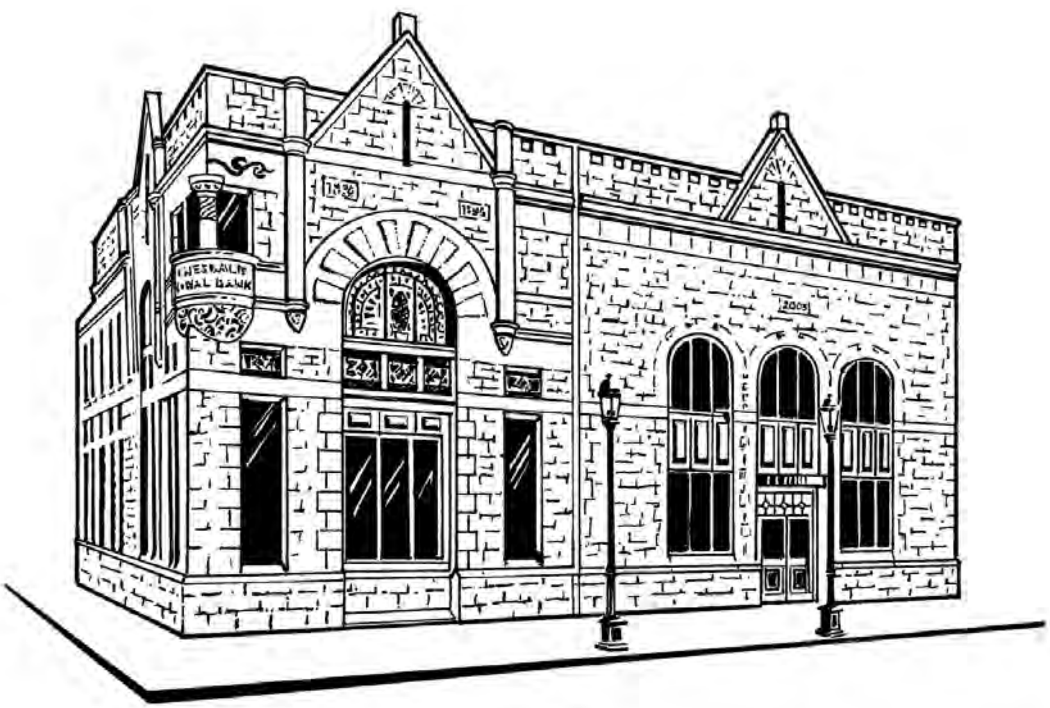
2017

# Honat Bancorp, Inc.

# Annual Report



# Directors and Officers
# of
# Honat Bancorp, Inc.

## Directors:

Alfred D. Beck

John P. Burlein

Michael W. Cavage

Roger L. Dirlam

Robert C. Grimm

Charles H. Jurgensen

Paul M. Meagher

Kurt I. Propst

David E. Raven

William Schweighofer

## Officers:

| | |
|---|---|
| William Schweighofer | Chairman of the Board |
| John P. Burlein | Vice Chairman |
| David E. Raven | President and Chief Executive Officer |
| Marcele R. Swingle | Secretary |
| Katherine M. Bryant | Treasurer |

# *Honat Bancorp, Inc. and its Subsidiary, The Honesdale National Bank*

# *1836 - 2017*

## Consolidated Financial Report

December 31, 2017

*SERVING 5 COUNTIES WITH 12 LOCATIONS*


HNB The Honesdale National Bank

800-HNB-9515 • www.hnbbank.bank • hnb@hnbbank.com

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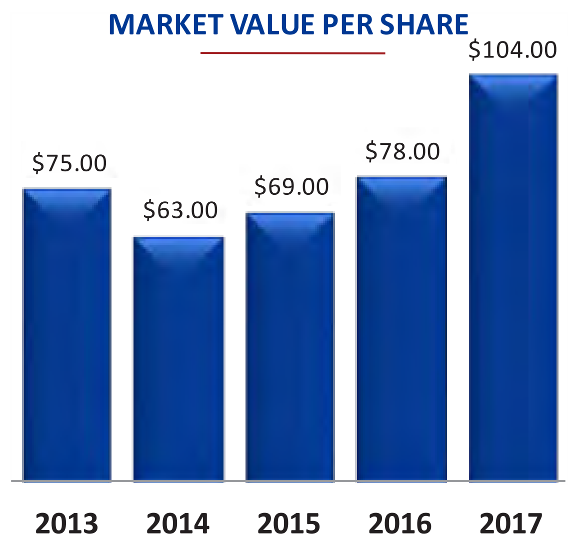
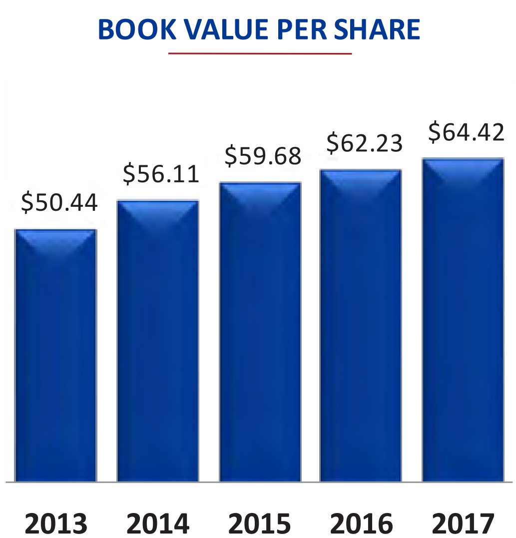
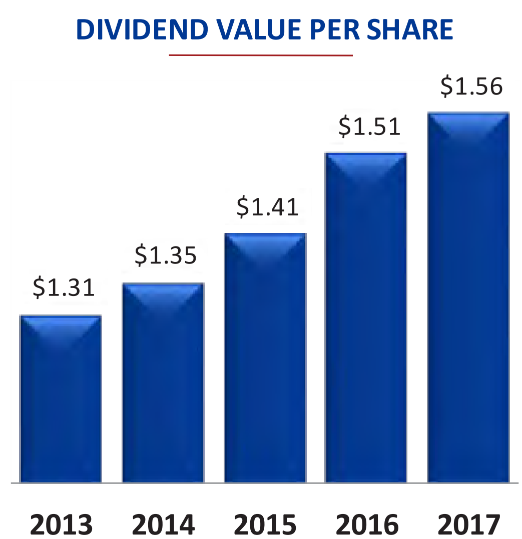
## CHAIRMAN'S INTRODUCTION

On behalf of the entire HNB family, I take this opportunity to welcome David E. Raven as President and CEO of Honat Bancorp, Inc. and The Honesdale National Bank. Throughout the year it became evident that Dave is a perfect fit for HNB. His vision, leadership skills, and knowledge of community banking will ensure that your company remains a high-performing institution that is the envy of peers. The annual report on the pages that follow reflects the first year's operations under the direction of Mr. Raven. We finished 2017 with enviable results. Dave, I congratulate you and your exceptional HNB team on a job well done and I look forward to working with you in the years to come.

William Schweighofer
Chairman of the Board



## MESSAGE FROM THE PRESIDENT

To Our Shareholders:

As 2017 came to a close, so did another eventful year in our company's and our nation's history. The Board of Directors, management and staff all take great pride in our organization's ability to withstand the test of time. For over 180 years, our bank's doors and now mobile app open each morning to a world different from the one that preceded it. But rest assured, one constant that does remain is the team of dedicated and talented employees whose hard work and commitment move our company forward each and every day.

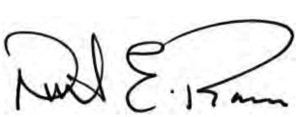
In my short tenure, I have come to find the team here to be exceptional; caring, dedicated professionals who work hard each and every day to do the right thing for their customers and their communities. This does not happen by accident and is in fact a direct reflection of the strong stewardship provided by your Board. We believe wholeheartedly that successful companies cannot remain idle, they must evolve, but they also must remain true to their roots – especially when their roots run as deep and as strong as ours.

Honat Bancorp continues to rise to the occasion with the best interests of our employees, customers, communities and stockholders always a top priority. Despite the changing and often times challenging environment, our commitment to customers remains stronger than ever.

As such, the financial results for your company also continued to be strong in 2017 and once again rank our performance among the best of our peer group. The Tax Cuts and Jobs Act ("The Tax Act") enacted on December 22, 2017 reduced corporate tax rates beginning in 2018. To account for the reduction in tax rates according to current accounting standards, the Bank realized a one-time $1,391,000 increase to tax expense as the tax rate applied to deferred assets was decreased from 34% to 21%. Our strong financial position allowed us to easily absorb this negative tax event for 2017 and we now look forward to the benefits of a reduced tax rate in the year ahead.

We are excited to see the addition of our newest branch in early 2018. Our Clarks Summit area office will be a positive addition to our existing branch network and expand our reach into a familiar market. We have received a great deal of early support for this new office and we would encourage all to stop in and visit. Or better yet, refer a friend or associate in that area to establish or expand a relationship with us. As we reflect on 2017, we are heartened by the unwavering support of our shareholders. Your confidence in us is not taken lightly and our commitment to the long-term success of your company is as strong as ever.

Sincerely,

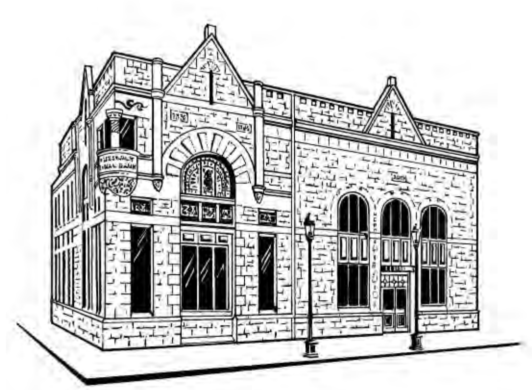


David E. Raven
President and CEO

## FINANCIAL HIGHLIGHTS

| | 2017 | 2016 | Increase (Decrease) |
|---|---|---|---|
| | (In Thousands, Except Per Share and Ratio Data) | | |
| **Assets, Liabilities & Equity:** | | | |
| Total Assets | $ 643,352 | $ 621,877 | 3.45% |
| Total Loans, net | $ 471,005 | $ 455,670 | 3.37% |
| Total Deposits | $ 539,248 | $ 520,101 | 3.68% |
| Total Equity | $ 95,779 | $ 93,859 | 2.05% |
| **Income & Expense:** | | | |
| Net Income | $ 6,193 | $ 7,679 | (19.35%) |
| Total Interest Income | $ 24,912 | $ 23,389 | 6.51% |
| Total Interest Expense | $ 2,047 | $ 2,062 | (0.73%) |
| **Per Share Data:** | | | |
| Book Value per Share | $ 64.42 | $ 62.23 | 3.52% |
| Earnings per Share | $ 4.13 | $ 5.07 | (18.54%) |
| Cash Dividend per Share | $ 1.56 | $ 1.51 | 3.31% |
| Market Value per Share | $ 104.00 | $ 78.00 | 33.33% |
| **Select Ratios:** | | | |
| Return on Average Assets | 0.99% | 1.27% | |
| Return on Average Equity | 6.59% | 8.26% | |
| Loans, net to Total Deposits | 87.34% | 87.61% | |
| Allowance for Loan Losses as a Percent of Total Loans | 1.82% | 1.81% | |

## COMPANY OVERVIEW



Honat Bancorp, Inc. (HONT: US OTC) is the parent company of its wholly owned subsidiary The Honesdale National Bank. Headquartered in Honesdale, Pennsylvania, we strive to achieve unparalleled levels of financial performance through superior service in meeting our customers' personal banking, business banking and wealth management needs while acting in the best interest of our employees, our customers, our communities and our shareholders.

