, other than class voting rights on matters that could adversely affect the shares, and are redeemable at any time, with Treasury, Federal Reserve and FDIC approval.

On November 17, 2015, the Bank redeemed 3,812 shares of Series 2011A Preferred Stock for an aggregate cost of $3,812,000. At December 31, 2015, there were 1,271 shares of Series 2011A Preferred Stock outstanding.

On March 14, 2016, the Bank redeemed the remaining 1,271 shares of Series 2011 A Preferred Stock for an aggregate cost of $1,271,000. At December 31, 2016, there were no shares of Series 2011A Preferred Stock outstanding.

During 2015, the Bank sold 360,000 shares of common stock at $6.50 per share which resulted in net proceeds of $2,293,428, after offering costs of $46,572. During 2016, the Bank declared a 5 percent common stock dividend which resulted in the issuance of 98,918 common stock shares.

The Bank has a Director Fee Plan. The Plan allows for non-employee directors to elect to receive a specified percentage of fees for services on the Board of Directors in the form of shares of the Bank's common stock. The purchase price for these shares is the volume weighted average price of the Bank's common stock as reported on the over-the-counter market on the OTCQX Marketplace for Banks, for the calendar quarter for which a Director's compensation is payable. During 2016 and 2015, the Bank sold 4,864 and 2,387 shares of common stock under this Plan.

The Bank has a Bank Shareholder Stock Purchase Plan. The Plan allows existing shareholders of record to purchase new shares of common stock directly from the Bank. The purchase price for these shares is the volume weighted average price for a share of Bank common stock during the full calendar quarter that precedes the calendar quarter in which the purchase date occurs, as reported by the National Association of Securities Dealers Automated Quotations ("NASDAQ"). At each quarterly purchase date, the minimum investment is $250 and the maximum investment is $100,000. During 2010, this Plan was frozen and no shares of common stock have been sold under this Plan since then.

The Bank has an Employee Stock Purchase Plan. The Employee Plan allows employees with at least six months of service and who customarily work more than five months per calendar year to purchase shares through a payroll deduction at a price set by the Capital Committee between 85 percent and 100 percent of the fair market value of such share on each quarterly purchase date. Payroll deductions for this Plan cannot exceed the lower of 5% of the employee's compensation or $2,500 per quarter. During 2016 and 2015, the Bank sold 3,875 and 2,658 shares of common stock under this Plan.

## 12. Stock Option Plan

The Bank had a Stock Compensation Plan (the "Plan"), which expired in 2016. The Plan authorized the Board of Directors to grant options and restricted stock up to an aggregate of 15% of the shares of common stock as of the effective date of the Plan to officers, other employees and directors of the Bank. For each fiscal year in which the Bank reported positive net income as determined by the Bank's audited GAAP financial statements, the number of shares of common stock available for issuance under the Plan would increase by 1% of the shares of common stock outstanding on December 31 of the immediately preceding calendar year. However, in no case could the aggregate number of shares of common stock issuable under the Plan exceed 18% of common stock outstanding as of December 31 of each applicable year. No incentive stock options could be granted on the basis of the additional shares of common stock resulting from such annual increases. Restricted stock awards could not exceed 25% of the total shares authorized under the Plan. Incentive stock awards could not exceed 75% of the shares initially issuable under the Plan. Awards to non-employee directors could not exceed 35% of the shares initially issuable under the Plan. As the Plan expired in 2016, at December 31, 2016, there were no shares available for grant under the Plan.

The shares granted under the Plan to directors were non-qualified options. The shares granted under the Plan to officers and other employees could be non-qualified options or incentive stock options, subject to the limitations under Section 422 of the Internal Revenue Code.

All options granted under the Plan had a term that did not exceed 10 years. The exercise price of the options granted was the fair value of a share of common stock at the time of the grant. The vesting period was at the discretion of the Board of Directors. Stock options granted in 2005 vested over 3 or 5 years. Stock options granted in 2006 vested over 5 years. There were no stock options granted since 2006.

During 2005, 70,175 stock options were granted to certain officers and directors of the Bank as compensation for their efforts in organizing the Bank. Such options had a term of 10 years, vested over 5 years and the exercise price equaled the fair value of a share of common stock at the time of the grant. Such options were not subject to the Plan. These options all expired unexercised during 2015.

