***Note 1 - Nature of Operations and Significant Accounting Policies***

*XYZ Bancorp, Inc. (the “Bancorp”) and its wholly-owned subsidiary XYZ Bank (the “Bank” and together with Bancorp, the “Company”) provide various banking and other financial services to their customers. The Bank's customers include individuals and commercial enterprises within its principal market area consisting of Smallville County, Maryland. The Bank has a direct subsidiary established to hold foreclosed properties known as XYZ Anytown, LLC. Bancorp also has a subsidiary trust, established to issue trust preferred securities, and one direct subsidiary established to hold foreclosed properties known as XYZ Holdings, Inc. See Note 8 for additional disclosures related to the subsidiary trust, which issued trust preferred securities.*

*Additionally, the Bank maintains correspondent banking relationships and transacts daily federal funds sales on an unsecured basis with regional correspondent banks. Note 3 discusses the types of securities in which the Bank invests. Note 4 discusses the types of lending in which the Bank engages. The Bank does not have any significant concentrations to any one industry or customer.*

*The accounting and reporting policies and practices of the Company conform to accounting principles generally accepted in the United States of America. The following is a summary of the Company's significant accounting policies:*

*Principles of consolidation:*

*The accompanying consolidated financial statements include the accounts of the Company and the Bank. In consolidation, all significant intercompany balances and transactions have been eliminated.*

*The Company also has an investment in FCBI Statutory Trust I, a statutory trust that is not consolidated in accordance with Financial Accounting Standards Board Accounting Standards Codification (“FASB ASC”)**810, Consolidation. See Note 8.*

*Use of estimates:*

*The preparation of consolidated financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.*

*Comprehensive income:*

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

*Presentation of cash flows:*

*For purposes of reporting cash flows, cash and cash equivalents includes cash on hand, amounts due from banks (including cash items in process of clearing) and interest-bearing deposits in banks with an original maturity of 90 days or less, and federal funds sold. Generally, federal funds are sold for one-day periods.*

*Investment securities:*

*Securities classified as held-to-maturity are those debt securities the Company has both the intent and ability to hold to maturity regardless of changes in market conditions, liquidity needs or changes in*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*general economic conditions. These securities are carried at cost, adjusted for amortization of premium and accretion of discount, computed using the interest method, over their contractual lives.*

*Securities classified as available-for-sale are equity securities with readily determinable fair values and those debt securities that the Company intends to hold for an indefinite period of time but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movement in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations, and other similar factors. These securities are carried at estimated fair value based on information provided by a third party pricing service with any unrealized gains or losses excluded from net income and reported in accumulated other comprehensive income (loss), which is reported as a separate component of shareholders' equity, net of the related deferred tax effect.*

*Dividend and interest income, including amortization of premium and accretion of discount arising at acquisition, from all categories of investment securities are included in interest income in the consolidated statements of income.*

*Gains and losses realized on sales of investment securities, determined using the adjusted cost basis of the specific securities sold, are included in noninterest income in the consolidated statements of income. Additionally, declines in the estimated fair value of individual investment securities below their cost that are other-than-temporary are reflected as realized losses in the statements of income. Factors affecting the determination of whether an other-than-temporary impairment has occurred include, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near term prospects of the issuer, (iii) that the Company does not intend to sell these securities, and (iv) it is more likely than not that the Company will not be required to sell before a period of time sufficient to allow for any anticipated recovery in fair value.*

*Restricted stock is stock from the Federal Home Loan Bank of Atlanta (“FHLB”), the Federal Reserve Bank and the Atlantic Central Banker's Bank, which are restricted as to their marketability. Because no ready market exists for these investments and they have no quoted market value, the Bank's investment in these stocks are carried at cost. A determination as to whether there has been an impairment of a restricted stock investment is performed on a quarterly basis and includes a review of the current financial condition of the issuer.*

*Loans and allowance for loan losses:*

*Loans are carried at the amount of unpaid principal, adjusted for deferred loan fees and origination costs. Interest on loans is accrued based on the principal amounts outstanding. Nonrefundable loan fees and related direct costs are deferred and the net amount is amortized to income as a yield adjustment over the life of the loan using the interest method. When principal or interest is delinquent for ninety days or more, the Company evaluates the loan for nonaccrual status.*

*After a loan is placed on nonaccrual status, all interest previously accrued but not collected is reversed against current period interest income. Subsequent collections of interest payments on nonaccrual loans are recognized as interest income unless ultimate collectability of the loan is in doubt. Cash collections on loans where ultimate collectability remains in doubt are applied as reductions of the loan principal balance and no interest income is recognized until the principal balance has been collected.*

*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 uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The allowance is based on two basic principles of accounting: (i)**[FASB ASC 450, Contingencies](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD46%3A1371.1&feature=ttoc&lastCpReqId=3564c" \t "_top), which requires that losses be accrued when they are probable of occurring*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*and estimable and (ii)**[FASB ASC 310, Receivables](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD13%3A3998.1&feature=ttoc&lastCpReqId=3564c" \t "_top), which requires that losses or impaired loans be accrued based on the differences between the loan balance and either the value of collateral, if such loans are considered to be collateral dependent and in the process of collection, or the present value of*

*future cash flows, or the loan's value as observable in the secondary market. A loan is considered impaired when, based on current information and events, the Company has concerns about the ability 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 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.*

*The Company's allowance for loan losses has three basic components: the specific allowance, the formula allowance and the pooled allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. As a result of the uncertainties inherent in the estimation process, management's estimate of loan losses and the related allowance could change in the near term.*

*The specific allowance component is used to individually establish an allowance for loans identified for impairment testing. When impairment is identified, a specific reserve may be established based on the Company's calculation of the estimated loss embedded in the individual loan. Impairment testing includes consideration of the borrower's overall financial condition, resources and payment record, support available from financial guarantors and the fair market value of collateral. These factors are combined to estimate the probability and severity of inherent losses. Large groups of smaller balance, homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately evaluate individual consumer and residential loans for impairment.*

