

# ANNUAL REPORT

2016



*Banking the Way  
it Should Be™*

## OUR MISSION

We are a community bank that partners with our customers to enhance their lives and enrich our communities through local decision-making.



MEMBER FDIC

*Banking the Way  
it Should Be™*

# LETTER TO SHAREHOLDERS

At our 2016 Annual Meeting of the Shareholders, I outlined the goals and objectives for the coming years to fulfill the strategic direction of the Board of Directors and shared my commitment to the future of Jefferson Security Bank. I have actively managed our growth and development and continue to do so as we build a stronger team to take full advantage of the endless opportunities our communities offer. Over the last year, we maintained our focus on our strategic planning goals and company-wide training; redefined our mission, vision and values; shifted assets to a more optimal mix; reduced our problem assets; addressed inefficiencies; and improved systems.

Our asset size remained stable throughout our fiscal year, as we have worked to reallocate assets from our investment portfolio to the loan portfolio generating an overall higher rate of return. As of December 31, 2016, our net loans grew over \$17 million to \$154 million representing an increase of over 12%. With this loan growth, our net loan to deposit ratio rose to 60%. In years past, our loan to deposit ratio had dropped below 50%, which is not the optimal position for us to take advantage of our earnings potential. Additionally, in 2016 we reduced our total problem assets by showing a reduction in each of the following categories: past due loans, nonaccrual loans, troubled debt restructurings and other real estate owned.

The income generated from the growth in our loan portfolio along with the savings realized from our ability to manage operational inefficiencies allowed for the strengthening of technologies and data processing systems and the resolution of problem assets. Overall, these changes resulted in an increase in net income of 22% to \$1.3 million for the year ended December 31, 2016 when compared to the year ended December 31, 2015. During the same period, our total shareholders' equity increased to \$21.6 million representing an increase in book value per share from \$73.07 to \$76.35 and an increase in tier 1 capital to average assets from 8.14% to 8.46%. While these levels allow us to remain well capitalized under regulatory guidelines, it is prudent for management and the Board of Directors to continue to monitor these levels and the impact of various activities. Therefore, the Board of Directors held dividends steady in March and September of 2016 with semi-annual payments of \$0.50 per share for each period and increased the March 2017 dividend to \$0.55 per share.

I am proud of our accomplishments in 2016 and appreciative of the continued support of our customers and shareholders. As we look toward our future, we know the economy remains challenging, the regulatory environment is uncertain and our industry will evolve with the development of Fin Tech or nonfinancial competition in our markets. However, as we continue to prepare to meet these challenges and stay true to our business model by partnering with our customers to enhance their lives and enrich our communities, we will drive forward and become a stronger community bank.



Sincerely,

*Cindy A. Kitner*

**Cindy A. Kitner, CPA**  
**President and CEO**

# BOARD OF DIRECTORS



BACK ROW: Cindy A. Kitner, CPA, President and CEO; Frederick K. Parsons, Vice Chair; James M. Davis, Chair; Suellen D. Myers FRONT ROW: Eric J. Lewis, CPA; Monica W. Lingenfelter, Corporate Secretary; R. Andrew McMillan Jr.

## OUR TEAM



**Dennis L. Barron**

Executive Vice President and  
Chief Operations Officer



**Karl J. "Jeff" Keller**

Executive Vice President  
of Lending



**Jenna L. Kesecker, CPA**

Senior Vice President and  
Chief Financial Officer

# THANK YOU FOR YOUR YEARS OF SERVICE

**MR. JAMES M. DAVIS** has served as a member of the Board of Directors of the Bank since April 2003 and has served as the Chair of the Board of Directors since April 2015. Mr. Davis served his community through his local involvement, including his support and service of the Shepherd University Foundation, Jefferson County Building Commission, Jefferson County Chamber of Commerce and the Jefferson County Development Authority. He proudly served his country from 1959 to 1964 with the U.S. Navy. In the last 14 years, Mr. Davis has brought a strong sense of executive management, business experience and leadership to the Board of Directors. We would like to thank Mr. Davis for his years of service and dedication to Jefferson Security Bank and we wish him the best!

## OUR COMMUNITY



### ANNUAL DUCK BUCK RACE

JSB employees, community members and Shepherdstown Elementary students come together to participate in the Duck Buck Race in the Town Run.



### HELPING WV FLOOD VICTIMS

Shepherdstown office manager Sharon Foster traveled to southern WV to help in clean-up efforts after severe flooding in the summer of 2016.



### HARPERS FERRY QUARTER LAUNCH

In June of 2016, JSB was invited to be the partner bank with the US Mint to unveil the new West Virginia quarter featuring Harpers Ferry, WV.

JSB is rooted in the history, families and businesses that are the heart of the communities we embrace. Our team is a blend of natives and newcomers that realize the significance that personal relationships bring to banking. We are proud of our employees for dedicating their time to be a part of helping our communities become stronger, and we will continue to give our support to our local organizations through sponsorships, donations and community involvement.



## Independent Auditor's Report

To the Shareholders and Board of Directors  
Jefferson Security Bank  
Shepherdstown, West Virginia

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Jefferson Security Bank and its subsidiary, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, the related consolidated statements of income, comprehensive income, changes in shareholders' equity and cash flows for the years ended December 31, 2016, 2015 and 2014 and the related notes to the consolidated financial statements, (collectively, 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 Jefferson Security Bank and its subsidiary as of December 31, 2016 and 2015, and the results of its operations and its cash flows for the years ended December 31, 2016, 2015 and 2014 in accordance with accounting principles generally accepted in the United States of America.

*Yount, Hyde & Barbour, P.C.*

Winchester, Virginia  
March 10, 2017

JEFFERSON SECURITY BANK AND SUBSIDIARY  
CONSOLIDATED BALANCE SHEETS  
December 31, 2016 and 2015

	2016	2015
<b>ASSETS</b>		
Cash and due from financial institutions	\$ 4,698,428	\$ 3,390,577
Interest bearing deposits with depository institutions	51,194	50,531
Cash and cash equivalents	4,749,622	3,441,108
Securities available for sale, at fair value	107,471,700	102,153,127
Securities held to maturity (fair value of \$4,692,110 - 2016; \$27,850,066 - 2015)	4,620,762	26,956,997
Restricted securities, at cost	706,900	501,900
Loans, net of allowance for loan losses of \$1,782,484 - 2016; \$1,710,142 - 2015	154,225,062	137,159,780
Accrued interest receivable	932,242	958,089
Premises and equipment, net	6,373,239	6,548,780
Bank owned life insurance	5,890,202	5,727,308
Other real estate owned, net of valuation allowances of \$41,644 - 2016; \$354,194 - 2015	75,900	844,967
Other assets	2,986,138	3,234,739
Total assets	\$ 288,031,767	\$ 287,526,795
 <b>LIABILITIES AND SHAREHOLDERS' EQUITY</b>		
Liabilities		
Deposits		
Interest bearing	\$ 191,029,907	\$ 200,425,605
Noninterest bearing	64,483,834	60,350,985
Total deposits	255,513,741	260,776,590
Securities sold under an agreement to repurchase	804,962	1,141,425
Accrued interest payable	42,997	53,324
Federal funds purchased	-	102,000
Federal Home Loan Bank advances	8,712,700	3,297,000
Other accrued expenses and other liabilities	1,406,913	1,386,588
Total liabilities	266,481,313	266,756,927
Shareholders' Equity		
Common stock, \$10 par value; 300,000 shares authorized; issued and outstanding, 282,246 shares at December 31, 2016 and 284,246 shares at December 31, 2015	2,822,460	2,842,460
Additional paid-in capital	2,822,460	2,842,460
Retained earnings	18,832,571	17,856,760
Accumulated other comprehensive (loss), net	(2,927,037)	(2,771,812)
Total shareholders' equity	21,550,454	20,769,868
Total liabilities and shareholders' equity	\$ 288,031,767	\$ 287,526,795

See accompanying notes to consolidated financial statements

JEFFERSON SECURITY BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF INCOME  
For the Years Ended December 31, 2016, 2015 and 2014

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Interest and dividend income			
Loans, including fees	\$ 6,396,543	\$ 5,793,641	\$ 5,525,828
Securities:			
Taxable	1,696,885	1,875,280	1,921,849
Nontaxable	870,554	735,054	709,973
Dividends and other interest	32,621	57,650	63,397
Total interest and dividend income	<u>8,996,603</u>	<u>8,461,625</u>	<u>8,221,047</u>
Interest expense			
Deposits	952,534	877,426	944,022
Borrowings	22,066	4,775	1,519
Total interest expense	<u>974,600</u>	<u>882,201</u>	<u>945,541</u>
<b>Net interest income</b>	8,022,003	7,579,424	7,275,506
Provision for loan losses	<u>40,000</u>	<u>15,000</u>	<u>420,000</u>
<b>Net interest income after provision for loan losses</b>	<u>7,982,003</u>	<u>7,564,424</u>	<u>6,855,506</u>
Noninterest income			
Service charges on deposit accounts	577,760	579,709	579,321
Other service charges, commissions and fees	882,432	878,624	864,677
Realized gain on securities	89,161	222,895	20,625
Income from bank owned life insurance	162,895	163,530	164,213
Other	111,239	103,150	99,691
Total noninterest income	<u>1,823,487</u>	<u>1,947,908</u>	<u>1,728,527</u>
Noninterest expense			
Salaries and employee benefits	4,120,140	4,432,184	4,184,158
Occupancy	1,207,722	1,140,847	1,056,419
Advertising and marketing	172,674	159,908	127,642
ATM and debit card fees	376,815	334,225	354,744
Data processing	707,945	673,733	660,492
Postage and stationery supplies	193,746	195,233	193,245
Professional services	290,522	307,579	295,947
FDIC and state assessments	213,190	266,701	273,701
Other real estate owned (benefit) expense, net	189,857	(40,810)	148,700
Director fees	92,000	88,000	96,000
Realized loss (gain) on fixed assets	43,290	--	(8,500)
Other	623,522	658,460	563,888
Total noninterest expense	<u>8,231,423</u>	<u>8,216,060</u>	<u>7,946,436</u>
<b>Income before income tax expense (benefit)</b>	1,574,067	1,296,272	637,597
Income tax expense (benefit)	<u>229,010</u>	<u>189,948</u>	<u>(75,640)</u>
<b>Net income</b>	<u>\$ 1,345,057</u>	<u>\$ 1,106,324</u>	<u>\$ 713,237</u>
<b>Basic and diluted earnings per common share</b>	<u>\$ 4.75</u>	<u>\$ 3.87</u>	<u>\$ 2.47</u>

See accompanying notes to consolidated financial statements

JEFFERSON SECURITY BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME  
For the Years Ended December 31, 2016, 2015 and 2014

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Net income	\$ 1,345,057	\$ 1,106,324	\$ 713,237
Other comprehensive income (loss), net of tax:			
Unrealized holding (losses) gains on securities available for sale arising during period	(974,102)	(191,691)	3,693,821
Reclassification adjustment for gains included in net income	(55,280)	(138,195)	(12,788)
Unrealized holding losses on securities prior to transfer to held to maturity	--	--	(1,291,816)
Amortization of unrealized holding losses on securities transferred to held to maturity	44,274	65,911	37,363
Reversal of unrealized holding losses on securities transferred to held to maturity	1,144,268	--	--
Change in pension benefits	(292,584)	45,284	(1,068,675)
Reclassification adjustment for change in pension benefits included in net income	49,100	66,951	37,429
Change in supplemental executive retirement benefits	(94,716)	162,893	(371,257)
Reclassification adjustment for change in supplemental executive retirement benefits included in net income	23,815	28,203	27,580
Total other comprehensive income (loss)	<u>(155,225)</u>	<u>39,356</u>	<u>1,051,657</u>
Comprehensive income	<u>\$ 1,189,832</u>	<u>\$ 1,145,680</u>	<u>\$ 1,764,894</u>

See accompanying notes to consolidated financial statements

JEFFERSON SECURITY BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY  
For the Years Ended December 31, 2016, 2015 and 2014

