

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES

GRATZ, PENNSYLVANIA

AUDIT REPORT

DECEMBER 31, 2016

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
AUDITED CONSOLIDATED FINANCIAL STATEMENTS  
DECEMBER 31, 2016

	<u>Page Number</u>
Independent Auditor's Report	1
Financial Statements	
Consolidated Balance Sheet	2
Consolidated Statement of Income	3
Consolidated Statement of Comprehensive Income	4
Consolidated Statement of Changes in Stockholders' Equity	5
Consolidated Statement of Cash Flows	6 - 7
Notes to the Consolidated Financial Statements	8 - 42



## INDEPENDENT AUDITOR'S REPORT

Board of Directors and Stockholders  
GNB Financial Services, Inc.

### **Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of GNB Financial Services, Inc. and subsidiaries which comprise the consolidated balance sheet as of December 31, 2016 and 2015; the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended; and the related notes to the consolidated financial statements.

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

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

### **Auditor's Responsibility**

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

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

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

### **Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of GNB Financial Services, Inc. and subsidiaries as of December 31, 2016 and 2015, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*S.R. Snodgrass, P.C.*

Cranberry Township, Pennsylvania  
March 10, 2017

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
CONSOLIDATED BALANCE SHEET

	December 31,	
	2016	2015
<b>ASSETS</b>		
Cash and due from banks	\$ 5,563,401	\$ 4,080,800
Interest-bearing deposits with other institutions	7,412,000	6,117,396
Cash and cash equivalents	12,975,401	10,198,196
Certificates of deposit with other banks	11,636,011	7,949,000
Investment securities available for sale	49,873,921	55,008,441
Investment securities held to maturity (fair value of \$24,246,623 and \$15,167,045)	24,723,393	15,099,671
Loans, net	203,571,712	192,683,611
Less: Allowance for loan losses	1,718,804	1,296,906
Net loans	201,852,908	191,386,705
Accrued interest receivable	945,997	778,805
Restricted investments in bank stock	1,092,900	633,600
Premises and equipment, net	3,758,545	3,981,711
Cash surrender value of life insurance	6,345,509	6,193,265
Goodwill	2,185,371	2,185,371
Intangible assets	322,103	407,113
Other real estate owned	23,500	-
Other assets	1,439,925	1,528,363
TOTAL ASSETS	\$ 317,175,484	\$ 295,350,241
 <b>LIABILITIES</b>		
Noninterest-bearing deposits	\$ 39,655,149	\$ 38,779,887
Interest-bearing deposits	226,038,608	214,418,755
Total deposits	265,693,757	253,198,642
Short-term borrowings	9,172,400	-
FHLB advances - long-term	3,357,522	5,000,000
Accrued interest payable	193,304	185,683
Other liabilities	2,186,568	2,121,058
TOTAL LIABILITIES	280,603,551	260,505,383
 <b>STOCKHOLDERS' EQUITY</b>		
Common stock (\$5 par value; 2,000,000 shares authorized; 782,321 and 783,735 shares issued; 777,543 and 778,957 shares outstanding)	3,911,605	3,918,675
Additional paid-in capital	17,746,931	17,814,520
Retained earnings	15,646,048	13,569,477
Accumulated other comprehensive loss	(462,692)	(187,855)
Treasury stock (4,778 shares)	(269,959)	(269,959)
TOTAL STOCKHOLDERS' EQUITY	36,571,933	34,844,858
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$ 317,175,484	\$ 295,350,241

See accompanying notes to the consolidated financial statements.

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF INCOME

	Year Ended December 31,	
	<u>2016</u>	<u>2015</u>
<b>INTEREST AND DIVIDEND INCOME</b>		
Loans, including fees	\$ 9,210,579	\$ 9,061,793
Investment securities:		
Taxable	480,268	331,249
Exempt from federal income tax	610,386	430,382
Certificates of deposit in other banks	303,068	262,621
Other interest and dividend income	<u>86,094</u>	<u>63,919</u>
Total interest and dividend income	<u>10,690,395</u>	<u>10,149,964</u>
<b>INTEREST EXPENSE</b>		
Deposits	1,395,932	1,141,829
Short-term borrowings	1,786	223
FHLB advances - long-term	<u>58,827</u>	<u>4,792</u>
Total interest expense	<u>1,456,545</u>	<u>1,146,844</u>
<b>NET INTEREST INCOME BEFORE PROVISION FOR</b>		
<b>LOAN LOSSES</b>	9,233,850	9,003,120
Provision for loan losses	<u>383,720</u>	<u>252,380</u>
<b>NET INTEREST INCOME AFTER PROVISION FOR</b>		
<b>LOAN LOSSES</b>	<u>8,850,130</u>	<u>8,750,740</u>
<b>NONINTEREST INCOME</b>		
Service charges on deposit accounts	843,831	767,007
Earnings on cash surrender value of life insurance	152,244	295,532
Investment securities gains	12,653	70,340
Income from fiduciary activities	295,161	240,027
Other	<u>196,711</u>	<u>238,267</u>
Total noninterest income	<u>1,500,600</u>	<u>1,611,173</u>
<b>NONINTEREST EXPENSE</b>		
Compensation and employee benefits	3,314,963	3,330,230
Occupancy	497,496	468,670
Furniture and fixtures	124,179	163,694
Data processing	691,849	860,907
Professional fees	404,906	717,756
Shares tax	139,158	129,274
Amortization of intangible assets	85,010	69,746
Other	<u>1,177,569</u>	<u>1,177,617</u>
Total noninterest expense	<u>6,435,130</u>	<u>6,917,894</u>
Income before income tax expense	3,915,600	3,444,019
Income tax expense	<u>999,845</u>	<u>833,354</u>
<b>NET INCOME</b>	<u>\$ 2,915,755</u>	<u>\$ 2,610,665</u>
<b>EARNINGS PER SHARE, BASIC AND DILUTED</b>	\$ 3.75	\$ 3.52
<b>WEIGHTED-AVERAGE COMMON SHARES OUTSTANDING,</b>		
<b>BASIC AND DILUTED</b>	777,914	741,961

See accompanying notes to the consolidated financial statements.

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

	Year Ended December 31,	
	2016	2015
Net income	\$ 2,915,755	\$ 2,610,665
Components of other comprehensive loss:		
Unrealized loss on available-for-sale securities	(403,766)	(101,815)
Tax effect	137,280	34,617
Reclassification adjustment for investment securities gains realized in net income	(12,653)	(70,340)
Tax effect	4,302	23,916
Total other comprehensive loss	(274,837)	(113,622)
Total comprehensive income	\$ 2,640,918	\$ 2,497,043

See accompanying notes to the consolidated financial statements.

