



March 24, 2017

To: Federal Deposit Insurance Corporation
Federal Reserve Bank of Richmond
Commonwealth of Virginia Bureau of Financial Institutions

From: John Marshall Bank (the "Bank")

RE: Part 363 Annual Report for the Year Ended December 31, 2016

This Annual Report is intended to fulfil the Bank's annual reporting requirements under Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC's regulations which impose annual audit and reporting requirements on insured depository institutions with \$500 million or more in total assets.

I. Audited Financial Statements – attached is a copy of the Bank's 2016 audited financial statements, including the audit opinion of our independent public accountant, Yount, Hyde & Barbour.

II. Management Report

a. Statement of Management's Responsibilities

The management of the Bank is responsible for preparing the Bank's annual financial statements in accordance with generally accepted accounting principles; for establishing and maintaining an adequate internal control structure and procedures for financial reporting, including controls over the preparation of regulatory financial statements in accordance with the instructions for the Call Report; and for complying with the Federal laws and regulations pertaining to insider loans and the Federal and State laws and regulations pertaining to dividend restrictions.

b. Management's Assessment of Compliance with Designated Laws and Regulations


The management of the Bank has assessed the Bank's compliance with the Federal laws and regulations pertaining to insider loans and the Federal and State laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 2016. Based upon its assessment, management has concluded that the Bank complied with the Federal laws and regulations pertaining to insider loans and the Federal and State laws and regulations pertaining to dividend restrictions during the fiscal year that ended on December 31, 2016.

John Marshall Bank

By:


John R. Maxwell
Chairman & Chief Executive Officer

By:


Carl E. Dodson
Executive Vice President
Chief Operating Officer and Chief Financial Officer

III. Independent Auditor Communications – attached is a copy of the annual report made to the Bank's Board Audit Committee by the Bank's independent public accountant, Yount, Hyde & Barbour.



JOHN MARSHALL BANK

Reston, Virginia

FINANCIAL STATEMENTS

DECEMBER 31, 2016 and 2015



Independent Auditor's Report

To the Audit Committee of the Board of Directors
John Marshall Bank
Reston, Virginia

Report on the Financial Statements

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

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

Yount, Hyde & Barbour, P.C.

Winchester, Virginia
March 23, 2017

JOHN MARSHALL BANK**Balance Sheets**

December 31, 2016 and 2015

(In thousands, except share and per share data)

Assets	2016	2015
Cash and due from banks	\$ 4,898	\$ 8,217
Interest-bearing deposits in banks	49,717	46,738
Federal funds sold	60	- -
Securities available-for-sale, at fair value	48,312	32,145
Securities held-to-maturity, fair value of \$44,067 in 2016 and \$46,780 in 2015	44,073	46,479
Restricted securities, at cost	7,873	6,210
Loans, net of allowance for loan losses of \$8,202 in 2016 and \$7,130 in 2015	886,220	774,633
Bank premises and equipment, net	2,471	2,690
Accrued interest receivable	2,988	2,318
Bank owned life insurance	18,540	- -
Other assets	10,205	9,190
Total assets	<u>\$ 1,075,357</u>	<u>\$ 928,620</u>
Liabilities and Shareholders' Equity		
Liabilities		
Deposits:		
Non-interest bearing demand deposits	\$ 195,065	\$ 136,361
Interest bearing demand deposits	211,495	235,313
Savings deposits	6,856	17,154
Time deposits	419,449	342,025
Total deposits	832,865	730,853
Repurchase agreements	14,206	11,972
Federal Home Loan Bank advances	104,000	71,000
Accrued interest payable	220	109
Other liabilities	5,271	5,384
Total liabilities	<u>956,562</u>	<u>819,318</u>
Shareholders' Equity		
Preferred stock, par value \$5 per share; authorized 1,000,000 shares; none issued	- -	- -
Common stock, nonvoting, par value \$5 per share; authorized 1,000,000 shares; none issued	- -	- -
Common stock, voting, par value \$5 per share; authorized 20,000,000 shares; issued and outstanding, 10,137,149 shares in 2016 and 10,016,574 in 2015	50,686	50,083
Additional paid-in capital	32,112	31,313
Retained earnings	36,454	28,153
Accumulated other comprehensive loss	(457)	(247)
Total shareholders' equity	<u>118,795</u>	<u>109,302</u>
	<u>\$ 1,075,357</u>	<u>\$ 928,620</u>

See Notes to Financial Statements.

JOHN MARSHALL BANK
Statements of Income
Years Ended December 31, 2016 and 2015
(In thousands, except per share data)

	<u>2016</u>	<u>2015</u>
Interest and Dividend Income		
Interest and fees on loans	\$ 40,250	\$ 37,145
Interest on investment securities, taxable	1,432	1,280
Interest on investment securities, tax-exempt	170	104
Dividends	341	296
Interest on deposits in banks	<u>168</u>	<u>65</u>
Total interest and dividend income	<u>42,361</u>	<u>38,890</u>
Interest Expense		
Deposits	5,411	4,572
Federal Home Loan Bank advances	784	580
Other short-term borrowings	<u>60</u>	<u>61</u>
Total interest expense	<u>6,255</u>	<u>5,213</u>
Net interest income	36,106	33,677
Provision for loan losses	<u>3,810</u>	<u>1,197</u>
Net interest income after provision for loan losses	<u>32,296</u>	<u>32,480</u>
Noninterest Income		
Service charges on deposit accounts	401	482
Bank owned life insurance	540	-
Other service charges and fees	77	68
Other operating income	<u>6</u>	<u>29</u>
Total noninterest income	<u>1,024</u>	<u>579</u>
Noninterest Expenses		
Salaries and employee benefits	12,548	11,421
Occupancy expense of premises	1,678	1,781
Furniture and equipment expenses	1,228	1,065
Other real estate owned expense	1	247
Other operating expenses	<u>5,523</u>	<u>4,767</u>
Total noninterest expenses	<u>20,978</u>	<u>19,281</u>
Income before income taxes	12,342	13,778
Income tax expense	<u>4,041</u>	<u>4,911</u>
Net income	<u><u>\$ 8,301</u></u>	<u><u>\$ 8,867</u></u>
Earnings Per Common Share		
Basic	\$ 0.82	\$ 0.89
Diluted	\$ 0.79	\$ 0.85

See Notes to Financial Statements.

JOHN MARSHALL BANK

Statements of Comprehensive Income

Years Ended December 31, 2016 and 2015

(In thousands)

	<u>2016</u>	<u>2015</u>
Net income	\$ 8,301	\$ 8,867
Other comprehensive loss:		
Unrealized loss on available for sale securities, net of tax of \$(114) and \$(57)	(222)	(111)
Recassification adjustment for gains on available-for-sale securities included in net income, net of tax of \$1 and \$--	(1)	- -
Amortization of unrealized loss on securities transferred to held-to-maturity, net of tax of \$7 and \$26	13	51
Total other comprehensive loss	<u>(210)</u>	<u>(60)</u>
Total comprehensive income	<u>\$ 8,091</u>	<u>\$ 8,807</u>

See Notes to Financial Statements.

JOHN MARSHALL BANK

Statements of Changes in Shareholders' Equity

Years Ended December 31, 2016 and 2015

(In thousands, excluding shares)

	Shares	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
Balance, December 31, 2014	8,305,086	\$ 41,525	\$ 39,023	\$ 19,288	\$ (187)	\$ 99,649
Net income	--	--	--	8,867	--	8,867
Other comprehensive loss	--	--	--	--	(60)	(60)
Exercise of stock options	48,209	242	100	--	--	342
6 for 5 stock split in the form of a 20% stock dividend	1,663,279	8,316	(8,316)	--	--	--
Share-based compensation	--	--	506	--	--	506
Cash paid in lieu of fractional shares	--	--	--	(2)	--	(2)
Balance, December 31, 2015	<u>10,016,574</u>	<u>50,083</u>	<u>31,313</u>	<u>28,153</u>	<u>(247)</u>	<u>109,302</u>
Net income	--	--	--	8,301	--	8,301
Other comprehensive loss	--	--	--	--	(210)	(210)
Exercise of stock options	120,575	603	248	--	--	851
Share-based compensation	--	--	325	--	--	325
Income tax benefit on stock options	--	--	226	--	--	226
Balance, December 31, 2016	<u><u>10,137,149</u></u>	<u><u>\$ 50,686</u></u>	<u><u>\$ 32,112</u></u>	<u><u>\$ 36,454</u></u>	<u><u>\$ (457)</u></u>	<u><u>\$ 118,795</u></u>

See Notes to Financial Statements.