The Honesdale National Bank, established in 1836, holds the distinction of being the area's oldest, independent, community bank headquartered in Northeastern PA, with ten full-service offices across Wayne, Pike, Susquehanna, Lackawanna and Luzerne Counties. Financial solutions for our customers are also serviced through our Trust Department and HNB Financial Services headquartered in Honesdale and the HNB Mortgage Center headquartered in Wilkes-Barre, Pennsylvania.

## TIMELINE

**1836**
Honesdale Bank opens at 1011 Main Street, Honesdale, PA on December 26.

**1851**
Relocates to new building at $10^{th}$ & Main Streets, Honesdale, PA.

**1864**
National currency & banking system established and the Bank begins operations under *The Honesdale National Bank.*

**1886**
HNB's $50^{th}$ Anniversary

**1896**
Main Office relocates to new building & present location at 733 Main Street, Honesdale, PA.

**1914**
HNB joins the Federal Reserve System.
This Central Banking System was created in 1913 largely in response to the "Severe Panic of 1907".

**1917**
Alice Ward becomes the first female employee of The Honesdale National Bank.

**1929**
The "Great Depression"
As other banks close or suspend operations, HNB continues to serve the community — even paying a dividend.

**1934**
HNB deposits insured by the new FDIC up to $2,500.

**1936**
HNB's $100^{th}$ Anniversary

**1957**
Bank Lobby Renovation
The wooden teller cages of the past were removed and a new lobby floor with a new customer service area were installed.

**1962**
Erected as a public service, the time & temperature sign on the corner of $8^{th}$ & Main Streets in Honesdale has become a familiar landmark for visitors and residents alike.

**1968**
TV Auto Bank Drive-In Banking System opens on September 12. The system included closed circuit TV, voice communication and a pneumatic tube system linking the bank and drive-up lanes through a tunnel under Main Street – the first such service in the area.

**1974**
HNB opens an office at the Route 6 Plaza, east of Honesdale. The facility was more than a branch, allowing customers to transact any of their business at either location. The building also included a spacious new Board of Directors room.

## COMPANY OVERVIEW AND TIMELINE (CONTINUED)

**1986**
As HNB commemorates its 150th Anniversary, the Bank expands into the adjacent building (formerly owned by the Honesdale Dime Bank), opening on September 22.

In November and December the area's first ATMs were installed at the Route 6 Plaza and adjacent to the Main Street Drive-Up Banking Lanes.

**1995**
HNB purchases United Security Mortgage Corporation in Wilkes-Barre, PA and opens it as HNB Mortgage on January 3.

**1996**
HNB purchases branches in Forest City, PA and Montdale, PA from PNC, opening them on June 17, 1996 as HNB Offices.

**1998**
HNB purchases branches at Lake Wallenpaupack & in Lackawaxen, PA from LA Bank and opens them on December 14 as offices of The Honesdale National Bank.

HNB launches its first website.

**2001**
HNB opens a temporary office in the Citgo Plaza on Route 590 in Hamlin, PA and relocates to its permanent location at 559 Hamlin Highway on August 1.

**2003**
HNB is approved by the Commonwealth of PA for Educational Improvement Tax Credits to contribute to the growth and development of educational opportunities throughout our local area.

**2005**
HNB opens the Corporate Center at 724 Main Street in Honesdale, also serving as headquarters for Honat Bancorp, Inc.

**2007**
On June 1, HNB opens a newly constructed office at 786 Wyoming Ave. in Kingston, PA.

**2011**
HNB's 175th Anniversary

HNB begins offering Mobile Banking services.

**2012**
HNB launches its Mobile Banking App.

On November 13, HNB opens its Lakewood Office at 18 Como Road, Lakewood, PA.

**2013**
On December 11, HNB opens its Eynon Office at 202 Betty Street, Eynon, PA.

**2015**
HNB integrates and begins offering Mobile Wallet and Person-to-Person Payment services.

## CONSOLIDATED BALANCE SHEET

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| | (In Thousands, Except Share and Per Share Data) | |
| **ASSETS** | | |
| Cash and due from banks | **$ 6,347** | $ 5,882 |
| Interest-bearing deposits | **10,571** | 10,905 |
| Short-term investments | **5,997** | 5,699 |
| Cash and cash equivalents | **22,915** | 22,486 |
| Securities available for sale | **108,307** | 107,485 |
| Mortgage loans held for sale | **1,633** | 1,702 |
| Loans receivable, net of allowance for loan losses 2017: $8,711; 2016: $8,405 | **471,005** | 455,670 |
| Investment in restricted stock, at cost | **574** | 517 |
| Premises and equipment, net | **7,801** | 8,005 |
| Accrued interest receivable | **2,307** | 2,216 |
| Bank-owned life insurance | **19,707** | 15,498 |
| Other assets | **9,103** | 8,298 |
| **Total Assets** | **$ 643,352** | $ 621,877 |

### LIABILITIES AND STOCKHOLDERS' EQUITY

| | 2017 | 2016 |
|---|---|---|
| **LIABILITIES** | | |
| Deposits: | | |
| Noninterest-bearing | **$ 142,567** | $ 132,454 |
| Interest-bearing | **396,681** | 387,647 |
| Total Deposits | **539,248** | 520,101 |
| Accrued interest payable | **642** | 580 |
| Other liabilities | **7,683** | 7,337 |
| **Total Liabilities** | **547,573** | 528,018 |
| **STOCKHOLDERS' EQUITY** | | |
| Common stock, par value $.20 per share; authorized 5,000,000 shares; issued 1,800,000 shares; outstanding 2017 and 2016 - 1,486,767 and 1,508,341 | **360** | 360 |
| Surplus | **1,015** | 1,015 |
| Retained earnings | **102,541** | 98,862 |
| Accumulated other comprehensive income | **1,090** | 734 |
| Treasury stock, at cost, 2017 and 2016 - 313,233 and 291,659 shares | **(9,227)** | (7,112) |
| **Total Stockholders' Equity** | **95,779** | 93,859 |
| **Total Liabilities and Stockholders' Equity** | **$ 643,352** | $ 621,877 |

*See notes to consolidated financial statements, pages 14-46.*

## CONSOLIDATED STATEMENTS OF INCOME

| | Years Ended December 31, 2017 | 2016 |
|---|---|---|
| | (In Thousands, Except Share and Per Share Data) | |
| **INTEREST INCOME** | | |
| Loans receivable, including fees | **$ 22,062** | $ 20,571 |
| Securities: | | |
| Taxable | **731** | 682 |
| Tax exempt | **2,058** | 2,118 |
| Other | **61** | 18 |
| **Total Interest Income** | **24,912** | 23,389 |
| **INTEREST EXPENSE** | | |
| Deposits | **1,986** | 2,002 |
| Long-term debt and other | **61** | 60 |
| **Total Interest Expense** | **2,047** | 2,062 |
| **Net Interest Income** | **22,865** | 21,327 |
| **PROVISION FOR LOAN LOSSES** | **750** | 575 |
| **Net Interest Income After Provision for Loan Losses** | **22,115** | 20,752 |
| **OTHER INCOME** | | |
| Customer service fees | **1,842** | 1,760 |
| Mortgage banking activities | **746** | 887 |
| Income from fiduciary accounts | **468** | 375 |
| Realized loss on sale of securities | **(89)** | - |
| Bank-owned life insurance earnings | **394** | 380 |
| Other | **488** | 674 |
| **Total Other Income** | **3,849** | 4,076 |
| **OTHER EXPENSES** | | |
| Salaries and wages | **6,393** | 6,004 |
| Employee benefits | **2,808** | 2,326 |
| Occupancy | **1,034** | 966 |
| Data processing | **672** | 685 |
| Furniture and equipment | **516** | 618 |
| Advertising and promotion | **383** | 433 |
| Legal and professional | **337** | 376 |
| Donations | **236** | 189 |
| State tax | **760** | 670 |
| Federal deposit insurance | **184** | 237 |
| Other | **2,801** | 2,355 |
| **Total Other Expenses** | **16,124** | 14,859 |
| **Income Before Federal Income Tax Expense** | **9,840** | 9,969 |
| **FEDERAL INCOME TAX EXPENSE** | **3,647** | 2,290 |
| **Net Income** | **$ 6,193** | $ 7,679 |
| **Earnings Per Share** | **$ 4.13** | $ 5.07 |
| **Average Shares Outstanding** | **1,498,499** | 1,515,939 |

*See notes to consolidated financial statements, pages 14-46.*

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

| | Years Ended December 31, | |
|---|---|---|
| | 2017 | 2016 |
| | (In Thousands) | |
| Net income | **$ 6,193** | $ 7,679 |
| Other comprehensive income (loss): | | |
| Unrealized gain (loss) on securities available for sale | **178** | (2,111) |
| Tax effect | **(60)** | 717 |
| Reclassification adjustment for loss recognized in net income | **89** | - |
| Tax effect | **(30)** | - |
| Total other comprehensive income (loss) | **177** | (1,394) |
| **Comprehensive Income** | **$ 6,370** | $ 6,285 |

*See notes to consolidated financial statements, pages 14-46.*

## CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY
**Years Ended December 31, 2017 and 2016**

| | Common Stock | Surplus | Retained Earnings | Accumulated Other Comprehensive Income | Treasury Stock | Total |
|---|---|---|---|---|---|---|
| | (In Thousands, Except Share and Per Share Data) | | | | | |
| **BALANCE - DECEMBER 31, 2015** | $ 360 | $ 1,015 | $ 93,439 | $ 2,128 | $ (6,009) | $ 90,933 |
| Net income | - | - | 7,679 | - | - | 7,679 |
| Other comprehensive income | - | - | - | (1,394) | - | (1,394) |
| Purchase of treasury stock, 15,287 shares | - | - | - | - | (1,103) | (1,103) |
| Dividends declared ($1.51 per share) | - | - | (2,256) | - | - | (2,256) |
| **BALANCE - DECEMBER 31, 2016** | $ 360 | $ 1,015 | $ 98,862 | $ 734 | $ (7,112) | $ 93,859 |
| **Cumulative effect adjustment for adoption of accounting standard** | - | - | **(179)** | **179** | **-** | - |
| **Net income** | **-** | **-** | **6,193** | **-** | **-** | **6,193** |
| **Other comprehensive income** | **-** | **-** | **-** | **177** | **-** | **177** |
| **Purchase of treasury stock, 21,574 shares** | **-** | **-** | **-** | **-** | **(2,115)** | **(2,115)** |
| **Dividends declared ($1.56 per share)** | **-** | **-** | **(2,335)** | **-** | **-** | **(2,335)** |
| **BALANCE - DECEMBER 31, 2017** | **$ 360** | **$ 1,015** | **$ 102,541** | **$ 1,090** | **$ (9,227)** | **$ 95,779** |