Following is a rollforward of stock option activity (adjusted for stock dividends) for the years ended December 31, 2016 and 2015:

| | Shares | Weighted Average Exercise Price | Weighted Average Remaining Life | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Options outstanding | | | | |
| January 1, 2015 | 207,849 | $ 7.42 | | |
| 2015 forfeitures | (177,231) | 7.46 | | |
| Options outstanding | | | | |
| December 31, 2015 | 30,618 | 7.17 | | |
| 2016 exercises | **(15,314)** | **6.86** | | |
| 2016 forfeitures | **(15,304)** | **7.49** | | |
| Options outstanding | | | | |
| December 31, 2016 | **-** | **$ -** | - | $ - |
| Options exercisable | | | | |
| December 31, 2016 | **-** | **$ -** | - | $ - |

As of December 31, 2016 and 2015, there was no unrecognized compensation cost related to stock options.

## 13. Federal Income Taxes

The components of federal income tax expense for the years ended December 31, 2016 and 2015 are as follows:

| | **2016** | 2015 |
|---|---|---|
| Current expense | **$ 617,813** | $ 642,383 |
| Deferred (benefit) expense | **(20,090)** | 45,091 |
| | **$ 597,723** | $ 687,474 |

A reconciliation of the statutory federal income tax at a rate of 34% to federal income tax expense included in the statements of income for the years ended December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---|---|---|
| Federal income tax at statutory rate | $ **638,845** | $ 636,903 |
| Tax exempt interest | **(20,191)** | (11,162) |
| Bank owned life insurance income | **(39,871)** | (40,820) |
| Expired stock options | **13,701** | 98,808 |
| Other | **5,239** | 3,745 |
| | $ **597,723** | $ 687,474 |

The components of the net deferred tax asset at December 31, 2016 and 2015 are as follows:

| | 2016 | 2015 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ **348,748** | $ 282,866 |
| Organization and start-up costs | **29,375** | 38,188 |
| Stock option compensation | **-** | 25,974 |
| Supplemental executive retirement plan | **66,173** | 50,148 |
| Nonaccrual interest | **23,732** | 16,734 |
| OREO valuation allowance | **37,760** | 34,980 |
| Deferred rent | **32,134** | 30,569 |
| Unrealized loss on available-for-sale securities | **38,043** | - |
| Total deferred tax assets | **575,965** | 479,459 |
| Deferred tax liabilities: | | |
| Deferred loan costs | **(89,017)** | (86,976) |
| Unrealized gain on available-for-sale securities | **-** | (16,593) |
| Depreciation on premises and equipment | **(205,307)** | (171,763) |
| Prepaid expenses | **(25,056)** | (22,268) |
| Total deferred tax liabilities | **(319,380)** | (297,600) |
| **Net Deferred Tax Assets, Included in Other Assets** | $ **256,585** | $ 181,859 |

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income and tax planning strategies in making this assessment. Management believes it is more likely than not that the Bank will realize the benefits of these deferred tax assets at December 31, 2016.

The Bank follows the provisions of Financial Accounting Standards Board ASC 740, *Accounting for Uncertainty in Income Taxes*. A tax position is recognized as a benefit only if it is “more likely than not” that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that has a likelihood of being realized on examination of more than 50 percent. For tax positions not meeting the “more likely than not” test, no tax benefit is recorded. Under the “more-likely-than-not” threshold guidelines, the Bank believes no significant uncertain tax positions exist, either individually or in the aggregate, that would give rise to the non-recognition of an existing tax benefit. As of December 31, 2016 and 2015, the Bank had no material unrecognized tax benefits or accrued interest and penalties. The Bank’s policy is to account for interest as a component of interest expense and penalties as a component of other expense. The Bank is no longer subject to examination by taxing authorities for the years before January 1, 2013.

## 14. Transactions with Executive Officers, Directors and Principal Stockholders

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties). Loans receivable of related parties totaled $8,706,028 at December 31, 2016 and $8,454,569 at December 31, 2015. During 2016, $1,872,985 of advances were made and repayments totaled $1,621,526. Deposits of related parties totaled $12,782,524 and $8,235,451 at December 31, 2016 and 2015, respectively.

The Bank paid legal fees of approximately $1,888 and $4,904 to a law firm of a director for the years ended December 31, 2016 and 2015, respectively. The Bank leased office space and a storefront used for a remote banking center from a related party. Total rent expense to the related party was $-0- and $400 for the years ended December 31, 2016 and 2015, respectively. The lease terminated March 1, 2015. The Bank leased its operations office space from a related party as described in Note 9. Total rent expense to the related party was $-0- and $5,288 for the years ended December 31, 2016 and 2015, respectively. The Bank uses a related party for site work on new branch construction and for diesel fuel purchases for an onsite generator. Total payments to this related party in $2,880 and $36,726 in 2016 and 2015, respectively. The Bank also uses a related party for construction consulting services. Total payments to this related party were $-0- and $13,197 in 2016 and 2015, respectively.