*The formula allowance component is used for estimating the loss on internally risk rated loans exclusive of those identified as impaired. The loans meeting the Company's internal criteria for classification, such as special mention, substandard, doubtful and loss, as well as specifically identified impaired loans, are segregated from performing loans within the portfolio. These internally classified loans are then grouped by loan type (commercial, commercial real estate, commercial construction, residential real estate, residential construction or installment). Each loan type is assigned an allowance factor based on management's estimate of the associated risk, complexity and size of the individual loans within the particular loan category. Classified loans are assigned a higher allowance factor than non-classified loans due to management's concerns regarding collectability or management's knowledge of particular elements surrounding the borrower. Allowance factors increase with the worsening of the internal risk rating.*

*The pooled formula component is used to estimate the losses inherent in the pools of non-classified loans. These loans are then also segregated by loan type and allowance factors are assigned by management based on delinquencies, loss history, trends in volume and terms of loans, effects of changes in lending policy, the experience and depth of management, national and local economic trends, concentrations of credit, results of the loan review system and the effect of external factors (i.e. competition and regulatory requirements). Current economic conditions take into account the average unemployment rate for Smallville County, Maryland, the State of Maryland and for the nation, with the most significance given to the Smallville County data. The allowance factors assigned differ by loan type.*

*Allowance factors and overall size of the allowance may change from period to period based on management's assessment of the above-described factors and the relative weights given to each factor. In addition, various regulatory agencies periodically review the allowance for loan losses. These agencies*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*may require the Bank to make additions to the allowance for loan losses based on their judgments of collectability based on information available to them at the time of their examination.*

*Loans are stated at the principal amount outstanding, net of unamortized deferred costs and fees. Interest income on loans is accrued at the contractual rate on the principal amount outstanding. It is the Company's policy to discontinue the accrual of interest when circumstances indicate that collection is doubtful. Deferred fees and costs on loans are being amortized on the interest method over the term of the loan. Management considers loans impaired when, based on current information, it is probable that the Company will not collect all principal and interest payments according to contractual terms. Loans are evaluated for impairment in accordance with the Company's portfolio monitoring and ongoing risk assessment procedures. Management considers the financial condition of the borrower, cash flow of the borrower, payment status of the loan, and the value of the collateral, if any, securing the loan. Generally, impaired loans do not include large groups of smaller balance homogenous loans such as residential real estate and consumer type loans which are evaluated collectively for impairment and are generally placed on nonaccrual when the loan becomes 90 days past due as to principal or interest. Loans specifically reviewed for impairment are not considered impaired during periods of “minimal delay” in payment (90 days or less) provided eventual collection of all amounts due is expected. The impairment of a loan is measured based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or the fair value of the collateral if repayment is expected to be provided solely by the collateral. In appropriate circumstances, interest income on impaired loans may be recognized on a cash basis.*

*The Company's charge-off policy states after all collection efforts have been exhausted and the loan is deemed to be a loss, it will be charged to the Company's established allowance for loan losses. Consumer loans subject to the Uniform Retail Credit Classification are charged-off as follows: (a) closed end loans are charged-off no later than 120 days after becoming delinquent, (b) consumer loans to borrowers who subsequently declare bankruptcy, where the Company is an unsecured creditor, are charged-off within 60 days of receipt of the notification from the bankruptcy court, (c) fraudulent loans are charged-off within 90 days of discovery and (d) death of a borrower will cause a charge-off to be incurred at such time an actual loss is determined. All other types of loans are generally evaluated for loss potential at the 90th day past due threshold, and any loss is recognized no later than the 120th day past due threshold; each loss is evaluated on its specific facts regarding the appropriate timing to recognize the loss.*

*Bank premises and equipment:*

*Bank premises and equipment are stated at cost less accumulated depreciation and amortization. The provision for depreciation is computed using straight-line and accelerated methods based on the estimated useful lives of the assets, which range from 5 to 10 years for bank equipment and 39 years for bank buildings. Leasehold improvements are amortized over the lesser of the terms of the leases or their estimated useful lives. Expenditures for improvements, which extend the life of an asset, are capitalized and depreciated over the asset's remaining useful life. Gains or losses realized on the disposition of properties and equipment are reflected in the statements of income. Expenditures for repairs and maintenance are charged to operating expenses as incurred.*

*Bank owned life insurance:*

*The Bank purchased single-premium life insurance on certain employees of the Bank. Appreciation in value of the insurance policies is classified as noninterest income. These insurance policies can be surrendered subject to certain surrender penalties applied by the insurance carriers, as well as potential income taxes to be paid.*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*Foreclosed properties:*

*Foreclosed properties include properties that have been acquired in complete or partial satisfaction of a debt. These properties are initially recorded at fair value on the date of acquisition. Any write-downs at the*

*time of acquisition are charged to the allowance for loan losses. Subsequent to acquisition, a valuation allowance is established, if necessary, to report these assets at the lower of (a) fair value minus estimated costs to sell or (b) cost. Gains and losses realized on the sale, and any adjustments resulting from periodic re-evaluation of the property are included in noninterest income or expense, as appropriate. Net costs of maintaining and operating the properties are expensed as incurred.*

*Stock-based compensation plan:*

*The Company maintains two stock-based compensation plans, as described more fully in Note 10, which provide for grants of incentive and non-incentive stock options, restricted stock and/or restricted stock units. These plans have been presented to and approved by the Company's shareholders.*

*Compensation cost for all stock-based awards is measured at fair value on the date of grant and recognized over the service period for awards expected to vest. Such value is recognized as expense over the service period. Any adjustment due to the forfeiture of stock-based awards will be recorded as a cumulative adjustment in the period the awards are forfeited.*