*See notes to consolidated financial statements, pages 14-46.*

## CONSOLIDATED STATEMENTS OF CASH FLOWS

| | Years Ended December 31, 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| **CASH FLOWS FROM OPERATING ACTIVITIES** | | |
| Net income | **$ 6,193** | $ 7,679 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | **750** | 575 |
| Provision for off balance sheet | **25** | - |
| Provision for depreciation | **396** | 491 |
| Net amortization of securities premiums and discounts | **776** | 866 |
| Losses on securities available for sale, net | **89** | - |
| Amortization of deferred fees | **(631)** | (571) |
| Amortization of mortgage servicing rights, net of change in valuation allowance | **277** | 300 |
| Deferred income taxes | **1,080** | (212) |
| Proceeds from sale of mortgage loans | **35,167** | 35,094 |
| Net gains on sale of loans | **(555)** | (743) |
| Loans originated for sale | **(34,543)** | (34,713) |
| Bank-owned life insurance earnings | **(394)** | (380) |
| (Increase) decrease in accrued interest receivable | **(91)** | 4 |
| Increase in accrued interest payable | **62** | 26 |
| Other, net | **(81)** | (292) |
| **Net Cash Provided by Operating Activities** | **8,520** | 8,124 |
| **CASH FLOWS FROM INVESTING ACTIVITIES** | | |
| Purchase of investment securities available for sale | **(22,005)** | (28,622) |
| Proceeds from maturities of and principal repayments of investment securities available for sale | **15,675** | 33,697 |
| Proceeds from sale of investment securities available for sale | **4,911** | - |
| Net increase in loans | **(16,467)** | (24,361) |
| Purchase of restricted stock, at cost | **(57)** | (6) |
| Purchase of premises, equipment, software and licensing | **(199)** | (314) |
| Purchase of bank-owned life insurance | **(3,815)** | (815) |
| Redemption of equity investment in partnership | **578** | 575 |
| Purchase of equity investment in partnership | **(2,412)** | (551) |
| Proceeds from liquidation of preferred stock investment | **400** | 1,500 |
| Proceeds from the sale of foreclosed assets | **603** | 249 |
| **Net Cash Used for Investing Activities** | **(22,788)** | (18,648) |
| **CASH FLOWS FROM FINANCING ACTIVITIES** | | |
| Net increase in deposits | **19,147** | 14,166 |
| Purchase of treasury stock | **(2,115)** | (1,103) |
| Dividends paid | **(2,335)** | (2,256) |
| **Net Cash Provided by Financing Activities** | **14,697** | 10,807 |
| **Net Increase in Cash and Cash Equivalents** | **429** | 283 |
| **CASH AND CASH EQUIVALENTS - BEGINNING** | **22,486** | 22,203 |
| **CASH AND CASH EQUIVALENTS - ENDING** | **$ 22,915** | $ 22,486 |
| **SUPPLEMENTARY CASH FLOWS INFORMATION** | | |
| Interest paid | **$ 1,985** | $ 2,036 |
| Income taxes paid | **$ 2,200** | $ 1,970 |
| **SUPPLEMENTARY SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES** | | |
| Foreclosed assets acquired in settlement of loans | **$ 1,013** | $ 286 |

*See notes to consolidated financial statements, pages 14-46.*

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### PRINCIPLES OF CONSOLIDATION

The consolidated financial statements include the accounts of Honat Bancorp, Inc. (the "Company"), a bank holding company, and its wholly owned subsidiary, The Honesdale National Bank (the "Bank"). All significant intercompany accounts and transactions have been eliminated.

### NATURE OF OPERATIONS

The Bank operates under a national bank charter and provides full banking services, including trust services. As a national bank, the Bank is subject to regulation of the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation. The Bank holding company is subject to regulation of the Federal Reserve Bank. The areas served by the Bank are principally Wayne, Luzerne, Lackawanna, Susquehanna, and Pike Counties, in Pennsylvania.

### ESTIMATES AND ASSUMPTIONS

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Consolidated Balance Sheet and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, determination of other-than-temporary impairment of securities, impairment of mortgage servicing rights, fair values of financial instruments, and the valuation of deferred tax assets.

### SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK

Most of the Company's activities are with customers located within northeastern Pennsylvania. Note 3 discusses the types of securities that the Company invests in. Note 4 discusses the types of lending that the Company engages in. The Company does not have any significant concentrations in any one industry or customer. Although the Company has a diversified loan portfolio at December 31, 2017 and 2016, its debtors' ability to honor their contracts is influenced by the region's economy.

### PRESENTATION OF CASH FLOWS

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits and short-term investments, all of which have original maturities of 90 days or less.

### TRUST ASSETS

Assets of the trust department are not included in these financial statements because they are not assets of the Company. Revenues of the trust department are included in income from fiduciary accounts on the Consolidated Statements of Income.

### SHORT-TERM INVESTMENTS

Short-term investments consist of corporate money market securities with maturities less than three months.

### SECURITIES

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

Management determines the appropriate classification of securities at the time of purchase and reevaluates such designation as of each Consolidated Balance Sheet date.

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

### SECURITIES (CONTINUED)

Securities are evaluated on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether a decline in their value is other than temporary. For debt securities, management considers whether the present value of future cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss). The magnitude and duration of the decline and the reasons underlying the decline will be evaluated. To determine whether the loss in value is other than temporary, the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value will be assessed. Once a decline in value is determined to be other than temporary, if the investor does not intend to sell the security, and it is more likely than not that it will not be required to sell the security, before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings.

### INVESTMENT IN RESTRICTED STOCK, AT COST

The Company holds restricted stock in the Federal Reserve Bank ("FRB"), the Federal Home Loan Bank ("FHLB") of Pittsburgh, and the Atlantic Community Bankers Bank ("ACBB") which is carried at cost. The Company holds $41,000 of FRB stock at December 31, 2017 and 2016. The Company holds $10,000 of ACBB stock at December 31, 2017 and 2016. The Company holds $523,000 and $466,000 of FHLB stock at December 31, 2017 and 2016, respectively.

The FHLB stock is bought from and sold to the FHLB based upon its $100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated for impairment as necessary. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted; (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance; (c) the impact of legislative and regulatory changes on the customer base of the FHLB; and (d) the liquidity position of the FHLB. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein.

### MORTGAGE LOANS HELD FOR SALE

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through charges to income.

### MORTGAGE SERVICING RIGHTS

An asset is recognized for mortgage servicing rights acquired through purchase or origination. Amounts capitalized are reported in other assets in the Consolidated Balance Sheet and are amortized in proportion to, and over the period of, estimated net servicing income. If mortgage loans are sold with servicing retained, the total cost of the mortgage loans is allocated to the loans and servicing rights based on their relative fair values. The Company performs a periodic review for impairment in the fair value of mortgage servicing rights. Fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Any impairment is recognized through a valuation allowance, with a corresponding charge in the Consolidated Statements of Income, to the extent the fair value is less than the capitalized amount.

### LOANS RECEIVABLE

Loans receivable that management has the intent and ability to hold for the foreseeable future until maturity or payoff are stated at their outstanding unpaid principal balances, net of any allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans.

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### LOANS RECEIVABLE (CONTINUED)

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

### ALLOWANCE FOR LOAN LOSSES

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectable are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective, since it requires material estimates that may be susceptible to significant revision as more information becomes available. The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as either Doubtful, Substandard, or Other Assets Especially Mentioned (“OAEM”). For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value for that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### TROUBLED DEBT RESTRUCTURINGS

In situations when a borrower experiences financial difficulties related to economic or legal reasons, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered. The related loan is classified as a troubled debt restructuring. Management strives to identify borrowers in financial difficulty early and work with them to modify 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 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 above for impaired loans. In addition to the allowance for the pooled portfolios, management has developed a separate allowance for loans that are identified as impaired through a troubled debt restructuring. These loans are excluded from pooled loss forecasts and a separate reserve is provided under the accounting guidance for loan impairment. Consumer loans whose terms have been modified in a troubled debt restructuring are also individually analyzed for estimated impairment.

### TRANSFERS OF FINANCIAL ASSETS

Transfers of financial assets, including loan and loan participation sales, are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when: (1) the assets have been isolated from the Company; (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 Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

### PREMISES AND EQUIPMENT

Land is stated at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the related assets, which range from three to fifteen years for furniture and equipment. Buildings are amortized over their estimated useful lives, which is over a forty-year period. Expenditures for maintenance and repairs are charged against income as incurred. Costs of major additions and improvements are capitalized.

### FORECLOSED ASSETS

Foreclosed assets consist of property acquired through a foreclosure proceeding or acceptance of a deed in lieu of foreclosure and loans classified as in-substance foreclosure. A loan is classified as in-substance foreclosure when the Company has taken possession of the collateral, regardless of whether formal proceedings take place. Foreclosed assets initially are recorded at fair value, net of estimated selling costs, at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell. Revenues and expenses from operations and changes in the valuation allowance are included in other expenses. In addition, any gain or loss realized upon disposal is included in other income or expense. Foreclosed assets at December 31, 2017 and 2016, were $497,000 and $145,000, respectively, and are included in other assets in the Consolidated Balance Sheet. As of December 31, 2017, the Bank had $1,954,000 in loans that were in the process of foreclosure although the Bank did not have possession of the property.

### BANK-OWNED LIFE INSURANCE

The Company invests in bank-owned life insurance ("BOLI") as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by the Company on a chosen group of employees. The Company is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies. Income from the increase in cash surrender value of the policies is included in other income in the Consolidated Statements of Income, net of expenses.

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### SPLIT DOLLAR LIFE INSURANCE

The Company recognizes a liability related to the postretirement benefits covered by an endorsement split dollar life insurance arrangement. The employer (who is also the policy holder) has a liability for the benefit it is providing to its employee. As such, the liability recognized during the employee's active service period is based on the future cost of insurance to be incurred during the employee's retirement. As of December 31, 2017 and 2016, the liability benefit balance is $644,000 and $632,000, respectively, and is included in other liabilities in the accompanying Consolidated Balance Sheet. The related benefit expense is recorded as a component of employee benefits expense on the Consolidated Statements of Income. The Bank reported related benefits expense of $12,000 for 2017 and 2016.

### EQUITY INVESTMENT IN PARTNERSHIPS

Equity investment in partnerships represents the Company's limited partnership investment in low-income housing projects. The projects are owned by the partnerships, and the housing units developed qualify for federal low-income housing tax credits. The Company elects to participate in these investments to aid in offering affordable housing in our communities and to reach the objective of the Community Reinvestment Act.

The investments are accounted for under the proportional amortization method unless the requirements are not met, in which case the equity method is used. The investment's amortized balance is $4,076,000 and $2,242,000 at December 31, 2017 and 2016, respectively, and is included in other assets in the accompanying Consolidated Balance Sheet. The Company amortized $578,000 and $575,000 of this equity investment during 2017 and 2016, respectively. The Bank recognized a credit to federal income tax expense of $219,000 during 2017 and $245,000 during 2016 due to federal low-income housing tax credits.

### TREASURY STOCK

Purchases of the Company's stock are recorded at cost.

### ADVERTISING COSTS

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

### INCOME TAXES

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

### EARNINGS PER SHARE

The Company currently maintains a simple capital structure; thus, there are no dilutive effects on earnings per share. Earnings per share are calculated by dividing net income by the weighted-average number of shares outstanding for the periods.