JOHN MARSHALL BANK
Statements of Cash Flows
Years Ended December 31, 2016 and 2015
(In thousands)

	<u>2016</u>	<u>2015</u>
Cash Flows from Operating Activities		
Net income	\$ 8,301	\$ 8,867
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	761	775
Provision for loan losses	3,810	1,197
Share-based compensation expense	325	506
Net amortization of securities	587	411
Gains on sales and calls of available-for-sale securities	(2)	--
Loss on impairment and sale of other real estate owned	--	176
Deferred tax (benefit)	(387)	(389)
Loss on disposal of fixed assets	--	1
Increase in cash surrender value of life insurance	(540)	--
Changes in assets and liabilities:		
(Increase) in accrued interest receivable	(670)	(150)
(Increase) in other assets	(520)	(1,320)
Increase (decrease) in accrued interest payable	111	(23)
(Decrease) increase in other liabilities	(113)	344
Net cash provided by operating activities	<u>\$ 11,663</u>	<u>\$ 10,395</u>
Cash Flows from Investing Activities		
Increase in interest bearing deposits in banks	\$ (2,979)	\$ (28,952)
Net increase in loans	(115,397)	(100,061)
Purchase of available-for-sale securities	(37,216)	(36,374)
Purchase of held-to-maturity securities	(3,583)	(3,114)
Proceeds from sales of available-for-sale securities	4,007	--
Proceeds from maturities, calls and principal repayments of available-for-sale securities	16,531	17,500
Proceeds from maturities, calls and principal repayments of held-to-maturity securities	5,597	6,278
Net purchase of restricted securities	(1,663)	(809)
Proceeds from sale of other real estate owned	--	832
Purchase of federal funds sold	(60)	--
Purchase of bank owned life insurance	(18,000)	--
Purchases of bank premises and equipment	(542)	(425)
Net cash used in investing activities	<u>\$ (153,305)</u>	<u>\$ (145,125)</u>

See Notes to Financial Statements.

JOHN MARSHALL BANK

Statements of Cash Flows (continued) Years Ended December 31, 2016 and 2015 (In thousands)

	<u>2016</u>	<u>2015</u>
Cash Flows from Financing Activities		
Net increase in deposits	\$ 102,012	\$ 113,240
Net proceeds from FHLB advances	33,000	19,000
Increase (decrease) in repurchase agreements	2,234	(432)
Issuance of common stock	851	342
Cash paid in lieu of fractional shares	- -	(2)
Excess tax benefit from share-based compensation	226	- -
Net cash provided by financing activities	<u>\$ 138,323</u>	<u>\$ 132,148</u>
 Net decrease in cash and cash equivalents	 \$ (3,319)	 \$ (2,582)
Cash and cash equivalents at beginning of period	<u>8,217</u>	<u>10,799</u>
Cash and cash equivalents at end of period	<u><u>\$ 4,898</u></u>	<u><u>\$ 8,217</u></u>
 Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	\$ 6,144	\$ 5,236
Income taxes	<u>\$ 4,098</u>	<u>\$ 4,766</u>
 Supplemental Disclosures of Noncash Transactions		
Unrealized loss on securities available for sale	<u>\$ (338)</u>	<u>\$ (168)</u>
Amortization of unrealized loss on securities transferred to held to maturity	<u>\$ 20</u>	<u>\$ 77</u>
Loans transferred to other real estate owned	<u><u>\$ - -</u></u>	<u><u>\$ 1,008</u></u>

See Notes to Financial Statements.

Notes to Financial Statements

JOHN MARSHALL BANK

Notes to Financial Statements

Note 1. Nature of Banking Activities and Significant Accounting Policies

Nature of Banking Activities

John Marshall Bank (the “Bank”) is a corporation formed on April 5, 2005 under the laws of the Commonwealth of Virginia and was chartered as a bank on February 9, 2006, by the State Corporation Commission – Bureau of Financial Institutions. The Bank is a member of the Federal Reserve System and is subject to the rules and regulations of the Virginia State Banking Commission, the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and the Federal Deposit Insurance Corporation (the “FDIC”). The Bank opened for business on April 17, 2006 and provides banking services to its customers primarily in the Washington, D.C. metropolitan area.

The accounting and reporting policies of John Marshall Bank conform to generally accepted accounting principles in the United States of America and reflect practices of the banking industry. The policies are summarized below.

Significant Accounting Policies

Use of Estimates

In preparing financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses and the evaluation for other-than-temporary impairment of securities.

Concentrations of Credit Risk

Most of the Bank’s activities are with customers located in the Washington, D.C. metropolitan area. Real estate loans, including commercial and construction and land development loans, represented 90% and 88% of the total portfolio at December 31, 2016 and 2015, respectively. The Bank does not have any significant concentrations to any one industry or customer.

Cash and Cash Equivalents

For the purposes of the statements of cash flows, cash and cash equivalents include cash and balances due from banks, all of which mature within ninety days.

Interest-Bearing Deposits in Banks

Interest-bearing deposits in banks mature within one year and are carried at cost.

Notes to Financial Statements

Securities

Certain debt securities that management has the positive intent and ability to hold-to-maturity are classified as “held-to-maturity” and recorded at amortized cost. Securities not classified as held-to-maturity, including equity securities with readily determinable fair value, are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded in noninterest income on the trade date and are determined using the specific identification method. Gains and losses on calls of securities are recorded in interest income as an adjustment of yield.

Impairment of securities occurs when the fair value of a security is less than its amortized cost. For debt securities, impairment is considered other-than-temporary and recognized in its entirety in net income if either (a) the intent is to sell the security or (b) it is more likely than not that it will be necessary to sell the security prior to recovery of its amortized cost basis. If, however, the Bank’s intent is not to sell the security and it is not more than likely that the Bank will be required to sell the security before recovery, the Bank must determine what portion of the impairment is attributable to a credit loss, which occurs when the amortized cost of the security exceeds the present value of the cash flows expected to be collected from the security. If there is no credit loss, there is no other-than-temporary impairment. If there is a credit loss, other-than-temporary impairment exists and the credit loss must be recognized in net income and the remaining portion of impairment must be recognized in other comprehensive income.

For equity securities carried at cost as restricted securities, impairment is considered to be other-than-temporary based on the Bank’s ability and intent to hold the investment until a recovery of fair value. Other-than-temporary impairment of an equity security results in a write-down that must be included in income.

The Bank regularly reviews each security for other-than-temporary impairment based on criteria that include the extent to which cost exceeds market price, the duration of that market decline, the financial health of and specific prospects for the issuer, the security’s ratings, the Bank’s best estimate of the present value of cash flows expected to be collected from debt securities, the intention with regards to holding the security to maturity and the likelihood that the Bank would be required to sell the security before recovery.

Loans

The Bank grants real estate, commercial and consumer loans to customers (representing the Bank’s loan segments). A substantial portion of the loan portfolio is represented by commercial real estate loans in the Washington, D.C. metropolitan area. Within the real estate segment, the Bank has also identified the residential, commercial and construction classes. The ability of the Bank’s debtors to honor their contracts is dependent upon the real estate market and general economic conditions in this area.

Underwriting and risk characteristics of each loan class are summarized as follows:

- Real estate residential mortgage loans carry risks associated with the continued creditworthiness of the borrower and changes in the value of the collateral.
- Real estate commercial mortgage loans carry risks associated with the successful operation of a business, the continued creditworthiness of the borrower and any related guarantors and changes in the value of the collateral. In the case of investor-owned commercial real estate,

Notes to Financial Statements

risks are expanded to include the financial strength of the tenants occupying the property and the stability of occupancy and lease rates.

- Real estate construction loans carry risks that the project will not be finished according to schedule, the project will not be finished according to budget and the value of the collateral may, at any point in time, be less than the principal amount of the loan. Construction loans also bear the risk that the general contractor, who may or may not be a customer of the Bank, may be unable to finish the construction project as planned because of financial pressure unrelated to the project.
- Commercial loans carry risks associated with the successful operation of a business and the financial strength of any related guarantors. In addition, there is risk associated with the value of collateral other than real estate which may depreciate over time and cannot be appraised with as much precision.
- Consumer loans carry the risks associated with the continued creditworthiness of the borrower and the value of any collateral. Consumer loans are more likely than real estate loans to be immediately adversely affected by job loss, divorce, illness or personal bankruptcy.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for the allowance for loan losses and any deferred fees or costs on originated loans. 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 related loan yield using the interest method.

The accrual of interest on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in the process of collection. Other personal loans are typically charged off no later than 180 days past due. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Loans are generally written down to the estimated liquidation value of the underlying collateral when the loan is 180 days past due. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans by segment in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are 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 impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market

Notes to Financial Statements

price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. Qualitative factors used for each segment include an analysis of the levels of and trends in delinquencies, nonaccrual loans, and watch list loans; trends in concentrations, volume and term of loans; effects of any changes in lending policies and practices; experience, ability, and depth of management; and national and local economic trends and conditions. 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 Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial, construction, and mortgage loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, 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 Bank does not separately identify individual consumer loans for impairment disclosures.

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial condition, the Bank may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). The Bank strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. The modified terms for a TDR 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 restructured loan as noted above for impaired loans.

Bank Premises and Equipment

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation of property and equipment is computed on the straight-line method over the useful lives of the assets, ranging from three to fifteen years, or the expected term of leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured. Maintenance and repairs of property and equipment are charged to operations and major improvements are capitalized.

Other Real Estate Owned

Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs

Notes to Financial Statements

to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed. There were no properties held in other real estate owned at December 31, 2016 and 2015. At December 31, 2016 and 2015, there were no consumer mortgage loans secured by residential real estate for which formal foreclosure proceedings were in place.