*Income taxes:*

*Provisions for income taxes are based on taxes payable or refundable for the current year and deferred taxes on temporary differences between the amount of taxable income and pretax financial income and between the tax bases of assets and liabilities and their reported amounts in the financial statements. Deferred tax assets and liabilities are included in the consolidated financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. In addition, 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.*

*The Company does not have uncertain tax positions that are deemed material, and did not recognize any adjustments for unrecognized tax benefits. The Company's policy is to recognize interest and penalties on income taxes in other noninterest expenses. The Company remains subject to examination for income tax returns for the years ending after December 31, 20W8.*

*Fair value measurements:*

*The Company follows the guidance of**[FASB ASC 825, Financial Instruments](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A4696.1&feature=ttoc&lastCpReqId=3564c" \t "_top), and**[FASB ASC 820, Fair Value Measurement](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A4367.1&feature=ttoc&lastCpReqId=3564c" \t "_top). This guidance permits entities to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. This guidance clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Under this guidance, fair value measurements are not adjusted for transaction costs. This guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements).*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*Transfers of financial assets:*

*The Company accounts for transfers and servicing of financial assets in accordance with**[FASB ASC 860, Transfers and Servicing](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A9822.1&feature=ttoc&lastCpReqId=3564c" \t "_top). Transfers of financial assets are accounted for as sales only when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.*

*Valuation of long-lived assets:*

*The Company accounts for the valuation of long-lived assets under**[FASB ASC 360, Property, Plant and Equipment](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD13%3A9465.1&feature=ttoc&lastCpReqId=3564c" \t "_top). This guidance requires that long-lived assets and certain identifiable intangible assets be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of the long-lived asset is measured by a comparison of the carrying amount of the asset to future undiscounted net cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the estimated fair value of the assets. Assets to be disposed of are reportable at the lower of the carrying amount or fair value, less costs to sell.*

*Segment reporting:*

*[FASB ASC 280, Segment Reporting](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD13%3A3791.1&feature=ttoc&lastCpReqId=3564c" \t "_top), encourages nonpublic entities to report selected information about operating segments in its financial reports issued to its shareholders. Based on the analysis performed by the Company, management has determined that the Company only has one operating segment, which is commercial banking. The chief operating decision-makers use consolidated results to make operating and strategic decisions, and therefore, are not required to disclose any additional segment information.*

*Reclassifications:*

*Certain reclassifications have been made to the 20X1 financial statement presentation to correspond to the current year's format. Total shareholders' equity and net income are unchanged due to these reclassifications.*

*Subsequent events:*

*The Company has evaluated the accompanying consolidated financial statements for subsequent events and transactions through March 7, 20X3, the date these financial statements were available for issue, based on**[FASB ASC 855, Subsequent Events](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A9633.1&feature=ttoc&lastCpReqId=3564c" \t "_top), and have determined that no material subsequent events have occurred that would affect the information presented in the accompanying consolidated financial statements or require additional disclosure.*

***New Authoritative Accounting Guidance***

*The Financial Accounting Standards Board (the FASB) issued Accounting Standards Update (ASU) 2016-01, Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. The amendments in this Update make targeted improvements to generally accepted accounting principles (GAAP) as follows: (1) Require equity investments to be measured at fair value with changes in fair value recognized in net income. (2) Simplify the impairment*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment. When a qualitative assessment indicates that impairment exists, an entity is required to measure the investment at fair value. (3) Eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet. (4) Require public business entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes. (5) Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. This ASU will be effective for financial institutions other than public business entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. The Company does not expect the guidance to have a material impact on its financial statements.*

*The FASB issued ASU 2016-02, Leases (Topic 842), to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. To meet that objective, the FASB is amending the FASB Accounting Standards Codification and creating Topic 842, Leases. Leasing is utilized by many entities. It is a means of gaining access to assets, of obtaining financing, and/or of reducing an entity's exposure to the full risks of asset ownership. The prevalence of leasing, therefore, means that it is important to users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, there had been long-standing requests from many users of financial statements to have a complete and understandable picture of an entity's leasing activities. Previous lease accounting was criticized for failing to meet the needs of users of financial statements because it did not always provide a faithful representation of leasing transactions. In particular, it did not require lessees to recognize assets and liabilities arising from operating leases on the balance sheet. As a result, there had been long-standing requests from many users of financial statements and others to change the accounting requirements so that lessees would be required to recognize the rights and obligations resulting from leases as assets and liabilities. This ASU will be effective for financial institutions other than public business entities for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. At this time, the Company has not determined the impact on its financial statements.*

*The FASB issued ASU 2016-09, Compensation—Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting, which made the following changes: (1) Accounting for Income Taxes: All excess tax benefits and tax deficiencies (including tax benefits of dividends on share-based payment awards) should be recognized as income tax expense or benefit in the income statement. The tax effects of exercised or vested awards should be treated as discrete items in the reporting period in which they occur. An entity also should recognize excess tax benefits regardless of whether the benefit reduces taxes payable in the current period. (2) Classification of Excess Tax Benefits on the Statement of Cash Flows: Excess tax benefits should be classified along with other income tax cash flows as an operating activity. (3) Forfeitures: An entity can make an entity wide accounting policy election to either estimate the number of awards that are expected to vest (current GAAP) or account for forfeitures when they occur. This ASU will be effective for entities other than public business entities for annual periods beginning after December 15, 2017, and interim periods within annual periods beginning after December 15, 2018. The Company is currently evaluating the impact that the guidance will have on its financial statements.*

*The FASB issued ASU 2016-13, Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. Current GAAP requires an incurred loss methodology for recognizing credit losses that delays recognition until it is probable a loss has been incurred. Users of financial statements expressed concern that current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the probable threshold. The main objective of the ASU is to provide financial statement users with more decision-useful information about the expected credit losses on*