### COMPREHENSIVE INCOME

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in net income. Certain changes in assets and liabilities, such as unrealized gains and losses on securities available for sale, are reported as a separate component of the stockholders' equity section of the Consolidated Balance Sheet. Such items, along with net income, are the components of comprehensive income as presented in the Consolidated Statements of Comprehensive Income.

## NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

### OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

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

### RECLASSIFICATIONS

Certain amounts in the prior year financial statements have been reclassified to conform to the current year presentation. These reclassifications had no effect on prior year net income and stockholders' equity.

## NOTE 2 - MORTGAGE BANKING ACTIVITIES

The HNB Mortgage Center, a division of the Bank, originates mortgage loans for portfolio investment or for sale in the secondary market. All sales are made without recourse. The mortgage center also services loans for the benefit of others, consisting of collecting mortgage payments, maintaining escrow accounts, disbursing payments to investors, and foreclosure processing. Loan servicing income is recorded upon receipt and includes servicing fees from investors and certain charges collected from borrowers.

The total cost of mortgage loans originated for sale is allocated between the mortgage servicing rights and the mortgage loans based on their relative fair values. The mortgage servicing rights are capitalized as assets and amortized over the period of estimated net servicing income. Additionally, they are subject to an impairment analysis based on their fair value in future periods. The Bank recorded improvements of $19,000 and $7,000 during 2017 and 2016, respectively, resulting in a valuation reserve against the mortgage servicing rights of $102,000 and $121,000 at December 31, 2017 and 2016, respectively.

Activity in mortgage servicing rights for the years ended December 31, 2017 and 2016, is as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Beginning balance | **$ 1,165** | $ 1,200 |
| Amounts capitalized | **236** | 265 |
| Amortization | **(296)** | (307) |
| Decrease in valuation allowance | **19** | 7 |
| **Ending Balance** | **$ 1,124** | $ 1,165 |

Mortgage servicing rights are included in other assets in the accompanying Consolidated Balance Sheet. Mortgage loans serviced for others totaled $196,159,000 and $196,214,000 at December 31, 2017 and 2016, respectively. In connection with loans serviced for others, the Bank held borrowers' escrow balances of $2,631,000 and $2,541,000 at December 31, 2017 and 2016, respectively.

## NOTE 3 - SECURITIES

The amortized cost and fair value of securities available for sale at December 31, 2017 is summarized as follows:

| | December 31, 2017 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| **AVAILABLE FOR SALE:** | | | | |
| U.S. treasury securities | **$ 991** | **$ -** | **$ (16)** | **$ 975** |
| U.S. government agency securities | **28,924** | **3** | **(184)** | **28,743** |
| States and political subdivisions | **67,678** | **1,597** | **(194)** | **69,081** |
| U.S. government-sponsored agency mortgage-backed securities | **9,085** | **1** | **(33)** | **9,053** |
| Equity securities - financial institutions | **250** | **205** | **-** | **455** |
| | **$ 106,928** | **$ 1,806** | **$ (427)** | **$ 108,307** |

The amortized cost and fair value of securities available for sale at December 31, 2016 is summarized as follows:

| | December 31, 2016 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| | (In Thousands) | | | |
| **AVAILABLE FOR SALE:** | | | | |
| U.S. treasury securities | $ 989 | $ - | $ (23) | $ 966 |
| U.S. government agency securities | 31,026 | 1 | (227) | 30,800 |
| States and political subdivisions | 73,057 | 1,979 | (765) | 74,271 |
| Other debt securities | 1,003 | - | - | 1,003 |
| U.S. government-sponsored agency mortgage-backed securities | 48 | 2 | - | 50 |
| Equity securities - financial institutions | 250 | 145 | - | 395 |
| | $ 106,373 | $ 2,127 | $ (1,015) | $ 107,485 |

## NOTE 3 – SECURITIES (CONTINUED)

The amortized cost and fair value of securities available for sale as of December 31, 2017, by contractual maturity, are shown below, excluding equity securities and mortgage-backed securities, which are shown gross. Expected maturities may differ from contractual maturities because the securities may be called or prepaid with or without any penalties.

| | Amortized Cost | Fair Value |
|---|---|---|
| | (In Thousands) | |
| Due in one year or less | $ 10,747 | $ 10,718 |
| Due after one year through five years | 21,248 | 21,117 |
| Due after five years through ten years | 7,236 | 7,415 |
| Due after ten years | 58,362 | 59,549 |
| | 97,593 | 98,799 |
| U.S. government-sponsored agency mortgage-backed securities | 9,085 | 9,053 |
| Equity securities - financial institutions | 250 | 455 |
| **Total** | $ 106,928 | $ 108,307 |

During the year ended December 31, 2017, there were $4,911,000 in proceeds from the sales of securities available for sale with gross realized losses of $89,000. During the year ended December 31, 2016, there were no sales of securities available for sale.

The following table shows securities gross unrealized losses and fair value, aggregated by security category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2017:

| | December 31, 2017 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In Thousands) | | | | | |
| U.S. treasury securities | $ - | $ - | $ 975 | $ (16) | $ 975 | $ (16) |
| U.S. government agency securities | 15,934 | (91) | 12,406 | (93) | 28,340 | (184) |
| States and political subdivisions | 5,424 | (27) | 10,213 | (167) | 15,637 | (194) |
| U.S. government-sponsored agency mortgage-backed securities | 9,031 | (33) | - | - | 9,031 | (33) |
| Total temporarily impaired securities | $ 30,389 | $ (151) | $ 23,594 | $ (276) | $ 53,983 | $ (427) |

## NOTE 3 – SECURITIES (CONTINUED)

The following table shows securities gross unrealized losses and fair value, aggregated by security category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2016:

| | December 31, 2016 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | (In Thousands) | | | | | |
| U.S. treasury securities | $ 966 | $ (23) | $ - | $ - | $ 966 | $ (23) |
| U.S. government agency securities | 26,799 | (227) | - | - | 26,799 | (227) |
| States and political subdivisions | 27,989 | (707) | 1,587 | (58) | 29,576 | (765) |
| Total temporarily impaired securities | $ 55,754 | $ (957) | $ 1,587 | $ (58) | $ 57,341 | $ (1,015) |

The Company reviews its position quarterly and has asserted at December 31, 2017 and 2016, the declines outlined in the above tables represent temporary declines and the Company does not intend to sell these securities nor is it more likely that the Company will be required to sell these securities before recovery of their cost basis, which may be at maturity. There were 62 positions that were temporarily impaired at December 31, 2017. The Company has concluded that the unrealized losses disclosed above are not other than temporary, but are the result of interest rate changes, sector credit ratings changes, or Company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

Securities with a carrying value of $50,748,000 and $46,611,000 at December 31, 2017 and 2016, respectively, were pledged to secure public deposits, long-term borrowings, and for other purposes as required or permitted by law.

## NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES

The composition of loans receivable at December 31, 2017 and 2016, is as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Commercial and industrial | **$ 80,025** | $ 84,124 |
| Commercial real estate | **192,049** | 175,061 |
| Consumer real estate: | | |
| Home equity lines of credit | **39,880** | 37,051 |
| One-to-four family residential - secured by first liens | **130,460** | 133,659 |
| One-to-four family residential - secured by junior liens | **9,662** | 10,528 |
| Total consumer real estate | **180,002** | 181,238 |
| Consumer | **27,640** | 23,652 |
| Total loans | **479,716** | 464,075 |
| Deduct: | | |
| Allowance for loan losses | **8,711** | 8,405 |
| **Loans receivable, net** | **$ 471,005** | $ 455,670 |

At December 31, 2017 and 2016, the amounts in the table above include net deferred loan origination fees of $541,000 and $710,000, respectively.

### ALLOWANCE FOR LOAN LOSSES

The Company is responsible for ensuring that controls are in place to determine the appropriate level of the allowance for loan losses (ALL), based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio. Loan Review personnel perform the ALL analysis and present it to the Board of Directors for approval on a quarterly basis, or more frequently if warranted. ALL estimates require analysis and reviews of individual loans and groups of loans.

For loans that are individually evaluated and found to be impaired, the associated allowance should be based upon one of the three impairment measurement methods as described in Impaired Loans.

For all other loans the Company will estimate loan losses for groups of loans with similar risk characteristics. These estimates will be based upon historical loss data to segmented portions of the loan portfolio, adjusted for environmental factors.

The ALL will be maintained at a level considered adequate to provide for reasonably anticipated losses.

## NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

### ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The following table presents changes in the allowance for loan losses for the years ended December 31, 2017 and 2016:

| | Commercial and Industrial | Commercial Real Estate | Consumer Real Estate | Consumer | Total |
|---|---|---|---|---|---|
| | | | (In Thousands) | | |
| **2017** | | | | | |
| Balance, beginning of year | **$ 1,064** | **$ 3,850** | **$ 3,052** | **$ 439** | **$ 8,405** |
| Provision for loan losses | **(4)** | **886** | **(108)** | **(24)** | **750** |
| Charge-offs | **(25)** | **(384)** | **(72)** | **(36)** | **(517)** |
| Recoveries | **13** | **4** | **1** | **55** | **73** |
| **Balance at December 31** | **$ 1,048** | **$ 4,356** | **$ 2,873** | **$ 434** | **$ 8,711** |

| | Commercial and Industrial | Commercial Real Estate | Consumer Real Estate | Consumer | Total |
|---|---|---|---|---|---|
| | | | (In Thousands) | | |
| **2016** | | | | | |
| Balance, beginning of year | $ 1,060 | $ 3,721 | $ 2,895 | $ 430 | $ 8,106 |
| Provision for loan losses | 11 | 272 | 236 | 56 | 575 |
| Charge-offs | (11) | (174) | (80) | (66) | (331) |
| Recoveries | 4 | 31 | 1 | 19 | 55 |
| **Balance at December 31** | $ 1,064 | $ 3,850 | $ 3,052 | $ 439 | $ 8,405 |

The changes in the allowance for loan losses year over year are impacted by portfolio segment loan volume, trends in delinquency and charge-offs, and qualitative risk factors applied by management. The portfolio segments management uses in their analysis of the allowance for loan losses are commercial and industrial, commercial real estate, consumer real estate, and consumer.

For the year ending December 31, 2017, the adjustment factor for national and local economic trends and conditions for commercial and industrial, commercial real estate and consumer loan pools was reduced, accounting for the positive economic outlook. In addition, the factor accounting for the experience, ability and depth of management was reduced reflecting the years of service and knowledge of our lending team.

Our commercial real estate portfolio experienced the most significant growth, increasing by $16,988,000. In addition, the Bank recognized net charge offs of $380,000 in commercial real estate loans. As a result of these factors, the provision allocated for this pool of loans increased by $506,000. The Bank’s consumer real estate loan portfolio declined by $1,236,000. This combined with the reduction in factor adjustments described above and net charge offs of $71,000 resulted in a decrease in the provision allocated for consumer real estate loans of $179,000.

## NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

### ALLOWANCE FOR LOAN LOSSES (CONTINUED)

For the year ending December 31, 2016, while commercial and industrial loans grew by $7,228,000, the allowance as a percentage of loans decreased due to the decline in the historical loss percentage. The Bank allocated $272,000 of the provision for loan losses to commercial real estate loans due to $13,268,000 in loan growth and realized net losses of $143,000. The Bank also increased the commercial real estate loans adjustment factor to reflect the rising risk of delinquencies due to the prime rate increase, resulting in higher payments for some borrowers. However, the reserves as a percentage of loans decreased due to a decline in loans classified as Other Assets Especially Mentioned. The consumer real estate allowance increased by $157,000 due to realized net losses of $79,000 and the addition of $236,000 of the provision for loan losses resulting from growth in the consumer real estate loans of over $5,116,000. In addition, the Bank increased the consumer real estate allowance adjustment factors to account for a rise in bankruptcy filings within our market area although the Bank's portfolio has not seen a significant increase in delinquencies.

*Analyzing Individual Loans*
Loans fitting the definition of "impaired" will be individually analyzed to determine an adequate allowance.

The following methodology is utilized to determine an adequate allowance on a loan-by-loan basis:

1. Determine a fair value of the collateral, utilizing appraisals, valuation assumptions, and other calculations deemed appropriate for the collateral involved.
2. Make any adjustment to the appraised value to determine a "reasonable sale price."
3. Deduct appropriate costs to sell, including applicable commissions or transfer tax, to determine a "net proceeds" amount.
4. Determine the final impairment by deducting the net proceeds from the recorded loan balance.
5. If a loan is determined to have "no impairment," then no allocation amount is recorded in the ALL.

Once a loan is analyzed for impairment, whether or not it results in an impairment allocation, it is excluded from the Homogenous Pool of Loans.

*Analyzing Homogenous Pool of Loans*
The loan portfolio is segmented into varying loan type categories (i.e., Commercial real estate, Consumer loans, etc.) allowing for a more in-depth analysis of higher-risk loan types. These segments may be adjusted based on changes in the portfolio or external factors affecting the overall risk of the loan portfolio.

The following methodology is utilized to determine an adequate allowance for each loan type segment:

1. Historical charge-offs are analyzed over a three-year period. A three-year weighted-average charge-off percentage is calculated and then adjusted for current conditions and environmental factors as follows:
    a. Levels of and trends in delinquencies and nonaccruals;
    b. Trends in volume and terms of loans;
    c. Effects of any changes in lending policies;
    d. Experience, ability, and depth of management;
    e. National and local economic trends and conditions;
    f. Concentrations of credit;
    g. Changes in the quality of the Bank's loan review system and the degree of oversight by the Bank's Board of Directors; and
    h. The effect of external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Bank's current portfolio.

2. This "Adjusted Loss Ratio" is then applied to the outstanding loan balances in the various loan categories, with any impaired loans being excluded.

3. Problem loans are analyzed within the loan-type category in which they exist. Separate historical analyses and environmental adjustments are applied to problem loans.

## NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

### ALLOWANCE FOR LOAN LOSSES (CONTINUED)

The Company's recorded investment in loans as of December 31, 2017 and 2016, related to each balance in the allowance for loan losses by portfolio segment and disaggregated on the basis of the Company's impairment methodology was as follows:

| 2017 | Commercial and Industrial | Commercial Real Estate | Consumer Real Estate | Consumer | Total |
|---|---|---|---|---|---|
| | | | (In Thousands) | | |
| Loans individually evaluated for impairment | $ 134 | $ 2,092 | $ 610 | $ - | $ 2,836 |
| Loans collectively evaluated for impairment | 79,891 | 189,957 | 179,392 | 27,640 | 476,880 |
| **Total** | $ 80,025 | $ 192,049 | $ 180,002 | $ 27,640 | $ 479,716 |
| Allowance for loans individually evaluated for impairment | $ 44 | $ 261 | $ 74 | $ - | $ 379 |
| Allowance for loans collectively evaluated for impairment | 1,004 | 4,095 | 2,799 | 434 | 8,332 |
| **Total** | $ 1,048 | $ 4,356 | $ 2,873 | $ 434 | $ 8,711 |

| 2016 | Commercial and Industrial | Commercial Real Estate | Consumer Real Estate | Consumer | Total |
|---|---|---|---|---|---|
| | | | (In Thousands) | | |
| Loans individually evaluated for impairment | $ - | $ 1,678 | $ 1,168 | $ - | $ 2,846 |
| Loans collectively evaluated for impairment | 84,124 | 173,383 | 180,070 | 23,652 | 461,229 |
| **Total** | $ 84,124 | $ 175,061 | $ 181,238 | $ 23,652 | $ 464,075 |
| Allowance for loans individually evaluated for impairment | $ - | $ 125 | $ 111 | $ - | $ 236 |
| Allowance for loans collectively evaluated for impairment | 1,064 | 3,725 | 2,941 | 439 | 8,169 |
| **Total** | $ 1,064 | $ 3,850 | $ 3,052 | $ 439 | $ 8,405 |

### LOAN ORIGINATION/RISK MANAGEMENT

The basic objectives of the lending activities of the Company are to profit from the investment of funds into good loans and to serve the credit needs of, and promote economic development within, the Company's market areas. The Board of Directors recognizes that certain risks are inherent in lending money and commits the Company to this activity with that in mind. The scope of the Company's lending activities is influenced by the belief that a sound financial (asset/liability) management function forms the basis for successful lending activities. Management divides the loan portfolio into classes to monitor risk, which are the same as the portfolio segments, with the exception of consumer real estate. Consumer real estate is divided into three classes, including home equity lines of credit, one-to-four family residential secured by first liens, and one-to-four family residential secured by junior liens.

### NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

#### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

Lending strategies and policies are influenced by competitive, economic, and regulatory factors. A reporting system supplements the review process by providing management with reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and nonperforming and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's business operation. Underwriting standards are designed to promote relationship banking rather than transactional banking. Current and projected cash flows are examined to determine the ability of borrowers to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral type and risk grade criteria.

Consumer real estate loans, which include home equity term loans and lines of credit, are subject to underwriting standards that are influenced by regulatory requirements, loan-to-value percentages, debt-to-income ratios, and overall credit worthiness of the borrower.

The Bank utilizes an automatic underwriting data system on direct and indirect consumer loans. In an effort to monitor and manage consumer loan risk, policies and procedures are developed and modified in accordance with changes in the portfolio and economic climate.

*Concentrations of Credit.* Diversification within the loan portfolio is important to minimize the risks involved in lending. Management will be alert to the development of such concentrations and report them to the Board of Directors for evaluation of the risk involved and for determination of a proper course of action. The Bank is aware of concentrations of credit in the real estate sector in rental of residential buildings. Management has developed reports to monitor these and all components of the portfolio in an effort to minimize risk.

*Nonaccrual and Past-Due Loans.* Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and maintained current for a period of at least six months. Student loans, which are included in the balance of the consumer loan class, past due greater than 90 days will continue to accrue interest until declared to be in default at which time the guaranteed portion of the loan will be refunded to the Bank.

### NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

#### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

Year-end nonaccrual loans, segregated by class of loans, were as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Commercial and industrial | $ 134 | $ - |
| Commercial real estate | 1,325 | 886 |
| Consumer real estate: | | |
| One-to-four family residential - secured by first liens | 482 | 824 |
| One-to-four family residential - secured by junior liens | 9 | 31 |
| Total consumer real estate | 491 | 855 |
| **Total nonaccrual loans** | $ 1,950 | $ 1,741 |

An age analysis of past-due loans, segregated by class of loans, as of December 31, 2017 was as follows:

| 2017 | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|---|---|---|---|---|---|---|
| | | | (In Thousands) | | | |
| Commercial and industrial | $ 134 | $ - | $ 134 | $ 79,891 | $ 80,025 | $ - |
| Commercial real estate | 1,065 | 1,325 | 2,390 | 189,659 | 192,049 | - |
| Consumer real estate: | | | | | | |
| Home equity lines of credit | - | - | - | 39,880 | 39,880 | - |
| One-to-four family residential - secured by first liens | 2,485 | 798 | 3,283 | 127,177 | 130,460 | 388 |
| One-to-four family residential - secured by junior liens | 64 | 9 | 73 | 9,589 | 9,662 | - |
| Consumer | 278 | 248 | 526 | 27,114 | 27,640 | 248 |
| Total | $ 4,026 | $ 2,380 | $ 6,406 | $ 473,310 | $ 479,716 | $ 636 |

## NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

An age analysis of past-due loans, segregated by class of loans, as of December 31, 2016 was as follows:

| 2016 | Loans 30-89 Days Past Due | Loans 90 or More Days Past Due | Total Past Due Loans | Current Loans | Total Loans | Accruing Loans 90 or More Days Past Due |
|---|---|---|---|---|---|---|
| | | | (In Thousands) | | | |
| Commercial and industrial | $ 121 | $ 3 | $ 124 | $ 84,000 | $ 84,124 | $ 3 |
| Commercial real estate | 774 | 1,067 | 1,841 | 173,220 | 175,061 | 181 |
| Consumer real estate: | | | | | | |
| Home equity lines of credit | - | - | - | 37,051 | 37,051 | - |
| One-to-four family residential - secured by first liens | 1,082 | 624 | 1,706 | 131,953 | 133,659 | 32 |
| One-to-four family residential - secured by junior liens | - | 31 | 31 | 10,497 | 10,528 | - |
| Consumer | 502 | 371 | 873 | 22,779 | 23,652 | 371 |
| Total | $ 2,479 | $ 2,096 | $ 4,575 | $ 459,500 | $ 464,075 | $ 587 |

*Impaired Loans.* On a quarterly basis, the Bank will maintain a list of loans identified as "Impaired Loans." A loan is considered impaired when, based on current information and events, it is probable the creditor will be unable to collect all contractual principal and interest payments due in accordance with the terms of the loan agreement. Loans modified and considered a troubled debt restructuring are also impaired loans. Impaired loans do not apply to homogeneous groups of loans evaluated collectively, loans accounted for at fair value or lower of cost or fair value, leases, and debt securities. Management strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. Concessions may include modified terms such as rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. Loans granted such concessions are considered impaired through a troubled debt restructuring. Individually reviewed loans that are determined impaired loans will have a specific reserve analysis on a case-by-case basis.

The methodology for determining and measuring impairment will be documented as follows: (a) if impairment is based on present value of expected cash flows, the amount and timing of cash flows, the effective interest rate used in discounting, and the basis for the determination of cash flows must be properly analyzed; (b) if based on the fair value of collateral, how fair value was determined, including valuation assumptions, costs to sell, appraisal quality, and experience and independence of the appraiser, must be clearly analyzed; (c) if based on observable market price, document amount, source, and date of the price. A valuation allowance is to be established at the time that a loan becomes impaired. The determined amount of impairment will be considered as a specific reserve in the allowance for loan losses ("ALL") for each loan.

### NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

#### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

Year-end impaired loans as of December 31, 2017 and 2016 are set forth in the following tables:

| 2017 | Unpaid Contractual Principal Balance | Recorded Investment with No Allowance | Recorded Investment with Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|---|---|
| | | | | (In Thousands) | | | |
| Commercial and industrial | $ 134 | $ - | $ 134 | $ 134 | $ 44 | $ 27 | $ 8 |
| Commercial real estate | 2,226 | 958 | 1,134 | 2,092 | 261 | 1,977 | 60 |
| Consumer real estate: | | | | | | | |
| Home equity lines of credit | - | - | - | - | - | 11 | - |
| One-to-four family residential - secured by first liens | 684 | 302 | 299 | 601 | 65 | 790 | 10 |
| One-to-four family residential - secured by junior liens | 10 | - | 9 | 9 | 9 | 14 | - |
| Total impaired loans | $ 3,054 | $ 1,260 | $ 1,576 | $ 2,836 | $ 379 | $ 2,820 | $ 78 |

During 2017, the Bank recognized three additional loans secured by consumer real estate, six additional loans secured by commercial real estate and one additional loan secured by inventory and equipment as impaired. The additional loans secured by consumer real estate with balances totaling $259,000 are either pending foreclosure or in the process of pursuing sale of the property. Two of the loans secured by commercial real estate with a combined outstanding balance of $466,000 are currently in bankruptcy proceedings. The remaining four commercial real estate loans recognized as impaired during 2017 with an outstanding balance of $444,000 are all pending foreclosure. The one commercial and industrial loan recognized as impaired for $134,000 is pending the repossession of assets.

| 2016 | Unpaid Contractual Principal Balance | Recorded Investment with No Allowance | Recorded Investment with Allowance | Total Recorded Investment | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|---|---|
| | | | | (In Thousands) | | | |
| Commercial and industrial | $ 1,702 | $ 673 | $ 1,005 | $ 1,678 | $ 125 | $ 1,562 | $ 51 |
| Consumer real estate: | | | | | | | |
| One-to-four family residential - secured by first liens | 1,288 | 655 | 482 | 1,137 | 80 | 1,351 | 30 |
| One-to-four family residential - secured by junior liens | 32 | - | 31 | 31 | 31 | 19 | 1 |
| Consumer | - | - | - | - | - | 3 | - |
| Total impaired loans | $ 3,022 | $ 1,328 | $ 1,518 | $ 2,846 | $ 236 | $ 2,935 | $ 82 |

### NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

#### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

During 2016, the Bank recognized four additional loans secured by consumer real estate and three additional loans secured by commercial real estate. The additional loans secured by consumer real estate with balances totaling $327,000 were either pending foreclosure or listed for sale by the borrower. The borrower of two commercial real estate loans with a combined outstanding balance of $112,000 was in bankruptcy proceedings. The third commercial real estate loan recognized as impaired during 2016 with a balance of $90,000 was on nonaccrual as loan payments were delinquent and the borrower was pursuing the sale of the associated property.

*Credit Quality Indicators*. The purpose of the internal loan review program is to identify and detect potential problem credits at an early stage to prevent possible losses to the Company. The internal loan review program performs reviews of various scopes of commercial and industrial and commercial real estate loans according to dollar amount or grade classification, as determined from time to time by Loan Review personnel or as directed by the Board of Directors. The loan grading classification will be similar in nature to that of the Office of the Comptroller of the Currency as follows:

<u>Pass</u>: These credits would have adequate sources of repayment without any identifiable risk of collection and conform to bank policy and are within compliance guidelines. The majority of bank credits will come under this category.

<u>Watchlist</u>: This classification is assigned to a loan that contains a weakness, but does not warrant a criticized or classified rating. The loan will be considered Pass; however, it will be monitored for repayment status. If an established period of consecutive on-time payments have been made (six months or more) the loan grade can be changed to Pass.

<u>Other Assets Especially Mentioned (“OAEM”)</u>: Assets in this category are currently protected but are potentially weak. Those assets constitute an undue and unwarranted credit risk but not to the point of justifying a classification of Substandard. The credit risk may be relatively minor yet constitute an unwarranted risk in light of the circumstances surrounding a specific asset. An OAEM classification should not be used as a compromise between Pass and Substandard.

<u>Substandard</u>: A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard assets, does not have to exist in individual assets classified Substandard.

<u>Doubtful</u>: An asset classified Doubtful has all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors, which may work to the advantage and strengthening of the asset, its classification as an estimated loss is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures; capital injection; perfecting liens on additional collateral; and refinancing plans.

<u>Loss</u>: Assets classified Loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not desirable to defer writing off this basically worthless asset even though partial recovery may occur in the future.

A meeting of the Asset Quality Committee is held quarterly to discuss any changes in ratings of loans and the appropriate administrative action to be taken for each account. If applicable, an estimate of loss to the Company will be discussed, as recommended by Loan Review personnel. The Asset Quality Committee consists of Loan Officers, Credit Administration, and Collection personnel.

### NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

#### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

Loan Review personnel reports to the Board of Directors with results and recommendations concerning the review process on a quarterly basis. In addition, the Company utilizes an outside consultant to perform an independent loan review from time to time as may be necessary in accordance with regulatory requirements.

The following table presents the credit exposure risk grades and classified loans by class of loan:

| 2017 | Pass | Watchlist | OAEM | Substandard | Doubtful | Total |
|---|---|---|---|---|---|---|
| | | | (In Thousands) | | | |
| Commercial and industrial | $ 73,832 | $ 4,881 | $ 86 | $ 1,226 | $ - | $ 80,025 |
| Commercial real estate | 178,070 | 5,957 | 1,301 | 6,721 | - | 192,049 |
| **Total** | $ 251,902 | $ 10,838 | $ 1,387 | $ 7,947 | $ - | $ 272,074 |

| 2016 | Pass | Watchlist | OAEM | Substandard | Doubtful | Total |
|---|---|---|---|---|---|---|
| | | | (In Thousands) | | | |
| Commercial and industrial | $ 77,092 | $ 5,613 | $ 1,189 | $ 230 | $ - | $ 84,124 |
| Commercial real estate | 161,187 | 6,165 | 1,087 | 6,622 | - | 175,061 |
| **Total** | $ 238,279 | $ 11,778 | $ 2,276 | $ 6,852 | $ - | $ 259,185 |

The following table presents performing and nonperforming loans based solely on payment activity for the period ended December 31, 2017 that have not been assigned an internal risk grade.

| 2017 | Performing | Nonperforming | Total |
|---|---|---|---|
| Consumer real estate: | | (In Thousands) | |
| Home equity lines of credit | $ 39,880 | $ - | $ 39,880 |
| One-to-four family residential - secured by first liens | 129,590 | 870 | 130,460 |
| One-to-four family residential - secured by junior liens | 9,653 | 9 | 9,662 |
| Consumer | 27,392 | 248 | 27,640 |
| **Total** | $ 206,515 | $ 1,127 | $ 207,642 |

### NOTE 4 - LOANS RECEIVABLE AND ALLOWANCE FOR LOAN LOSSES (CONTINUED)

#### LOAN ORIGINATION/RISK MANAGEMENT (CONTINUED)

The following table presents performing and nonperforming loans based solely on payment activity for the period ended December 31, 2016 that have not been assigned an internal risk grade.

| 2016 | Performing | Nonperforming | Total |
|---|---|---|---|
| | | (In Thousands) | |
| Consumer real estate: | | | |
| Home equity lines of credit | $ 37,051 | $ - | $ 37,051 |
| One-to-four family residential - secured by first liens | 132,803 | 856 | 133,659 |
| One-to-four family residential - secured by junior liens | 10,497 | 31 | 10,528 |
| Consumer | 23,281 | 371 | 23,652 |
| Total | $ 203,632 | $ 1,258 | $ 204,890 |

These consumer performing and nonperforming loans presented in the prior tables are not assigned a risk grade unless there is evidence of a problem. Payment activity is reviewed by management on a monthly basis to evaluate performance. Loans are considered to be nonperforming when they become 90 days past due or if management believes they may not collect all of the principal and interest.

#### TROUBLED DEBT RESTRUCTURING

There were no new loan modifications considered troubled debt restructurings completed during the year ending December 31, 2017. Loan modifications that were considered troubled debt restructurings completed during the year ended December 31, 2016, are as follows:

| 2016 | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| | | (In Thousands) | |
| Commercial real estate | 2 | $ 556 | $ 556 |
| **Total** | 2 | $ 556 | $ 556 |

The two new troubled debt restructurings reported for the year ended December 31, 2016, granted payment concessions.

Within the allowance for loan losses, $93,000 and $70,000 have been allocated to troubled debt restructurings at December 31, 2017 and 2016 respectively. The troubled debt restructurings in 2016 were further modifications of existing troubled debt restructurings. The Bank has no commitments to lend additional funds to any borrowers whose loans have been modified in a troubled debt restructuring. No loans previously classified as a troubled debt restructuring defaulted in the twelve month period ending December 31, 2017.

## NOTE 5 - PREMISES AND EQUIPMENT

The components of premises and equipment at December 31, 2017 and 2016, are as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Land | **$ 2,249** | $ 2,249 |
| Bank buildings and building improvements | **9,410** | 9,379 |
| Bank furniture and equipment | **2,755** | 2,990 |
| | **14,414** | 14,618 |
| Accumulated depreciation | **(6,613)** | (6,613) |
| | **$ 7,801** | $ 8,005 |

Depreciation expense was $396,000 and $491,000 for the years ended December 31, 2017 and 2016, respectively.

## NOTE 6 - DEPOSITS

The components of deposits at December 31, 2017 and 2016, were as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Demand, noninterest-bearing | **$ 142,567** | $ 132,454 |
| Demand, interest-bearing | **143,561** | 134,000 |
| Savings | **92,424** | 85,882 |
| Time, $250,000 and over | **24,124** | 21,379 |
| Time, other | **136,572** | 146,386 |
| | **$ 539,248** | $ 520,101 |

At December 31, 2017 the scheduled maturities of time deposits are as follows (in thousands):

| | |
|---|---|
| 2018 | **$ 110,065** |
| 2019 | **27,918** |
| 2020 | **7,138** |
| 2021 | **11,450** |
| 2022 | **4,035** |
| Thereafter | **90** |
| | **$ 160,696** |

## NOTE 7 – BORROWINGS

The Company has a maximum borrowing capacity with FHLB of $189,049,000 at December 31, 2017. The Company had no FHLB long-term debt outstanding as of December 31, 2017 or December 31, 2016.

The Company has a $90,109,000 cash management advance line of credit with FHLB. The interest rate applied to borrowings under this facility is floating and was 1.57% as of December 31, 2017. The Company had no outstanding balance on this line as of December 31, 2017 and December 31, 2016.

The Company has outstanding letters of credit with the FHLB totaling $16,000,000 and $15,000,000, respectively, as of December 31, 2017 and 2016 used for pledging to secure public funds. FHLB borrowings and the letters of credit are collateralized by FHLB stock and qualifying pledged loans.

The Company has outstanding lines of credit with ACBB of $10,500,000. The line of credit for $10,000,000 is subject to a floating rate of interest equal to the current Federal Funds Rate which was 1.50% as of December 31, 2017. The line of credit for $500,000 has a floating interest rate equivalent to the Wall Street Journal Prime rate which was 4.50% as of December 31, 2017. The Company had no outstanding balances on these lines as of December 31, 2017.

## NOTE 8 - EMPLOYEE BENEFITS

The Company has an Employee Stock Ownership Plan with 401(k) provisions (the "Plan"). The Plan is for the benefit of all employees who meet the eligibility requirements set forth in the Plan. The amount of employer contributions to the Plan, including 401(k) matching contributions, is at the discretion of the Board of Directors. Company contributions charged to expense for the years ended December 31, 2017 and 2016, were $848,000 and $775,000, respectively. At December 31, 2017 and 2016, 186,374 and 185,032 shares, respectively, of the Company's common stock were held in the Plan. In the event a terminated Plan participant desires to sell his or her shares of the Company's stock, or for certain employees who elect to diversify their account balances, the Company may be required to purchase the shares from the participant at their fair market value.