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

	Common Stock		Additional	Retained	Accumulated	Treasury	Total
	Shares	Amount	Paid-In Capital	Earnings	Other Comprehensive Loss	Stock	
Balance, December 31, 2014	\$ 511,277	\$ 2,556,385	\$ 3,970,201	\$ 20,082,567	\$ (74,233)	\$ (346,053)	\$ 26,188,867
Net income				2,610,665			2,610,665
Stock issued for acquisition	115,711	578,555	6,364,105				6,942,660
Other comprehensive loss					(113,622)		(113,622)
Sale of treasury stock (1,100 shares)			(12,293)			76,094	63,801
Stock dividend (25 percent)	156,747	783,735	7,492,507	(8,276,242)			-
Dividends declared (\$1.12 per share)				(847,513)			(847,513)
Balance, December 31, 2015	783,735	3,918,675	17,814,520	13,569,477	(187,855)	(269,959)	34,844,858
Net income				2,915,755			2,915,755
Other comprehensive loss					(274,837)		(274,837)
Cash paid in lieu of fractional shares associated with 25 percent stock dividend	(1,414)	(7,070)	(67,589)	62,801			(11,858)
Dividends declared (\$1.20 per share)				(901,985)			(901,985)
Balance, December 31, 2016	<u>782,321</u>	<u>\$ 3,911,605</u>	<u>\$ 17,746,931</u>	<u>\$ 15,646,048</u>	<u>\$ (462,692)</u>	<u>\$ (269,959)</u>	<u>\$ 36,571,933</u>

See accompanying notes to the consolidated financial statements.

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CASH FLOWS

	<u>Year Ended December 31,</u> <u>2016</u>	<u>2015</u>
<b>OPERATING ACTIVITIES</b>		
Net income	\$ 2,915,755	\$ 2,610,665
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	383,720	252,380
Depreciation	258,635	289,718
Amortization of intangible assets	85,010	69,746
Deferred income taxes	(55,599)	(292,825)
Net amortization of premiums and discounts	560,184	165,502
Earnings on cash surrender value of life insurance	(152,244)	(159,532)
Investment securities gains	(12,653)	(70,340)
(Gain) loss on sale of other real estate owned	(2,939)	55,560
Increase in accrued interest receivable	(167,192)	(49,997)
Increase in accrued interest payable	7,621	40,053
Other, net	372,959	249,549
Net cash provided by operating activities	<u>4,193,257</u>	<u>3,160,479</u>
<b>INVESTING ACTIVITIES</b>		
Investment securities available for sale:		
Proceeds from sales	9,704,207	5,938,860
Proceeds from calls, maturities, and paydowns	20,883,422	10,802,387
Purchases	(26,287,476)	(25,000,947)
Investment securities held to maturity:		
Proceeds from calls and maturities	2,600,000	2,625,000
Purchases	(12,353,305)	(7,554,645)
Purchases of certificates of deposit with other banks	(7,461,000)	(2,727,000)
Proceeds from maturities of certificates of deposit with other banks	3,770,000	1,885,600
Increase in loans, net	(10,938,489)	(11,250,320)
Purchase of restricted investments in bank stock	(778,300)	(182,900)
Redemptions of restricted investments in bank stock	319,000	145,500
Purchase of premises and equipment	(53,310)	(245,264)
Proceeds from cash surrender value of life insurance death benefit, net	-	116,035
Proceeds from the sale of other real estate owned	68,005	14,526
Acquisition of FNBM Financial Corporation, net of cash acquired	-	2,490,774
Net cash used for investing activities	<u>(20,527,246)</u>	<u>(22,942,994)</u>
<b>FINANCING ACTIVITIES</b>		
Increase in deposits, net	12,495,115	5,975,502
Repayment of FHLB advances - long-term	(1,642,478)	(437,875)
Proceeds from FHLB advances - long-term	-	5,000,000
Increase in short-term borrowings, net	9,172,400	-
Sale of treasury stock	-	63,801
Cash paid in lieu of fractional shares	(11,858)	-
Cash dividends paid	(901,985)	(847,513)
Net cash provided by financing activities	<u>19,111,194</u>	<u>9,753,915</u>
Increase (decrease) in cash and cash equivalents	2,777,205	(10,028,600)
CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD	<u>10,198,196</u>	<u>20,226,796</u>
CASH AND CASH EQUIVALENTS AT END OF PERIOD	<u>\$ 12,975,401</u>	<u>\$ 10,198,196</u>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURES</b>		
Cash paid during the period for:		
Interest	\$ 1,448,924	\$ 1,106,791
Income taxes	920,000	809,660
Noncash activity:		
Loans transferred to other real estate owned	\$ 88,566	\$ 35,086

GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES  
CONSOLIDATED STATEMENT OF CASH FLOWS (Continued)

	<u>Year Ended</u> <u>December 31, 2015</u>
<b>SUPPLEMENTAL CASH FLOW DISCLOSURES (Continued)</b>	
Acquisition of FNBM Financial Corporation:	
Noncash assets acquired:	\$
Investment securities available for sale	27,093,494
Restricted investments in bank stock	72,500
Loans	38,572,528
Bank-owned life insurance	9,144
Premises and equipment, net	758,847
Accrued interest receivable	214,760
Core deposit intangibles	381,641
Other real estate owned	35,000
Other assets	548,689
Goodwill	<u>2,052,522</u>
	69,739,125
Liabilities assumed:	
Deposits	(64,903,632)
Accrued interest payable	(13,706)
Other liabilities	<u>(369,902)</u>
	(65,287,240)
Net noncash assets acquired	<u>4,451,885</u>
Cash and cash equivalents acquired	<u>\$ 9,201,414</u>

See accompanying notes to the consolidated financial statements.

**GNB FINANCIAL SERVICES, INC. AND SUBSIDIARIES**  
**NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS**

**1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

A summary of significant accounting and reporting policies applied in the presentation of the accompanying consolidated financial statements follows:

**Nature of Operations and Basis of Presentation**

GNB Financial Services, Inc. (the “Company”) is a bank holding company for its wholly owned subsidiaries, The Gratz Bank (the “Bank”) and GNB Investment Corp. The Bank is a full-service state chartered commercial bank. The Bank is subject to regulation and supervision by the Federal Deposit Insurance Corporation (“FDIC”) and the Pennsylvania Department of Banking.

The Bank provides a variety of financial services to individual and commercial customers throughout Dauphin County, Pennsylvania, and other contiguous counties, through its main office located in Gratz, Pennsylvania, and its branch offices in Valley View, Herndon, Pottsville, and Minersville, Pennsylvania. The Bank’s primary deposit products are interest and noninterest-bearing checking accounts, savings accounts, and certificates of deposit. Its primary lending products are residential real estate, consumer, agriculture, and commercial and commercial real estate loans.

GNB Investment Corp., a Delaware investment subsidiary of the Company, holds and manages an investment portfolio.

**Principles of Consolidation**

The consolidated financial statements include the accounts of the Company, the Bank, and the Company’s wholly owned subsidiary, GNB Investment Corp. All significant intercompany amounts have been eliminated in the consolidation. GNB Financial Services, Inc. transacts no other material business.

**Estimates**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions. Such estimates and assumptions affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of deferred tax assets, the evaluation of securities for other-than-temporary impairment and the fair value of financial instruments.