Transfers of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (a) the assets have been isolated from the Bank – put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (b) 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 (c) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

Income Taxes

Deferred taxes are provided on a liability method whereby deferred tax assets are recognized for deductible temporary differences, operating loss carryforwards, and tax credit carryforwards. Deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are differences between the reported amounts of assets and liabilities and their tax bases. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion or all 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.

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

Earnings Per Common Share

Basic earnings per common share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares relate solely to outstanding stock options and are determined using the treasury stock method.

Notes to Financial Statements

Advertising Costs

The Bank follows the policy of charging the production costs of advertising to expense as incurred. Advertising expense was \$460 thousand and \$450 thousand for the years ended December 31, 2016 and 2015, respectively.

Share-Based Compensation

The Bank recognizes the compensation cost relating to share-based payment transactions based on the grant date fair value of the equity instruments issued. The share compensation accounting guidance requires that compensation cost for all share-based awards be calculated and recognized over the vesting period. A Black-Scholes model is used to estimate the fair value of stock options.

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains (losses) on securities available-for-sale, which is also recognized as a separate component of equity.

Fair Value of Financial Instruments

Fair values of various assets and liabilities are estimated using relevant market information, valuation techniques and other assumptions, as more fully disclosed in Note 14. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Recent Accounting Pronouncements

In August 2014, the FASB issued ASU No. 2014-15, "Presentation of Financial Statements – Going Concern (Subtopic 205-40): Disclosure of Uncertainties about an Entity's Ability to Continue as a Going Concern." This update is intended to provide guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. Management is required under the new guidance to evaluate whether there are conditions or events, considered in the aggregate, that raise substantial doubt about the entity's ability to continue as a going concern within one year after the date the financial statements are issued when preparing financial statements for each interim and annual reporting period. If conditions or events are identified, the ASU specifies the process that must be followed by management and also clarifies the timing and content of going concern footnote disclosures in order to reduce diversity in practice. The amendments in this ASU are effective for annual periods and interim periods within those annual periods beginning after December 15, 2016. Early adoption is permitted. The Bank does not expect the adoption of ASU 2014-2015 to have a material impact on its financial statements.

In January 2016, the FASB issued ASU 2016-01, "Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities." The amendments in ASU 2016-01, among other things: (1) Requires equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income. (2) Requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. (3) Requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). (4) Eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be

Notes to Financial Statements

disclosed for financial instruments measured at amortized cost. The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Bank is currently assessing the impact that ASU 2016-01 will have on its financial statements.

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

In March 2016, the FASB issued ASU No. 2016-05, "Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships." The amendments in this ASU clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria remain intact. The amendments in this ASU are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Bank does not expect the adoption of ASU 2016-05 to have a material impact on its financial statements.

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

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In March 2016, the FASB issued ASU No. 2016-09, “Compensation – Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting.” The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including: (a) income tax consequences; (b) classification of awards as either equity or liabilities; and (c) classification on the statement of cash flows. The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods. The Bank is currently assessing the impact that ASU 2016-09 will have on its financial statements.

In June 2016, the FASB issued ASU No. 2016-13, “Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020. The Bank is currently assessing the impact that ASU 2016-13 will have on its financial statements.

In August 2016, the FASB issued ASU No. 2016-15, “Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments,” to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The amendments should be applied using a retrospective transition method to each period presented. If retrospective application is impractical for some of the issues addressed by the update, the amendments for those issues would be applied prospectively as of the earliest date practicable. Early adoption is permitted, including adoption in an interim period. The Bank does not expect the adoption of ASU 2016-15 to have a material impact on its financial statements.

In January 2017, the FASB issued ASU No. 2017-01, “Business Combinations (Topic 805): Clarifying the Definition of a Business.” The amendments in this ASU clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under the current implementation guidance in Topic 805, there are three elements of a business—inputs, processes, and outputs. While an integrated set of assets and activities (collectively referred to as a “set”) that is a business usually has outputs, outputs are not required to be present. In addition, all the inputs and processes that a seller uses in operating a set are not required if market participants can acquire the set and continue to produce outputs. The amendments in this ASU provide a screen to determine when a set is not a business. If the screen is not met, the amendments (1) require that to be considered a business, a set must include, at a minimum, an input and a substantive process that together significantly contribute to the ability to create output and (2) remove the evaluation of whether a market participant could replace missing elements. The ASU provides a framework to assist entities in evaluating whether both an input and a substantive process are present. The amendments in this ASU are effective for annual periods beginning after December 15, 2017, including interim periods within those annual periods. The amendments in this ASU should be applied prospectively on or after the effective date. No disclosures are required at transition. The Bank does not expect the adoption of ASU 2017-01 to have a material impact on its financial statements.

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In January 2017, the FASB issued ASU No. 2017-04, “Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment.” The amendments in this ASU simplify how an entity is required to test goodwill for impairment by eliminating Step 2 from the goodwill impairment test. Step 2 measures a goodwill impairment loss by comparing the implied fair value of a reporting unit’s goodwill with the carrying amount of that goodwill. Instead, under the amendments in this ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity still has the option to perform the qualitative assessment for a reporting unit to determine if the quantitative impairment test is necessary. Public business entities that are SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Public business entities that are not SEC filers should adopt the amendments in this ASU for annual or interim goodwill impairment tests in fiscal years beginning after December 15, 2020. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Bank does not expect the adoption of ASU 2017-04 to have a material impact on its financial statements.

Notes to Financial Statements

Note 2. Securities

The amortized cost and fair values of securities available-for-sale and held-to-maturity as of December 31, 2016 and 2015 were as follows:

Available for Sale				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
(In thousands)	2016			
U.S government and federal agencies	\$ 32,423	\$ 4	\$ (243)	\$ 32,184
Corporate	5,000	100	--	5,100
Tax-exempt municipal	2,576	--	(132)	2,444
Mortgage-backed	8,837	--	(253)	8,584
	<u>\$ 48,836</u>	<u>\$ 104</u>	<u>\$ (628)</u>	<u>\$ 48,312</u>
	2015			
U.S government and federal agencies	\$ 32,331	\$ --	\$ (186)	\$ 32,145
	<u>\$ 32,331</u>	<u>\$ --</u>	<u>\$ (186)</u>	<u>\$ 32,145</u>
Held to Maturity				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized (Losses)	Fair Value
	2016			
U.S government and federal agencies	\$ 6,908	\$ 7	\$ (23)	\$ 6,892
Taxable municipal	8,260	120	(16)	8,364
Tax-exempt municipal	9,314	52	(174)	9,192
Mortgage-backed	19,591	150	(122)	19,619
	<u>\$ 44,073</u>	<u>\$ 329</u>	<u>\$ (335)</u>	<u>\$ 44,067</u>
	2015			
U.S government and federal agencies	\$ 7,916	\$ 10	\$ (48)	\$ 7,878
Taxable municipal	8,333	126	(20)	8,439
Tax-exempt municipal	5,926	92	(3)	6,015
Mortgage-backed	24,304	255	(111)	24,448
	<u>\$ 46,479</u>	<u>\$ 483</u>	<u>\$ (182)</u>	<u>\$ 46,780</u>

Notes to Financial Statements

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

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(In thousands)				
Due in one year or less	\$ 1,001	\$ 1,002	\$ 3,589	\$ 3,597
Due after one year through five years	27,344	27,165	9,009	9,050
Due after five years through ten years	9,344	9,337	8,775	8,859
Due after ten years	11,147	10,808	22,700	22,561
	<u>\$ 48,836</u>	<u>\$ 48,312</u>	<u>\$ 44,073</u>	<u>\$ 44,067</u>

The following table shows the gross unrealized losses and fair value of the Bank's investments with unrealized losses that are not deemed to be other-than-temporarily impaired aggregated by category and length of time that individual securities have been in a continuous loss position at December 31, 2016 and 2015.

	Less Than 12 Months		12 Months or Longer	
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value
(In thousands)				
<u>2016</u>				
U.S. government and federal agencies	\$ 258	\$ 27,894	\$ 8	\$ 1,993
Taxable municipal	--	--	16	504
Tax-exempt municipal	306	8,172	--	--
Mortgage-backed	373	16,947	2	94
	<u>\$ 937</u>	<u>\$ 53,013</u>	<u>\$ 26</u>	<u>\$ 2,591</u>
<u>2015</u>				
U.S. government and federal agencies	\$ 212	\$ 34,515	\$ 22	\$ 1,945
Taxable municipal	--	--	20	512
Tax-exempt municipal	1	563	2	219
Mortgage-backed	52	6,567	59	2,873
	<u>\$ 265</u>	<u>\$ 41,645</u>	<u>\$ 103</u>	<u>\$ 5,549</u>

U.S. Government and Federal Agencies

The unrealized losses in thirty and thirty-seven investments in direct obligations of U.S. government agencies at December 31, 2016 and 2015, respectively, were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2016 or 2015.

Notes to Financial Statements

Mortgage-Backed Securities

The unrealized losses on the Bank's investment in twenty-nine and eighteen federal agency mortgage-backed securities at December 31, 2016 and 2015, respectively, were caused by interest rate changes. The contractual cash flows of those investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Bank's investments. Because the decline in market value is attributable to change in interest rates and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2016 or 2015.