	<u>Common Stock</u>	<u>Additional Paid-In Capital</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive (Loss)</u>	<u>Total Shareholders' Equity</u>
<b>Balance at December 31, 2013</b>	\$ 2,884,000	\$ 2,884,000	\$ 16,745,326	\$ (3,862,825)	\$ 18,650,501
Net income	--	--	713,237	--	713,237
Other comprehensive income	--	--	--	1,051,657	1,051,657
Repurchase of common stock	(1,800)	(1,800)	(8,460)	--	(12,060)
Cash dividends - \$0.90 per share	--	--	(259,452)	--	(259,452)
<b>Balance at December 31, 2014</b>	\$ 2,882,200	\$ 2,882,200	\$ 17,190,651	\$ (2,811,168)	\$ 20,143,883
Net income	--	--	1,106,324	--	1,106,324
Other comprehensive income	--	--	--	39,356	39,356
Repurchase of common stock	(39,740)	(39,740)	(182,804)	--	(262,284)
Cash dividends - \$0.90 per share	--	--	(257,411)	--	(257,411)
<b>Balance at December 31, 2015</b>	\$ 2,842,460	\$ 2,842,460	\$ 17,856,760	\$ (2,771,812)	\$ 20,769,868
Net income	--	--	1,345,057	--	1,345,057
Other comprehensive loss	--	--	--	(155,225)	(155,225)
Repurchase of common stock	(20,000)	(20,000)	(86,000)	--	(126,000)
Cash dividends - \$1.00 per share	--	--	(283,246)	--	(283,246)
<b>Balance at December 31, 2016</b>	<u>\$ 2,822,460</u>	<u>\$ 2,822,460</u>	<u>\$ 18,832,571</u>	<u>\$ (2,927,037)</u>	<u>\$ 21,550,454</u>

See accompanying notes to consolidated financial statements

JEFFERSON SECURITY BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Years Ended December 31, 2016, 2015 and 2014

	<u>2016</u>	<u>2015</u>	<u>2014</u>
<b>Cash flows from operating activities</b>			
Net income	\$ 1,345,057	\$ 1,106,324	\$ 713,237
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation	537,079	493,312	445,759
Provision for loan losses	40,000	15,000	420,000
Provision for other real estate owned	175,569	8,804	122,500
Deferred income tax (benefit) expense	(11,860)	146,955	(157,042)
Net amortization of securities	736,489	880,399	950,274
Net gain on sale of securities	(51,157)	(221,753)	(475)
Net gain on call of securities	(38,004)	(1,142)	(20,150)
Net gain on sale of other real estate owned	(10,212)	(174,672)	(3,347)
Deferred gains recognized on other real estate owned	(4,121)	(8,296)	--
Net loss (gain) on fixed assets	43,290	--	(8,500)
Income from bank owned life insurance	(162,895)	(163,530)	(164,213)
Net change in:			
Accrued interest receivable	25,847	(50,613)	184,351
Accrued interest payable	(10,327)	(3,155)	(9,196)
Other assets	162,912	(384,996)	532,242
Other accrued expenses and other liabilities	(294,059)	(277,789)	(636,708)
Net cash provided by operating activities	<u>2,483,608</u>	<u>1,364,848</u>	<u>2,368,732</u>
<b>Cash flows from investing activities</b>			
Net increase in loans	(17,294,282)	(6,554,377)	(6,453,089)
Net decrease (increase) in interest bearing time deposits	--	5,245,815	(3,509,207)
Purchase of securities available for sale	(27,270,590)	(46,390,101)	(14,724,984)
Purchase of securities held to maturity	--	(1,087,906)	--
Proceeds from sale of securities available for sale	3,963,580	26,655,953	775,475
Proceeds from calls, maturities and principal paydowns of securities available for sale	15,641,594	15,102,933	18,414,321
Proceeds from calls, maturities and principal paydowns of securities held to maturity	24,292,459	498,408	493,985
Proceeds from the sale of other real estate owned	796,831	565,969	153,597
Net (increase) decrease in Federal Home Loan Bank stock	(205,000)	(252,100)	440,700
Premises and equipment expenditures, net	(404,828)	(244,841)	(350,334)
Net cash used in investing activities	<u>(480,236)</u>	<u>(6,460,247)</u>	<u>(4,759,536)</u>
<b>Cash flows from financing activities</b>			
Net increase in demand deposits, NOW accounts and savings accounts	18,708,249	1,757,761	2,925,300
Net decrease in time deposits	(23,971,098)	(2,686,904)	(2,805,641)
Net (decrease) increase in securities sold under an agreement to repurchase	(336,463)	(708,279)	1,485,487
Net (decrease) increase in federal funds purchased	(102,000)	102,000	--
Net increase in Federal Home Loan Bank advances	5,415,700	3,297,000	--
Repurchase of common stock	(126,000)	(262,284)	(12,060)
Dividends paid	(283,246)	(257,411)	(259,452)
Net cash (used in) provided by financing activities	<u>(694,858)</u>	<u>1,241,883</u>	<u>1,333,634</u>
Net change in cash and cash equivalents	1,308,514	(3,853,516)	(1,057,170)
Cash and cash equivalents at beginning of year	<u>3,441,108</u>	<u>7,294,624</u>	<u>8,351,794</u>
<b>Cash and cash equivalents at end of year</b>	<u>\$ 4,749,622</u>	<u>\$ 3,441,108</u>	<u>\$ 7,294,624</u>

See accompanying notes to consolidated financial statements

JEFFERSON SECURITY BANK AND SUBSIDIARY  
CONSOLIDATED STATEMENTS OF CASH FLOWS  
For the Years Ended December 31, 2016, 2015 and 2014  
(Continued)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Supplemental disclosures:			
Interest paid	\$ 984,927	\$ 885,356	\$ 954,737
Income taxes paid	93,075	30,678	237,526
Transfers from loans to other real estate owned	189,000	701,900	541,000
Transfers from other real estate owned to loans	--	798,900	22,000
Change in unrealized holding (losses) gains on available for sale securities	(1,660,294)	(532,073)	5,937,150
Securities transferred from available for sale to held to maturity	--	--	23,655,717
Unrealized holding losses as of transfer date on securities transferred from available for sale to held to maturity	--	--	(2,083,574)
Amortization of unrealized holding losses on securities transferred from available for sale to held to maturity	71,409	106,308	60,263
Reversal of unrealized holding losses on securities transferred from available for sale to held to maturity	1,845,594	--	--
Change in pension benefits	392,716	181,024	(1,663,300)
Change in supplemental executive retirement benefits	114,355	308,219	(554,317)

See accompanying notes to consolidated financial statements

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies of Jefferson Security Bank and Subsidiary conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. The following describes the significant accounting and reporting policies which are employed in the preparation of the consolidated financial statements.

Basis of Presentation: The consolidated financial statements include the accounts of Jefferson Security Bank and its wholly-owned limited liability company, JSB Financial, LLC. JSB Financial, LLC is an inactive subsidiary previously used for offering financial services therefore, no elimination entries were needed for consolidation.

Nature of Operations, Business Segments: Jefferson Security Bank is headquartered in Shepherdstown, West Virginia. The principal markets for the Bank's financial services are the eastern panhandle region of West Virginia in Jefferson and Berkeley Counties and in adjacent Washington County, Maryland including the areas immediately surrounding these communities.

The Bank provides a full range of banking services to individuals, agricultural businesses and commercial businesses through its main office and five full-service offices located throughout its market area. It maintains a diversified loan portfolio, including loans to individuals for home mortgages, automobiles and personal expenditures, and loans to business enterprises for current operations and expansion.

The Bank offers a variety of deposit products, including checking, savings, money market, individual retirement accounts and certificates of deposit. While the Bank's management monitors the revenue stream of various products and services, operations are managed and financial performance is evaluated on a Bank wide basis. Accordingly, all of the Bank's operations are considered by management to be aggregated into one operating segment.

Use of Estimates: To prepare financial statements in conformity with accounting principles generally accepted in the United States of America, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the consolidated financial statements and the disclosures provided, and future results could differ. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of other real estate owned, valuation of deferred tax assets, other than temporary impairment of securities and the determination of the pension and supplemental executive retirement plan benefits and obligations.

Cash and Cash Equivalents: For purposes of the consolidated balance sheets and the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, cash items, amounts due from financial institutions with original maturities less than 90 days and federal funds sold. Amounts due from financial institutions may, at times, exceed federally insured limits.

Interest Bearing Deposits with Depository Institutions: Interest bearing deposits mature within 90 days and are carried at cost.

Interest Bearing Time Deposits: Interest bearing time deposits mature within two years and are carried at cost.

Securities: Certain debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity," which are accounted for at cost and adjusted for amortization of premiums and accretion of discounts. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held to maturity or trading, including debt and equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. Other restricted securities are carried at cost. All investments are classified as either held to maturity or available for sale, except for stock in Federal Home Loan Bank and Community Bankers Bank, which are restricted securities.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

The Bank follows relevant accounting guidance related to recognition and presentation of other than temporary impairment. This accounting guidance specifies that (a) if a company does not have the intent to sell the debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other than temporarily impaired unless there is a credit loss. When the Bank does not intend to sell the security, and it is more likely than not the Bank will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other than temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

For equity securities, when the Bank has decided to sell an impaired available for sale security and the Bank does not expect the fair value of the security to fully recover before the expected time of sale, the security is deemed other than temporarily impaired in the period in which the decision to sell is made. The Bank recognizes an impairment loss when the impairment is deemed other than temporary even if a decision to sell has not been made.

Federal Home Loan Bank Stock: The Bank, as a member of the Federal Home Loan Bank (FHLB) of Pittsburgh, is required to maintain an investment in capital stock of the FHLB. Based on redemption provisions of the FHLB, the stock has no quoted market value and is carried at cost. The redemption of FHLB stock is subject to certain limitations and conditions. At its discretion, the FHLB may declare dividends on the stock. Management reviews for impairment based on the ultimate recoverability of the cost basis in the FHLB stock.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until payoff or maturity are reported at the principal balance outstanding less the allowance for loan losses and any deferred fees or costs. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using either the interest method or straight-line method.

Interest income is reported on the interest method and includes amortization of net deferred loan fees and costs over the estimated loan term. Interest income is not recorded when full loan repayment is in doubt, typically when the loan is impaired or payments are past due over 90 days, unless the loan is both well secured and in the process of collection. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

When a loan is not fully collateralized and is in the process of collection, the Bank may charge off the account balance or some portion thereof as a loss. Generally, a delinquency over 120 days past due will be charged off unless the loan is well secured and an acceptable collection plan is in place with the exception of personal residential property which may be charged off at 150 days.

All charge offs are approved by the Loan Committee and reported to the Board of Directors.

Risk characteristics associated with specific segments of the loan portfolio are detailed below:

Commercial loans not secured by real estate carry risks associated with the successful operation of a business, and the repayments of these loans depend on the profitability and cash flows of the business. Borrowers may be subject to changes in industry conditions including decreasing demand and increasing material and production costs that cannot be immediately recaptured. Interest rate increases could have an adverse impact on the profitability of the business. Additional risk relates to the value of collateral where depreciation occurs and the valuation is less precise.

Commercial loans secured by real estate carry risks associated with the profitability of the business and the ability to generate positive cash flows sufficient to service debts. Real estate security diminishes risks only to the extent that a market exists for the collateral. Real estate secured construction loans carry risks that a project will not be completed as scheduled and budgeted and that the value of the collateral may, at any point, be less than the principal amount of the loan. Additional risks may occur if the general contractor, who may not be a loan customer, is unable to finish the project as planned due to financial pressures unrelated to the project.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Residential real estate loans carry risks associated with the continued credit worthiness of the borrower and changes in the value of collateral. These loans are subject to adverse employment conditions in the local economy leading to an increase in default rates. Residential real estate loans are mainly comprised of adjustable rate mortgages. In the event of incremental rate increases, the borrowers' ability to maintain payments may be impacted.

Consumer loans carry risks associated with the continued credit worthiness of the borrower and the value of the underlying collateral. In addition, these loans may be unsecured. Consumer loans are more likely to be immediately affected adversely by unemployment, divorce, illness or personal bankruptcy. Consumer loans are further segmented into credit cards and all other consumer loans.

Allowance for Loan Losses: The allowance for loan losses is an estimate of probable losses inherent in the loan portfolio. The allowance for loan losses is increased by the provision for loan losses and decreased by charged off loans less recoveries. Management's evaluation of the adequacy of the allowance for loan losses is based on a quarterly evaluation of the loan portfolio. Management estimates the allowance balance required using historical experience, the nature and volume of the portfolio, information about specific borrower situations, estimated collateral values, economic conditions and other factors. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that in management's judgment, should be charged off. Loan losses are charged against the allowance when management believes the loan to be uncollectible. Subsequent recoveries, if any, are credited to the allowance for loan losses.