**Presentation of Cash Flows**

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

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Investment Securities

Debt securities which management has the positive intent and ability to hold until maturity are classified as held to maturity. Held-to-maturity securities are stated at cost, adjusted for amortization of premium, and accretion of discount computed on a level yield basis. Securities not classified as held to maturity or trading are classified as available for sale and recorded at fair value with unrealized gains and losses excluded from earnings and reported, net of tax, in accumulated other comprehensive income (loss). Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each balance sheet date. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in earnings.

The Company periodically evaluates its investments for other-than-temporary impairment. Declines in the fair value of held-to-maturity and available-for-sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses and a new cost basis is established. Factors considered in determining whether declines in fair value are other than temporary include the significance of the decline, the duration of the decline, current economic conditions, and whether management intends to sell the security; if it is more likely than not that management will be required to sell the security before recovery; or if management does not expect to recover the entire amortized cost basis. A decline that is considered to be other than temporary is recorded as a loss within noninterest income on the Consolidated Statement of Income.

### Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees and costs. Interest income is accrued on the unpaid principal balance.

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

Loan origination and commitment fees, as well as certain direct origination costs, are to be deferred and amortized as a yield adjustment over the lives of the related loans using the interest method. Amortization of deferred loan fees is discontinued when a loan is placed on nonaccrual status.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Allowance for Loan Losses

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

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

The allowance for loan losses consists of specific, general, and unallocated components. The specific component relates to loans that are classified as Doubtful, Substandard, or Special Mention. For such loans that are also classified as impaired, an allowance for loan losses is established when the present value of expected cash flows discounted at the loan's effective interest rate, the fair value of the collateral if the loan is collateral dependent less costs to sell, or observable market price of the impaired loan is lower than its carrying value. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance for loan losses reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

When foreclosure is probable, impairment is measured based on the fair value of the collateral. Impaired loans, or portions thereof, are charged off when it is determined a realized loss has occurred, generally when foreclosure proceedings have begun, and the fair value of the collateral exceeds the recorded investment in the loan.

Large groups of smaller-balance homogenous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### Loans Acquired

Loans acquired, including loans that have evidence of deterioration of credit quality since origination and for which it is probable, at acquisition, that the Company will be unable to collect all contractually required payments receivable, are initially recorded at fair value (as determined by the present value of expected future cash flows) with no valuation allowance. In determining the fair value of purchased loans, management considers a number of factors including, among other things, the remaining life of the acquired loans, estimated repayments, estimated loss ratios, estimated value of the underlying collateral, estimated holding periods, and net present value of cash flows expected to be received. Purchased credit-impaired loans are accounted for in accordance with guidance for certain loans or debt securities acquired in a transfer when the loans have evidence of credit deterioration since origination and it is probable at the date of acquisition that the acquirer will not collect all contractually required principal and interest payments. For evidence of credit deterioration since origination, the Company considered loans on a loan-by-loan basis by primarily focusing on past-due status, frequency of late payments, internal loan classification, as well as interviews with current loan officers and collection employees for other evidence that may be indicative of deterioration of credit quality. Once these loans were segregated, the Company evaluated each of these loans on a loan-by-loan basis to determine the probability of collecting all contractually required payments.

The difference between the undiscounted cash flows expected at acquisition and the investment in the loan, or the “accretable yield,” is recognized as interest income on a level-yield method over the life of the loan. Contractually required payments for interest and principal that exceed the undiscounted cash flows expected at acquisition, or the “non-accretable difference,” are not recognized as a yield adjustment or as a loss accrual or a valuation allowance. Increases in expected cash flows subsequent to the initial investment are recognized prospectively through adjustment of the yield on the loan over its remaining estimated life. Decreases in expected cash flows are recognized immediately as impairment. Any valuation allowances on these impaired loans reflect only losses incurred after acquisition.

For purchased loans acquired that are not deemed impaired at acquisition, credit discounts representing the principal losses expected over the life of the loan are a component of the initial fair value. Subsequent to the purchase date, the methods utilized to estimate the required allowance for credit losses for these loans is similar to originated loans; however, the Company records a provision for loan losses only when the required allowance exceeds any remaining credit discounts. The remaining differences between the purchase price and the unpaid principal balance at the date of acquisition are recorded in interest income over the life of the loans.

### Loan Charge-Off Policies

Consumer loans are generally charged down to the fair value of collateral securing the asset when the loan is 120 days past due. Loans secured by real estate are generally charged down to the fair value of real estate securing the asset when the loan is 180 days past due. All other loans are generally charged down to the net realizable value when the loan is 90 days past due.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### **Troubled Debt Restructurings**

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance, and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans.

### **Premises and Equipment**

Land is carried at cost. Buildings and equipment are stated at cost, less accumulated depreciation. Depreciation is computed on both the straight-line and accelerated methods over the estimated useful lives of the related assets, which range from 3 to 15 years for furniture, fixtures, and equipment and 5 to 50 years for building and improvements. Expenditures for maintenance and repairs are charged against income as incurred. Costs of major additions and improvements are capitalized.

### **Restricted Investments in Bank Stock**

Restricted investments in bank stock, which represent required investments in the common stock of correspondent banks, are carried at cost, and consist of common stock in the Federal Home Loan Bank ("FHLB") of Pittsburgh and Atlantic Community Bancshares, Inc. ("ACB").

Management evaluates the restricted stock for impairment. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the FHLB as compared to the capital stock amounts for the FHLB and the length of time this situation has persisted, (2) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLB, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLB.

Management believes no impairment charge is necessary relating to the FHLB and ACB restricted stock as of December 31, 2016 and 2015.

### **Goodwill**

The Company accounts for goodwill using a two-step process for testing the impairment of goodwill on at least an annual basis. This approach could cause more volatility in the Company's reported net income because impairment losses, if any, could occur irregularly and in varying amounts. No impairment of goodwill was recognized in any of the periods presented.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### **Business Combinations**

At the date of acquisition, the Company records the net assets of acquired companies on the Consolidated Balance Sheet at their estimated fair value, and goodwill is recognized for the excess of the estimated fair value over the purchase price of the acquired net assets. The results of operations for acquired companies are included in the Company's Consolidated Statement of Income beginning at the acquisition date. Expenses arising from acquisition activities are recorded in the Consolidated Statement of Income during the period incurred.

### **Intangible Assets**

Intangible assets include core deposit intangibles, which are a measure of the value of consumer demand and savings deposits acquired in business combinations accounted for as purchases. The core deposit intangibles are being amortized to expense over a 10-year life using the sum of the years' digits method. The recoverability of the carrying value of intangible assets is evaluated on an ongoing basis, and permanent declines in value, if any, are charged to expense. The Company had core deposit intangible assets totaling \$322,103 which is net of accumulated amortization of \$219,367 at December 31, 2016. At December 31, 2015, core deposit intangible assets totaled \$407,113 which was net of accumulated amortization of \$134,357.