Municipal Securities

The unrealized losses in ten and three investments in municipal securities at December 31, 2016 and 2015, respectively, were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be at maturity, the Bank does not consider those investments to be other-than-temporarily impaired at December 31, 2016 or 2015.

Securities having an amortized cost of \$74.4 million and \$71.9 million at December 31, 2016 and 2015, respectively, were pledged to secure public deposits and for other purposes required by law. These securities had a carrying value of \$74.0 million and \$71.7 million at December 31, 2016 and 2015, respectively.

During 2016, the Bank sold certain available-for-sale securities for total proceeds of \$4.0 million. Gross gains of \$2 thousand and gross losses of \$1 thousand were realized on those sales. There were no sales of available-for-sale securities during 2015.

Notes to Financial Statements

Note 3. Loans

A summary of the balances of loans follows:

	December 31,	
	2016	2015
	<i>(In thousands)</i>	
Real estate loans:		
Residential	\$ 107,534	\$ 95,496
Commercial	519,857	441,309
Construction and land development	180,318	150,786
Total real estate loans	807,709	687,591
Commercial loans	86,498	94,371
Consumer installment loans	1,820	1,203
Total loans	896,027	783,165
Less: Allowance for loan losses	(8,202)	(7,130)
Net deferred loan fees	(1,605)	(1,402)
Loans, net	<u>\$ 886,220</u>	<u>\$ 774,633</u>

Note 4. Allowance for Loan Losses

The following tables present, as of December 31, 2016 and December 31, 2015, the total allowance for loan losses, the allowance by impairment methodology and loans by impairment methodology:

	December 31, 2016						
	<i>(In thousands)</i>						
	Real Estate Construction & Land						
	Commercial	Development	Residential	Commercial	Consumer	Unallocated	Total
Allowance for loan losses:							
Beginning Balance, December 31, 2015	\$ 3,850	\$ 1,403	\$ 802	\$ 1,021	\$ 6	\$ 48	\$ 7,130
Charge-offs	--	--	(218)	(2,636)	--	--	(2,854)
Recoveries	--	--	--	116	--	--	116
Provision	302	522	250	2,729	21	(14)	3,810
Ending Balance, December 31, 2016	<u>\$ 4,152</u>	<u>\$ 1,925</u>	<u>\$ 834</u>	<u>\$ 1,230</u>	<u>\$ 27</u>	<u>\$ 34</u>	<u>\$ 8,202</u>
Individually evaluated for impairment	\$ --	\$ --	\$ --	\$ 55	\$ --	\$ --	\$ 55
Collectively evaluated for impairment	\$ 4,152	\$ 1,925	\$ 834	\$ 1,175	\$ 27	\$ 34	\$ 8,147
Loans:							
Ending Balance, December 31, 2016	<u>\$ 519,857</u>	<u>\$ 180,318</u>	<u>\$ 107,534</u>	<u>\$ 86,498</u>	<u>\$ 1,820</u>	<u>\$ --</u>	<u>\$ 896,027</u>
Individually evaluated for impairment	\$ --	\$ --	\$ 508	\$ 55	\$ --	\$ --	\$ 563
Collectively evaluated for impairment	\$ 519,857	\$ 180,318	\$ 107,026	\$ 86,443	\$ 1,820	\$ --	\$ 895,464

Notes to Financial Statements

December 31, 2015

(In thousands)

	Real Estate						
	Construction & Land						Total
	Commercial	Development	Residential	Commercial	Consumer	Unallocated	
Allowance for loan losses:							
Beginning Balance, December 31, 2014	\$ 3,546	\$ 1,169	\$ 865	\$ 985	\$ 20	\$ (79)	\$ 6,506
Charge-offs	(279)	--	--	(343)	--	--	(622)
Recoveries	--	--	--	49	--	--	49
Provision	583	234	(63)	330	(14)	127	1,197
Ending Balance, December 31, 2015	<u>\$ 3,850</u>	<u>\$ 1,403</u>	<u>\$ 802</u>	<u>\$ 1,021</u>	<u>\$ 6</u>	<u>\$ 48</u>	<u>\$ 7,130</u>
Individually evaluated for impairment	\$ --	\$ --	\$ --	\$ 208	\$ --	\$ --	\$ 208
Collectively evaluated for impairment	\$ 3,850	\$ 1,403	\$ 802	\$ 813	\$ 6	\$ 48	\$ 6,922
Loans:							
Ending Balance, December 31, 2015	<u>\$ 441,309</u>	<u>\$ 150,786</u>	<u>\$ 95,496</u>	<u>\$ 94,371</u>	<u>\$ 1,203</u>	<u>\$ --</u>	<u>\$ 783,165</u>
Individually evaluated for impairment	\$ 953	\$ --	\$ 3,059	\$ 419	\$ --	\$ --	\$ 4,431
Collectively evaluated for impairment	\$ 440,356	\$ 150,786	\$ 92,437	\$ 93,952	\$ 1,203	\$ --	\$ 778,734

The provision indicated with respect to the each of the segments is primarily due to the relative loan growth experienced over the course of the year in the segments, with the exception of the commercial and industrial segment in 2016. An unanticipated loss of \$2.6 million was realized in the commercial and industrial segment during the first quarter of 2016, requiring a \$2.7 million provision to restore reserves to levels indicated in the Bank's allowance analysis. Loss factors for non-classified loans are determined based upon actual and peer group historical loss ratios, adjusted for loan duration and for the effect of certain qualitative factors, which are analyzed and adjusted quarterly.

Impaired loans and the related allowance at December 31, 2016 and December 31, 2015, were as follows:

December 31, 2016

(In thousands)

	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real Estate							
Commercial	\$ --	\$ --	\$ --	\$ --	\$ --	\$ --	\$ --
Construction and land development	--	--	--	--	--	--	--
Residential	508	508	--	508	--	513	18
Commercial	55	--	55	55	55	60	--
Consumer	--	--	--	--	--	--	--
Total impaired loans	<u>\$ 563</u>	<u>\$ 508</u>	<u>\$ 55</u>	<u>\$ 563</u>	<u>\$ 55</u>	<u>\$ 573</u>	<u>\$ 18</u>

December 31, 2015

(In thousands)

	Unpaid Principal Balance	Recorded Investment with No Allowance	Recorded Investment with Allowance	Total Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
Real Estate							
Commercial	\$ 953	\$ 953	\$ --	\$ 953	\$ --	\$ 969	\$ 35
Construction and land development	--	--	--	--	--	--	--
Residential	3,059	3,059	--	3,059	--	3,070	95
Commercial	419	211	208	419	208	430	31
Consumer	--	--	--	--	--	--	--
Total impaired loans	<u>\$ 4,431</u>	<u>\$ 4,223</u>	<u>\$ 208</u>	<u>\$ 4,431</u>	<u>\$ 208</u>	<u>\$ 4,469</u>	<u>\$ 161</u>

As of December 31, 2016, \$508 thousand of impaired loans were classified as troubled debt restructurings, a decline from \$1.5 million as of December 31, 2015. During 2016, a troubled debt restructuring totaling \$953 thousand in the commercial real estate segment was removed from

Notes to Financial Statements

troubled debt restructuring status and restored to a performing loan. There were no new loans recognized as a troubled debt restructuring in 2016 or 2015. All troubled debt restructurings were in compliance with the modified terms as of December 31, 2016.

There were no troubled debt restructurings that subsequently defaulted within the first twelve months after modification during year ended December 31, 2016, with default being defined as past due thirty or more days.

All troubled debt restructurings have loan loss reserves allocated to them equal to 100% of estimated impairment on the loan. Impairment is determined 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. As of December 31, 2016, none of the Bank's troubled debt restructurings had a recorded specific reserve.