The allowance consists of specific and general components. The specific component relates to loans that are classified as nonaccrual, troubled debt restructurings, doubtful or substandard. 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 and 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 history, and the amount of the shortfall in relation to the principal and interest owed. The recorded investment in impaired loans is defined as the unpaid principal balance less any partial charge offs and/or net of any interest payments made by the borrower during the nonaccrual period.

Impairment is evaluated in total for smaller-balance loans of similar nature such as consumer loans and on an individual loan basis for other loans. For impaired loans, specific allocations are based on the present value of expected future cash flows from the loan discounted at the loan's effective rate or the fair value of collateral less estimated costs to sell if the loan is collateral dependent.

The general component covers non-classified loans and is based on historical loss experience adjusted for nine qualitative factors. The historical loss experience is calculated based on losses in the portfolio over the previous five years. For the qualitative factors, the first factor is comprised of delinquent loans, accruing watchlist, nonaccrual loans and net charge offs. The factor is applied to each loan segment. The second factor involves economic and industry conditions. Economic and industry conditions are assessed as well as their impact on collateral value to arrive at assigned factor values, which are then applied to the loan segment balances. The other seven factors are based on economic conditions, lending policy and procedures, the experience of the loan department, quality of loan review, the composition of the loan portfolio, concentrations of credit and external factors such as competition, legal issues and regulatory requirements. These factors are subjective and the Bank's management provides input on these factors to determine the factor value to be equally applied to each loan segment.

Troubled Debt Restructurings: In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted previously for impaired loans. TDRs are individually evaluated for impairment.

Other Real Estate Owned: Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value, less estimated selling costs, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in noninterest expense.

Concentrations of Credit Risk: Most of the Bank's activities are with customers located within Berkeley and Jefferson counties of West Virginia and in areas of Washington County, Maryland. Note 4, Notes to Consolidated Financial Statements, details the types of lending in which the Bank engages. The Bank does not have any significant concentrations in any one industry or customer.

Premises and Equipment: Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation. Depreciation is computed using the straight-line method with useful lives ranging from 5 to 40 years for buildings and improvements, and 3 to 35 years for furniture and equipment. Maintenance, repairs and minor alterations are charged to current operations as expenditures are incurred. Major improvements are capitalized.

Employee Benefits: As of December 31, 2013, the Bank froze the defined benefit pension plan. A benefit plan with 401(k) features is available to employees age 21 and over who have worked at least one year with 1,000 hours of service. The plan allows employee contributions, with matching contributions, to be allocated based on a percentage of the employee salary deferral. The Bank contributed a percentage of each eligible employees' salary to their 401(k) plan account during 2016 and intends to continue this practice. The Bank provides a supplemental executive retirement plan to members of senior management who had not obtained their maximum benefit under the defined benefit pension plan.

Income Taxes: When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainty about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority. The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheets along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest and penalties associated with unrecognized tax benefits, if any, are classified as additional income taxes in the consolidated statements of income. As of December 31, 2016 and 2015, there was no liability for unrecognized tax benefits.

Deferred income tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws.

Comprehensive Income: Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized holding gains and losses on securities available for sale, unrealized holding losses on securities transferred from available for sale to held to maturity and pension and postretirement benefits.

Fair Values of Financial Instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Bank Owned Life Insurance: The Bank has purchased life insurance policies on certain key employees. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value.

Stock Repurchase Plan: In June 2015, the Federal Deposit Insurance Corporation (FDIC) approved the open market repurchase of up to 16,000 shares of the issued and outstanding shares of Jefferson Security Bank's common stock. In 2016, under this approval, the Bank repurchased 2,000 shares of common stock as part of a publicly announced plan. In May 2016, the FDIC approved the purchases of up to 15,000 shares under similar terms. The approval will expire in 12 months unless a request for an extension is approved. The timing and quantity of purchases under this stock repurchase program will be at the discretion of the Board of Directors, and the program may be discontinued, or suspended and reinitiated, at any time. Under this approval, there were no additional purchases of the Bank's common stock, either as part of a publicly announced plan or otherwise.

Dividend Restriction: Bank regulatory agencies restrict, without prior approval, the total dividend payments of a bank in any calendar year to the bank's retained net income of that year to date, as defined, combined with its retained net income of the preceding two years, less any required transfers to surplus. At December 31, 2016, retained net income, which was free of such restriction, amounted to approximately \$2,364,509.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation. Such reclassifications had no material effect on the financial position and results of operations.

Financial Instruments with Off-Balance Sheet Risk: Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and standby letters of credit issued to meet customer needs. The face amount for these items represents the exposure to loss before considering customer collateral or repayment ability. Such financial instruments are recorded when they are funded.

Advertising Costs: The Bank follows the policy of charging the costs of advertising to expense as incurred. Total advertising expense incurred for 2016, 2015 and 2014 was \$36,187, \$32,475 and \$35,247, respectively.

Transfers of Financial Assets: Transfers of financial assets 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 – put presumptively beyond reach of the transferor and its creditors, even in bankruptcy or other receivership, (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 or the ability to unilaterally cause the holder to return specific assets.

### Recent Accounting Pronouncements

#### Adoption of New Accounting Standards

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Bank does not expect the adoption of ASU 2014-15 to have a material impact on its consolidated financial statements.

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

In January 2016, the FASB issued ASU 2016-01, “Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities.” The amendments in ASU 2016-01, among other things: 1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. 2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. 3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). 4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Bank is currently assessing the impact that ASU 2016-01 will have on its consolidated financial statements.

In February 2016, the FASB issued ASU No. 2016-02, “Leases (Topic 842).” Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee’s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The Bank is currently assessing the impact that ASU 2016-02 will have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-07, “Investments – Equity Method and Joint Ventures (Topic 323): Simplifying the Transition to the Equity Method of Accounting.” The amendments in this ASU eliminate the requirement that when an investment qualifies for use of the equity method as a result of an increase in the level of ownership interest or degree of influence, an investor must adjust the investment, results of operations, and retained earnings retroactively on a step-by-step basis as if the equity method had been in effect during all previous periods that the investment had been held. The amendments require that the equity method investor add the cost of acquiring the additional interest in the investee to the current basis of the investor’s previously held interest and adopt the equity method of accounting as of the date the investment becomes qualified for equity method accounting. Therefore, upon qualifying for the equity method of accounting, no retroactive adjustment of the investment is required. In addition, the amendments in this ASU require that an entity that has an available-for-sale equity security that becomes qualified for the equity method of accounting recognize through earnings the unrealized holding gain or loss in accumulated other comprehensive income at the date the investment becomes qualified for use of the equity method. The amendments are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2016. The amendments should be applied prospectively upon their effective date to increases in the level of ownership interest or degree of influence that result in the adoption of the equity method. Early Adoption is permitted. The Bank does not expect the adoption of ASU 2016-07 to have a material impact on its consolidated financial statements.

During June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. The amendments in this ASU are effective for SEC filers for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. For public companies that are not SEC filers, the

## NOTE 1 – SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Bank is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements.

During August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments”, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable.

Early adoption is permitted, including adoption in an interim period. The Bank does not expect the adoption of ASU 2016-15 to have a material impact on its consolidated financial statements.

## NOTE 2 – EARNINGS PER SHARE

Basic and diluted earnings per common share are calculated by dividing net income by the weighted average number of common shares outstanding during the period. Diluted earnings per share include the dilutive effects of additional potential common shares, if present. No such items exist as of December 31, 2016, 2015 and 2014. Therefore, diluted earnings per share equals basic earnings per share for all three years. Basic and diluted earnings per share are calculated based on weighted average common shares outstanding of 282,900 for December 31, 2016, 286,121 for December 31, 2015 and 288,290 for December 31, 2014. Basic and diluted earnings per common share was \$4.75, \$3.87 and \$2.47 for the years ended December 31, 2016, 2015 and 2014, respectively.

## NOTE 3 – SECURITIES

The primary purposes of the securities portfolio are to generate income, supply collateral for public funds on deposit and meet liquidity needs of the Bank through readily saleable financial instruments. The portfolio is made up of fixed rate bonds, whose prices move inversely with interest rates, as well as variable rate bonds, whose prices correspond directly with interest rates. At the end of any accounting period, the securities portfolio may have both unrealized gains and losses. The Bank monitors the portfolio which is subject to liquidity needs, market rate changes and credit risk changes to determine if adjustments are needed.

The recorded investment and fair value of securities, with unrealized gains and losses, for the available for sale portfolio is shown in the following table.

Available for Sale	<u>Recorded Investment</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
<b>December 31, 2016</b>				
U.S. Government and agency	\$ 70,435,849	\$ 414,878	\$ (929,187)	\$ 69,921,540
State and municipal	<u>37,903,733</u>	<u>215,381</u>	<u>(568,954)</u>	<u>37,550,160</u>
	<u>\$ 108,339,582</u>	<u>\$ 630,259</u>	<u>\$ (1,498,141)</u>	<u>\$ 107,471,700</u>
<b>December 31, 2015</b>				
U.S. Government and agency	\$ 66,472,623	\$ 481,445	\$ (309,285)	\$ 66,644,783
State and municipal	<u>34,888,092</u>	<u>638,501</u>	<u>(18,249)</u>	<u>35,508,344</u>
	<u>\$ 101,360,715</u>	<u>\$ 1,119,946</u>	<u>\$ (327,534)</u>	<u>\$ 102,153,127</u>

### NOTE 3 – SECURITIES (Continued)

During the second quarter of 2014, the Bank transferred U.S Government and agency securities with a fair value of \$21,572,143 and unrealized losses of \$2,083,574 from available for sale to held to maturity. The unrealized losses at the time of transfer were recorded in accumulated other comprehensive income and in the carrying value of the held to maturity securities and amortized over the remaining life of the securities as a yield adjustment. During 2016, all of the U.S. Government and agency securities transferred to held to maturity were called.

The amortized cost, unrealized holding losses, recorded investment and fair value of securities, with unrealized gains and losses, net of the unrealized holding losses, for the held to maturity portfolio is shown in the following table.

Held to Maturity	Amortized Cost	Unrealized Holding Losses on Securities		Recorded Investment	Unrealized Gains	Unrealized Losses	Fair Value
		Transferred to Held to Maturity					
<b>December 31, 2016</b>							
U.S. Government and agency	\$ 2,061,217	\$ --	\$ 2,061,217	\$ 23,962	\$ (1,073)	\$ 2,084,106	
State and municipal	2,559,545	--	2,559,545	59,591	(11,132)	2,608,004	
	<u>\$ 4,620,762</u>	<u>\$ --</u>	<u>\$ 4,620,762</u>	<u>\$ 83,553</u>	<u>\$ (12,205)</u>	<u>\$ 4,692,110</u>	
<b>December 31, 2015</b>							
U.S. Government and agency	\$ 26,300,794	\$ (1,917,003)	\$ 24,383,791	\$ 774,724	\$ --	\$ 25,158,515	
State and municipal	2,573,206	--	2,573,206	118,345	--	2,691,551	
	<u>\$ 28,874,000</u>	<u>\$ (1,917,003)</u>	<u>\$ 26,956,997</u>	<u>\$ 893,069</u>	<u>\$ --</u>	<u>\$ 27,850,066</u>	

The unrealized gains and losses of the securities transferred to held to maturity, excluding the unrealized holding losses related to the transfer, totaled \$730,359 and \$0 at December 31, 2015.

At December 31, 2016 and 2015, securities were pledged to secure public deposits and for other purposes required or permitted by law. These securities had a fair value of \$69,295,768 and \$80,444,564, and the recorded investment of \$69,246,878 and \$79,053,458, at December 31, 2016 and 2015, respectively. The fair value of securities pledged to secure securities sold under an agreement to repurchase was \$1,981,180 and \$2,027,400, and the recorded investment of these securities was \$1,960,634 and \$2,015,730 at December 31, 2016 and 2015, respectively.

The recorded investment and fair value of debt securities by contractual maturity at December 31, 2016 follows:

	Available for Sale		Held to Maturity	
	Recorded Investment	Fair Value	Recorded Investment	Fair Value
Due in less than one year	\$ 110,452	\$ 110,414	\$ --	\$ --
Due from one to five years	4,612,906	4,644,843	--	--
Due from five to ten years	36,598,138	36,351,558	--	--
Due after ten years	67,018,086	66,364,885	4,620,762	4,692,110
	<u>\$ 108,339,582</u>	<u>\$ 107,471,700</u>	<u>\$ 4,620,762</u>	<u>\$ 4,692,110</u>

**NOTE 3 – SECURITIES (Continued)**

For the years ended December 31, 2016, 2015 and 2014, proceeds from sales and calls of securities available for sale were \$6,393,580, \$27,155,953 and \$4,215,475, respectively. Gross realized gains on sales and calls on available for sale securities amounted to \$58,757, \$343,644 and \$39,525, while gross realized losses amounted to \$7,600, \$120,749 and \$18,900 for the years ended December 31, 2016, 2015 and 2014, respectively. The tax provision applicable to these net realized gains were \$19,440, \$84,700 and \$7,837 in 2016, 2015 and 2014, respectively.