***Note 1 - Nature of Operations and Significant Accounting Policies, continued***

*financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in this Update replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. This ASU will be effective for financial institutions other than public business entities for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. At this time, the Company has not determined the impact on its financial statements.*

*The FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which made the following changes that may affect the Company: (1) Debt Prepayment or Debt Extinguishment Costs: Cash payments for debt prepayment or debt extinguishment costs should be classified as cash flows for financing activities. (2) Proceeds from the Settlement of Bank-Owned Life Insurance Policies: Cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash flows from investing activities. The cash payments for premiums on*

*bank-owned policies may be classified as cash flows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this ASU will be effective for entities other than public business entities for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. The Company does not expect the guidance to have a material impact on its financial statements.*

***Note 2 - Compensating Balances***

*Compensating balance arrangements exist with various correspondent banks. These noninterest-bearing deposits are maintained in lieu of cash payments for standard bank services. The required balances amounted to $1.25 million and $750 thousand at December 31, 20X2 and 20X1, respectively. In addition, for the reserve maintenance period in effect at December 31, 20X2 and 20X1, the Company was required to maintain balances of $350 thousand with the Federal Reserve Bank.*

***Note 3 - Investments***

*The amortized cost and fair value of securities classified as available-for-sale at December 31, 20X2 and 20X1 are as follows:*

***Available-for-sale***

*Information pertaining to securities with gross unrealized losses, aggregated by investment category and length of time that individual securities have been in a continuous loss position, are as follows:*

**

***Note 3 - Investments, continued***

*The bonds in an unrealized loss position at December 31, 20X2 and 20X1 were temporarily impaired due to the current interest rate environment and not increased credit risk. In estimating other-than-temporary*

*impairment losses, the Company considers, among other things, (i) the length of time and the extent to which the fair value has been less than cost, (ii) the financial condition and near term prospects of the issuer, (iii) that the Company does not intend to sell these securities and (iv) it is more likely than not that the Company will not be required to sell before a period of time sufficient to allow for any anticipated recovery in fair value. All securities owned by the Company are payable at par at maturity. The temporarily impaired securities consisted of two (2) state and political subdivisions, one rated AA− by Standard and Poor's and the other rated Aa3 by Moody's, with an aggregated book value of $1.31 million.*

*Included in the investment portfolio at December 31, 20X2 and 20X1 are securities carried at $8.94 million and $5.43 million, respectively, which are pledged for public fund deposits, to secure repurchase agreements and for other purposes as required and permitted by law.*

*Gross gains of $1.05 million and $386 thousand in 20X2 and 20X1, respectively, were realized from sales of investment securities available-for-sale with proceeds of $17.62 million and $7.61 million, respectively.*

***Restricted Stock***

*The following table shows the amounts of restricted stock as of December 31, 20X2 and 20X1:*

**

***Note 4 - Loans and Allowance for Loan Losses***

*Loans consist of the following at December 31, 20X2 and 20X1:*

**

***Note 4 - Loans and Allowance for Loan Losses, continued***

*The loan categories in the table above include net deferred fees and costs of $361 thousand and $304 thousand as of December 31, 20X2 and 20X1, respectively.*

*At December 31, 20X2 and 20X1 the Company has $32.09 million and $30.31 million of commercial real estate and residential real estate mortgage loans pledged as collateral for certain borrowings.*

*The Company's goal is to mitigate risks from an unforeseen threat to the loan portfolio as a result of an economic downturn or other negative influences. Plans that aid in mitigating these potential risks in managing the loan portfolio include: enforcing loan policies and procedures, evaluating the borrower's business plan through the loan term, identifying and monitoring primary and alternative sources of repayment, and obtaining adequate collateral to mitigate loss in the event of liquidation. Specific reserves are established based upon credit and/or collateral risks on an individual loan basis. A risk rating system is used to estimate potential loss exposure and to provide a measuring system for setting general and specific reserve allocations.*

*As of December 31, 20X2, the real estate loan portfolio constituted 86% of the total loan portfolio. This can be broken down further into the following categories: 8% construction and land development, 60% commercial real estate and 18% residential real estate loans, as a percent of total loans. The commercial real estate can be further broken down to 44% of owner occupied properties and 26% of non-owner occupied properties, as a percent of total loans.*

*The Company's construction and land development loans are secured by real property where the loan funds will be used to acquire land and to construct or improve appropriately zoned real property for the creation of income producing or owner occupied commercial properties. Borrowers are generally required to put equity into the project at levels determined by the loan committee and usually are underwritten with a maximum term of 24 months.*

*Commercial real estate loans are secured by improved real property which is generating income in the normal course of business. Debt service coverage, assuming stabilized occupancy, must be satisfied to support a permanent loan. The debt service coverage ratio is ordinarily at 1.20 to 1.00. These loans are generally underwritten with a term not greater than 10 years or the remaining useful life of the property,*

*whichever is lower. The preferred term is between 5 to 7 years, with amortization to a maximum of 25 years.*

*Residential real estate loans are secured by the improved real property of the borrower and are usually underwritten with a term of 1 to 5 years, but may be underwritten with terms up to 30 years.*

*The Company also makes commercial and industrial loans for a variety of purposes, which include working capital, equipment and accounts receivable financing. This category represents about 13% of the loan portfolio at December 31, 20X2. Loans in this category generally carry a variable interest rate. Commercial loans meet reasonable underwriting standards, including appropriate collateral and cash flow necessary to support debt service. Personal guarantees are generally required, but may be limited.*

***Note 4 - Loans and Allowance for Loan Losses, continued***

*The following tables show the allowance for loan losses and recorded investment in loans for the years ended December 31, 20X2 and 20X1:*