## 15. Financial Instruments with Off-Balance Sheet Risk

The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and letters of credit. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Bank’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

A summary of the Bank's financial instrument commitments at December 31, 2016 and 2015 is as follows:

| | Contract Amount | |
|---|---|---|
| | **2016** | 2015 |
| Commitments to grant loans | $ **6,179,000** | $ 175,000 |
| Unfunded commitments under lines of credit | **27,975,126** | 23,971,733 |
| Letters of credit | **1,444,353** | 1,267,998 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment.

Outstanding letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. The majority of these standby letters of credit expire within the next twelve months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Bank requires collateral supporting these letters of credit as deemed necessary. The maximum undiscounted exposure related to those commitments at December 31, 2016 and 2015 was $1,444,353 and $1,267,998, respectively. The current amount of the liability as of December 31, 2016 and 2015 for guarantees under standby letters of credit issued is not material.

## 16. Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary-actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth below) of Total, Tier 1, and Common Equity Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2016, that the Bank meets all capital adequacy requirements to which it is subject.

In July 2013, the federal banking agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III, that (i) introduced a new capital ratio pursuant to the prompt corrective action provisions, the common equity tier 1 capital to risk weighted assets ratio, (ii) increased the adequately capitalized and well capitalized thresholds for the Tier 1 risk based capital ratios to 6% and 8%, respectively, (iii) changed the treatment of certain capital components for determining Tier 1 and Tier 2 capital, and (iv) changed the risk weighting of certain assets and off balance sheet items in determining risk weighted assets. The new rules, which were effective January 1, 2015, also require that banks maintain a "capital conservation buffer" of 250 basis points in excess of the "minimum capital ratio." The minimum capital ratio is equal to the prompt corrective action adequately capitalized threshold ratio. The capital conservation buffer will be phased in over four years beginning on January 1, 2016, with a maximum buffer of 0.625% of risk weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. Failure to maintain the required capital conservation buffer will result in limitations on capital distributions and on discretionary bonuses to executive officers.

The Bank's actual capital amounts and ratios at December 31, 2016 and 2015 are presented below:

| *December 31, 2016* | Actual | | Minimum Capital Adequacy | | Minimum Capital Adequacy with Capital Buffer | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total capital (to risk-weighted assets) | **$ 23,240** | **12.19%** | **$ ≥15,246** | **≥8.0%** | **$ ≥16,437** | **≥8.625%** | **$ ≥19,058** | **≥10.0%** |
| Tier 1 capital (to risk-weighted assets) | **17,692** | **9.28%** | **≥11,435** | **≥6.0%** | **≥12,626** | **≥6.625%** | **≥15,246** | **≥ 8.0%** |
| Common Equity Tier 1 capital (to risk-weighted assets) | **17,692** | **9.28%** | **≥ 8,576** | **≥4.5%** | **≥ 9,767** | **≥5.125%** | **≥12,388** | **≥ 6.5%** |
| Tier 1 capital (to average assets) | **17,692** | **7.64%** | **≥ 9,264** | **≥4.0%** | **N/A** | **N/A** | **≥11,581** | **≥ 5.0%** |

| *December 31, 2015* | Actual | | Minimum Capital Adequacy | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total capital (to risk-weighted assets) | $ 22,935 | 13.55% | $ ≥13,540 | ≥8.0% | $ ≥16,925 | ≥10.0% |
| Tier 1 capital (to risk-weighted assets) | 17,523 | 10.35% | ≥10,155 | ≥6.0% | ≥13,540 | ≥ 8.0% |
| Common Equity Tier 1 capital (to risk-weighted assets) | 16,252 | 9.60% | ≥ 7,616 | ≥4.5% | ≥11,001 | ≥ 6.5% |
| Tier 1 capital (to average assets) | 17,523 | 8.74% | ≥ 8,019 | ≥4.0% | ≥10,024 | ≥ 5.0% |

The Bank is subject to certain restrictions on the amount of cash dividends that it may declare due to regulatory considerations. The Pennsylvania Banking Code provides that cash dividends may be declared and paid only out of accumulated net earnings. The Pennsylvania Department of Banking waived this requirement for dividends payable under Treasury's SBLF program.

## 17. Fair Value Measurements and Fair Values of Financial Instruments

Management uses its best judgment in estimating the fair value of the Bank's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Bank could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to these respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each reporting date.