For the years ended December 31 2016, 2015 and 2014, there were no proceeds from the sales of securities held to maturity. For the year ended December 31, 2016, proceeds from the calls of securities held to maturity were \$23,700,000. Gross realized gains on the calls of held to maturity securities amounted to \$38,004 with no gross realized losses for the year ended December 31, 2016. The tax provision applicable to the net realized gains amounted to \$14,441 in 2016. During 2015 and 2014, there were no proceeds for the calls of securities held to maturity and no gross gains or gross losses realized.

An impairment is considered “other than temporary” if any of the following conditions are met: the Bank intends to sell the security, it is more likely than not that the Bank will be required to sell the security before the recovery of its cost basis, or the Bank does not expect to recover the security’s entire cost basis, even if the Bank does not intend to sell. The Bank does not have any securities that are considered “other than temporarily impaired” at December 31, 2016 and 2015. The following tables detail securities with unrealized losses, including those with unrealized holding losses at December 31, 2016 and 2015. Based on market prices at the respective dates, the Bank had one hundred securities at December 31, 2016 and forty-seven securities at December 31, 2015 with unrealized losses, including unrealized holding losses. These unrealized losses were caused by interest rate fluctuations and not due to credit deterioration of the issuers.

	<b>Duration of Unrealized Losses at December 31, 2016</b>					
	<b>Less than 12 months</b>		<b>12 months or longer</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
U.S. Government and agency	\$ 49,811,740	\$ (929,985)	\$ 106,372	\$ (275)	\$ 49,918,112	\$ (930,260)
State and municipal	21,096,538	(580,086)	--	--	21,096,538	(580,086)
	<u>\$ 70,908,278</u>	<u>\$ (1,510,071)</u>	<u>\$ 106,372</u>	<u>\$ (275)</u>	<u>\$ 71,014,650</u>	<u>\$ (1,510,346)</u>

	<b>Duration of Unrealized Losses at December 31, 2015</b>					
	<b>Less than 12 months</b>		<b>12 months or longer</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
U.S. Government and agency	\$ 36,195,830	\$ (309,285)	\$ 22,473,887	\$ (1,186,644)	\$ 58,669,717	\$ (1,495,929)
State and municipal	2,992,636	(18,249)	--	--	2,992,636	(18,249)
	<u>\$ 39,188,466</u>	<u>\$ (327,534)</u>	<u>\$ 22,473,887</u>	<u>\$ (1,186,644)</u>	<u>\$ 61,662,353</u>	<u>\$ (1,514,178)</u>

#### NOTE 4 – LOANS

Loans are shown on the consolidated balance sheets net of the allowance for loan losses. Interest is computed by methods that result in level rates of return on principal. Loans are charged off when, in the opinion of management, they are deemed to be uncollectible after taking into consideration such factors as the current financial condition of the customer and the underlying collateral and guarantees.

A summary of the balances of loans follows:

	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Loans secured by real estate:		
Commercial real estate:		
Construction	\$ 11,020,577	\$ 9,770,802
Owner occupied	18,480,006	13,849,861
Non-owner occupied	20,473,097	20,602,768
Residential real estate:		
Construction	4,082,253	3,252,410
Home equity	13,742,873	15,813,138
Other	83,593,002	70,764,394
Total loans secured by real estate	151,391,808	134,053,373
Commercial	1,856,816	2,182,696
Consumer:		
Credit cards	246,078	208,664
Revolving credit plans	153,538	199,578
Other	2,629,755	2,415,070
	156,277,995	139,059,381
Net deferred loan fees and costs	(270,449)	(189,459)
Allowance for loan losses	(1,782,484)	(1,710,142)
Loans, net	<u>\$ 154,225,062</u>	<u>\$ 137,159,780</u>

#### NOTE 5 – ALLOWANCE FOR LOAN LOSSES

Management's evaluation of the adequacy of the allowance for loan losses is based on many factors including historical 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, and current economic conditions.

An analysis of the allowance for loan losses follows for the years ended December 31, 2016, 2015 and 2014:

	<b>2016</b>	<b>2015</b>	<b>2014</b>
Beginning balance	\$ 1,710,142	\$ 1,820,765	\$ 1,608,019
Loans charged off	(86,146)	(130,804)	(248,495)
Recoveries	118,488	5,181	41,241
Provision for loan losses	40,000	15,000	420,000
Ending balance	<u>\$ 1,782,484</u>	<u>\$ 1,710,142</u>	<u>\$ 1,820,765</u>

**NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)**

	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Commercial</b>	<b>Consumer</b>	<b>Total</b>
<b><u>December 31, 2016</u></b>					
<b>Allowance for loan losses:</b>					
Beginning balance	\$ 558,346	\$ 1,096,346	\$ 24,253	\$ 31,197	\$ 1,710,142
Loans charged off	(12,223)	(63,948)	--	(9,975)	(86,146)
Recoveries	87,814	29,145	--	1,529	118,488
Provision for loan losses	(67,812)	103,308	(5,819)	10,323	40,000
Ending balance	<u>\$ 566,125</u>	<u>\$ 1,164,851</u>	<u>\$ 18,434</u>	<u>\$ 33,074</u>	<u>\$ 1,782,484</u>
Ending balance: individually evaluated for impairment	<u>\$ 70,000</u>	<u>\$ 158,000</u>	<u>\$ --</u>	<u>\$ 3,000</u>	<u>\$ 231,000</u>
Ending balance: collectively evaluated for impairment	<u>\$ 496,125</u>	<u>\$ 1,006,851</u>	<u>\$ 18,434</u>	<u>\$ 30,074</u>	<u>\$ 1,551,484</u>
<b>Loans:</b>					
Ending balance	<u>\$ 49,973,680</u>	<u>\$ 101,418,128</u>	<u>\$ 1,856,816</u>	<u>\$ 3,029,371</u>	<u>\$ 156,277,995</u>
Ending balance: individually evaluated for impairment	<u>\$ 6,058,831</u>	<u>\$ 922,964</u>	<u>\$ --</u>	<u>\$ 21,735</u>	<u>\$ 7,003,530</u>
Ending balance: collectively evaluated for impairment	<u>\$ 43,914,849</u>	<u>\$ 100,495,164</u>	<u>\$ 1,856,816</u>	<u>\$ 3,007,636</u>	<u>\$ 149,274,465</u>
	<b>Commercial Real Estate</b>	<b>Residential Real Estate</b>	<b>Commercial</b>	<b>Consumer</b>	<b>Total</b>
<b><u>December 31, 2015</u></b>					
<b>Allowance for loan losses:</b>					
Beginning balance	\$ 584,785	\$ 1,172,565	\$ 33,853	\$ 29,562	\$ 1,820,765
Loans charged off	--	(119,765)	--	(11,039)	(130,804)
Recoveries	1,023	1,477	--	2,681	5,181
Provision for loan losses	(27,462)	42,069	(9,600)	9,993	15,000
Ending balance	<u>\$ 558,346</u>	<u>\$ 1,096,346</u>	<u>\$ 24,253</u>	<u>\$ 31,197</u>	<u>\$ 1,710,142</u>
Ending balance: individually evaluated for impairment	<u>\$ 148,000</u>	<u>\$ 262,821</u>	<u>\$ 4,000</u>	<u>\$ 5,000</u>	<u>\$ 419,821</u>
Ending balance: collectively evaluated for impairment	<u>\$ 410,346</u>	<u>\$ 833,525</u>	<u>\$ 20,253</u>	<u>\$ 26,197</u>	<u>\$ 1,290,321</u>
<b>Loans:</b>					
Ending balance	<u>\$ 44,223,431</u>	<u>\$ 89,829,942</u>	<u>\$ 2,182,696</u>	<u>\$ 2,823,312</u>	<u>\$ 139,059,381</u>
Ending balance: individually evaluated for impairment	<u>\$ 6,428,661</u>	<u>\$ 1,266,455</u>	<u>\$ 9,065</u>	<u>\$ 25,081</u>	<u>\$ 7,729,262</u>
Ending balance: collectively evaluated for impairment	<u>\$ 37,794,770</u>	<u>\$ 88,563,487</u>	<u>\$ 2,173,631</u>	<u>\$ 2,798,231</u>	<u>\$ 131,330,119</u>

**NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)**

For the impaired loans represented in the tables below, the recorded investment amounts represent the outstanding principal balance on each loan represented. The unpaid principal balance represents the outstanding principal balance plus any amount that has been charged off and/or any payments that have been applied towards principal on nonaccrual loans. Impaired loans at December 31, 2016 and 2015 were as follows:

<u>December 31, 2016</u>	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<b>With no related allowance recorded:</b>					
Commercial real estate:					
Construction	\$ 592,815	\$ 770,713	\$ --	\$ 206,716	\$ 6,792
Owner occupied	227,834	227,834	--	387,999	29,136
Non-owner occupied	4,248,618	4,256,118	--	4,304,825	53,655
Residential real estate:					
Construction	--	--	--	--	--
Home equity	--	--	--	--	--
Other	305,997	336,582	--	326,055	16,119
Commercial	--	--	--	--	--
Consumer:					
Credit cards	--	--	--	--	--
Revolving credit plans	--	--	--	--	--
Other	--	--	--	--	--
<b>With an allowance recorded:</b>					
Commercial real estate:					
Construction	989,564	989,564	70,000	989,564	--
Owner occupied	--	--	--	252,926	21,548
Non-owner occupied	--	--	--	--	--
Residential real estate:					
Construction	--	--	--	--	--
Home equity	--	--	--	--	--
Other	616,967	618,093	158,000	940,847	33,508
Commercial	--	--	--	--	--
Consumer:					
Credit cards	--	--	--	--	--
Revolving credit plans	--	--	--	--	--
Other	21,735	21,735	3,000	23,115	1,403
Total	<u>\$ 7,003,530</u>	<u>\$ 7,220,639</u>	<u>\$ 231,000</u>	<u>\$ 7,432,047</u>	<u>\$ 162,161</u>

**NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)**

<u>December 31, 2015</u>	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<b>With no related allowance recorded:</b>					
Commercial real estate:					
Construction	\$ 1,537,444	\$ 1,715,342	\$ --	\$ 1,801,815	\$ --
Owner occupied	--	--	--	--	--
Non-owner occupied	4,342,014	4,342,014	--	4,468,609	76,603
Residential real estate:					
Construction	--	--	--	--	--
Home equity	--	--	--	--	--
Other	109,540	131,808	--	429,966	30,300
Commercial	--	--	--	--	--
Consumer:					
Credit cards	--	--	--	--	--
Revolving credit plans	--	--	--	--	--
Other	--	--	--	--	--
<b>With an allowance recorded:</b>					
Commercial real estate:					
Construction	--	--	--	--	--
Owner occupied	347,980	347,980	136,000	349,632	14,973
Non-owner occupied	201,223	201,223	12,000	216,756	--
Residential real estate:					
Construction	--	--	--	--	--
Home equity	--	--	--	--	--
Other	1,156,915	1,196,907	262,821	1,329,832	51,334
Commercial	9,065	9,065	4,000	13,662	973
Consumer:					
Credit cards	--	--	--	--	--
Revolving credit plans	--	--	--	--	--
Other	25,081	25,081	5,000	26,449	1,621
Total	<u>\$ 7,729,262</u>	<u>\$ 7,969,420</u>	<u>\$ 419,821</u>	<u>\$ 8,636,721</u>	<u>\$ 175,804</u>

**NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)**

The following tables present the aging of past due loans including nonaccrual loans as of December 31, 2016 and 2015 by class of loans:

<u>December 31, 2016</u>	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days and Greater</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Recorded Investment &gt; 90 Days and Accruing</u>
Commercial real estate:							
Construction	\$ 18,186	\$ --	\$ 1,003,725	\$ 1,021,911	\$ 9,998,666	\$ 11,020,577	\$ --
Owner occupied	--	--	--	--	18,480,006	18,480,006	--
Non-owner occupied	--	--	2,590,423	2,590,423	17,882,674	20,473,097	--
Residential real estate:							
Construction	--	--	--	--	4,082,253	4,082,253	--
Home equity	--	--	--	--	13,742,873	13,742,873	--
Other	180,884	11,347	27,062	219,293	83,373,709	83,593,002	--
Commercial	--	--	--	--	1,856,816	1,856,816	--
Consumer:							
Credit cards	--	--	--	--	246,078	246,078	--
Revolving credit plans	--	--	3,530	3,530	150,008	153,538	--
Other	--	--	--	--	2,629,755	2,629,755	--
<b>Total</b>	<b>\$ 199,070</b>	<b>\$ 11,347</b>	<b>\$ 3,624,740</b>	<b>\$ 3,835,157</b>	<b>\$ 152,442,838</b>	<b>\$ 156,277,995</b>	<b>\$ --</b>

<u>December 31, 2015</u>	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>90 Days and Greater</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans</u>	<u>Recorded Investment &gt; 90 Days and Accruing</u>
Commercial real estate:							
Construction	\$ --	\$ --	\$ 1,537,444	\$ 1,537,444	\$ 8,233,358	\$ 9,770,802	\$ --
Owner occupied	--	--	347,980	347,980	13,501,881	13,849,861	--
Non-owner occupied	--	--	2,867,920	2,867,920	17,734,848	20,602,768	--
Residential real estate:							
Construction	--	--	--	--	3,252,410	3,252,410	--
Home equity	235,403	9,821	176,844	422,068	15,391,070	15,813,138	--
Other	125,412	222,617	114,390	462,419	70,301,975	70,764,394	--
Commercial	--	--	--	--	2,182,696	2,182,696	--
Consumer:							
Credit cards	--	--	--	--	208,664	208,664	--
Revolving credit plans	--	--	--	--	199,578	199,578	--
Other	3,193	--	--	3,193	2,411,877	2,415,070	--
<b>Total</b>	<b>\$ 364,008</b>	<b>\$ 232,438</b>	<b>\$ 5,044,578</b>	<b>\$ 5,641,024</b>	<b>\$ 133,418,357</b>	<b>\$ 139,059,381</b>	<b>\$ --</b>

## NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)

The following table displays the types of loans that comprised nonaccruals at December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Commercial real estate:		
Construction	\$ 1,003,725	\$ 1,537,444
Owner occupied	--	347,980
Non-owner occupied	2,590,423	2,867,920
Residential real estate:		
Construction	--	--
Home equity	--	186,665
Other	298,168	575,789
Commercial	--	--
Consumer:		
Credit cards	--	--
Revolving credit plans	--	--
Other	3,530	--
Total	<u>\$ 3,895,846</u>	<u>\$ 5,515,798</u>

The Bank monitors credit quality indicators including risk ratings on loans to determine trends in credit quality of the loan portfolio. Every loan is assessed and assigned a risk rating by the loan officer prior to approval of the credit and monitored on an ongoing basis. The loan review policy dictates which portions of the loan portfolio will be periodically reassessed, which includes a review of the accuracy of the assigned risk ratings.

Loans are rated on a scale from pass to doubtful. The grade considers and reflects the credit worthiness, documentation and credit file completeness as well as legal and policy compliance. Each grade is described below.

### Pass

Loans graded as pass are strong borrowers. The Bank will likely not incur a loss on loans graded as pass. Any inadequacies evident in financial performance and/or management sufficiency are offset by other features such as adequate collateral, good guarantors with liquid assets and/or cash flow capacity to repay the debt. Generally loans classified as pass meet the terms of repayment but may be susceptible to deterioration if adverse factors are encountered.

### Special Mention

Loans are graded as special mention when the borrower's character, credit, capacity or collateral is questionable. These weaknesses may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. Circumstances warrant more than normal monitoring, as these borrowers reflect the risks described in the following categories. These loans should be placed on the Bank's watchlist, and are considered adversely classified. These credits are considered bankable assets with no apparent loss of principal or interest envisioned but may require a higher level of management attention. Assets are currently protected but potentially weak. Potential weaknesses include declining trends in operating earnings and cash flows and/or reliance on the secondary source of repayment. Credits subject to economic, industry, or management factors having an adverse impact upon the credit's prospects for timely payment may also be classified as special mention.

### Substandard

Loans graded as substandard are inadequately protected by the net worth and/or cash flow capacity of the borrower or of the collateral pledged. Loans graded as substandard have a borrower whose character has become suspect. The source of repayment is considered conditional, problematic or marginal. Substandard loans would include unsecured or partially secured loans to financially weak borrowers with a strong guarantor or endorser who did not benefit from the loan and without a curtailment in over one year. Some of the loans are workout loans with potential loss consideration. The credit risk in this situation relates to the possibility of some loss of principal and/or interest if the deficiencies are not corrected.

## NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)

### Doubtful

Loans graded as doubtful are inadequately protected by the net worth of the borrower or by the collateral pledged and repayment in full is improbable on the basis of existing facts, values and conditions. These loans may include those over two months past due that are not adequately secured or are in the process of collection. The probability of some loss is high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the facility, its classification as an estimated loss is deferred until a more exact status may be determined.

### Loss

Loans graded as loss are considered uncollectible and continuance as an acceptable asset is not warranted. A loan classified as a loss is generally charged off.

The following tables display loans by credit quality indicators at December 31, 2016 and 2015:

<u>December 31, 2016</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Commercial real estate:					
Construction	\$ 8,428,034	\$ 1,010,164	\$ 1,582,379	\$ --	\$ 11,020,577
Owner occupied	16,190,211	2,289,795	--	--	18,480,006
Non-owner occupied	13,008,861	4,873,813	2,590,423	--	20,473,097
Residential real estate:					
Construction	4,082,253	--	--	--	4,082,253
Home equity	12,581,488	700,399	460,986	--	13,742,873
Other	77,424,076	5,222,774	946,152	--	83,593,002
Commercial	1,805,628	51,188	--	--	1,856,816
Consumer:					
Credit cards	246,078	--	--	--	246,078
Revolving credit plans	146,607	3,401	3,530	--	153,538
Other	2,608,020	21,735	--	--	2,629,755
Total	<u>\$ 136,521,256</u>	<u>\$ 14,173,269</u>	<u>\$ 5,583,470</u>	<u>\$ --</u>	<u>\$ 156,277,995</u>

<u>December 31, 2015</u>	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Commercial real estate:					
Construction	\$ 6,770,058	\$ 1,463,300	\$ 1,537,444	\$ --	\$ 9,770,802
Owner occupied	11,642,904	1,858,977	347,980	--	13,849,861
Non-owner occupied	14,437,979	3,296,869	2,867,920	--	20,602,768
Residential real estate:					
Construction	3,252,410	--	--	--	3,252,410
Home equity	14,685,962	968,282	158,894	--	15,813,138
Other	64,192,718	5,142,243	1,429,433	--	70,764,394
Commercial	2,117,651	55,980	9,065	--	2,182,696
Consumer:					
Credit cards	208,664	--	--	--	208,664
Revolving credit plans	195,814	3,764	--	--	199,578
Other	2,389,989	25,081	--	--	2,415,070
Total	<u>\$ 119,894,149</u>	<u>\$ 12,814,496</u>	<u>\$ 6,350,736</u>	<u>\$ --</u>	<u>\$ 139,059,381</u>

## NOTE 5 – ALLOWANCE FOR LOAN LOSSES (Continued)

Loans are classified as troubled debt restructurings (TDR) when, for economic or legal reasons related to the borrower's financial position, management grants a concession to the borrower that would not have otherwise been considered. At December 31, 2016 and 2015, the Bank had a total of \$2,296,897 and \$2,847,492, respectively, in loans classified as troubled debt restructurings.

Troubled debt restructurings are considered subsequently defaulted once the loan is past due greater than 90 days and/or the foreclosure or repossession of collateral with a subsequent charge off of the loan. During the year ended December 31, 2016 and 2015, the Bank had no loans that subsequently defaulted during the period within twelve months of modification.

The Bank had no additions to troubled debt restructurings during the year ended December 31, 2016. There was one troubled debt restructuring that was modified during 2016. The following table details the modification.

<u>December 31, 2016</u>	<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>	<u>Post-Modification Outstanding Recorded Investment</u>
Residential real estate:			
Other	<u>1</u>	<u>\$ 151,698</u>	<u>\$ 169,033</u>
Total	<u>1</u>	<u>\$ 151,698</u>	<u>\$ 169,033</u>

The loan was previously classified as a troubled debt restructuring because of an extended term and below market rate for similar risk. The loan was refinanced and modified to further extend the term and lower the rate. A charged off consumer loan was added to the principal of the loan at the time of modification.

There were no additions to troubled debt restructurings during the year ended December 31, 2015.

## NOTE 6 – OTHER REAL ESTATE OWNED

The table below reflects changes in other real estate owned (OREO) for the years ended:

	<u>2016</u>	<u>2015</u>
Balance, beginning of year	\$ 844,967	\$ 1,333,772
Properties acquired at foreclosure	189,000	701,900
Sale of foreclosed properties	(782,498)	(1,181,901)
Valuation adjustments	<u>(175,569)</u>	<u>(8,804)</u>
Balance, end of year	<u>\$ 75,900</u>	<u>\$ 844,967</u>

Net expense (benefit) applicable to OREO, other than valuation adjustments, was \$14,288, (\$49,614) and \$26,200 for the years ended December 31, 2016, 2015 and 2014, respectively.

There were no residential real estate properties included in the carrying amount of OREO at December 31, 2016 and 2015. The Bank did not have any consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings were in process as of December 31, 2016.

## NOTE 7 – PREMISES AND EQUIPMENT

A summary of the cost and accumulated depreciation of premises and equipment follows:

	December 31,	
	<u>2016</u>	<u>2015</u>
Land	\$ 1,580,761	\$ 1,580,761
Buildings and improvements	8,370,669	8,347,375
Furniture and equipment	<u>3,921,513</u>	<u>3,919,493</u>
Total cost	13,872,943	13,847,629
Less accumulated depreciation	<u>(7,499,704)</u>	<u>(7,298,849)</u>
Premises and equipment, net	<u>\$ 6,373,239</u>	<u>\$ 6,548,780</u>

Depreciation expense for the years ended December 31, 2016, 2015 and 2014 was \$537,079, \$493,312, and \$445,759, respectively.

## NOTE 8 – DEPOSITS

The Bank makes every effort to obtain deposits to fund loan growth or the growth of the securities portfolio. The Bank had two deposit relationships that, collectively, represented 19.09% of total deposits at December 31, 2016 and three deposit relationships that, collectively, represented 24.83% of total deposits at December 31, 2015.

The aggregate amount of time deposit accounts in denominations of \$250,000 or more at December 31, 2016 and 2015 was \$7,600,887 and \$26,973,772, respectively.

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

2017	\$ 27,388,669
2018	8,988,351
2019	2,440,797
2020	2,996,760
2021	<u>3,393,456</u>
	<u>\$ 45,208,033</u>

## **NOTE 9 – BORROWINGS**

### ***Securities Sold Under an Agreement to Repurchase***

Securities sold under an agreement to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under an agreement to repurchase are reflected as the amount of cash received in connection with the transaction. The Bank may be required to provide additional collateral based on the fair value of the underlying securities. Pledged securities related to securities sold under an agreement to repurchase are discussed in Note 3, Notes to Consolidated Financial Statements. Securities sold under an agreement to repurchase amounted to \$804,962 and \$1,141,425 at December 31, 2016 and 2015, respectively.

### ***Federal Home Loan Bank Advances***

The Bank is a member of the Federal Home Loan Bank of Pittsburgh (FHLB) which allows for participation in FHLB borrowing programs. At December 31, 2016, the Bank had a maximum borrowing capacity with the FHLB of \$66,389,450 which is unrestricted and does not require the Bank to pledge securities or make other commitments. Under the terms of the agreement, advances from the FHLB are collateralized by one-to-four family mortgage loans totaling approximately \$91,164,000 and \$82,431,000 at December 31, 2016 and 2015, respectively, and Federal Home Loan Bank stock. This borrowing capacity has no scheduled maturity date. The Bank had outstanding advances from the FHLB of \$8,712,700 and \$3,297,000 at December 31, 2016 and 2015, respectively. The outstanding advances on December 31, 2016 were overnight borrowings at a rate of .77%.