The Company has adopted various deferred compensation plans for certain directors and officers of the Company. Under the deferred compensation plan's provisions, benefits will be payable upon retirement, death, or permanent disability of the participant. As of December 31, 2017 and 2016, $4,735,000 and $4,668,000, respectively, of deferred compensation expense has been accrued. The deferred compensation plan is funded by life insurance carried on the lives of the participants. The Company recognized deferred compensation expense of $297,000 and $107,000 in 2017 and 2016, respectively.

## NOTE 9 - INCOME TAXES

The components of income tax expense for the years ended December 31, 2017 and 2016, are listed in the table below. The enactment of the Tax Cuts and Jobs Act ("the Tax Act") in December 2017 resulted in a one-time $1,391,000 reduction in net income as the Bank recognized the decrease in the future corporate tax rate from 34% to 21% on deferred assets.

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Current | **$ 2,567** | $ 2,502 |
| Deferred | **(311)** | (212) |
| Change in corporate tax rate | **1,391** | - |
| | **$ 3,647** | $ 2,290 |

## NOTE 9 - INCOME TAXES (CONTINUED)

A reconciliation of the statutory income tax expense computed at 34% to the income tax expense included in the Consolidated Statements of Income for the years ended December 31, 2017 and 2016, is as follows:

| | | 2017 | | | | 2016 | | |
|---|---|---|---|---|---|---|---|---|
| | | Amount | % of Pretax Income | | | Amount | % of Pretax Income | |
| | | (In Thousands) | | | | | | |
| Federal income tax at statutory rate | **$** | **3,348** | **34** | **%** | $ | 3,389 | 34 | % |
| Tax-exempt income | | **(736)** | **(7)** | | | (751) | (7) | |
| Interest disallowance | | **17** | - | | | 18 | - | |
| Bank-owned life insurance income | | **(130)** | **(1)** | | | (157) | (1) | |
| Low-income housing credit | | **(251)** | **(3)** | | | (254) | (3) | |
| Change in corporate tax rate | | **1,391** | **14** | | | - | - | |
| Other, net | | **8** | **-** | | | 45 | - | |
| | **$** | **3,647** | **37** | **%** | $ | 2,290 | 23 | % |

The components of the net deferred tax assets at December 31, 2017 and 2016, are as follows:

| | | 2017 | | 2016 |
|---|---|---|---|---|
| | | (In Thousands) | | |
| Deferred tax assets: | | | | |
| Allowance for loan losses | **$** | **1,846** | $ | 2,876 |
| Securities impairment charges | | **7** | | 12 |
| Deferred compensation | | **993** | | 1,587 |
| Investment in low-income housing partnerships | | **356** | | 460 |
| Nonaccrual interest | | **22** | | 33 |
| Accrued expenses | | **11** | | - |
| Impairment allowance | | **218** | | 352 |
| | | **3,453** | | 5,320 |
| Valuation allowance | | **(130)** | | (130) |
| **Total deferred tax assets** | | **3,323** | | 5,190 |
| Deferred tax liabilities: | | | | |
| Bank premises and equipment | | **(166)** | | (363) |
| Mortgage servicing rights | | **(236)** | | (396) |
| Unrealized gains on available-for-sale securities | | **(290)** | | (378) |
| Prepaid expenses and loan origination costs | | **(435)** | | (634) |
| **Total deferred tax liabilities** | | **(1,127)** | | (1,771) |
| **Net deferred tax assets** | **$** | **2,196** | $ | 3,419 |

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### NOTE 9 - INCOME TAXES (CONTINUED)

The ability to realize the benefits of deferred tax assets is dependent on a number of factors, including the generation of future taxable income, the ability to carryback to taxable income in previous years, the ability to offset capital losses with capital gains, the reversal of deferred tax liabilities, and certain tax planning strategies. A valuation allowance has been established to offset deferred tax assets that could result in future capital losses which management believes may not be realizable. The valuation allowance is $130,000 at December 31, 2017 and 2016

The Company uses a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statement only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold shall be recognized in the first subsequent financial reporting period in which the threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met. There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the Consolidated Statements of Income. The Company's policy is to account for interest as a component of interest expense and penalties as a component of other expense. The Company's federal and Pennsylvania income tax returns for taxable years prior to 2014 have been closed for purposes of examination by the Internal Revenue Service and the Pennsylvania Department of Revenue. The Company's New Jersey income tax returns for taxable years prior to 2013 have been closed for purposes of examination.

### NOTE 10 - TRANSACTIONS WITH EXECUTIVE OFFICERS, DIRECTORS, AND PRINCIPAL STOCKHOLDERS

The Company has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, and their related interests on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. There were three new executive members added during 2017.

An analysis of the activity for loans to related parties is as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Balance, beginning | **$ 30,164** | $ 25,640 |
| New loans | **12,812** | 27,554 |
| Repayments | **(14,420)** | (23,030) |
| **Balance, ending** | **$ 28,556** | $ 30,164 |

### NOTE 11 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

### NOTE 11 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK (CONTINUED)

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

A summary of the Company's financial instrument commitments at December 31, 2017 and 2016, is as follows:

| | 2017 | 2016 |
|---|---|---|
| | (In Thousands) | |
| Commitments to grant loans | **$ 30,850** | $ 22,256 |
| Unfunded commitments under lines of credit | **103,548** | 92,440 |
| Outstanding letters of credit | **4,639** | 6,473 |

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

Outstanding letters of credit written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These standby letters of credit expire within the next 12 months. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending other loan commitments. The Company requires collateral supporting these letters of credit, as deemed necessary. The maximum undiscounted exposure related to these commitments at December 31, 2017 and 2016, was $4,639,000 and $6,473,000, respectively.

### NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES

Management uses its best judgment in estimating the fair value of the Company's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year-ends and have not been reevaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year-end. The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

### NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES (CONTINUED)

The recent fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

*Level I:* Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level I assets and liabilities generally include debt and equity securities that are traded in active exchange markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

*Level II*: Valuation is based on inputs other than quoted prices included within Level I that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted policies for similar assets or liabilities, quoted prices in markets that are not active, or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

*Level III*: Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level III assets and liabilities include financial instruments, the value of which is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

The hierarchy requires the use of observable market data when available.

The fair value of investment securities available for sale is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2017 are as follows:

| **Description** | **Total** | **Level I** | **Level II** | **Level III** |
|---|---|---|---|---|
| | | **(In Thousands)** | | |
| **December 31, 2017:** | | | | |
| Investment securities available for sale: | | | | |
| U.S. treasury securities | **$ 975** | $ - | **$ 975** | $ - |
| U.S. government agency securities | **28,743** | - | **28,743** | - |
| States and political subdivisions | **69,081** | - | **69,081** | - |
| U.S. government-sponsored mortgage-backed securities | **9,053** | - | **9,053** | - |
| Equity securities - financial institutions | **455** | **455** | **-** | - |

### NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES (CONTINUED)

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

| Description | Total | Level I | Level II | Level III |
|---|---|---|---|---|
| | | (In Thousands) | | |
| **December 31, 2016:** | | | | |
| Investment securities available for sale: | | | | |
| U.S. treasury securities | $ 966 | $ - | $ 966 | $ - |
| U.S. government agency securities | 30,800 | - | 30,800 | - |
| States and political subdivisions | 74,271 | - | 74,271 | - |
| Other debt securities | 1,003 | - | 1,003 | - |
| U.S. government-sponsored mortgage-backed securities | 50 | - | 50 | - |
| Equity securities - financial institutions | 395 | 395 | - | - |

*Impaired loans.* The Company has measured impairment on impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral-dependent loan is less than the carrying amount of the loan, a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the following tables as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is not included in the following tables as it is not currently being carried at its fair value. At December 31, 2017 and 2016, the fair values in the following tables exclude estimated selling costs of $133,000.

*Other real estate owned.* OREO is carried at the lower of cost or fair value, which is measured at the date of foreclosure. If the fair value of the collateral exceeds the carrying amount of the loan, no charge-off or adjustment is necessary, the loan is not considered to be carried at fair value, and is therefore not included in the following tables. If the fair value of the collateral is less than the carrying amount of the loan, management will charge the loan down to its estimated realizable value. The fair value of OREO is based on the appraised value of the property, which is generally unadjusted by management and is based on comparable sales for similar properties in the same geographic region as the subject property, and is included in the following tables as a Level II measurement. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. In these cases, the loans are categorized in the following tables as a Level III measurement since these adjustments are considered to be unobservable inputs. Income and expenses from operations and further declines in the fair value of the collateral subsequent to foreclosure are included in net expenses from OREO.

*Mortgage servicing rights.* The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation incorporates assumptions that market participants would use in estimating future net servicing income. The Bank is able to compare the valuation model inputs and results with widely available published industry data for reasonableness.

### NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES (CONTINUED)

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at December 31, 2017 and 2016 are as follows:

| Description | Total | Level I | Level II | Level III |
|---|---|---|---|---|
| | | | (In Thousands) | |
| **December 31, 2017:** | | | | |
| Financial assets: | | | | |
| Impaired loans | **$ 1,868** | **$ -** | **$ -** | **$ 1,868** |
| Other real estate owned | **497** | **-** | **-** | **497** |
| Mortgage servicing rights | **1,408** | **-** | **-** | **1,408** |

| Description | Total | Level I | Level II | Level III |
|---|---|---|---|---|
| | | | (In Thousands) | |
| **December 31, 2016:** | | | | |
| Financial assets: | | | | |
| Impaired loans | $ 1,651 | $ - | $ - | $ 1,651 |
| Other real estate owned | 145 | - | - | 145 |
| Mortgage servicing rights | 1,165 | - | - | 1,165 |

The following table presents quantitative information about the Level III significant unobservable inputs for assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2017:

**Quantitative Information About Level III Fair Value Measurements**
**(In Thousands)**

| 2017 | Fair Value | Valuation Technique | Unobservable Input | Range | Weighted Average |
|---|---|---|---|---|---|
| Impaired loans | **$ 1,868** | Appraisal of collateral | Appraisal adjustments | **0% - 67%** | **33%** |
| Other real estate owned | **497** | Appraisal of collateral | Appraisal adjustments | **6% - 23%** | **17%** |
| | | | Liquidation expenses | **7%** | **7%** |
| Mortgage servicing rights | **1,408** | Discounted cash flow | Discount rates | **14%** | **14%** |
| | | | Prepayment speeds | **109% - 293%** | **152%** |

### NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES (CONTINUED)

The following table presents quantitative information about the Level III significant unobservable inputs for assets and liabilities measured at fair value on a nonrecurring basis at December 31, 2016:

**Quantitative Information About Level III Fair Value Measurements**
**(In Thousands)**

| 2016 | Fair Value | Valuation Technique | Unobservable Input | Range | Weighted Average |
|---|---|---|---|---|---|
| Impaired loans | $ 1,651 | Appraisal of collateral | Appraisal adjustments | 0% - 50% | 30% |
| Other real estate owned | 145 | Appraisal of collateral | Appraisal adjustments | 10% | 10% |
| | | | Liquidation expenses | 7% | 7% |
| Mortgage servicing rights | 1,165 | Discounted cash flow | Discount rates | 12% | 12% |
| | | | Prepayment speeds | 119% - 320% | 208% |

The following information should not be interpreted as an estimate of the fair value of the entire Company, since a fair value calculation is only provided for a limited portion of the Company's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at December 31, 2017 and 2016:

**Cash and Cash Equivalents**
The carrying amount of cash and cash equivalents approximates their fair value.

**Securities**
The fair value of trading securities (carried at fair value) and securities available for sale (carried at fair value) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level I), or matrix pricing (Level II), which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices.