**

***Note 4 - Loans and Allowance for Loan Losses, continued***

*Credit quality indicators as of December 31, 20X2 and 20X1 are as follows:*

*Internally assigned grade:*

*Pass—loans in this category have strong asset quality and liquidity along with a multi-year track record of profitability.*

*Special mention—loans in this category are currently protected but are potentially weak. The credit risk may be relatively minor, yet constitute an increased risk in light of the circumstances surrounding a specific loan.*

*Substandard—loans in this category show signs of continuing negative financial trends and unprofitability at various times, and therefore, are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any.*

*Doubtful—loans in this category are illiquid and highly leveraged, have negative net worth, cash flow, and continuing trend serious losses. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors which may work to the advantage and strengthening of the asset, its classification as loss is deferred until its more exact status may be determined.*

*Loss—loans in this category are considered uncollectible and of such little value that their continuance as bankable loans is not warranted. This classification does not mean that the loan has no recovery value, but that it is not practical to defer writing it off, even though partial recovery may be affected in the future. Such credits should be recommended for charge-off.*

*The information for each of the credit quality indicators is updated on a quarterly basis in conjunction with the determination of the adequacy of the allowance for loan losses.*

*Commercial credit exposure—Credit risk profile by internally assigned grade:*

**

***Note 4 - Loans and Allowance for Loan Losses, continued***

*Consumer credit exposure—Credit risk profile by internally assigned grade:*

**

*Information on impaired loans for the years ended December 31, 20X2 and 20X1 are as follows:*

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***Note 4 - Loans and Allowance for Loan Losses, continued***

**

*Age analysis tables of past due loans as of December 31, 20X2 and 20X1 are as follows:*

**

***Note 4 - Loans and Allowance for Loan Losses, continued***

*Information on performing and nonaccrual impaired loans as of December 31, 20X2 and 20X1 is as follows:*

**

***Note 4 - Loans and Allowance for Loan Losses, continued***

*Information on troubled debt restructurings for the years ended December 31, 20X2 and 20X1 is as follows:*

**

*The troubled debt restructured loans shown in the table were modified during 20X2 with the following terms: one (1) loan in the amount of $550 thousand converted to interest only periods for six to twelve months; and one (1) loan in the amount of $622 thousand that has been re-amortized. The troubled debt restructured loans shown in the table were modified during 20X1 with the following terms: four (4) loans in the aggregate amount of $728 thousand converted to interest only periods for six to twelve months; and one (1) loan in the amount of $568 thousand that has been re-amortized.*

*There were no loans as of December 31, 20X2 that had been modified as troubled debt restructurings during 20X2 and then subsequently re-defaulted in 20X2.*

*At December 31, 20X2 there are no commitments to lend additional funds to any borrower whose loan terms have been modified in a troubled debt restructuring.*

*At December 31, 20X2 , the Company had $160 thousand in foreclosed residential real estate properties where physical possession has occurred and no properties where formal foreclosure procedures are in process. There were no foreclosed residential real estate properties at December 31, 20X1.*

***Note 5 - Bank Premises and Equipment***

*Bank premises and equipment consisted of the following at December 31, 20X2 and 20X1:*

**

*Depreciation and amortization charged to operations amounted to $373 thousand in 20X2 and $286 thousand in 20X1.*

***Note 6 - Deposits***

*Certificates of deposit and other time deposits issued in denominations that meet or exceed the FDIC insurance limit of $250 thousand or more totaled $48.63 million and $39.65 million at December 31, 20X2 and 20X1, respectively, and are included in interest-bearing deposits in the consolidated balance sheet.*

*At December 31, 20X2, the maturity distribution of certificates of deposit are as follows:*

**

*Interest on deposits for the years ended December 31, 20X2 and 20X1 consists of the following:*

**

***Note 7 - Borrowings***

*During 20X2 and 20X1, the Company had no sales of securities under agreements to repurchase the same securities.*

*Short-term borrowings:*

**

*The Company's unused lines of credit for short-term borrowings totaled $13.00 million at December 31, 20X2 and 20X1. These include an unsecured line of credit from an unaffiliated financial institution for Bancorp in the amount of $4.00 million at December 31, 20X2 and 20X1, and unsecured federal funds lines of credit from unaffiliated financial institutions for the Bank in an aggregate amount of $9.00 million at December 31, 20X2 and 20X1.*

*FHLB Advances:*

*The Company has a secured line of credit with the FHLB in the amount of $23.64 million, which is secured by a blanket lien on its 1-4 family residential mortgage loan portfolio and certain commercial real estate loans. At December 31, 20X2 and 20X1, the Company had $10.00 million in borrowings under this credit facility. There were two fixed rate advances in the amounts of $5.00 million each, with rates of 3.29% and 3.05%, and with a maturity of November 19, 20X5.*

***Note 8 - Trust Preferred Securities/Junior Subordinated Debentures***

*In December 2006, Bancorp completed the private placement of an aggregate of $6.00 million of trust preferred securities through FCBI Statutory Trust I (the “Trust”), a trust subsidiary organized under Connecticut law, of which Bancorp owns all of the common securities of $186 thousand. The principal asset of the Trust is a similar amount of Bancorp's junior subordinated debentures. The interest rate on the junior subordinated debentures is currently adjusted quarterly to 163 basis points over three-month LIBOR. On December 15, 20X2, the most recent interest reset date, the interest rate was adjusted to 1.87060% for the period ending March 15, 20X3. The junior subordinated debentures mature on December 15, 20Z6, and may be redeemed at par, at Bancorp's option, on any interest payment date. The obligations of Bancorp with respect to the Trust's preferred securities constitute a full and unconditional guarantee by Bancorp of Trust's obligations with respect to the trust preferred securities to the extent set forth in the related guarantee. Subject to certain exceptions and limitations, Bancorp may elect from time to time to defer interest payments on the junior subordinated debentures, resulting in a deferral of distribution payments on the related trust preferred securities. If the Company defers interest payments on the junior subordinated debentures, or otherwise is in default of the obligations, the Company would be prohibited from making dividend payments to its shareholders.*