### ***Available Lines of Credit***

At December 31, 2016, the Bank had lines of credit available with various financial institutions totaling \$12,000,000 for the purchase of federal funds. The Bank had no outstanding borrowing against these lines as of December 31, 2016 and outstanding borrowings of \$102,000 as of December 31, 2015. The Bank has an agreement with the Federal Reserve Bank to borrow from the discount window, which is classified as a short term borrowing. In order to borrow funds under this agreement, the Bank must pledge securities to the Federal Reserve Bank. As of December 31, 2016 and 2015, the Bank had no borrowings from the discount window.

## NOTE 10 – EMPLOYEE BENEFIT PLANS

### *Pension Plan*

As of December 31, 2013, the defined benefit pension plan was frozen. The pension plan's funded status as of December 31, 2016, 2015 and 2014 follows. The amounts shown below are recognized in the Bank's consolidated balance sheets as of December 31, 2016, 2015 and 2014.

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Change in benefit obligation:			
Beginning benefit obligation	\$ 9,065,095	\$ 9,657,579	\$ 7,915,756
Interest cost	407,862	399,318	391,925
Actuarial loss (gain)	75,667	(688,120)	1,579,497
Benefits paid	<u>(345,282)</u>	<u>(303,682)</u>	<u>(229,599)</u>
Ending benefit obligation	<u>\$ 9,203,342</u>	<u>\$ 9,065,095</u>	<u>\$ 9,657,579</u>
Change in plan assets, at fair value:			
Beginning plan assets	\$ 9,777,027	\$ 9,294,194	\$ 9,040,584
Actual return on plan assets	249,200	36,515	483,209
Employer contribution	--	750,000	--
Benefits paid	<u>(345,282)</u>	<u>(303,682)</u>	<u>(229,599)</u>
Ending plan assets	<u>\$ 9,680,945</u>	<u>\$ 9,777,027</u>	<u>\$ 9,294,194</u>
Funded status	<u>\$ 477,603</u>	<u>\$ 711,932</u>	<u>\$ (363,385)</u>
Accrued benefit asset (liability) recognized on the consolidated balance sheets at December 31	<u>\$ 477,603</u>	<u>\$ 711,932</u>	<u>\$ (363,385)</u>
Amounts recognized in accumulated other comprehensive loss:			
Net loss	\$ 3,492,692	\$ 3,099,976	\$ 3,281,000
Deferred tax asset	<u>(1,327,223)</u>	<u>(1,177,991)</u>	<u>(1,246,780)</u>
Net amount recognized	<u>\$ 2,165,469</u>	<u>\$ 1,921,985</u>	<u>\$ 2,034,220</u>

The accumulated benefit obligation for the defined benefit plan was \$9,203,342, \$9,065,095 and \$9,657,579 at December 31, 2016, 2015 and 2014, respectively.

At December 31, 2016, 2015 and 2014, the assumptions used to determine the benefit obligation are as follows:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Discount rate	4.35%	4.61%	4.22%
Expected rate of return on plan assets	6.21%	6.61%	6.91%

**NOTE 10 – EMPLOYEE BENEFIT PLANS (Continued)**

The components of net periodic benefit cost, other amounts recognized in other comprehensive (income) loss and the assumptions used to determine net periodic pension cost are as follows:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
<b>Components of net periodic benefit cost:</b>			
Interest cost	\$ 407,862	\$ 399,318	\$ 391,925
Expected return on plan assets	(645,443)	(651,596)	(627,382)
Net amortization and deferral	<u>79,194</u>	<u>107,985</u>	<u>60,370</u>
Net periodic benefit income	<u>(158,387)</u>	<u>(144,293)</u>	<u>(175,087)</u>
<b>Other changes in plan assets and benefit obligations recognized in other comprehensive (income) loss:</b>			
Net actuarial loss (gain) at December 31	471,910	(73,039)	1,723,670
Amortization of net loss	<u>(79,194)</u>	<u>(107,985)</u>	<u>(60,370)</u>
Total recognized in other comprehensive (income) loss	<u>392,716</u>	<u>(181,024)</u>	<u>1,663,300</u>
Total recognized in net periodic benefit cost and other comprehensive (income) loss	<u>\$ 234,329</u>	<u>\$ (325,317)</u>	<u>\$ 1,488,213</u>
Discount rate	4.61%	4.22%	5.05%
Expected rate of return on plan assets	6.61%	6.91%	7.60%

The estimated net actuarial loss for the defined benefit pension plan that will be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year is \$83,402.

**NOTE 10 – EMPLOYEE BENEFIT PLANS (Continued)**

*Determination of Expected Long-term Rate of Return*

The expected long-term rate of return for the plan’s total assets is based on the expected return of each of the below categories, weighted based on the median of the target allocation for each class.

The Bank’s pension plan weighted average asset allocations at December 31, 2016 and 2015 are as follows:

<u>Asset Category</u>	<b>Percentage of Plan Assets at December 31,</b>	
	<u>2016</u>	<u>2015</u>
Equity Securities	59%	60%
Debt Securities	39%	37%
Cash	2%	3%
Total	<u>100%</u>	<u>100%</u>

The following tables present the balance of plan assets measured at fair value on a recurring basis as of December 31, 2016 and 2015:

<u>Description</u>	<u>Balance as of December 31, 2016</u>	<b>Fair Value Measurements at Report Date Using</b>		
		<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
<b>Cash</b>	\$ 157,039	\$ 157,039	\$ --	\$ --
<b>Equity Securities</b>				
U.S. Large cap	3,609,554	3,609,554	--	--
U.S. Mid cap	965,080	965,080	--	--
U.S. Small cap	237,927	237,927	--	--
International	924,093	924,093	--	--
<b>Fixed Income Securities</b>				
Core fixed income	3,509,259	--	3,509,259	--
International	277,993	--	277,993	--
Total	<u>\$ 9,680,945</u>	<u>\$ 5,893,693</u>	<u>\$ 3,787,252</u>	<u>\$ --</u>

**NOTE 10 – EMPLOYEE BENEFIT PLANS (Continued)**

Description	Balance as of December 31, 2015	Fair Value Measurements at Report Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Cash</b>	\$ 306,527	\$ 306,527	\$ --	\$ --
<b>Equity Securities</b>				
U.S. Large cap	3,022,425	3,022,425	--	--
U.S. Mid cap	1,319,397	1,319,397	--	--
U.S. Small cap	376,499	376,499	--	--
International	1,176,006	1,176,006	--	--
<b>Fixed Income Securities</b>				
Core fixed income	3,245,889	--	3,245,889	--
International	330,284	--	330,284	--
<b>Total</b>	<u>\$ 9,777,027</u>	<u>\$ 6,200,854</u>	<u>\$ 3,576,173</u>	<u>\$ --</u>

*Investment Policy and Strategy*

The policy, as established by the Pension Committee, is to invest assets in a diversified portfolio per target allocations. The assets will be reallocated periodically to meet the target allocations of 60% equity securities and 40% debt securities. The investment policy will be reviewed periodically, under the advisement of a registered investment advisor.

The overall investment objective is to provide for long-term growth of capital through participation in the equity markets with a moderate level of income. The investment time horizon is estimated at five to ten years. The investment return objective is to achieve a return greater than a blended mix of stated indices tailored to the same asset mix of the plan assets by 0.5% after fees over a rolling five-year moving average basis.

Allowable assets include cash equivalents, taxable bonds, U.S. equity securities, international equity securities, institutional mutual funds and guaranteed investment contracts (GICs).

In order to achieve a prudent level of portfolio diversification, the securities of any one company should not exceed more than 10% of the total plan assets, and no more than 25% of total plan assets should be invested in any one industry (other than securities of the U.S. Government or Agencies). Additionally, no more than 20% of the plan assets shall be invested in foreign securities (both equity and fixed).

The Bank does not expect to make any contributions to the plan in 2017.

Estimated future benefit payments are as follows:

2017	\$ 490,000
2018	505,000
2019	509,000
2020	522,000
2021	524,000
2022 to 2026	2,659,000

**NOTE 10 – EMPLOYEE BENEFIT PLANS (Continued)**

***Supplemental Executive Retirement Plan***

In 2014, the Bank provided a supplemental executive retirement plan for senior management. The plan's funded status as of December 31, 2016, 2015 and 2014 follows. The amounts shown below are recognized in the Bank's consolidated balance sheet as of December 31, 2016, 2015 and 2014.

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Change in benefit obligation:			
Beginning benefit obligation	\$ 445,779	\$ 648,129	\$ --
Service cost	34,576	37,466	25,406
Interest cost	21,196	22,915	23,922
Plan amendments	--	--	450,624
Actuarial loss (gain)	152,767	(262,731)	148,177
Benefits paid	(8,504)	--	--
Ending benefit obligation	<u>\$ 645,814</u>	<u>\$ 445,779</u>	<u>\$ 648,129</u>
Change in plan assets, at fair value:			
Beginning plan assets	\$ --	\$ --	\$ --
Employer contributions	8,504	-	-
Actual benefits paid	(8,504)	-	-
Ending plan assets	<u>\$ --</u>	<u>\$ --</u>	<u>\$ --</u>
Funded status	<u>\$ (645,814)</u>	<u>\$ (445,779)</u>	<u>\$ (648,129)</u>
Accrued benefit liability recognized on the consolidated balance sheet at December 31	<u>\$ (645,814)</u>	<u>\$ (445,779)</u>	<u>\$ (648,129)</u>
Amounts recognized in accumulated other comprehensive loss:			
Net loss (gain)	\$ 43,281	\$ (115,558)	\$ 148,177
Prior service cost	317,172	361,656	406,140
Deferred tax asset	(136,972)	(93,517)	(210,640)
Net amount recognized	<u>\$ 223,481</u>	<u>\$ 152,581</u>	<u>\$ 343,677</u>

The accumulated benefit obligation for the supplemental executive retirement plan was \$645,814, \$445,779 and \$482,598 at December 31, 2016, 2015 and 2014, respectively.

At December 31, 2016, 2015 and 2014, the assumptions used to determine the benefit obligation are as follows:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Discount rate	4.63%	4.80%	4.40%
Rate of compensation increase	3.00%	3.00%	3.00%

**NOTE 10 – EMPLOYEE BENEFIT PLANS (Continued)**

The components of net periodic benefit cost, other amounts recognized in other comprehensive (income) loss and the assumptions used to determine net periodic benefit cost are as follows:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
<b>Components of net periodic benefit cost:</b>			
Service cost	\$ 34,576	\$ 37,466	\$ 25,406
Interest cost	21,196	22,915	23,922
Amortization of prior service cost	44,484	44,484	44,484
Amortization of net (gain) loss	<u>(6,072)</u>	<u>1,004</u>	<u>--</u>
Net periodic benefit cost	<u>94,184</u>	<u>105,869</u>	<u>93,812</u>
<b>Other changes in plan assets and benefit obligations recognized in other comprehensive (income) loss :</b>			
Net actuarial loss (gain) at December 31	152,767	(262,731)	148,177
Prior service cost	--	--	450,624
Amortization of prior service cost	(44,484)	(44,484)	(44,484)
Amortization of gain	<u>6,072</u>	<u>(1,004)</u>	<u>--</u>
Total recognized in other comprehensive (income) loss	<u>114,355</u>	<u>(308,219)</u>	<u>554,317</u>
Total recognized in net periodic benefit cost and other comprehensive (income) loss	<u>\$ 208,539</u>	<u>\$ (202,350)</u>	<u>\$ 648,129</u>
Discount rate	4.80%	4.40%	5.31%
Rate of compensation increase	3.00%	3.00%	3.00%

There is no estimated net actuarial loss for the supplemental executive retirement to be amortized from accumulated other comprehensive loss into net periodic benefit cost over the next fiscal year.

The Bank will make a contribution to the plan of \$12,756 in 2017.

Estimated future benefit payments are as follows:

2017	\$ 12,756
2018	13,352
2019	13,541
2020	13,767
2021	14,033
2022 to 2026	109,358

**401(k) Plan**

The Bank has a 401(k) Plan whereby employees age 21 and over who have worked at least one year with 1,000 hours of service may participate in the Plan. The Bank makes matching contributions equal to 25 percent of the first five percent of an employee's compensation contributed to the Plan. Matching contributions vest to the employee over a five-year period based on a tiered schedule. Starting on January 1, 2014, the Bank contributed a percentage of each eligible employees' salary to their 401(k) Plan account in addition to matching contributions. For the years ended December 31, 2016, 2015 and 2014, the matching contribution expense attributable to the Plan amounted to \$30,341, \$30,029 and \$27,794, respectively.