The Bank uses fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. In accordance with the accounting guidance adopted by the Bank, the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Bank's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

Fair value measurement guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1 - Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2 - Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3 - Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported with little or no market activity).

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2016 and 2015 are as follows:

| *December 31, 2016* | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Securities available-for-sale: | | | | |
| U. S. government agency securities | **$ 9,998,600** | **$ -** | **$ 9,998,600** | **$ -** |
| U. S. government mortgage-backed securities, residential | **13,831,013** | **-** | **13,831,013** | **-** |
| | **$ 23,829,613** | **$ -** | **$ 23,829,613** | **$ -** |

| *December 31, 2015* | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Securities available-for-sale: | | | | |
| U. S. government agency securities | $ 9,000,000 | $ - | $ 9,000,000 | $ - |
| U. S. government mortgage-backed securities, residential | 7,020,725 | - | 7,020,725 | - |
| | $ 16,020,725 | $ - | $ 16,020,725 | $ - |

There were no financial assets measured at fair value on a nonrecurring basis at December 31, 2016.

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2015 are as follows:

| *December 31, 2015* | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Impaired loans | $ 707,500 | $ - | $ - | $ 707,500 |

For non-financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2016 and 2015 are as follows:

| *December 31, 2016* | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
|---|---|---|---|---|
| Other real estate owned | **$ 54,426** | **$ -** | **$ -** | **$ 54,426** |
| *December 31, 2015* | | | | |
| Other real estate owned | $ 117,232 | $ - | $ - | $ 117,232 |

Quantitative information about Level 3 Fair Value Measurements at December 31, 2016 is included in the table below:

| *December 31, 2016* | Quantitative Information about Level 3 Fair Value Measurements | | | |
|---|---|---|---|---|
| | Fair Value Estimate | Valuation Techniques | Unobservable Inputs | Estimated Range (Weighted Average) |
| Other real estate owned | **$ 54,426** | Appraisal of property | Appraisal adjustments | None |
| | | | Liquidation expenses | 6.0%-6.0% (6.00%) |

There were no appraisal adjustments as all appraisals used were current.

Quantitative information about Level 3 Fair Value Measurements at December 31, 2015 is included in the table below:

| *December 31, 2015* | Quantitative Information about Level 3 Fair Value Measurements | | | |
|---|---|---|---|---|
| | Fair Value Estimate | Valuation Techniques | Unobservable Inputs | Estimated Range (Weighted Average) |
| Impaired loans | $ 707,500 | Appraisal of collateral | Appraisal adjustments | None |
| | | | Liquidation expenses | 6.0%-6.0% (6.00%) |
| Other real estate owned | $ 117,232 | Appraisal of property | Appraisal adjustments | None |
| | | | Liquidation expenses | 6.0%-6.0% (6.00%) |

There were no appraisal adjustments as all appraisals used were current.

Below is management's estimate of the fair value of all financial instruments whether carried at cost or fair value on the Bank's balance sheet. The following information should not be interpreted as an estimate of the fair value of the entire Bank since a fair value calculation is only provided for a limited portion of the Bank's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Bank's disclosures and those of other companies may not be meaningful.

Fair value estimates, methods and assumptions for the Bank's financial instruments are set forth below:

***Cash and Short-Term Time Deposits (Carried at Cost)***

The carrying amounts reported in the balance sheets for cash and due from banks and short-term time deposits approximate their fair values due primarily to their short-term nature.

***Securities***

The fair value of securities available-for-sale (carried at fair value) and held-to-maturity (carried at amortized cost) are determined by matrix pricing (Level 2), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices.

***Loans Receivable (Carried at Cost)***

The fair values of loans other than impaired loans are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

***Impaired Loans (Generally Carried at Fair Value)***

Impaired loans are those in which the Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. Impaired loans with current year write downs are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. There were no impaired loans carried at fair value at December 31, 2016. The fair value at December 31, 2015 consists of loan balances of $886,500, net of partial charge-offs of $179,000.

***Other Real Estate Owned (OREO)***

OREO assets are originally recorded at fair value upon transfer of the loans to OREO and a new cost basis is established. Subsequently, OREO assets are carried at the lower of carrying value or fair value. The fair value of OREO is based on independent appraisals less selling costs. Appraised values may be discounted based upon management's historical knowledge and changes in the market conditions from the time of the appraisal. Because of the high degree of judgment required in estimating the fair value of OREO and because of the relationship between fair value and general economic conditions, the Company considers fair values of OREO to be highly sensitive to market conditions. OREO assets with write downs subsequent to the initial transfer to OREO are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements. At December 31, 2016 and 2015, the fair value consists of OREO balances of $165,483 and $220,115, respectively, net of valuation allowances of $111,057 and $102,883, respectively.