*Through December 31, 20X2, trust preferred securities may be included in Tier 1 capital for regulatory capital adequacy purposes up to 25% of Tier 1 capital, net of goodwill after its inclusion, and the portion of the trust preferred securities not qualifying as Tier 1 capital may be included as part of total qualifying*

***Note 8 - Trust Preferred Securities/Junior Subordinated Debentures, continued***

*capital in Tier 2 capital, subject to limitation. Subsequent to December 31, 20X2, the Company may include trust preferred securities as an additional Tier I capital element, without limitation.*

***Note 9 - Leasing Arrangements***

*The Company leases branch and administrative office facilities under noncancelable operating lease arrangements whose maturity dates extend to May 20Y0. These leases contain options, which enable the Company to renew the leases at fair rental value for periods of 5 to 10 years. In addition to minimum rentals, certain leases have escalation clauses based upon various price indices and include provisions for additional payments to cover taxes, insurance and maintenance. See Note 16 for a discussion of the terms of a lease agreement with related parties. The total minimum rental commitment, including renewal periods, under these leases at December 31, 20X2 is outlined below:*

**

*Rent expense included in occupancy and equipment expenses amounted to $397 thousand in 20X2 and $376 thousand in 20X1.*

***Note 10 - Employee Benefit Plans***

*401(k) profit sharing plan:*

*The Company has a Section 401(k) profit sharing plan [the 401(k) Plan] covering employees meeting certain eligibility requirements as to minimum age and years of service. Employees may make voluntary contributions to the 401(k) Plan through payroll deductions on a pre-tax basis. The Company has the discretion to make matching contributions of 100% of the employee's contributions up to 4% of the employee's salary. A participant's account under the 401(k) Plan, together with investment earnings thereon, is normally distributable, following retirement, death, disability or other termination of employment, in a single lump-sum payment.*

*In 20X2 and 20X1, the Company made matching contributions of 100%. The Company expensed contributions to the 401(k) Plan in the amounts of $126 thousand in 20X2 and $124 thousand in 20X1.*

*Stock-based compensation plans:*

*The Company's 20W1 Stock Option Plan (“20W1 Plan”) and 20X1 Stock Incentive Plan (“20X1 Plan”) provide that 260,000 shares and 250,000 shares, respectively, of the Company's common stock will be reserved for the award of incentive stock options (“ISO”) and nonincentive stock options (“NQSO”) to purchase shares of common stock, and under the 20X1 Plan, shares of restricted stock and restricted stock units. At December 31, 20X2, there are 200,000 shares remaining that are reserved for future grants under the 20X1 Plan, but no shares remaining under the 20W1 Plan. The exercise price per share shall not be less than the fair market value of a share of common stock on the date on which an option is granted, subject to adjustments for the effects of any stock splits or stock dividends, and may be exercised not later than ten years after the grant date.*

***Note 10 - Employee Benefit Plans, continued***

*The following is a summary of transactions in the 20W1 and 20X1 Plans during the years ended December 31, 20X2 and 20X1.*

**

*As noted in the table above, there were 50,000 options granted in 20X2, but no options granted in 20X1. The Company recognizes the cost of employee services received in exchange for an award of equity investment based on the grant-date fair value of the award. That cost will be recognized over the vesting period of the award. Stock-based compensation expense related to stock options for the years ended December 31, 20X2 and 20X1 was $107 thousand and $109 thousand, respectively. As of December 31, 20X2, there was $46 thousand of total unrecognized compensation cost related to non-vested stock options that will be expensed over the period ending in April 20X4.*

*The Company received $180 thousand and $9 thousand from the exercise of stock options in 20X2 and 20X1, respectively. The Company also recognized $28 thousand in excess tax benefits from equity-based awards in 20X2, but none in 20X1.*

*The weighted-average fair value of options granted in the year ended December 31, 20X2 was $2.64 and was estimated at the date of grant, which was in April 20X2, using the Black-Scholes Option Pricing Model with the following weighted-average assumptions. There were no options granted in 20X1.*

**

***Note 10 - Employee Benefit Plans, continued***

*The risk-free interest rate is based on the U.S. Treasury yield curve in effect at the time of the grant. The expected lives are based on the Company's historical experience. The expected volatility is based on the Company's estimated level of volatility. The dividend yield assumption is based on the Company's expectation of dividend payouts.*

*The 152,840 and 120,500 options outstanding as of December 31, 20X2 and 20X1, respectively, have an aggregate intrinsic value, which is the amount that the market value of the underlying stock exceeds the exercise price of the option, of $438 thousand and $1 thousand, respectively. The aggregate intrinsic value of the options exercised in 20X2 and 20X1 amounted to $0 and $145 thousand, respectively.*

*At December 31, 20X2 and 20X1, the 152,840 and 120,500 options issued and outstanding, respectively, had exercise prices and weighted average remaining contractual lives as follows:*

**

***Note 11 - Income Taxes***

*Significant components of the Company's deferred tax assets and liabilities at December 31, 20X2 and 20X1 were as follows:*

**

*A reconciliation of the statutory income tax to the provision for income taxes included in the consolidated statements of income for the years ended December 31, 20X2 and 20X1 is as follows:*

**

***Note 11 - Income Taxes, continued***

*Significant components of the provision for income taxes for the years ended December 31, 20X2 and 20X1 are as follows:*

**

***Note 12 - Noninterest Expenses***

*Noninterest expenses included in the consolidated statements of income for the years ended December 31, 20X2 and 20X1 include the following:*