## NOTE 11 – INCOME TAXES

The Bank files income tax returns in the U.S. federal jurisdiction and the states of West Virginia and Maryland. With few exceptions, the Bank is no longer subject to U.S. federal, state and local income tax examinations by tax authorities for years prior to 2013.

Allocation of federal and state income taxes between current and deferred portions is as follows for the years ended December 31, 2016, 2015 and 2014:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Federal			
Current	\$ 223,179	\$ 45,413	\$ 64,946
Deferred	<u>(36,474)</u>	<u>111,430</u>	<u>(155,036)</u>
	<u>186,705</u>	<u>156,843</u>	<u>(90,090)</u>
State			
Current	17,691	(2,420)	16,456
Deferred	<u>24,614</u>	<u>35,525</u>	<u>(2,006)</u>
	<u>42,305</u>	<u>33,105</u>	<u>14,450</u>
Income tax expense (benefit)	<u>\$ 229,010</u>	<u>\$ 189,948</u>	<u>\$ (75,640)</u>

Effective tax rates differ from the statutory federal income tax rate due to the following:

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Federal statutory rate	34.0%	34.0%	34.0%
Increase (decrease) resulting from:			
Tax-exempt income	(22.6)	(23.3)	(46.1)
State taxes, net of federal income tax effect	0.9	0.9	0.8
Nondeductible expenses and other, net	<u>2.2</u>	<u>3.0</u>	<u>(0.6)</u>
	<u>14.5%</u>	<u>14.6%</u>	<u>(11.9%)</u>

Under the provisions of the Internal Revenue Code, the Bank has \$1,195,303 of net operating loss carryforwards which can be offset against future taxable income as of December 31, 2016. These carryforwards expire through December 31, 2035. The full realization of tax benefits associated with carryforwards depends predominately upon the recognition of ordinary income during the carryforward period.

## NOTE 11 – INCOME TAXES (Continued)

The components of the net deferred tax asset, included in other assets, are as follows:

	December 31,	
	<u>2016</u>	<u>2015</u>
Deferred tax assets:		
Allowance for loan losses	\$ 293,741	\$ 278,541
Allowance for other real estate owned	15,825	134,594
Tax basis adjustment for other real estate owned	17,008	65,333
Deferred real estate gains	12,138	13,703
Deferred loan fees	102,771	71,994
Nonaccrual loan income	398,255	304,317
Supplemental executive retirement benefits, net	402,598	329,511
Alternative minimum tax credit	474,486	259,300
Net unrealized loss on available for sale securities	329,795	--
Net unrealized loss on securities transferred to held to maturity	--	728,461
Net operating loss carryforwards	406,403	573,833
Other	22,707	26,188
	<u>2,475,727</u>	<u>2,785,775</u>
Deferred tax liabilities:		
Fixed assets, net	(216,651)	(235,637)
Pension benefits, net	(181,489)	(270,534)
Net unrealized gain on available for sale securities	--	(301,117)
Accretion on investment securities	(14,339)	(14,203)
	<u>(412,479)</u>	<u>(821,491)</u>
Net deferred tax asset	<u>\$ 2,063,248</u>	<u>\$ 1,964,284</u>

## NOTE 12 – RELATED PARTY TRANSACTIONS

The Bank had, and may be expected to have in the future, banking transactions in the ordinary course of business with directors, executive officers, their immediate families and affiliated companies in which they are principal shareholders (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. Loans to these parties totaled \$2,143,193 and \$3,090,254 at December 31, 2016 and 2015, respectively. During 2016, total principal additions were \$115,694 and total principal payments were \$122,716. In 2016, there was a change in related party relationships which resulted in a change in balance of loans related to these parties of \$940,039. Deposits from related parties held by the Bank at December 31, 2016 and 2015 amounted to \$845,893 and \$915,324, respectively.

## NOTE 13 – COMMITMENTS, OFF-BALANCE SHEET RISK AND CONTINGENCIES

There are various contingent liabilities that are not reflected in the consolidated financial statements, including claims and legal actions arising in the ordinary course of business. In the opinion of management, after consultation with legal counsel, the ultimate disposition of these matters is not expected to have a material effect on the financial condition or results of operations of the Bank.

Some financial instruments are used in the normal course of business to meet the financing needs of customers and to reduce exposure to interest rate changes. These financial instruments include commitments to extend credit and standby letters of credit, which involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated financial statements.

Exposure to credit loss, if the other party does not perform, is represented by the contractual amount of these commitments to extend credit and standby letters of credit. The same credit policies are used for commitments and conditional obligations as are used for loans.

A summary of the notional or contractual amounts of financial instruments with off-balance sheet risk at year end follows:

	<b>December 31,</b>	
	<b>2016</b>	<b>2015</b>
Commitments to extend credit	\$ 4,008,000	\$ 5,161,000
Unfunded commitments	25,579,000	26,293,000
Standby letters of credit	1,160,000	376,000

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the commitment. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being used, the total commitments do not necessarily represent future cash requirements.

Unfunded commitments under commercial lines-of-credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are collateralized as deemed necessary and usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed.

Standby letters of credit are conditional lending commitments issued by the Bank to guarantee the performance of a customer to a third party. Letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

The Bank generally holds collateral supporting these commitments. The amount of collateral obtained, if deemed necessary, is based upon management's credit evaluation of the customer. The Bank is required to maintain average balances on hand or with the Federal Reserve Bank. At December 31, 2016 and 2015, reserve balances amounted to \$675,000 and \$537,000, respectively.

## NOTE 14 – FAIR VALUE MEASUREMENTS

The Bank follows Accounting Standards Codification (ASC) 820, *Fair Value Measurements and Disclosures*, to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. ASC 820 clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

## NOTE 14 – FAIR VALUE MEASUREMENTS (Continued)

ASC 820 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Bank’s market assumptions. The three levels of the fair value hierarchy under ASC 820 based on these two types of inputs are as follows:

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

Level 2 – Valuation is based on observable inputs including quoted prices in active markets for similar assets and liabilities, quoted prices for identical or similar assets and liabilities in less active markets, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Bank to measure certain assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

Securities Available for Sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2).

The following tables present the balance of assets measured at fair value on a recurring basis as of December 31, 2016 and 2015:

Description	Balance as of December 31, 2016	Fair Value Measurements at Reporting Date Using		
		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 and agency	\$ 69,921,540	\$ --	\$ 69,921,540	\$ --
State and municipal	37,550,160	--	37,550,160	--
	<u>\$ 107,471,700</u>	<u>\$ --</u>	<u>\$ 107,471,700</u>	<u>\$ --</u>

Description	Balance as of December 31, 2015	Fair Value Measurements at Reporting Date Using		
		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 and agency	\$ 66,644,783	\$ --	\$ 66,644,783	\$ --
State and municipal	35,508,344	--	35,508,344	--
	<u>\$ 102,153,127</u>	<u>\$ --</u>	<u>\$ 102,153,127</u>	<u>\$ --</u>

## NOTE 14 – FAIR VALUE MEASUREMENTS (Continued)

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Bank to measure certain assets recorded at fair value on a nonrecurring basis in the consolidated financial statements:

**Impaired Loans:** Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreements will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan, the fair value of the collateral or present value of cash flows. Collateral may be in the form of real estate or business assets including equipment, inventory and accounts receivable. The vast majority of the Bank's collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal, of one year or less, conducted by an independent, licensed appraiser using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the property is more than one year old and not solely based on observable market comparables or management determines the fair value of the collateral is further impaired below the appraised value, then a Level 3 valuation is considered to measure the fair value. The value of business equipment is based upon an outside appraisal, of one year or less, if deemed significant, or the net book value on the applicable business's financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the allowance for loan losses are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Consolidated Statements of Income.

**Other Real Estate Owned:** Loans are transferred to other real estate owned when the collateral securing them is foreclosed upon. The measurement of loss associated with other real estate owned is based on the fair value of the collateral compared to the unpaid loan balance and anticipated costs to sell the property and initial losses are charged against the allowance for loan losses at the time of the transfer. Subsequent to transfer, fair values are determined in a similar manner to impaired loans secured by real estate previously discussed. Any additional fair value adjustments to other real estate owned are recorded in the period incurred and expensed against current earnings through a valuation allowance for other real estate owned.

The following tables present the balances of assets and liabilities measured at fair value on a nonrecurring basis as of December 31, 2016 and 2015:

Description	Fair Value as of December 31, 2016	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired Loans, net	\$ 1,397,266	\$ --	\$ --	\$ 1,397,266
Other Real Estate Owned, net	\$ 75,900	\$ --	\$ --	\$ 75,900

Description	Fair Value as of December 31, 2015	Fair Value Measurements at Reporting Date Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Impaired Loans, net	\$ 1,320,443	\$ --	\$ --	\$ 1,320,443
Other Real Estate Owned, net	\$ 844,967	\$ --	\$ --	\$ 844,967

## NOTE 14 – FAIR VALUE MEASUREMENTS (Continued)

The following table displays quantitative information about Level 3 Fair Value Measurements for December 31, 2016 (dollars in thousands):

Assets	Quantitative Information about Level 3 Fair Value Measurements for December 31, 2016			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired Loans, net	\$ 1,038	Discounted appraised value	Selling cost	3% - 6% (3%)
	359	Present value of future cash flows	Discount rate	6% - 18% (11%)
Other Real Estate Owned, net	\$ 76	Discounted appraised value	Selling cost	6% - 17% (10%)
			Discount for lack of marketability and age of	0% - 47% (15%)

The following methods and assumptions were used to estimate fair values for assets and liabilities:

- Carrying amount is considered to estimate fair value for cash and due from financial institutions, interest bearing deposits with depository institutions, accrued interest receivable, securities sold under an agreement to repurchase, accrued interest payable and variable rate loans or deposits that re-price frequently.
- The fair value of interest bearing time deposits is estimated using the rates currently offered for deposits with similar maturities.
- Securities fair values are based on quoted market prices or, if no quotes are available, on the rate and term of the security, on information about the issuer and third party pricing models.
- The carrying value of restricted securities approximates fair value based on the redemption provisions of the respective entity.
- Fixed rate loans and variable rate loans with infrequent repricing or repricing limits, are estimated using discounted cash flow analyses or underlying collateral values, where applicable.
- The fair value of demand and savings deposits is the amount payable on demand. The fair value of certificates of deposit is estimated using the rates currently offered for deposits with similar maturities.
- Bank owned life insurance represents insurance policies on past and current officers and directors of the Bank. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value which approximates fair value.
- The carrying amount of federal funds purchased, Federal Home Loan Bank advances and other short term borrowings maturing within ninety days is considered to approximate fair value. Fair values of all other borrowings are estimated using a discounted cash flow analysis based on the Bank's current incremental borrowing rate for similar types of borrowing arrangements.
- Fair value of other financial instruments and off-balance sheet items are not considered significant to this presentation.