### **Other Real Estate Owned**

Other real estate owned is comprised of property acquired through a foreclosure proceeding or acceptance of a deed-in-lieu of foreclosure and loans classified as in-substance foreclosure. A loan is classified as in-substance foreclosure when the Bank has taken possession of the collateral regardless of whether formal foreclosure proceedings take place. Other real estate owned is initially recorded at fair value, net of estimated selling costs, at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the assets are carried at the lower of cost or fair value minus estimated costs to sell. Revenues and expenses from operations and changes in the valuation allowance are included in other expenses.

### **Bank-Owned Life Insurance**

The Company owns insurance on the lives of a certain group of employees and directors. The cash surrender value of these policies is included as an asset on the Consolidated Balance Sheet, and any increases in the cash surrender value are recorded as noninterest income on the Consolidated Statement of Income. In the event of the death of an insured individual under these policies, the Company would receive a death benefit, which would be recorded as noninterest income.

### **Employee Benefits**

Salaries and employee benefit expenses include contributions to a 401(k) plan covering eligible employees of the Company and a deferred compensation plan for the benefit of members of the Board of Directors and certain officers.

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

### **Income Taxes**

The Company accounts for income taxes using an asset and liability approach to financial accounting and reporting. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. When necessary, valuation allowances are established to reduce deferred tax assets to the amount expected to be realized. Income tax expense is the tax payable or refundable for the period plus or minus the change during the period in deferred tax assets and liabilities. The Company files consolidated federal income tax returns with its subsidiaries.

### **Earnings Per Share**

The Company currently maintains a simple capital structure; therefore, there are no dilutive effects on earnings per share. As such, earnings per share computations are based upon the weighted number of shares outstanding for each of the reported periods. Treasury shares are not deemed outstanding for earnings per share calculations.

### **Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale.

### **Advertising Costs**

The Company expenses advertising costs as incurred. Advertising costs for the years ended December 31, 2016 and 2015, were \$28,201 and \$51,726, respectively.

### **Trust Assets and Income**

Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the accompanying financial statements, since such items are not assets of the Company. In accordance with banking industry practice, income from trust services is recognized on the cash basis and is not materially different than if it was reported on the accrual basis.

### **Off-Balance-Sheet Financial Instruments**

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

### **Reclassifications**

Certain previously reported items have been reclassified to conform to the current year's classifications. The reclassifications have no effect on total assets, total liabilities, and stockholders' equity.

## 2. INVESTMENT SECURITIES

The amortized cost and fair value of investment securities available for sale and held to maturity are summarized as follows:

	December 31, 2016			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for Sale:</b>				
Negotiable certificates of deposit	\$ 5,646,000	\$ 40,927	\$ (14,497)	\$ 5,672,430
U.S. government agency securities	22,566,725	2,154	(405,014)	22,163,865
Small Business Administration loan pools	5,912,339	-	(88,529)	5,823,810
Corporate bonds	1,797,975	3,325	(46,359)	1,754,941
Obligations of state and political subdivisions	9,811,496	5,577	(95,814)	9,721,259
Mortgage-backed securities in government-sponsored entities	4,840,433	1,343	(104,160)	4,737,616
Total available-for-sale securities	<u>\$ 50,574,968</u>	<u>\$ 53,326</u>	<u>\$ (754,373)</u>	<u>\$ 49,873,921</u>

### Held to Maturity:

Obligations of state and political subdivisions	<u>\$ 24,723,393</u>	<u>\$ 26,770</u>	<u>\$ (503,540)</u>	<u>\$ 24,246,623</u>
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	December 31, 2015			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<b>Available for Sale:</b>				
Negotiable certificates of deposit	\$ 6,135,695	\$ 14,545	\$ (35,705)	\$ 6,114,535
U.S. government agency securities	35,231,861	127,970	(203,168)	35,156,663
Mortgage-backed securities in government-sponsored entities	13,925,513	91	(188,361)	13,737,243
Total available-for-sale securities	<u>\$ 55,293,069</u>	<u>\$ 142,606</u>	<u>\$ (427,234)</u>	<u>\$ 55,008,441</u>

### Held to Maturity:

Obligations of state and political subdivisions	<u>\$ 15,099,671</u>	<u>\$ 94,981</u>	<u>\$ (27,607)</u>	<u>\$ 15,167,045</u>
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## 2. INVESTMENT SECURITIES (Continued)

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position.

	December 31, 2016					
	Less Than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Negotiable certificates of deposit	\$ 483,543	\$ (14,457)	\$ 247,960	\$ (40)	\$ 731,503	\$ (14,497)
U.S. government agency securities	20,332,265	(381,761)	1,831,599	(23,253)	22,163,864	(405,014)
Obligations of state and political subdivisions	29,549,948	(535,352)	2,328,044	(64,002)	31,877,992	(599,354)
Small Business Administration loan pools	5,823,810	(88,529)	-	-	5,823,810	(88,529)
Corporate bonds	1,257,954	(16,054)	496,987	(30,305)	1,754,941	(46,359)
Mortgage-backed securities in government-sponsored entities	3,762,615	(84,980)	975,000	(19,180)	4,737,615	(104,160)
<b>Total</b>	<b>\$ 61,210,135</b>	<b>\$ (1,121,133)</b>	<b>\$ 5,879,590</b>	<b>\$ (136,780)</b>	<b>\$ 67,089,725</b>	<b>\$ (1,257,913)</b>

	December 31, 2015					
	Less Than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Negotiable certificates of deposit	\$ 3,149,852	\$ (17,148)	\$ 1,068,138	\$ (18,557)	\$ 4,217,990	\$ (35,705)
U.S. government agency securities	17,818,660	(170,100)	2,417,893	(33,068)	20,236,553	(203,168)
Obligations of state and political subdivisions	3,732,009	(15,320)	1,260,152	(12,287)	4,992,161	(27,607)
Mortgage-backed securities in government-sponsored entities	13,637,320	(188,361)	-	-	13,637,320	(188,361)
<b>Total</b>	<b>\$ 38,337,841</b>	<b>\$ (390,929)</b>	<b>\$ 4,746,183</b>	<b>\$ (63,912)</b>	<b>\$ 43,084,024</b>	<b>\$ (454,841)</b>

The Company reviews its position quarterly and has asserted that as of December 31, 2016 and 2015, the declines outlined in the above tables represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. There were 199 positions that were temporarily impaired at December 31, 2016. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes that are not expected to result in the noncollection of principal and interest during the period.

## 2. INVESTMENT SECURITIES (Continued)

The amortized cost and fair value of debt securities at December 31, 2016 and 2015, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

December 31, 2016	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due within one year	\$ 1,424,539	\$ 1,407,001	\$ 1,546,313	\$ 1,543,376
Due after one year through five years	19,226,227	19,138,829	9,885,120	9,838,147
Due after five years through ten years	15,003,865	14,614,208	11,063,062	10,744,707
Due after ten years	14,920,337	14,713,883	2,228,898	2,120,393
Total	<u>\$ 50,574,968</u>	<u>\$ 49,873,921</u>	<u>\$ 24,723,393</u>	<u>\$ 24,246,623</u>

During the year ended December 31, 2016, proceeds from the sale of securities were \$9,704,207 resulting in gross gains of \$12,653. During the year ended December 31, 2015, proceeds from the sale of securities were \$5,938,860 resulting in gross gains of \$70,340.