Following is a summary of past due and non-accrual loans by class as of December 31, 2016 and December 31, 2015:

December 31, 2016 (In thousands)								
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90-Days Past Due and Still Accruing	Nonaccrual Loans
Real Estate								
Commercial	\$ --	\$ --	\$ --	\$ --	\$ 519,857	\$ 519,857	\$ --	\$ --
Construction and land development	--	--	--	--	180,318	180,318	--	--
Residential	557	--	--	557	106,977	107,534	--	--
Commercial	451	--	--	451	86,047	86,498	--	55
Consumer	--	--	--	--	1,820	1,820	--	--
Total	<u>\$ 1,008</u>	<u>\$ --</u>	<u>\$ --</u>	<u>\$ 1,008</u>	<u>\$ 895,019</u>	<u>\$ 896,027</u>	<u>\$ --</u>	<u>\$ 55</u>

December 31, 2015 (In thousands)								
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90-Days Past Due and Still Accruing	Nonaccrual Loans
Real Estate								
Commercial	\$ --	\$ --	\$ --	\$ --	\$ 441,309	\$ 441,309	\$ --	\$ --
Construction and land development	--	--	--	--	150,786	150,786	--	--
Residential	--	--	2,538	2,538	92,958	95,496	--	2,538
Commercial	40	--	168	208	94,163	94,371	--	419
Consumer	--	--	--	--	1,203	1,203	--	--
Total	<u>\$ 40</u>	<u>\$ --</u>	<u>\$ 2,706</u>	<u>\$ 2,746</u>	<u>\$ 780,419</u>	<u>\$ 783,165</u>	<u>\$ --</u>	<u>\$ 2,957</u>

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Following is a summary of the Bank's credit quality information for loans by class as of December 31, 2016 and 2015:

December 31, 2016						
<i>(In thousands)</i>						
	Pass	Special Mention	Substandard	Doubtful	Loss	Total
Real Estate						
Commercial	\$ 514,290	\$ 5,567	\$ --	\$ --	\$ --	\$ 519,857
Construction and land development	180,318	--	--	--	--	180,318
Residential	105,119	1,934	481	--	--	107,534
Commercial	82,196	4,247	--	55	--	86,498
Consumer	1,814	6	--	--	--	1,820
Total	<u>\$ 883,737</u>	<u>\$ 11,754</u>	<u>\$ 481</u>	<u>\$ 55</u>	<u>\$ --</u>	<u>\$ 896,027</u>

December 31, 2015						
<i>(In thousands)</i>						
	Pass	Special Mention	Substandard	Doubtful	Loss	Total
Real Estate						
Commercial	\$ 439,851	\$ 505	\$ 953	\$ --	\$ --	\$ 441,309
Construction and land development	150,786	--	--	--	--	150,786
Residential	91,494	972	3,030	--	--	95,496
Commercial	93,602	308	253	208	--	94,371
Consumer	1,194	9	--	--	--	1,203
Total	<u>\$ 776,927</u>	<u>\$ 1,794</u>	<u>\$ 4,236</u>	<u>\$ 208</u>	<u>\$ --</u>	<u>\$ 783,165</u>

The Bank assesses credit quality based on internal risk rating of loans. Internal risk rating definitions are:

Pass: These include satisfactory loans which have acceptable levels of risk.

Special Mention: These loans have a potential weakness that requires management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. These credits do not expose the Bank to sufficient risk to warrant further adverse classification.

Substandard: A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as such 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.

Doubtful: Loans classified doubtful have all the weaknesses inherent in a substandard asset 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.

Loss: Loans classified loss are considered uncollectible 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 practical or desirable to defer writing off this basically worthless asset even though partial recovery may be received in the future.

Notes to Financial Statements

Note 5. Bank Premises and Equipment

The major classes of bank premises and equipment and the total accumulated depreciation are as follows:

	December 31,	
	2016	2015
(In thousands)		
Leasehold improvements	\$ 2,091	\$ 2,085
Furniture and equipment	4,483	3,948
	\$ 6,574	\$ 6,033
Less accumulated depreciation	(4,103)	(3,343)
Bank premises and equipment, net	<u>\$ 2,471</u>	<u>\$ 2,690</u>

Depreciation expense was \$761 thousand and \$775 thousand for the years ended December 31, 2016 and 2015, respectively.

Pursuant to the terms of noncancelable lease agreements at December 31, 2016, pertaining to Bank premises and equipment, future minimum rent commitments under various operating leases are as follows:

(In thousands)	
2017	\$ 1,233
2018	1,128
2019	600
2020	616
2021	490
2022 and thereafter	830
	<u>\$ 4,897</u>

The leases contain options to extend for periods from five to ten years. The cost of such rental is not included above.

Total rent expense amounted to \$1.3 million for the years ended December 31, 2016 and 2015.

Note 6. Income Taxes

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

Notes to Financial Statements

Net deferred tax assets consist of the following components as of December 31, 2016 and 2015:

(In thousands)	<u>2016</u>	<u>2015</u>
Deferred tax assets:		
Allowance for loan losses	\$ 2,803	\$ 2,448
Start-up costs	46	62
Deferred loan fees	549	481
Share-based compensation expense	325	343
Unrealized losses on securities	237	128
Depreciation	2	-
Other	52	85
	<u>\$ 4,014</u>	<u>\$ 3,547</u>
Deferred tax liabilities:		
Depreciation	\$ -	\$ 29
	<u>\$ -</u>	<u>\$ 29</u>
Net deferred tax assets	<u>\$ 4,014</u>	<u>\$ 3,518</u>

The provision for income taxes charged to operations for the years ended December 31, 2016 and 2015, consists of the following:

(In thousands)	<u>2016</u>	<u>2015</u>
Current tax expense	\$ 4,428	\$ 5,300
Deferred tax (benefit)	(387)	(389)
	<u>\$ 4,041</u>	<u>\$ 4,911</u>

Income tax expense differs from the amount of tax determined by applying the federal income tax rate to pretax income due to the following:

(In thousands)	<u>2016</u>	<u>2015</u>
Computed "expected" tax expense	\$ 4,217	\$ 4,719
Increase (decrease) in income taxes resulting from:		
Bank-owned life insurance	(184)	-
Tax-exempt interest income	(42)	(35)
Share-based compensation	64	105
State income taxes, net of federal benefit	41	150
Other, net	(55)	(28)
	<u>\$ 4,041</u>	<u>\$ 4,911</u>

Note 7. Fund Restrictions and Reserve Balance

The Bank must maintain a reserve against its deposits in accordance with Regulation D of the Federal Reserve Act. For the final weekly reporting period in the years ended December 31, 2016

Notes to Financial Statements

and 2015, the aggregate amounts of daily average required balances were approximately \$9.5 million and \$5.8 million.

Note 8. Related Party Transactions

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with directors, principal shareholders, executive officers, their immediate families and affiliated companies in which they are principal shareholders (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. At December 31, 2016 and 2015, these loans totaled \$8.9 million and \$9.2 million, respectively. During 2016, total principal additions were \$765 thousand and total principal payments were \$1.1 million. Deposits of directors and executive officers totaled \$26.7 million and \$25.1 million at December 31, 2016 and 2015, respectively.

Note 9. Deposits

The aggregate amount of certificates of deposit with a minimum denomination of \$250,000 was \$190.3 million and \$141.1 million at December 31, 2016 and 2015, respectively.

At December 31, 2016, the scheduled maturities of time deposits (including brokered deposits) are as follows:

(In thousands)	
2017	\$ 288,452
2018	89,426
2019	15,914
2020	5,295
2021	<u>20,362</u>
	<u>\$ 419,449</u>

At December 31, 2016 and 2015, overdraft demand deposits reclassified to loans totaled \$60 thousand and \$555 thousand, respectively. The Bank obtains certain deposits through the efforts of third-party brokers. At December 31, 2016 and 2015, brokered deposits (not including CDARS) totaled \$46.9 million and \$22.5 million respectively, and were included in time deposits on the Bank's balance sheets. At December 31, 2016 and 2015, CDARS deposits totaled \$71.8 million and \$62.9 million, respectively.

At December 31, 2016, there were no depositors that represent 5% of the Bank's total deposits.

Note 10. Federal Home Loan Bank Advances and Other Borrowings

The Bank has entered into various note agreements with the Federal Home Loan Bank of Atlanta ("FHLB"). Total FHLB advances were \$104.0 million and \$71.0 million at December 31, 2016 and 2015, respectively. At December 31, 2016, the Bank had entered into short-term note agreements for \$39.0 million maturing through December 31, 2017 at a weighted average interest rate of 0.92%. The Bank also has \$65.0 million in fixed-rate term borrowings at a weighted rate of 1.32%. These advances mature \$40.5 million in 2018, \$19.5 million in 2019, \$4.0 million in 2020 and \$1.0 million in 2021. These advances are secured by a blanket floating lien on all real estate mortgage loans secured by 1 to 4 family residential properties, unpledged U.S. Government and agencies and mortgage-backed securities and any other real estate related collateral. Total

Notes to Financial Statements

collateral under the blanket lien amounted to approximately \$151.7 million as of December 31, 2016. Total FHLB available borrowing capacity was \$140.4 million at December 31, 2016.

The Bank also has federal funds lines of credit with correspondent banks available for overnight borrowing of \$67.0 million. No amounts were drawn on these lines at December 31, 2016.

Securities sold under agreements to repurchase amounted to \$14.2 million at December 31, 2016 and \$12.0 million at December 31, 2015, mature on a daily basis and are secured by U.S. government securities. The weighted average interest rate on these agreements was 0.34% at December 31, 2016 and was 0.43% at December 31, 2015

Note 11. Other Operating Expenses

Other operating expenses in the statements of income include the following components:

	Years Ended December 31,	
	2016	2015
(In thousands)		
Advertising expense	\$ 460	\$ 450
Data processing	1,435	1,142
FDIC insurance	557	425
Professional fees	532	528
State franchise tax	786	727
Other operating expense	1,753	1,495
Total other operating expenses	<u>\$ 5,523</u>	<u>\$ 4,767</u>

Note 12. Commitments and Contingencies

In the normal course of business, there are outstanding various commitments and contingent liabilities, which are not reflected in the accompanying financial statements. The Bank does not anticipate any material losses as a result of these transactions. See Note 13 with respect to financial instruments with off-balance-sheet risk.