**NOTE 14 – FAIR VALUE MEASUREMENTS (Continued)**

While these estimates of fair value are based on management’s judgment of the most appropriate factors, there is no assurance that if the Bank had disposed of such items at December 31, 2016 and 2015, the estimated fair values would have been achieved. Market values may differ depending on various circumstances not taken into consideration in this methodology. The estimated fair values at December 31, 2016 and 2015 should not necessarily be considered to apply at subsequent dates. The following tables show the estimated fair values and the related carrying values of the Bank’s financial instruments at December 31, 2016 and 2015:

(dollars in thousands)	December 31, 2016		Fair Value Measurements at Reporting Date Using		
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial assets:</b>					
Cash and due from financial institutions	\$ 4,698	\$ 4,698	\$ 4,698	\$ --	\$ --
Interest bearing deposits with depository institutions	51	51	51	--	--
Securities available for sale	107,472	107,472	--	107,472	--
Securities held to maturity	4,621	4,692	--	4,692	--
Restricted securities	707	707	--	707	--
Loans, net	154,225	155,714	--	--	155,714
Accrued interest receivable	932	932	--	932	--
Bank owned life insurance	5,890	5,890	--	5,890	--
<b>Financial liabilities:</b>					
Deposits	\$ 255,514	\$ 255,528	\$ --	\$ 210,306	\$ 45,222
Securities sold under an agreement to repurchase	805	805	--	805	--
Accrued interest payable	43	43	--	43	--
Federal Home Loan Bank advances	8,713	8,713	8,713	--	--

**NOTE 14 – FAIR VALUE MEASUREMENTS (Continued)**

(dollars in thousands)	December 31, 2015		Fair Value Measurements at Reporting Date Using		
	Carrying Amount	Estimated Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Financial assets:</b>					
Cash and due from financial institutions	\$ 3,391	\$ 3,391	\$ 3,391	\$ --	\$ --
Interest bearing deposits with depository institutions	51	51	51	--	--
Securities available for sale	102,153	102,153	--	102,153	--
Securities held to maturity	26,957	27,850	--	27,850	--
Restricted securities	502	502	--	502	--
Loans, net	137,160	138,801	--	--	138,801
Accrued interest receivable	958	958	--	958	--
Bank owned life insurance	5,727	5,727	--	5,727	--
<b>Financial liabilities:</b>					
Deposits	\$ 260,777	\$ 260,834	\$ --	\$ 191,597	\$ 69,237
Securities sold under an agreement to repurchase	1,141	1,141	--	1,141	--
Accrued interest payable	53	53	--	53	--
Federal funds purchased	102	102	102	--	--
Federal Home Loan Bank advances	3,297	3,297	3,297	--	--

***Interest Rate Risk***

The Bank assumes interest rate risk, the risk that general interest rate levels will change, as a result of its normal operations. As a result, the fair values of the Bank's financial instruments will change when interest rate levels change and that change may be either favorable or unfavorable to the Bank. Management attempts to match maturities of assets and liabilities to the extent believed necessary to minimize interest rate risk. However, borrowers with fixed rate obligations are less likely to prepay in a rising rate environment and more likely to prepay in a falling rate environment. Conversely, depositors who are receiving fixed rates are more likely to withdraw funds before maturity in a rising rate environment and less likely to do so in a falling rate environment. Management monitors rates and maturities of assets and liabilities and attempts to minimize interest rate risk by adjusting terms of new loans and deposits and by investing in securities with terms that mitigate the Bank's overall interest rate risk.

## NOTE 15 – REGULATORY MATTERS

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet 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 consolidated 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 its assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. As part of the new requirements, the Common Equity Tier I Capital ratio is calculated and utilized in the assessment of capital for all institutions.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios as presented in the table below of Total capital, Tier 1 capital and Common Equity Tier 1 capital (as defined in the regulations) to risk weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of December 31, 2016 and 2015, that the Bank met all capital adequacy requirements to which it is subject.

Under the Basel III rules, the capital conservation buffer of 0.625% was effective January 1, 2016. The capital conservation buffer will be phased through increases of 0.625% each year thereafter, until reaching 2.5% in January 2019. The purpose of the capital conservation buffer is to absorb losses during periods of economic stress and requires increased capital levels for the purpose of capital distributions and other payments. Failure to maintain the buffer will result in restrictions on the Bank's ability to make capital distributions and pay discretionary bonuses to executive officers. As of December 31, 2016, the Bank's capital conservation buffer was 8.71%.

As of December 31, 2016, the most recent notification from the Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, an institution must maintain minimum total risk-based, Tier 1 risk-based, Common Equity Tier 1 risk-based and Tier 1 leverage ratios as set forth in the following table. There are no conditions or events since the notification that management believes have changed the Bank's category. The Bank's actual capital amounts (dollars in thousands) and ratios as of December 31, 2016 and 2015 are also presented in the following table.

	Actual		Minimum For Capital Adequacy Purposes		Minimum For Capital Adequacy with Capital Conservation Buffer		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>2016</b>								
Total capital (to risk weighted assets)	\$ 26,144	16.71%	\$ 12,516	8.00%	\$ 13,494	8.625%	\$ 15,645	10.00%
Tier 1 capital (to risk weighted assets)	\$ 24,362	15.57%	\$ 9,387	6.00%	\$ 10,365	6.625%	\$ 12,516	8.00%
Common equity tier 1 (to risk weighted assets)	\$ 24,362	15.57%	\$ 7,040	4.50%	\$ 8,018	5.125%	\$ 10,169	6.50%
Tier 1 capital (to average assets)	\$ 24,362	8.46%	\$ 11,512	4.00%	N/A	N/A	\$ 14,391	5.00%
<b>2015</b>								
Total capital (to risk weighted assets)	\$ 25,140	16.47%	\$ 12,208	8.00%	N/A	N/A	\$ 15,260	10.00%
Tier 1 capital (to risk weighted assets)	\$ 23,430	15.35%	\$ 9,156	6.00%	N/A	N/A	\$ 12,208	8.00%
Common equity tier 1 (to risk weighted assets)	\$ 23,430	15.35%	\$ 6,867	4.50%	N/A	N/A	\$ 9,919	6.50%
Tier 1 capital (to average assets)	\$ 23,430	8.14%	\$ 11,514	4.00%	N/A	N/A	\$ 14,392	5.00%

## NOTE 16 – ACCUMULATED OTHER COMPREHENSIVE LOSS

Changes in each component of accumulated other comprehensive loss were as follows:

	Net Unrealized Gains (Losses) on Securities	Unrealized Losses on Securities Transferred to Held to Maturity	Adjustments Related to Pension Benefits	Adjustments Related to Supplemental Executive Retirement Benefits	Accumulated Other Comprehensive (Loss)
<b>Balance at December 31, 2013</b>	\$ (2,859,851)	\$ --	\$ (1,002,974)	\$ --	\$ (3,862,825)
Unrealized holding gains on available for sale securities, net of tax \$2,263,954	3,693,821	--	--	--	3,693,821
Reclassification adjustment, net of tax (\$7,837)	(12,788)	--	--	--	(12,788)
Unrealized holding losses on securities prior to transfer to held to maturity, net of tax (\$791,758)	--	(1,291,816)	--	--	(1,291,816)
Amortization of unrealized holding losses on securities transferred to held to maturity, net of tax \$22,900	--	37,363	--	--	37,363
Change in pension benefits, net of tax (\$654,995)	--	--	(1,068,675)	--	(1,068,675)
Reclassification adjustment, net of tax \$22,941	--	--	37,429	--	37,429
Change in supplemental executive retirement benefits, net of tax (\$227,544)	--	--	--	(371,257)	(371,257)
Reclassification adjustment, net of tax \$16,904	--	--	--	27,580	27,580
<b>Balance at December 31, 2014</b>	\$ 821,182	\$ (1,254,453)	\$ (2,034,220)	\$ (343,677)	\$ (2,811,168)
Unrealized holding losses on available for sale securities, net of tax (\$117,487)	(191,691)	--	--	--	(191,691)
Reclassification adjustment, net of tax (\$84,700)	(138,195)	--	--	--	(138,195)
Amortization of unrealized holding losses on securities transferred to held to maturity, net of tax \$40,397	--	65,911	--	--	65,911
Change in pension benefits, net of tax \$27,755	--	--	45,284	--	45,284
Reclassification adjustment, net of tax \$41,034	--	--	66,951	--	66,951
Change in supplemental executive retirement benefits, net of tax \$99,838	--	--	--	162,893	162,893
Reclassification adjustment, net of tax \$17,285	--	--	--	28,203	28,203
<b>Balance at December 31, 2015</b>	\$ 491,296	\$ (1,188,542)	\$ (1,921,985)	\$ (152,581)	\$ (2,771,812)
Unrealized holding losses on available for sale securities, net of tax (\$597,031)	(974,102)	--	--	--	(974,102)
Reclassification adjustment, net of tax (\$33,881)	(55,280)	--	--	--	(55,280)
Amortization of unrealized holding losses on securities transferred to held to maturity, net of tax \$27,135	--	44,274	--	--	44,274
Reversal of unrealized holding losses on securities transferred to held to maturity, net of tax \$701,326	--	1,144,268	--	--	1,144,268
Change in pension benefits, net of tax (\$179,326)	--	--	(292,584)	--	(292,584)
Reclassification adjustment, net of tax \$30,094	--	--	49,100	--	49,100
Change in supplemental executive retirement benefits, net of tax (\$58,051)	--	--	--	(94,716)	(94,716)
Reclassification adjustment, net of tax \$14,597	--	--	--	23,815	23,815
<b>Balance at December 31, 2016</b>	<u>\$ (538,086)</u>	<u>\$ --</u>	<u>\$ (2,165,469)</u>	<u>\$ (223,482)</u>	<u>\$ (2,927,037)</u>

**NOTE 16 – ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)**

Reclassification out of accumulated other comprehensive loss for December 2016, 2015 and 2014 is as follows:

<u>Details about Accumulated Other Comprehensive Loss Components</u>	<u>Amount Reclassified from Accumulated Other Comprehensive Loss</u>	<u>Affected Line Item in the Statement Where Net Income is Presented</u>
<b>December 31, 2016</b>		
Amortization of defined benefit pension items		
Net actuarial loss	\$ (79,194) <sup>(1)</sup>	
Amortization of supplemental executive retirement benefit items		
Prior service cost	(44,484) <sup>(2)</sup>	
Net gain	6,072 <sup>(2)</sup>	
Reclassification adjustment for gains on available for sale securities	89,161	Realized gain on securities
	<u>10,809</u>	Income tax benefit
	<u>\$ (17,636)</u>	Net of tax

<sup>(1)</sup> This accumulated other comprehensive loss component is included in the computation of net periodic pension cost. See Note 10, Notes to Consolidated Financial Statements, for additional information.

<sup>(2)</sup> This accumulated other comprehensive loss component is included in the computation of net periodic benefit cost. See Note 10, Notes to Consolidated Financial Statements, for additional information.

<u>Details about Accumulated Other Comprehensive Loss Components</u>	<u>Amount Reclassified from Accumulated Other Comprehensive Loss</u>	<u>Affected Line Item in the Statement Where Net Income is Presented</u>
<b>December 31, 2015</b>		
Amortization of defined benefit pension items		
Net actuarial loss	\$ (107,985) <sup>(1)</sup>	
Amortization of supplemental executive retirement benefit items		
Prior service cost	(44,484) <sup>(2)</sup>	
Net Loss	(1,004) <sup>(2)</sup>	
Reclassification adjustment for gains on available for sale securities	222,895	Realized gain on securities
	<u>(26,381)</u>	Income tax expense
	<u>\$ 43,041</u>	Net of tax

<sup>(1)</sup> This accumulated other comprehensive loss component is included in the computation of net periodic pension cost. See Note 10, Notes to Consolidated Financial Statements, for additional information.

<sup>(2)</sup> This accumulated other comprehensive loss component is included in the computation of net periodic benefit cost. See Note 10, Notes to Consolidated Financial Statements, for additional information.

**NOTE 16 – ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)**

<u>Details about Accumulated Other Comprehensive Loss Components</u>	<u>Amount Reclassified from Accumulated Other Comprehensive Loss</u>	<u>Affected Line Item in the Statement Where Net Income is Presented</u>
<b>December 31, 2014</b>		
Amortization of defined benefit pension items		
Net actuarial loss	\$ (60,370) <sup>(1)</sup>	
Amortization of supplemental executive retirement benefit items		
Prior service cost	(44,484) <sup>(2)</sup>	
Reclassification adjustment for gains on available for sale securities	20,625	Realized gain on securities
	32,007	Income tax benefit
	<u>\$ (52,222)</u>	Net of tax

<sup>(1)</sup> This accumulated other comprehensive loss component is included in the computation of net periodic pension cost. See Note 10, Notes to Consolidated Financial Statements, for additional information.

<sup>(2)</sup> This accumulated other comprehensive loss component is included in the computation of net periodic benefit cost. See Note 10, Notes to Consolidated Financial Statements, for additional information.

**NOTE 17 – CONCENTRATION RISK**

The Bank maintains its cash accounts in several correspondent banks. As of December 31, 2016, cash balances in excess of amounts insured by the Federal Deposit Insurance Corporation (FDIC) were \$31,918. Most of the Bank's activities are with customers located within its local market areas. As of December 31, 2016, the Bank had two deposit relationships totaling \$48,770,536 with each relationship holding more than 5% of total deposits. Significant changes in these accounts are monitored on an ongoing basis. As of December 31, 2016, real estate loans represented 96.9% of the loan portfolio. A detailed schedule is provided in Note 4, Notes to Consolidated Financial Statements. The Bank does not have any significant concentrations to any one customer.

**NOTE 18 – SUBSEQUENT EVENTS**

The Bank evaluated subsequent events that have occurred after the balance sheet date, but before the consolidated financial statements are issued. There are two types of subsequent events (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date.

Subsequent events have been considered through March 10, 2017, the date the financial statements were available to be issued. Based on the evaluation, the Bank did not identify any recognized or nonrecognized subsequent events that would have required adjustment to or disclosure in the consolidated financial statements.

# NOTES





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