The Company had pledged investment securities with a carrying value of \$30,318,712 and \$27,647,661 to secure public monies as of December 31, 2016 and 2015, respectively.

## 3. LOANS RECEIVABLE

Loans receivable consist of the following:

	December 31,	
	2016	2015
Agriculture loans	\$ 17,859,819	\$ 17,005,020
Commercial loans	24,790,023	19,524,248
Commercial real estate loans	4,482,411	4,462,239
Residential real estate loans	142,420,241	132,411,933
Consumer loans	3,869,630	4,674,469
Municipal loans	10,278,849	14,655,167
	<u>203,700,973</u>	<u>192,733,076</u>
Less:		
Deferred fees	129,261	49,465
Allowance for loan losses	<u>1,718,804</u>	<u>1,296,906</u>
Total	<u>\$ 201,852,908</u>	<u>\$ 191,386,705</u>

Purchased loans acquired are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses. Purchased credit-impaired loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. There were no material increases or decreases in the expected cash flows of these loans between the acquisition dates and December 31, 2016 and 2015. The fair value of purchased credit-impaired loans, on the acquisition date, was determined, primarily based on the fair value of loan collateral. The carrying value of purchased loans acquired with deteriorated credit quality was \$132,018 and \$199,709 at December 31, 2016 and 2015, respectively.

### 3. LOANS RECEIVABLE (Continued)

The Company's loan portfolio consists predominantly of one-to-four family first mortgage loans throughout Dauphin County, Pennsylvania, and other contiguous counties. These loans are typically secured by first lien positions on the respective real estate properties and are subject to the Bank's loan underwriting policies. In general, the Company's loan portfolio performance is dependent upon the local economic conditions.

In the normal course of business, loans are extended to officers, directors, and corporations in which they are beneficially interested as stockholders, officers, or directors. Other refers to loans outstanding for employees who became officers during the year. A summary of loan activity for those officers and directors for the years ended December 31, 2016 and 2015, is as follows:

<u>December 31,</u> <u>2015</u>	<u>Additions</u>	<u>Amounts</u> <u>Collected</u>	<u>Other</u>	<u>December 31,</u> <u>2016</u>
\$ 326,829	\$ 3,018,080	\$ (2,736,013)	\$ -	\$ 608,896
<u>December 31,</u> <u>2014</u>	<u>Additions</u>	<u>Amounts</u> <u>Collected</u>	<u>Other</u>	<u>December 31,</u> <u>2015</u>
\$ 699,867	\$ 1,093,524	\$ (1,505,385)	\$ 38,823	\$ 326,829

### 4. ALLOWANCE FOR LOAN LOSSES

The segments of the Company's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. The loan segments used are consistent with the internal reports evaluated by the Company's management and Board of Directors to monitor risk and performance within various segments of its loan portfolio and therefore, no further disaggregation is considered necessary. The Company's loan portfolio consists primarily of one-to-four family residential real estate loans, and to a lesser extent, agricultural loans, commercial real estate loans, commercial loans, consumer loans including home equity loans, and municipal loans.

The Company's primary lending activity is the origination of residential real estate loans to enable borrowers to purchase or refinance existing homes. The Company also originates agricultural loans to local farmers and agricultural businesses that are generally secured by farmland and equipment as well as commercial loans extended to small to mid-sized commercial and industrial entities. The Company's commercial real estate loans consist of mortgage loans secured by income producing multi-family and nonresidential real estate, such as by apartment buildings, small office buildings, and owner-occupied properties. The consumer loan portfolio consists of lending in the form of home equity loans secured by financed property and personal consumer loans, which may be secured or unsecured, and the municipal loans portfolio consists of loans to qualified local municipalities, which are generally supported by the taxing authority of the borrowing municipality, and is frequently secured by collateral.

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses the Company has segmented certain loans in the portfolio by product type. Loans are segmented into the following pools: agriculture loans, commercial real estate loans, commercial loans, residential real estate loans, consumer loans, and municipal loans. Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. These historical loss percentages are calculated over a two-year period for all portfolio segments.

#### 4. ALLOWANCE FOR LOAN LOSSES (Continued)

Certain qualitative factors are then added to the historical allocation percentage to get the adjusted factor to be applied to nonclassified loans. The following qualitative factors are analyzed for each portfolio segment:

- Levels of and trends in delinquencies
- Trends in volume and terms
- Changes in collateral
- Changes in management and lending staff
- Economic trends
- Concentrations of credit
- Changes in lending policies
- External factors
- Changes in underwriting process
- Trends in credit quality ratings

These qualitative factors are reviewed each quarter and adjusted based upon relevant changes within the portfolio.

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the Consolidated Balance Sheet date. The Company considers the allowance for loan losses adequate to cover loan losses inherent in the loan portfolio at December 31, 2016 and 2015.

The following tables present balances in the allowance for loan losses and recorded investment in loans by portfolio segment and based on impairment method as of and for the years ended December 31, 2016 and 2015:

	December 31, 2016							Total
	Agriculture Loans	Commercial Loans	Commercial Real Estate Loans	Residential Real Estate Loans	Consumer Loans	Municipal Loans	Unallocated Loans	
<b>Allowance for loan losses:</b>								
Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ 2,937	\$ -	\$ -	\$ -	\$ 2,937
Collectively evaluated for impairment	167,634	342,941	29,495	1,034,344	41,644	7,602	92,207	1,715,867
<b>Total</b>	<b>\$ 167,634</b>	<b>\$ 342,941</b>	<b>\$ 29,495</b>	<b>\$ 1,037,281</b>	<b>\$ 41,644</b>	<b>\$ 7,602</b>	<b>\$ 92,207</b>	<b>\$ 1,718,804</b>
<b>Loans:</b>								
Individually evaluated for impairment	\$ 297,749	\$ -	\$ -	\$ 629,482	\$ -	\$ -	\$ -	\$ 927,231
Loans acquired with deteriorated credit quality	-	-	-	132,018	-	-	-	132,018
Collectively evaluated for impairment	17,562,070	24,790,023	4,482,411	141,658,741	3,869,630	10,278,849	-	202,641,724
<b>Total</b>	<b>\$ 17,859,819</b>	<b>\$ 24,790,023</b>	<b>\$ 4,482,411</b>	<b>\$ 142,420,241</b>	<b>\$ 3,869,630</b>	<b>\$ 10,278,849</b>	<b>\$ -</b>	<b>\$ 203,700,973</b>