***Restricted Investment in Bank Stock (Carried at Cost)***

The carrying amount of restricted investment in bank stock approximates fair value, and considers the limited marketability of such securities.

***Accrued Interest Receivable and Payable (Carried at Cost)***

The carrying amount of accrued interest receivable and payable approximates fair value.

***Deposit Liabilities (Carried at Cost)***

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

### *Short-Term Borrowings (Carried at Cost)*

The carrying amounts of short-term borrowings approximate their fair values.

### *Long-Term Borrowings (Carried at Cost)*

Fair values of FHLB advances are estimated using discounted cash flow analysis, based on quoted prices for new FHLB advances with similar credit risk characteristics, terms and remaining maturity. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

### *Subordinated Debt (Carried at Cost)*

The fair values of subordinated debt are estimated using discounted cash flow analysis, based on current interest rates from debt with similar credit risk characteristics, terms and remaining maturity.

### *Off-Balance Sheet Instruments (Disclosed at Cost)*

Off-balance sheet instruments are primarily comprised of loan commitments that are generally priced at market at the time of funding. Fees on commitments to extend credit are deemed to be immaterial, and these instruments are expected to be settled at face value or expire unused. It is impractical to assign any fair value to these instruments.

The following tables summarize the carrying amount and fair value estimates of the Bank's financial instruments at December 31, 2016 and 2015 (in thousands):

| *December 31, 2016* | Carrying Amount | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Observable Inputs (Level 3) |
|---|---|---|---|---|---|
| Assets: | | | | | |
| Cash and short-term time deposits | $ 3,810 | $ 3,810 | $ 3,810 | $ - | $ - |
| Securities available-for-sale | 23,830 | 23,830 | - | 23,830 | - |
| Securities held-to-maturity | 4,531 | 4,423 | - | 4,423 | - |
| Loans receivable, net | 196,260 | 196,174 | - | - | 196,174 |
| Restricted investment in bank stock | 837 | 837 | - | 837 | - |
| Accrued interest receivable | 565 | 565 | - | 565 | - |
| Liabilities: | | | | | |
| Demand and savings deposits | 118,928 | 118,928 | - | 118,928 | - |
| Time deposits | 83,727 | 83,500 | - | 83,500 | - |
| Accrued interest payable | 172 | 172 | - | 172 | - |
| Long-term borrowings | 15,608 | 15,379 | - | 15,379 | - |
| Subordinated debt | 3,969 | 4,149 | - | 4,149 | - |
| Off-Balance Sheet Asset (Liability): | | | | | |
| Commitments to extend credit | - | - | - | - | - |
| Unfunded commitments under lines of credit | - | - | - | - | - |

| *December 31, 2015* | Carrying Amount | Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Observable Inputs (Level 3) |
|---|---|---|---|---|---|
| Assets: | | | | | |
| Cash and short-term time deposits | $ 1,505 | $ 1,505 | $ 1,505 | $ - | $ - |
| Securities available-for-sale | 16,021 | 16,021 | - | 16,021 | - |
| Securities held-to-maturity | 3,273 | 3,326 | - | 3,326 | - |
| Loans receivable, net | 174,652 | 174,650 | - | - | 174,650 |
| Restricted investment in bank stock | 929 | 929 | - | 929 | - |
| Accrued interest receivable | 471 | 471 | - | 471 | - |
| Liabilities: | | | | | |
| Demand and savings deposits | 81,047 | 81,047 | - | 81,047 | - |
| Time deposits | 84,937 | 84,840 | - | 84,840 | - |
| Accrued interest payable | 138 | 138 | - | 138 | - |
| Short-term borrowings | 10,177 | 10,177 | - | 10,177 | - |
| Long-term borrowings | 9,410 | 9,353 | - | 9,353 | - |
| Subordinated debt | 3,961 | 5,130 | | 5,130 | - |
| Off-Balance Sheet Asset (Liability): | | | | | |
| Commitments to extend credit | - | - | - | - | - |
| Unfunded commitments under lines of credit | - | - | - | - | - |

## Annual Shareholders Meeting

Thursday, June 22, 2017 • 9:00 A.M.

Hilton Garden Inn
720 E. Eagleview Boulevard
Exton, PA 19341

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