Note 13. Financial Instruments With Off-Balance-Sheet Risk

The Bank is 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, standby letters of credit and financial guarantees. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in particular classes of financial instruments. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual notional amount of those instruments.

The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

Notes to Financial Statements

A summary of the contract or notional amount of the Bank's exposure to off-balance-sheet risk as of December 31, 2016 and 2015 is as follows:

	<u>2016</u>	<u>2015</u>
(In thousands)		
Commitments to extend credit	\$ 175,745	\$ 179,772
Standby letters of credit	14,174	12,259

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. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property and equipment, income-producing commercial properties, and other real estate properties.

Unfunded commitments under lines of credit are commitments for possible future extensions of credit to existing customers. Those lines of credit may not be drawn upon to the total extent to which the Company is committed.

Standby letters of credit written are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing, and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers.

Note 14. Fair Value Measurements

Determination of Fair Value

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

The 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 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

Notes to Financial Statements

significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

Fair Value Hierarchy

In accordance with this guidance, the Bank 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 1 - Valuation is based on quoted prices in active markets for identical assets and liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices 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 3 - 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 3 assets and liabilities include financial instruments whose value 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.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

The following methods and assumptions were used by the Bank in estimating fair value disclosures for financial instruments:

Cash and Cash Equivalents and Interest-Bearing Deposits in Banks

The carrying amounts of cash and short-term instruments approximate fair values based on the short-term nature of the assets.

Fair values of other interest-bearing deposits are estimated using discounted cash flow analyses based on current rates for similar types of deposits.

Securities

Securities available-for-sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data (level 2). If the inputs used to provide the evaluation for certain securities are unobservable and/or there is little, if any, market activity then the security would fall to the lowest level of the hierarchy (level 3).

The Bank's investment portfolio is primarily valued using fair value measurements that are considered to be level 2. The Bank has contracted with a third party portfolio accounting service

Notes to Financial Statements

vendor for valuation of its securities portfolio. The vendor's primary source for security valuation is J.J. Kenny Drake, which evaluates securities based on market data. J.J. Kenny Drake utilizes evaluated pricing models that vary by asset class and include available trade, bid, and other market information. Generally, the methodology includes broker quotes, proprietary models, vast descriptive terms and conditions databases, as well as extensive quality control programs.

The vendor utilizes proprietary valuation matrices for valuing all municipals securities. The initial curves for determining the price, movement, and yield relationships within the municipal matrices are derived from industry benchmark curves or sourced from a municipal trading desk. The securities are further broken down according to issuer, credit support, state of issuance and rating to incorporate additional spreads to the industry benchmark curves.

Loans

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair values for other loans, commercial real estate and investment property mortgage loans, and commercial and industrial loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

Bank Owned Life Insurance

Bank owned life insurance represents insurance policies on officers, directors and past employees of the Bank. The cash values of the policies are estimates using information provided by insurance carriers. These policies are carried at their cash surrender value, which approximates the fair value.

Deposit Liabilities

The fair values disclosed for demand deposits (for example, interest and noninterest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The carrying amounts of variable-rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Borrowings

The carrying amounts of federal funds purchased, borrowings under repurchase agreements, and other short-term borrowings maturing within ninety days approximate their fair values. Fair values of other short-term borrowings are estimated using discounted cash flow analyses based on current market rates and similar types of borrowing arrangements. Current market rates for debt with similar terms, and remaining maturities are used to estimate fair value of long-term debt. Fair value of long-term debt is based on quoted market prices or dealer quotes for the identical liability when traded as an asset in an active market. If a quoted market price is not available, an expected present value technique is used to estimate fair value.

Accrued Interest

The carrying amounts of accrued interest approximate fair value.

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Off-Balance Sheet Credit-Related Instruments

Fair values for off-balance-sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking in to account the remaining terms of the agreements and the counterparties' credit standing. Those items were deemed immaterial.

Assets Measured at Fair Value on a Recurring Basis

Assets measured at fair value on a recurring basis are summarized below:

		Fair Value Measurements Using		
		Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(In thousands)				
Description	Balance			
December 31, 2016				
Assets:				
U.S. government and federal agencies	\$32,184	\$ - -	\$ 32,184	\$ - -
Corporate	5,100	- -	5,100	- -
Tax-exempt municipal	2,444	- -	2,444	- -
Mortgage-backed	8,484	- -	8,484	- -
	<u>\$48,212</u>	<u>\$ - -</u>	<u>\$ 48,212</u>	<u>\$ - -</u>
December 31, 2015				
Assets:				
U.S. government and federal agencies	\$32,145	\$ - -	\$ 32,145	\$ - -

Assets Measured at Fair Value on a Nonrecurring Basis

Under certain circumstances, the Bank makes adjustment to fair value for assets and liabilities although they are not measured at fair value on an ongoing basis. The following describes the valuation techniques used by the Bank to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

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

Notes to Financial Statements

Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Income. Impaired loans were fully reserved as of December 31, 2016.

Other Real Estate Owned: Other real estate owned (“OREO”) is carried at the lower of carrying value or fair value less selling costs. Fair value is based upon independent market prices, appraised values of the collateral or management’s estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price or a current appraised value using observable market data, the Bank records the property as level 2. When an appraised value using observable market data is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the property as level 3 valuation. Any fair value adjustments are recorded in the period incurred and expensed against current earnings. The Bank had no other real estate owned as of December 31, 2016 and 2015.

The estimated fair values, and related carrying or notional amounts, of the Bank's financial instruments are as follows:

Fair Value Measurements at December 31, 2016						
	Carrying Value	Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs	Total Fair Value	
		Level 1	Level 2	Level 3	Balance	
(In Thousands)						
Financial assets:						
Cash and short-term investments	\$ 54,615	\$ 54,615	\$ - -	\$ - -	\$ 54,615	
Securities available for sale	48,312	- -	48,312	- -	48,312	
Securities held to maturity	44,073	- -	44,067	- -	44,067	
Loans, net	886,220	- -	- -	892,424	892,424	
Bank owned life insurance	18,540	- -	18,540	- -	18,540	
Accrued interest receivable	2,988	- -	2,988	- -	2,988	
Financial liabilities:						
Deposits	\$ 832,865	\$ - -	\$ 835,096	\$ - -	\$ 835,096	
FHLB advances and other debt	118,206	- -	117,998	- -	117,998	
Accrued interest payable	220	- -	220	- -	220	

Fair Value Measurements at December 31, 2015						
	Carrying Value	Quoted Prices in Active Markets for Identical Assets Level 1	Significant Other Observable Inputs Level 2	Significant Unobservable Inputs Level 3	Total Fair Value Balance	
(In Thousands)						
Financial assets:						
Cash and short-term investments	\$ 54,955	\$ 54,955	\$ - -	\$ - -	\$ 54,955	
Securities available for sale	32,145	- -	32,145	- -	32,145	
Securities held to maturity	46,479	- -	46,780	- -	46,780	
Loans, net	774,633	- -	- -	777,808	777,808	
Accrued interest receivable	2,318	- -	2,318	- -	2,318	
Financial liabilities:						
Deposits	\$ 730,853	\$ - -	\$ 732,398	\$ - -	\$ 732,398	
FHLB advances and other debt	82,972	- -	83,008	- -	83,008	
Accrued interest payable	109	- -	109	- -	109	

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

Note 15. Concentration Risk

The Bank maintains its cash accounts in several correspondent banks. As of December 31, 2016, deposits in excess of amounts insured by the FDIC were insignificant.

Note 16. Share Compensation Plan

The Bank's share based compensation plan, approved by stockholders and effective April 28, 2015 (the "2015 Plan"), provides for the grant of share-based awards in the form of incentive stock options, nonincentive stock options, restricted stock and restricted stock units to directors and employees. The Bank has reserved 460,969 shares of common stock for issuance under the 2015 Plan, which will remain in effect until April 28, 2025. The Bank's Personnel and Compensation Committee administers the 2015 Plan and has the authority to determine the terms and conditions of each award thereunder. To date, options granted under the 2015 Plan vest over five years and expire ten years from the grant date. Under the 2015 Plan, shares may be granted at not less than 100 percent of the fair market value at the grant date. As of December 31, 2016, 96,925 shares are available to grant in future periods under the 2015 Plan. The maximum term for an option award is ten years from the date of grant.

The Bank's previous share based compensation plan, the 2006 Stock Option Plan (the "2006 Plan"), provided for the grant of share-based awards in the form of incentive stock options and nonincentive stock options to directors and employees. As amended, the 2006 Plan provided for awards of up to 1,490,700 shares. In April 2015, the Plan was terminated and replaced with the 2015 Plan. Options outstanding prior to April 28, 2015 were granted under the 2006 Plan and shall be subject to the provisions of the 2006 Plan.