**

***Note 13 - Shareholders' Equity***

*Restrictions on dividends:*

*The amount of dividends that the Bank can pay to Bancorp without approval from the Federal Reserve Board is limited to its net profits for the current year plus its retained net profits for the preceding two years. Under Maryland law, dividends may be paid without approval from the Department of Financial Regulation only out of undivided profits. At December 31, 20X2, the Bank was limited from paying dividends to Bancorp in excess of $4.02 million, and by the requirement to meet certain capital ratios. The Bank paid approximately $320 thousand and $150 thousand in dividends to Bancorp in 20X2 and 20X1.*

*Under Maryland law, Bancorp may pay dividends only out of retained earnings. State and federal bank regulatory agencies have authority to prohibit a bank from paying dividends if such payment is deemed to be an unsafe or unsound practice, and the Federal Reserve Board has the same authority over bank holding companies.*

*The Federal Reserve Board has established guidelines with respect to the maintenance of appropriate levels of capital by registered bank holding companies. Compliance with such standards, as presently in effect, or as they may be amended from time to time, could possibly limit the amount of dividends that the Company may pay in the future. In 1985, the Federal Reserve Board issued a policy statement on the payment of cash dividends by bank holding companies. In the statement, the Federal Reserve Board expressed its view that a holding company experiencing earnings weaknesses should not pay cash dividends exceeding its net income, or which could only be funded in ways that weaken the holding company's financial health, such as by borrowing.*

*Restrictions on lending from subsidiary to parent:*

*Federal law imposes certain restrictions limiting the ability of the Bank to transfer funds to Bancorp in the forms of loans or advances. Section 23A of the Federal Reserve Act prohibits the Bank from making loans or advances to Bancorp in excess of 10 percent of its capital stock and surplus, as defined therein. There were no loans or advances outstanding at December 31, 20X2 and 20X1.*

*Capital:*

*The Bank is, and when the Company's assets exceed $1 billion, or the Company engages in certain highly significant nonbanking activities, conducts significant off-balance sheet activities, or has a material amount of debt or equity securities registered with the Securities and Exchange Commission, the Company will be, subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory—and possibly additional discretionary—actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and the Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Prompt corrective action provisions are not applicable to bank holding companies.*

*Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of common equity, total, and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and Tier 1 capital (as defined) to average assets (as defined). Management believes that the Company and the Bank met all capital adequacy requirements to which they are subject as of December 31, 20X2 and 20X1.*

*As of December 31, 20X2, the most recent notification from the regulatory agencies categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized the Bank must maintain minimum common equity risk-based, Tier 1 risk-based, and Tier 1*

***Note 13 - Shareholders' Equity, continued***

*leverage ratios as set forth in the table. There are no conditions or events since that notification which management believes have changed the Bank's category.*

*The Company's and the Bank's actual capital amounts and ratios at December 31, 20X2 and 20X1 are presented in the following tables:*

**

***Note 13 - Shareholders' Equity, continued***

*****Note 14 - Fair Value Measurements***

*[FASB ASC 825, Financial Instruments](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A4696.1&feature=ttoc&lastCpReqId=3564c" \t "_top), permits entities to measure many financial instruments and certain other items at fair value. The objective is to improve financial reporting by providing entities with the opportunity to mitigate volatility in reported earnings caused by measuring related assets and liabilities differently without having to apply complex hedge accounting provisions. The election to use the fair value option is available when an entity first recognizes a financial asset or financial liability or upon entering into a Company commitment. Subsequent changes must be recorded in earnings.*

*[FASB ASC 820, Fair Value Measurement](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A4367.1&feature=ttoc&lastCpReqId=3564c" \t "_top), clarifies that fair value is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. Under this guidance, fair value measurements are not adjusted for transaction costs. This guidance establishes a fair value hierarchy that prioritizes the inputs to valuation techniques used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under this guidance are described below.*

***Note 14 - Fair Value Measurements, continued***

*Level 1 - Valuations for assets and liabilities traded in active exchange markets. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.*

*Level 2 - Valuations for assets and liabilities traded in less active dealer or broker markets. Valuations are obtained from third party pricing services for identical or comparable assets or liabilities which use observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in active 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 assets or liabilities.*

*Level 3 - Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.*

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

*The types of instruments valued based on quoted market prices in active markets include most U.S. government and agency securities, liquid mortgage products, active listed equities and most money market securities. Such instruments are generally classified within Level 1 or Level 2 of the fair value hierarchy. As required by this guidance, the Company does not adjust the quoted price for such instruments.*

*The types of instruments valued based on quoted prices in markets that are not active, broker or dealer quotations, or alternative pricing sources with reasonable levels of price transparency include most investment-grade and high-yield corporate bonds, less liquid mortgage products, less liquid equities, state, municipal and provincial obligations, and certain physical commodities. Such instruments are generally classified within Level 2 of the fair value hierarchy.*

*Level 3 is for positions that are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence. In the absence of such evidence, management's best estimate is used.*

*Impaired loans are evaluated and valued at the time the loan is identified as impaired, using the present value of expected cash flows, the loan's observable market price or the fair value of the collateral (less cost to sell) if the loans are collateral dependent. Market value is measured based on the value of the collateral securing these loans and is classified at a Level 3 in the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory and/or accounts receivable. The value of real estate collateral is determined based on appraisal by qualified licensed appraisers hired by the Company. The value of business equipment, inventory and accounts receivable collateral is based on the net book value on the business' financial statements and, if necessary, discounted based on management's review and analysis. Discounts applied to appraisals have been in the range of 0% to 50%. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors identified above.*