#### 4. ALLOWANCE FOR LOAN LOSSES (Continued)

		December 31, 2015							
		Agriculture Loans	Commercial Loans	Commercial Real Estate Loans	Residential Real Estate Loans	Consumer Loans	Municipal Loans	Unallocated Loans	Total
<b>Allowance for loan losses:</b>									
Individually evaluated for impairment	\$	-	-	-	8,500	-	-	-	8,500
Collectively evaluated for impairment		142,805	245,390	18,697	769,794	41,307	15,355	55,058	1,288,406
<b>Total</b>	<b>\$</b>	<b>142,805</b>	<b>245,390</b>	<b>18,697</b>	<b>778,294</b>	<b>41,307</b>	<b>15,355</b>	<b>55,058</b>	<b>1,296,906</b>
<b>Loans:</b>									
Individually evaluated for impairment	\$	224,242	52,824	-	1,026,428	-	-	-	1,303,494
Loans acquired with deteriorated credit quality		-	-	-	199,709	-	-	-	199,709
Collectively evaluated for impairment		16,780,778	19,471,424	4,462,239	131,185,796	4,674,469	14,655,167	-	191,229,873
<b>Total</b>	<b>\$</b>	<b>17,005,020</b>	<b>19,524,248</b>	<b>4,462,239</b>	<b>132,411,933</b>	<b>4,674,469</b>	<b>14,655,167</b>	<b>-</b>	<b>192,733,076</b>

The following tables present the activity in the allowance for loan losses by portfolio segment during the years ended December 31, 2016 and 2015, respectively.

		For the Year Ended December 31, 2016							
		Agriculture Loans	Commercial Loans	Commercial Real Estate Loans	Residential Real Estate Loans	Consumer Loans	Municipal Loans	Unallocated Loans	Total
<b>Beginning balance</b>	\$	142,805	245,390	18,697	778,294	41,307	15,355	55,058	1,296,906
Charge-offs		-	-	-	(135,850)	(28,616)	-	-	(164,466)
Recoveries		9,209	47,922	-	135,211	10,302	-	-	202,644
Provision (credit)		15,620	49,629	10,798	259,626	18,651	(7,753)	37,149	383,720
<b>Ending balance</b>	<b>\$</b>	<b>167,634</b>	<b>342,941</b>	<b>29,495</b>	<b>1,037,281</b>	<b>41,644</b>	<b>7,602</b>	<b>92,207</b>	<b>1,718,804</b>
		For the Year Ended December 31, 2015							
		Agriculture Loans	Commercial Loans	Commercial Real Estate Loans	Residential Real Estate Loans	Consumer Loans	Municipal Loans	Unallocated Loans	Total
<b>Beginning balance</b>	\$	165,366	187,810	20,076	621,785	13,919	9,070	140,234	1,158,260
Charge-offs		-	(58,535)	-	(259,725)	(32,111)	-	-	(350,371)
Recoveries		5,950	32,086	-	180,427	18,174	-	-	236,637
Provision (credit)		(28,511)	84,029	(1,379)	235,807	41,325	6,285	(85,176)	252,380
<b>Ending balance</b>	<b>\$</b>	<b>142,805</b>	<b>245,390</b>	<b>18,697</b>	<b>778,294</b>	<b>41,307</b>	<b>15,355</b>	<b>55,058</b>	<b>1,296,906</b>

#### 4. ALLOWANCE FOR LOAN LOSSES (Continued)

The Company recorded provision expense for the residential real estate loan portfolio to compensate for increases in delinquency and growth within the portfolio. As the overall economic condition and underwriting practices of the Company remain strong, the qualitative factors remained steady related to the allowance for loan losses.

##### Credit Quality Information

The following tables represent credit exposures by internally assigned grades as of December 31, 2016 and 2015. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans.

The Company's internally assigned grades are as follows:

Pass – loans which are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. There are three sub-grades within the Pass category to further distinguish the loan.

Special Mention – loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard – loans that have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – loans classified as Doubtful have all the weaknesses inherent in a Substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

Loss – loans classified as a Loss are considered uncollectible, or of such value that continuance as an asset is not warranted.

The following table presents the classes of the loan portfolio summarized by the aggregate Pass and the criticized categories of Special Mention, Substandard, Doubtful, and Loss within the internal risk rating system as of December 31, 2016 and 2015:

As of December 31, 2016	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Agriculture loans	\$ 17,859,819	\$ -	\$ -	\$ -	\$ 17,859,819
Commercial loans	24,387,338	105,946	296,739	-	24,790,023
Commercial real estate loans	4,438,752	43,659	-	-	4,482,411
Municipal loans	10,278,849	-	-	-	10,278,849
Total	<u>\$ 56,964,758</u>	<u>\$ 149,605</u>	<u>\$ 296,739</u>	<u>\$ -</u>	<u>\$ 57,411,102</u>

As of December 31, 2015	<u>Pass</u>	<u>Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Agriculture loans	\$ 16,872,725	\$ -	\$ 132,295	\$ -	\$ 17,005,020
Commercial loans	19,220,277	-	303,971	-	19,524,248
Commercial real estate loans	4,462,239	-	-	-	4,462,239
Municipal loans	14,655,167	-	-	-	14,655,167
Total	<u>\$ 55,210,408</u>	<u>\$ -</u>	<u>\$ 436,266</u>	<u>\$ -</u>	<u>\$ 55,646,674</u>

#### 4. ALLOWANCE FOR LOAN LOSSES (Continued)

##### Credit Quality Information (Continued)

For all other loans, the Company evaluates credit quality based on whether the loan is considered performing or nonperforming. The following tables present the balances of loans by classes of loan portfolio based on payment performance as of December 31, 2016 and 2015:

	December 31, 2016		
	Residential	Consumer	Total
	Loans	Loans	
Performing	\$ 141,291,828	\$ 3,869,630	\$ 145,161,458
Nonperforming	1,128,413	-	1,128,413
Total	<u>\$ 142,420,241</u>	<u>\$ 3,869,630</u>	<u>\$ 146,289,871</u>

	December 31, 2015		
	Residential	Consumer	Total
	Loans	Loans	
Performing	\$ 132,031,714	\$ 4,674,469	\$ 136,706,183
Nonperforming	380,219	-	380,219
Total	<u>\$ 132,411,933</u>	<u>\$ 4,674,469</u>	<u>\$ 137,086,402</u>

The following tables present an aging analysis of the recorded investment of past-due loans.