**Mortgage Loans Held for Sale**
The fair value of mortgage loans held for sale is determined, when possible, using quoted secondary market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan.

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

**Mortgage Servicing Rights**
The fair value of mortgage servicing rights is based on a valuation model that calculates the present value of estimated net servicing income. The valuation incorporates assumptions that market participants would use in estimating future net servicing income. The Bank is able to compare the valuation model inputs and results with widely available published industry data for reasonableness.

## NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES (CONTINUED)

**Investment in Restricted Stock**
The carrying amount of investment in restricted stock approximates fair value and considers the limited marketability of such securities.

**Accrued Interest Receivable and Payable**
The carrying amount of accrued interest receivable and accrued interest payable approximates its fair value.

**Bank-Owned Life Insurance**
The fair value is equal to the cash surrender value of the life insurance policies.

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

**Off-Balance Sheet Financial Instruments**
Fair values for the Bank's off-balance sheet financial instruments (lending commitments and letters of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The estimated fair values of the Company's financial instruments at December 31, 2017 were as follows:

| | 2017 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level I | Level II | Level III |
| | | | (In Thousands) | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 22,915 | $ 22,915 | $ 22,915 | $ - | $ - |
| Securities available for sale | 108,307 | 108,307 | 455 | 107,852 | - |
| Mortgage loans held for sale | 1,633 | 1,633 | 1,633 | - | - |
| Loans receivable, net | 471,005 | 472,359 | - | - | 472,359 |
| Investment in restricted stock | 574 | 574 | 574 | - | - |
| Accrued interest receivable | 2,307 | 2,307 | 2,307 | - | - |
| Bank-owned life insurance | 19,707 | 19,707 | 19,707 | - | - |
| Mortgage servicing rights | 1,124 | 1,408 | - | - | 1,408 |
| Financial liabilities: | | | | | |
| Deposits | 539,248 | 537,551 | 378,552 | - | 158,999 |
| Accrued interest payable | 642 | 642 | 642 | - | - |

### NOTE 12 - FAIR VALUE MEASUREMENTS AND DISCLOSURES (CONTINUED)

The estimated fair values of the Company's financial instruments at December 31, 2016 were as follows:

| | 2016 | | | | |
|---|---|---|---|---|---|
| | Carrying Amount | Fair Value | Level I | Level II | Level III |
| | | | (In Thousands) | | |
| Financial assets: | | | | | |
| Cash and cash equivalents | $ 22,486 | $ 22,486 | $ 22,486 | $ - | $ - |
| Securities available for sale | 107,485 | 107,485 | 395 | 107,090 | - |
| Mortgage loans held for sale | 1,702 | 1,702 | 1,702 | - | - |
| Loans receivable, net | 455,670 | 458,082 | - | - | 458,082 |
| Investment in restricted stock | 517 | 517 | 517 | - | - |
| Accrued interest receivable | 2,216 | 2,216 | 2,216 | - | - |
| Bank-owned life insurance | 15,498 | 15,498 | 15,498 | - | - |
| Mortgage servicing rights | 1,165 | 1,165 | - | - | 1,165 |
| Financial liabilities: | | | | | |
| Deposits | 520,101 | 519,189 | 352,336 | - | 166,853 |
| Accrued interest payable | 580 | 580 | 580 | - | - |

### NOTE 13 - REGULATORY MATTERS

The Bank is required to maintain cash reserve balances in vault cash or with the Federal Reserve Bank. The total of those reserve balances was approximately $605,000 at December 31, 2017 and $496,000 at December 31, 2016.

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios of total, Tier 1 capital (as defined in the regulations), common equity Tier 1 capital to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2017, that the Bank meets all capital adequacy requirements to which it is subject.

### NOTE 13 - REGULATORY MATTERS (CONTINUED)

As of December 31, 2017, the most recent notification from the Office of the Comptroller of the Currency categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, common equity Tier 1 risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category. Consolidated capital amounts and ratios are not materially different from those presented below.

| | Actual | | For Capital Adequacy Purposes | | To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (In Thousands) | | | | | |
| **As of December 31, 2017:** | | | | | | |
| Total capital (to risk-weighted assets) | **$ 99,830** | **19.55** % | ≥ **$ 40,843** | ≥ **8.0** % | **$ 51,054** | **10.0 %** |
| Common Equity Tier 1 Capital (to risk-weighted assets) | **93,417** | **18.30** | **22,974** | **4.5** | **33,185** | **6.5** |
| Tier I capital (to risk-weighted assets) | **93,417** | **18.30** | **30,632** | **6.0** | **30,633** | **8.0** |
| Tier I capital (to average assets) | **93,417** | **14.63** | **25,534** | **4.0** | **31,918** | **5.0** |
| **As of December 31, 2016:** | | | | | | |
| Total capital (to risk-weighted assets) | $ 98,469 | 19.68 % | ≥ $ 39,836 | ≥ 8.0 % | $ 49,794 | 10.0 % |
| Common Equity Tier 1 Capital (to risk-weighted assets) | 92,186 | 18.43 | 22,407 | 4.5 | 32,366 | 6.5 |
| Tier I capital (to risk-weighted assets) | 92,186 | 18.43 | 30,012 | 6.0 | 40,016 | 8.0 |
| Tier I capital (to average assets) | 92,186 | 14.95 | 24,672 | 4.0 | 30,840 | 5.0 |

Banking regulations place certain restrictions on dividends paid by the Bank to the Company. A national bank is required to obtain the approval of the Office of the Comptroller of the Currency if the total of all dividends declared in any calendar year exceeds the Bank's net profits (as defined) for that year combined with its retained net profits for the preceding two calendar years. Under this formula, the Bank can declare dividends in 2018 of approximately $5,827,000 plus an additional amount equal to the Bank's net profits for 2018, up to the date of any such dividend declaration. In addition, dividends paid by the Bank to the Company would be prohibited if the effect thereof would cause the Bank's capital to be reduced below applicable minimum capital requirements above.

## NOTE 14 - ACCUMULATED OTHER COMPREHENSIVE INCOME

The activity in accumulated other comprehensive income for the years ended December 31, 2017 and 2016, is as follows:

| | Unrealized Gains on Securities Available for Sale [1] [2] | |
|---|---|---|
| | **2017** | **2016** |
| | (In Thousands) | |
| Beginning Balance | **$ 734** | $ 2,128 |
| Other comprehensive income (loss) before reclassifications | **118** | (1,394) |
| Amounts reclassified from accumulated other comprehensive income | **59** | - |
| Cumulative effect adjustment for change in accounting principle | **179** | - |
| Period change | **356** | (1,394) |
| **Ending Balance** | **$ 1,090** | $ 734 |

(1) All amounts are net of tax. Related income tax expense or benefit is calculated using an income tax rate approximating 34%.
(2) At December 31, 2017, a cumulative effect adjustment was made to reflect these values assuming the reduced effective corporate tax rate of 21%.

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified from Accumulated Other Comprehensive Income (Loss) For the Year Ended December 31, [2] | | Affected Line Item in the Consolidated Statements of Income |
|---|---|---|---|
| | 2017 | 2016 | |
| | (In Thousands) | | |
| Securities available for sale [1]: | | | |
| Net securities gains reclassified into earnings | **$ (89)** | $ - | Realized loss on sale of securities |
| Related income tax expense | **30** | - | Federal income tax expense |
| **Total reclassifications for the period** | **$ (59)** | $ - | |

(1) For additional details related to unrealized gains (losses) on securities and related amounts reclassified from accumulated other comprehensive income, see Note 3, "Securities."
(2) Amounts in parenthesis indicate debits.

## NOTE 15 - SUBSEQUENT EVENTS

On February 14, 2018 the Financial Accounting Standards Board finalized ASU 2018-02 and, as a result, the Company has elected to reclassify the income tax effects of the Tax Cuts and Jobs Act from accumulated other comprehensive income into retained earnings This election resulted in the reclassification of ($179,000) from accumulated other comprehensive income to retained earnings.

Management has reviewed events occurring through March 1, 2018, the date the financial statements were issued, and no additional subsequent events occurred requiring accrual or disclosure.

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SNODGRASS
CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Stockholders
Honat Bancorp, Inc.
Honesdale, Pennsylvania

**Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of Honat Bancorp, Inc. and subsidiary which comprise the consolidated balance sheet as of December 31, 2017 and 2016; the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended; and the related notes to the consolidated financial statements.

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

Management is responsible for the preparation and fair presentation of these consolidated 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 consolidated 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 consolidated 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 consolidated financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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 consolidated financial statements referred to above present fairly, in all material respects, the financial position of Honat Bancorp, Inc. and subsidiary as of December 31, 2017 and 2016, and the results of their operations and their cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

S.R. Snodgrass, P.C.

Cranberry Township, Pennsylvania
March 1, 2018

# Officers of
# The Honesdale National Bank

| | |
|---|---|
| William Schweighofer | Chairman of the Board |
| John P. Burlein | Vice Chairman |
| David E. Raven | President and Chief Executive Officer |
| Marcele R. Swingle | Executive Vice President |
| Raymond J. Ceccotti | Senior Vice President |
| Christopher Bresset | Vice President |
| Katherine M. Bryant | Vice President |
| Christopher T. Cook | Vice President |
| Charles D. Curtin | Vice President |
| Kathleen Enslin | Vice President |
| Sean A. Finan | Vice President |
| Mark A. Graziadio | Vice President |
| Gregory G. Gula | Vice President |
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| Mary Ann Risboskin | Loan Officer |
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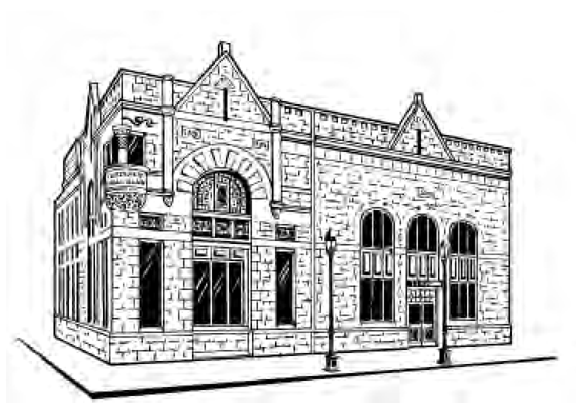
| Beverly A. Simons | Branch Manager/Loan Officer |
| Brian P. Wilken | Business Development Officer |
| Linda A. Miller | Collection Officer |
| Virginia A. Connor | Deposit Operations Officer |
| Kevin Colgan | Fraud/Security Officer |



Honat Bancorp, Inc.