Notes to Financial Statements

A summary of the status of awards under the Bank's share based compensation plans is presented below:

	2016		
	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Outstanding at beginning of year	1,309,410	\$ 9.40	
Granted	14,500	16.40	
Exercised	(120,575)	7.06	
Forfeited	(24,176)	13.80	
Outstanding at end of year	<u>1,179,159</u>	<u>\$ 9.64</u>	<u>\$ 13,105,842</u>
Exercisable at end of year	<u>847,330</u>	<u>\$ 7.70</u>	<u>\$ 11,056,941</u>
Weighted average fair value of options granted during the year	<u>\$ 4.11</u>		

The aggregate intrinsic value of stock options in the table above represents the total amount by which the current market value of the underlying stock exceeds the exercise price of the option that would have been received by the Bank had all option holders exercised their options on December 31, 2016. The intrinsic value of options exercised was \$1.1 million in 2016 and \$506 thousand in 2015. This amount changes based on changes in the market value of the Bank's stock.

Information pertaining to options outstanding at December 31, 2016 is as follows:

Exercise Prices	Options Outstanding		Options Exercisable	
	Number Outstanding	Weighted Average Remaining Contractual Life	Number Exercisable	Weighted Average Remaining Contractual Life
\$0.00 - \$8.00	759,124	4.09	756,225	4.08
\$8.01 - \$9.00	11,175	6.04	7,155	6.04
\$9.01 - \$10.00	2,250	6.38	1,350	6.38
\$10.01 - \$11.00	12,000	6.63	7,200	6.63
\$11.01 - \$14.00	--	--	--	--
\$14.01 - \$15.00	367,610	8.29	69,200	8.24
\$15.00 - \$16.00	17,500	7.72	6,200	7.62
\$16.01 - \$17.06	9,500	9.70	--	--
	<u>1,179,159</u>	<u>5.55 years</u>	<u>847,330</u>	<u>4.49 years</u>

For the years ended December 31, 2016 and 2015, share-based compensation expense applicable to the Bank's share based compensation plans was \$325 thousand and \$506 thousand, respectively.

As of December 31, 2016, unrecognized share-based compensation expense related to nonvested

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options amounted to \$1.0 million. This amount is expected to be recognized over a weighted-average period of 2.1 years.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option-pricing model. Following are the weighted average assumptions used to value options granted in 2016:

	<u>2016</u>
Dividend yield	0.00%
Expected life	6.20 years
Expected volatility	21.50%
Risk-free interest rate	1.51%

The expected volatility is based on historical volatility of the Bank's stock. The risk-free interest rates for periods within the contractual life of the awards are based on the U.S. Treasury yield curve in effect at the time of the grant. The expected life is based on the average of the contractual life and vesting schedule. The dividend yield assumption is based on the Bank's history and expectation of dividend payouts.

Note 17. Earnings Per Common Share

Earnings per common share were computed based on the following for the years ended December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
Weighted average common shares outstanding - basic	10,069,537	9,993,231
Effect of dilutive options	<u>492,300</u>	<u>490,200</u>
Weighted average common shares outstanding used to compute diluted earnings per share	<u><u>10,561,837</u></u>	<u><u>10,483,431</u></u>

Potential common shares did not impact net income. Options with respect to 394,610 and 309,433 shares were excluded from the calculation of diluted earnings per share for the years ended December 31, 2016 and 2015, respectively, because their impact would have been anti-dilutive.

Note 18. Minimum Regulatory Capital Requirements

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - 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 assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. The Basel III Capital Rules became effective January 1, 2015, subject to a phase-in period extending through January 1, 2019.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as

Notes to Financial Statements

defined in the regulations) to risk-weighted assets (as defined), common equity tier 1 (“CET 1”) to risk-weighted assets (as defined in the regulations) and of Tier 1 capital to average assets (as defined in the regulations). Management believes, as of December 31, 2016 and 2015, that the Bank meets all capital adequacy requirements to which it is subject.

In addition to the minimum regulatory capital required for capital adequacy purposes the Bank is required to maintain a minimum Capital Conservation Buffer above those minimums in the form of common equity, in order to avoid restrictions on capital distributions and discretionary bonuses. The required amount of the Capital Conservation Buffer was 0.625% on January 1, 2016 and will increase by 0.625% each year until it reaches 2.5% on January 1, 2019, and is applicable for the Common Equity Tier 1, Tier 1, and Total Capital Ratios.

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

	Actual		Minimum Capital Requirement ¹		Minimum To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
As of December 31, 2016:						
Total Capital (to Risk Weighted Assets)	\$ 127,667	12.3%	\$ 89,319	8.6%	\$ 103,558	10.0%
Tier 1 Capital (to Risk Weighted Assets)	\$ 119,252	11.5%	\$ 68,607	6.6%	\$ 82,846	8.0%
CET 1 Capital (to Risk Weighted Assets)	\$ 119,252	11.5%	\$ 53,073	5.1%	\$ 67,313	6.5%
Tier 1 Capital (to Average Assets)	\$ 119,252	11.5%	\$ 41,563	4.0%	\$ 51,954	5.0%
As of December 31, 2015:						
Total Capital (to Risk Weighted Assets)	\$ 116,852	13.6%	\$ 68,991	8.0%	\$ 86,239	10.0%
Tier 1 Capital (to Risk Weighted Assets)	\$ 109,549	12.7%	\$ 51,743	6.0%	\$ 68,991	8.0%
CET 1 Capital (to Average Assets)	\$ 109,549	12.7%	\$ 38,807	4.5%	\$ 56,055	6.5%
Tier 1 Capital (to Average Assets)	\$ 109,549	12.1%	\$ 36,175	4.0%	\$ 45,219	5.0%

¹ Including Capital Conservation Buffer

Note 19. Restrictions on Dividends

The Bank is subject to certain restrictions on the amount of dividends that it may pay without prior regulatory approval.

Notes to Financial Statements

Note 20. 401(k) Plan

Effective August 1, 2006, the Bank adopted a contributory 401(k) savings plan (the “401(k) Plan”) covering substantially all employees. Eligible employees may elect to defer a portion of their compensation to the 401(k) Plan. The Board of Directors may elect to match a portion of each employee’s contribution. Contributions of \$334 thousand were made by the Bank for the year ended December 31, 2016 and \$301 thousand were made by the Bank in 2015.

Note 21. Subsequent Events

The Bank evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including estimates inherent in the process of preparing financial statements, and (2) nonrecognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Subsequent events were evaluated through March 23, 2017, the date the financial statements were issued.

Note 22. Low Income Housing Tax Credit Investments

The Bank has invested in six separate housing equity funds as of December 31, 2016 and five separate housing equity funds as of December 31, 2015. The general purpose of these funds is to encourage and assist participate in investing low-income residential rental properties located in the Commonwealth of Virginia, develop and implement strategies to maintain project as low-income housing, deliver Federal Low Income Housing Credits to investors, allocate tax losses and other possible tax benefits to investors, and to preserve and protect project assets. The investments in these funds were recorded as other assets on the Bank’s balance sheets and were \$5.2 million and \$4.5 million at December 31, 2016 and 2015, respectively. The expected terms of these investments and the related tax benefits run through 2033. The net impact of amortizing tax credits and other tax benefits recognized related to these investments as a component of income tax expense in the Statements of Income during the years ended December 31, 2016 and 2015, were \$110 thousand and \$48 thousand, respectively. Additional capital calls expected for the funds totaled \$3.7 million and \$3.6 million at December 31, 2016 and 2015, respectively, and are included in other assets and other liabilities on the Bank’s balance sheets.

Notes to Financial Statements

Note 23. Accumulated Other Comprehensive Loss

The following table presents the changes in accumulated other comprehensive loss, by category, net of tax for the periods presented:

Year ended December 31, 2016			
	Unrealized Losses on Available-for-Sale Securities	Unrealized Losses on Securities Transferred from Available-for-Sale Securities to Held-to-Maturity	Accumulated Other Comprehensive loss
		<i>(In Thousands)</i>	
Beginning balance	\$ (122)	\$ (125)	\$ (247)
Net change during the year	(223)	13	(210)
Ending balance	<u>\$ (345)</u>	<u>\$ (112)</u>	<u>\$ (457)</u>
Year ended December 31, 2015			
	Unrealized Losses on Available-for-Sale Securities	Unrealized Losses on Securities Transferred from Available-for-Sale Securities to Held-to-Maturity	Accumulated Other Comprehensive loss
		<i>(In Thousands)</i>	
Beginning balance	\$ (11)	\$ (176)	\$ (187)
Net change during the year	(111)	51	(60)
Ending balance	<u>\$ (122)</u>	<u>\$ (125)</u>	<u>\$ (247)</u>

Items reclassified out of accumulated other comprehensive loss to net income during 2016 consisted of net gains on sales and calls of securities available-for-sale. Net gains on these sales and calls were \$2 thousand and their related tax was \$1 thousand. Gains on sales are reflected in other operating income, gains on calls are reflected in interest on investment securities, and the related tax is presented as income tax expense, in the Statements of Income. There were no similar reclassifications during 2015.



**Report to the
Audit Committee**
March 21, 2017



Dedicated to Trust and Excellence.

March 21, 2017

To the Audit Committee of the Board of Directors
John Marshall Bank
Reston, Virginia

To the Members of the Audit Committee:

We are pleased to present this report related to our audit of the financial statements of John Marshall Bank (the "Bank") for the year ended December 31, 2016. This report summarizes certain matters required by professional standards to be communicated to you in your oversight responsibility for the Bank's financial reporting process. The communications regarding the matters addressed herein reflect the results of our audit procedures through the date of this report. If during the completion of our audit we identify issues that result in changes to any of the communications herein, we will provide you with a revised report and explanations thereof. Also, included is a summary of new accounting pronouncements that may affect the future financial reporting of the Bank.