	December 31, 2016						
	30-59 Days	60-89 Days	90 Days	Total Past	Current	Total	Total >
	Past Due	Past Due	or Greater				
Agriculture loans	\$ -	\$ 6,500	\$ -	\$ 6,500	\$ 17,853,319	\$ 17,859,819	\$ -
Commercial loans	39,925	76,339	-	116,264	24,673,759	24,790,023	-
Commercial real estate loans	-	-	-	-	4,482,411	4,482,411	-
Residential real estate loans	477,713	779,232	1,015,450	2,272,395	140,147,846	142,420,241	592,431
Consumer loans	24,543	850	-	25,393	3,844,237	3,869,630	-
Municipal loans	-	-	-	-	10,278,849	10,278,849	-
Total	<u>\$ 542,181</u>	<u>\$ 862,921</u>	<u>\$ 1,015,450</u>	<u>\$ 2,420,552</u>	<u>\$ 201,280,421</u>	<u>\$ 203,700,973</u>	<u>\$ 592,431</u>

**4. ALLOWANCE FOR LOAN LOSSES (Continued)**

**Credit Quality Information (Continued)**

	December 31, 2015						
	30-59 Days	60-89 Days	90 Days	Total Past	Current	Total	Total >
	Past Due	Past Due	or Greater Past Due	Due			
Agriculture loans	\$ -	\$ -	\$ -	\$ -	\$ 17,005,020	\$ 17,005,020	\$ -
Commercial loans	95,759	138,237	59,059	293,055	19,231,193	19,524,248	59,059
Commercial real estate loans	-	-	-	-	4,462,239	4,462,239	-
Residential real estate loans	1,086,067	371,108	259,136	1,716,311	130,695,622	132,411,933	-
Consumer loans	11,835	-	-	11,835	4,662,634	4,674,469	-
Municipal loans	-	-	-	-	14,655,167	14,655,167	-
<b>Total</b>	<b>\$ 1,193,661</b>	<b>\$ 509,345</b>	<b>\$ 318,195</b>	<b>\$ 2,021,201</b>	<b>\$ 190,711,875</b>	<b>\$ 192,733,076</b>	<b>\$ 59,059</b>

**Nonaccrual Loans**

Loans are generally considered for nonaccrual status upon 90 days delinquency. When a loan is placed on nonaccrual status, previously accrued but unpaid interest is deducted from interest income.

The following table presents the loans on nonaccrual status as of December 31, 2016 and 2015. The balances are presented by class of loans.

	December 31,	
	2016	2015
Agriculture loans	\$ -	\$ -
Commercial loans	55,478	-
Commercial real estate loans	-	-
Residential real estate loans	535,982	380,219
Consumer loans	-	-
Municipal loans	-	-
	<b>\$ 591,460</b>	<b>\$ 380,219</b>

Interest income on loans would have increased by approximately \$36,687 and \$29,098 during the years ended December 31, 2016 and 2015, respectively, if these loans had performed in accordance with their original terms.

#### 4. ALLOWANCE FOR LOAN LOSSES (Continued)

##### Impaired Loans

The following tables present the recorded investment and unpaid principal balances for impaired loans and related allowance, if applicable. Also presented are the average recorded investments in the impaired loans and the related amount of interest recognized during the time within the period that the impaired loans were impaired.

	December 31, 2016				
	<u>Recorded</u>	<u>Unpaid</u>	<u>Related</u>	<u>Average</u>	<u>Interest</u>
	<u>Investment</u>	<u>Principal</u>	<u>Allowance</u>	<u>Recorded</u>	<u>Recognized</u>
				<u>Investment</u>	
<b>With no related allowance recorded:</b>					
Agriculture loans	\$ 297,749	\$ 297,749	\$ -	\$ 300,895	\$ 20,658
Commercial loans	-	-	-	-	-
Commercial real estate loans	-	-	-	-	-
Residential real estate loans	598,645	633,935	-	642,463	35,962
Consumer loans	-	-	-	-	-
Municipal loans	-	-	-	-	-
<b>With an allowance recorded:</b>					
Agriculture loans	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial loans	-	-	-	-	-
Commercial real estate loans	-	-	-	-	-
Residential real estate loans	30,837	69,395	2,937	45,671	1,955
Consumer loans	-	-	-	-	-
Municipal loans	-	-	-	-	-
<b>Total</b>					
Agriculture loans	\$ 297,749	\$ 297,749	\$ -	\$ 300,895	\$ 20,658
Commercial loans	-	-	-	-	-
Commercial real estate loans	-	-	-	-	-
Residential real estate loans	629,482	703,330	2,937	688,134	37,917
Consumer loans	-	-	-	-	-
Municipal loans	-	-	-	-	-

#### 4. ALLOWANCE FOR LOAN LOSSES (Continued)

##### Impaired Loans (Continued)

	December 31, 2015				
	Recorded	Unpaid	Related	Average	Interest
	<u>Investment</u>	<u>Principal</u>	<u>Allowance</u>	<u>Recorded</u>	<u>Recognized</u>
		Balance		Investment	
With no related allowance recorded:					
Agriculture loans	\$ 224,242	\$ 304,693	\$ -	\$ 292,534	\$ 15,043
Commercial loans	52,824	52,824	-	53,994	3,642
Commercial real estate loans	-	-	-	-	-
Residential real estate loans	999,428	999,428	-	972,805	52,156
Consumer loans	-	-	-	-	-
Municipal loans	-	-	-	-	-
With an allowance recorded:					
Agriculture loans	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial loans	-	-	-	-	-
Commercial real estate loans	-	-	-	-	-
Residential real estate loans	27,000	37,227	8,500	27,000	1,402
Consumer loans	-	-	-	-	-
Municipal loans	-	-	-	-	-
Total					
Agriculture loans	\$ 224,242	\$ 304,693	\$ -	\$ 292,534	\$ 15,043
Commercial loans	52,824	52,824	-	53,994	3,642
Commercial real estate loans	-	-	-	-	-
Residential real estate loans	1,026,428	1,036,655	8,500	999,805	53,558
Consumer loans	-	-	-	-	-
Municipal loans	-	-	-	-	-

##### Loan Modifications and Troubled Debt Restructurings

A loan is considered to be a troubled debt restructuring loan when the Company grants a concession to the borrower because of the borrower's financial condition that it would not otherwise consider. Such concessions include the reduction of interest rates, forgiveness of principal or interest, or other modifications of interest rates that are less than the current market rate for new obligations with similar risk.

**4. ALLOWANCE FOR LOAN LOSSES (Continued)**

**Loan Modifications and Troubled Debt Restructurings (Continued)**

Loan modifications considered troubled debt restructurings completed during the years ended December 31, 2016 and 2015, were as follows:

	<u>December 31, 2016</u>		
<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>		<u>Post-Modification Outstanding Recorded Investment</u>
Residential real estate loans	1	\$ 198,296	\$ 198,296

	<u>December 31, 2015</u>		
<u>Number of Contracts</u>	<u>Pre-Modification Outstanding Recorded Investment</u>		<u>Post-Modification Outstanding Recorded Investment</u>
Residential real estate loans	2	\$ 305,112	\$ 208,727

There were no troubled debt restructurings modified during the years ended December 31, 2016 and 2015, that subsequently defaulted during the years ended December 31, 2016 and 2015, respectively.

**5. GOODWILL AND INTANGIBLE ASSETS**

Goodwill totaled \$2,185,371 at December 31, 2016 and 2015. The Company recorded goodwill of \$2,052,522 due to the FNBM Financial Corporation acquisition during the year ended December 31, 2015. The Company recorded goodwill of \$132,849 due to the Liberty Centre Bancorp, Inc. acquisition during the year ended December 31, 2014. Core deposit intangible gross carrying amounts were \$322,103 and \$407,113 at the years ended December 31, 2016 and 2015.