*Foreclosed properties are adjusted to fair value upon transfer of the loans to foreclosed properties. Subsequently, foreclosed properties are carried at the lower of carrying value or fair value. The estimated fair value for foreclosed properties included in Level 3 is determined by independent market based appraisals and other available market information. Discounts applied to appraisals have predominantly been in the range of 0% to 50%; however, in certain cases the discounts have ranged up to 75%, which include estimated costs to sell or other reductions based on market expectations or an executed sales contract. If fair value of the collateral deteriorates subsequent to initial recognition, the Company records the foreclosed properties as a nonrecurring Level 3 adjustment. Valuation techniques are consistent with those techniques applied in prior periods.*

***Note 14 - Fair Value Measurements, continued***

*The following tables set forth the Company's assets and liabilities that were accounted for or disclosed at fair value on a recurring basis as of December 31, 20X2 and 20X1.*

**

***Note 14 - Fair Value Measurements, continued***

*The following tables set forth the Company's financial assets and liabilities that were accounted for or disclosed at fair value on a nonrecurring basis as of December 31, 20X2 and 20X1.*

**

***Note 15 - Fair Value of Financial Instruments***

*In accordance with the disclosure requirements of**[FASB ASC 825, Financial Instruments](https://checkpoint.riag.com/app/main/tocFrameTocParms?baseTid=T0GAAPCD08%3A4696.1&feature=ttoc&lastCpReqId=3564c" \t "_top), the estimated fair values of the Company's financial instruments are as follows:*

*The following methods and assumptions were used to estimate the fair value disclosures for financial instruments as of December 31, 20X2 and 20X1:*

*Cash and cash equivalents:*

*The fair value of cash and cash equivalents is estimated to approximate the carrying amounts.*

*Investment securities and restricted stock:*

*Fair values are based on quoted market prices, except for certain restricted stocks where fair value equals par value because of certain redemption restrictions.*

*Loans:*

*Fair values are estimated for portfolios of loans with similar financial characteristics. Each portfolio is further segmented into fixed and adjustable rate interest terms by performing and non-performing categories.*

***Note 15 - Fair Value of Financial Instruments, continued***

*The fair value of performing loans is calculated by discounting estimated cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. The estimated cash flows do not anticipate prepayments.*

*Management has made estimates of fair value discount rates that it believes to be reasonable. However, because there is no market for many of these financial instruments, management has no basis to determine whether the fair value presented for loans would be indicative of the value negotiated in an actual sale.*

*Deposits:*

*The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW accounts and money market accounts, is equal to the amount payable on demand at the reporting date (that is, their carrying amounts). The fair value of certificates of deposit is based on the discounted value of contractual cash flows. The discount rate is estimated using the rates currently offered for deposits of similar remaining maturities. The fair value estimates do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market.*

*Short-term borrowings:*

*The fair value of short-term borrowings is determined using rates currently available to the Company for debt with similar terms and remaining maturities.*

*FHLB advances:*

*The fair value of the FHLB advances is determined using rates currently available to the Company for debt with similar terms and remaining maturities.*

*Junior subordinated debentures:*

*The junior subordinated debentures are unsecured obligations of the Company and are subordinate and junior in right of payment to all present and future senior indebtedness of the Company. The Company has entered into a guarantee, which together with its obligations under the junior subordinated debentures and the declaration of trust governing the Trust provides a full and unconditional guarantee of the Trust's preferred securities. The fair value of junior subordinated debentures is determined using rates currently available to the Company for debt with similar terms and remaining maturities. See Note 8 for additional disclosures.*

***Note 16 - Transactions with Related Parties***

*Loans:*

*In the normal course of banking business, loans are made to officers and directors of the Company, as well as to their affiliates. Such loans are made in the ordinary course of business with substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons. They do not involve more than normal risk of collectability or present other unfavorable features. An analysis of the activity during 20X2 and 20X1 is as follows:*

**

*Included in the new loans for 20X2 are loans that pertain to the addition of two (2) new directors with outstanding loans in the aggregate of $4.45 million when they were added to the board of directors.*

*Deposits:*

*The deposits from officers and directors of the Company totaled $4.02 million and $5.35 million at December 31, 20X2 and 20X1, respectively.*

*Lease agreement:*

*The Company entered into a new lease in July 20X1 for approximately 10,521 square feet of office space owned by a limited liability company owned by three directors. The lease term commenced on July 11, 20X1 and will expire on July 10, 20X6. Under this lease, monthly payments for the period July 11, 20X1 to July 10, 20X2 were $14,583 and July 11, 20X2 to July 10, 20X3 are $14,583.*

***Note 17 - Commitments and Contingencies***

*Financial instruments:*

*In the normal course of business, there are outstanding commitments, contingent liabilities and other financial instruments that are not reflected in the accompanying consolidated financial statements. These include commitments to extend credit and standby letters of credit, which are some of the instruments used by the Company to meet the financing needs of its customers. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the balance sheet.*

***Note 17 - Commitments and Contingencies, continued***

*The Company's exposure to credit loss in the event of nonperformance by the other parties to the financial instrument for these commitments is represented by the contractual amounts of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments. These commitments as of December 31, 20X2 and 20X1 were as follows:*

**

*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. Certain commitments have fixed expiration dates, or other termination clauses, and may require payment of a fee. Many of the commitments are expected to expire without being drawn upon; accordingly, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral or other security obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include deposits held in financial institutions; U.S. Treasury securities; other marketable securities; accounts receivable; inventory; property and equipment; personal residences; income-producing commercial properties and land under development. Personal guarantees are also obtained to provide added security for certain commitments.*

*Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to guarantee the installation of real property improvements 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. The Company holds collateral and obtains personal guarantees supporting those commitments for which collateral or other security is deemed necessary.*

***Note 18 - Components of Other Comprehensive Income***

*The following table presents the components of other comprehensive income (loss) for the years ended December 31, 20X2 and 20X1.*

**

***Note 18 - Components of Other Comprehensive Income, continued***

*The following table presents the changes in each component of accumulated other comprehensive income, net of tax, for the years ended December 31, 20X2 and 20X1.*

**