This report is intended solely for the information and use of the Board of Directors, Audit Committee, and Management and is not intended to be and should not be used by anyone other than these specified parties. It will be our pleasure to respond to any questions you have regarding this report. We appreciate the opportunity to be of service to you.

Yount, Hyde & Barbour, P.C.

Dedicated to Trust and Excellence.



REQUIRED COMMUNICATIONS

Generally accepted auditing standards (AU-C 260, *The Auditor's Communication with Those Charged with Governance*) require the auditor to promote effective two-way communication between the auditor and those charged with governance. Consistent with this requirement, the following summarizes our responsibilities regarding the financial statement audit as well as observations arising from our audit that are significant and relevant to your responsibility to oversee the financial reporting process.

Area	Comments
Our Responsibilities With Regard to the Financial Statement Audit	Our responsibilities under auditing standards generally accepted in the United States of America have been described to you in our arrangement letter dated June 3, 2016. Our audit of the financial statements does not relieve management or those charged with governance of their responsibilities, which are also described in that letter.
Overview of the Planned Scope and Timing of the Financial Statement Audit	We have issued a separate communication regarding the planned scope and timing of our audit and have discussed with you our identification of, and planned audit response to, significant risks of material misstatement. There were no changes to the planned scope and timing of our audit.
Financial Statement Disclosures	We feel that the Management has prepared the financial statement disclosures in a manner that is neutral, consistent, and clear.
Accounting Policies and Practices	<p>Preferability of Accounting Policies and Practices</p> <p>Under generally accepted accounting principles, in certain circumstances, management may select among alternative accounting practices. In our view, in such circumstances, management has selected the preferable accounting practice.</p>
	<p>Adoption of, or Change in, Accounting Policies</p> <p>Management has the ultimate responsibility for the appropriateness of the accounting policies used by the Bank. The Bank did not adopt any significant new accounting policies, nor have there been any changes in existing significant accounting policies during the current period.</p>
	<p>Significant or Unusual Transactions</p> <p>We did not identify any significant or unusual transactions or significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.</p>

REQUIRED COMMUNICATIONS

Area	Comments
Accounting Policies and Practices (Continued)	Management's Judgments and Accounting Estimates Information on the Bank's significant accounting estimates is summarized on page 4.
Audit Adjustments	Adjustments were made to the original trial balances presented to us to begin our audit by management due to the timing of our initial visit with respect to year end. These adjustments were proposed by management and were normal closing entries related to income taxes and the provision for loan losses.
Uncorrected Misstatements	There were no uncorrected misstatements, other than those that were clearly trivial, of which we are aware.
Disagreements with Management	We encountered no disagreements with management over the application of significant accounting principles, the basis for management's judgments on any significant matters, the scope of the audit, or significant disclosures to be included in the financial statements.
Consultations with Other Accountants	We are not aware of any consultations management had with other accountants about accounting or auditing matters.
Significant Issues Discussed with Management	No significant issues arising from the audit were discussed with or the subject of correspondence with management.
Significant Difficulties Encountered in Performing the Audit	We did not encounter any significant difficulties in dealing with management during the audit.
Significant Written Communications between Management and Our Firm	The December 31, 2016 audit management representation letter was the only material written communication between our Firm and the Management of the Bank. A copy of the representation letter has been provided to the Audit Committee.
Independence	No additional factors have been identified since our communication dated December 7, 2016 that may reasonably be thought to bear on independence with respect to the Bank. Therefore, as of the date of this communication, we reaffirm that Yount, Hyde & Barbour, P.C. is independent with respect to the Bank in compliance with PCAOB Rule 3520.

REQUIRED COMMUNICATIONS

Area	Comments
Peer Review	YHB underwent the peer review process in September 2016. The Firm received the highest possible rating of pass with no deficiencies. We have attached a copy of this report.
PCAOB Inspection	YHB was inspected by the Public Company Accounting Oversight Board in June 2015. We received a report with no findings. We have previously provided you with a copy of this report.

SIGNIFICANT ACCOUNTING ESTIMATES

Accounting estimates are an integral part of the preparation of financial statements and are based upon management's current judgment. The process used by management encompasses their knowledge and experience about past and current events, and certain assumptions about future events. As such, many of the assumptions utilized in the determination of the Bank's significant accounting estimates carry a high degree of subjectivity. Descriptions of the accounting policies related to the Bank's significant estimates are reflected in Note 1 of the financial statements. You may wish to monitor throughout the year the processes used to determine and record these accounting estimates. The following summarizes the significant accounting estimates reflected in the Bank's December 31, 2016 financial statements and our audit response related to these estimates.

Significant Estimate	Auditor's Response to Significant Estimates
Determination of the Allowance for Loan Losses	<ul style="list-style-type: none"> Obtained an understanding of how management determines the allowance for loan losses. Reviewed and tested management's process, including: <ul style="list-style-type: none"> Review of the overall calculation and individual impaired loan calculations for accuracy. Analysis of historical data and qualitative adjustments to historical loss rates. Review of data used in forming assumptions related to qualitative factors. Review of available information to determine proper identification and classification of impaired loans. Analysis of inputs and assumptions utilized in the valuation of a sample of impaired loans. Reviewed subsequent events or transactions.
Evaluation for Potential Other-than-temporary Impairment (OTTI)	<ul style="list-style-type: none"> Obtained an understanding of management's process for evaluating the need for recordation of an OTTI charge. Reviewed and tested management's process, including: <ul style="list-style-type: none"> Independent verification of fair values for a sample of investment securities through use of an outside investments specialist. Review of third party reports including unrealized losses, credit ratings, and length of time in unrealized loss position. Consideration of other available evidence, including the Bank's history to corroborate assertions regarding OTTI. Reviewed subsequent events and/or transactions.

RECENTLY ISSUED PRONOUNCEMENTS

The following accounting pronouncements have been issued but are not yet effective, and may affect the future financial reporting by the Bank:

Accounting Standards Update (ASU)	ASU Description
ASU 2016-01, <i>Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities</i>	<p>The amendments in ASU 2016-01, among other things, require:</p> <ul style="list-style-type: none"> • Equity investments (except those accounted for under the equity method of accounting, or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; • Public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and • Separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables). <p>The amendments in this ASU are effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years.</p>
ASU 2016-02, <i>Leases (Topic 842)</i>	<p>The amendments in ASU 2016-02, among other things, require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date:</p> <ul style="list-style-type: none"> • A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and • A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. <p>The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.</p>

RECENTLY ISSUED PRONOUNCEMENTS

Accounting Standards Update (ASU)	ASU Description
ASU 2016-09, <i>Compensation – Stock Compensation (Topic 718): Improvements to Employee Shares-Based Payment Accounting</i>	<p>The amendments in this ASU simplify several aspects of the accounting for share-based payment award transactions including:</p> <ul style="list-style-type: none"> • Income tax consequences; • Classification of awards as either equity or liabilities; and • Classification on the statement of cash flows. <p>The amendments are effective for public companies for annual periods beginning after December 15, 2016, and interim periods within those annual periods.</p>
ASU 2016-13, <i>Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments</i>	<p>The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2020.</p>
ASU 2016-15, <i>Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments</i>	<p>This ASU was issued to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years.</p>

System Review Report

September 29, 2016

To the Shareholders of
Yount, Hyde & Barbour, P.C.
and the AICPA National Peer Review Committee

We have reviewed the system of quality control for the accounting and auditing practice of **Yount, Hyde & Barbour, P.C.** (the firm) applicable to engagements not subject to PCAOB permanent inspection in effect for the year ended April 30, 2016. Our peer review was conducted in accordance with the Standards for Performing and Reporting on Peer Reviews established by the Peer Review Board of the American Institute of Certified Public Accountants. As a part of our peer review, we considered reviews by regulatory entities, if applicable, in determining the nature and extent of our procedures. The firm is responsible for designing a system of quality control and complying with it to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Our responsibility is to express an opinion on the design of the system of quality control and the firm's compliance therewith based on our review. The nature, objectives, scope, limitations of, and the procedures performed in a System Review are described in the standards at www.aicpa.org/prsummary.

As required by the standards, engagements selected for review included engagements performed under *Government Auditing Standards*; audits of employee benefit plans, audits performed under FDICIA, and examinations of service organizations [Service Organizations Control (SOC) 1 and 2 engagements].

In our opinion, the system of quality control for the accounting and auditing practice of **Yount, Hyde & Barbour, P.C.** applicable to engagements not subject to PCAOB permanent inspection in effect for the year ended April 30, 2016, has been suitably designed and complied with to provide the firm with reasonable assurance of performing and reporting in conformity with applicable professional standards in all material respects. Firms can receive a rating of *pass*, *pass with deficiency(ies)* or *fail*. **Yount, Hyde & Barbour, P.C.** has received a peer review rating of *pass*.

Davis Kinard & Co., PC

Certified Public Accountants