Core deposit intangible assets are amortized using the sum-of-the-years-digits method over their estimated lives of ten years. Amortization expense totaled \$85,010 and \$69,746 for the years ended December 31, 2016 and 2015, respectively. The estimated aggregate future amortization expense for core deposit intangible assets as of December 31, 2016, is as follows:

	2017	\$ 73,555
	2018	63,710
	2019	53,865
	2020	44,020
	2021	34,176
	2022 and thereafter	<u>52,777</u>
Total		<u>\$ 322,103</u>

## 6. PREMISES AND EQUIPMENT

Premises and equipment consist of the following:

	December 31,	
	2016	2015
Land	\$ 709,184	\$ 727,024
Buildings and improvements	3,803,950	3,775,450
Furniture, fixtures, and equipment	1,246,448	1,221,638
	<u>5,759,582</u>	<u>5,724,112</u>
Less accumulated depreciation	2,001,037	1,742,401
Total	<u>\$ 3,758,545</u>	<u>\$ 3,981,711</u>

Depreciation expense amounted to \$258,635 and \$289,718 for the years ended December 31, 2016 and 2015, respectively.

## 7. DEPOSITS

Deposit accounts are summarized as follows:

	December 31,			
	2016		2015	
	Amount	%	Amount	%
Demand, noninterest-bearing	\$ 39,655,149	14.9	\$ 38,779,887	15.3
Demand, interest-bearing	86,839,243	32.7	76,912,065	30.4
Savings	57,302,785	21.6	55,257,776	21.8
Time deposits, \$100,000 and over	31,933,442	12.0	30,132,915	11.9
Time deposits, other	49,963,138	18.8	52,115,999	20.6
	<u>\$ 265,693,757</u>	<u>100.0</u>	<u>\$ 253,198,642</u>	<u>100.0</u>

The scheduled maturities of time deposits are as follows:

	December 31, 2016
One year or less	\$ 45,050,055
More than one year to two years	13,725,086
More than two years to three years	3,330,238
More than three years to four years	12,425,854
More than four years to five years	6,577,128
More than five years	788,219
Total	<u>\$ 81,896,580</u>

Time deposits include those in denominations of \$250,000 or more. Such deposits aggregated \$10,249,011 and \$9,022,975 at December 31, 2016 and 2015, respectively.

## 8. BORROWINGS

The outstanding balances and related information of short-term borrowings represent federal funds purchased and short-term advances with the FHLB are summarized as follows:

	December 31, 2016
Balance at year-end	\$ 9,172,400
Average balance outstanding	429,215
Maximum month-end balance	9,172,400
Weighted-average rate at year-end	0.84 %
Weighted-average rate during the year	0.42 %

Average balances outstanding during the year represent daily average balances, and average interest rates represent interest expense divided by the related average balance.

The Company maintained a \$5,000,000 federal funds borrowing facility with Atlantic Community Bankers Bank during 2016 and 2015. Under the agreement, borrowings of up to \$5,000,000 are available on an unsecured basis for a period of 14 calendar days. Usage of the facility beyond 14 days may require the borrowing to be fully secured. At December 31, 2016, the balance outstanding under the agreement was \$839,000.

Additionally, the Company maintained a short-term borrowing with the FHLB at December 31, 2016, in the amount of \$8,333,400. The advance maintains a fixed rate of interest of 0.82 percent and matures January 1, 2017.

The Company entered into a \$5,000,000 amortizing borrowing with the FHLB on December 16, 2015. The advance maintains an interest rate of 1.46 percent and matures on December 17, 2018. At December 31, 2016 and 2015, the balance outstanding was \$3,357,522 and \$5,000,000, respectively.

The following are the maturities of FHLB advances as of December 31, 2016:

2017	\$ 1,666,549
2018	<u>1,690,973</u>
	<u>\$ 3,357,522</u>

All borrowings from the FHLB are secured by a blanket lien on qualified collateral, defined principally as investment securities and mortgage loans which are owned by the Company free and clear of any liens or encumbrances. In addition, the Company had a maximum borrowing capacity of \$117.9 million with the FHLB at December 31, 2016.

## 9. INCOME TAXES

The provision for income taxes consists of:

	For the Year Ended December 31,	
	2016	2015
Current tax expense	\$ 1,055,444	\$ 1,126,179
Deferred taxes	<u>(55,599)</u>	<u>(292,825)</u>
Total	<u>\$ 999,845</u>	<u>\$ 833,354</u>

## 9. INCOME TAXES (Continued)

The tax effects of deductible and taxable temporary differences that gave rise to significant portions of the deferred tax assets and deferred tax liabilities, respectively, are as follows:

	December 31,	
	2016	2015
Deferred tax assets:		
Allowance for loan losses	\$ 556,547	\$ 417,992
Deferred compensation	277,944	258,711
Capital loss carryforward	3,011	3,011
Net unrealized loss on securities	238,356	96,774
Purchase accounting adjustments	105,420	68,728
Net operating loss	281,275	420,160
Other	13,533	6,319
Total gross deferred tax assets	<u>1,476,086</u>	<u>1,271,695</u>
Valuation allowance	<u>(3,011)</u>	<u>(3,011)</u>
Total net deferred tax assets	<u>1,473,075</u>	<u>1,268,684</u>
Deferred tax liabilities:		
Premises and equipment	165,487	142,418
Deferred loan fees	<u>54,777</u>	<u>70,637</u>
Total gross deferred tax liabilities	<u>220,264</u>	<u>213,055</u>
Net deferred tax assets	<u>\$ 1,252,811</u>	<u>\$ 1,055,629</u>

As of December 31, 2016 and 2015, the Company had federal capital loss carryforwards of \$8,855, respectively, that expire in 2018. Management does not believe that the capital loss carryforwards will be utilized prior to their expiration, as the Company has limited capital gain opportunities to offset the losses and, as such, a valuation allowance has been established. The Company also has a \$827,279 net operating loss carryforward at December 31, 2016, that will begin to expire in 2027. The Company had no other valuation allowance against its deferred tax assets in view of the Company's ability to carry back taxes paid in previous years and certain tax strategies and anticipated future taxable income as evidenced by the Company's earnings potential.

The reconciliation of the federal statutory rate and the Company's effective income tax rate is as follows:

	For the Year Ended December 31,			
	2016		2015	
	Amount	% of Pretax Income	Amount	% of Pretax Income
Provision at statutory rate	\$ 1,331,304	34.0 %	\$ 1,170,966	34.0 %
Tax-exempt income on investment securities	(317,791)	(8.1)	(197,044)	(5.7)
Bank-owned life insurance	(51,763)	(1.3)	(100,481)	(2.9)
Nondeductible merger costs	-	-	118,890	3.5
Other	38,095	0.9	(158,977)	(4.7)
Actual tax expense and effective rate	<u>\$ 999,845</u>	<u>25.5 %</u>	<u>\$ 833,354</u>	<u>24.2 %</u>

## 9. INCOME TAXES (Continued)

U.S. generally accepted accounting principles prescribe a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the Consolidated Statement of Income. With few exceptions, the Company is no longer subject to U.S. federal, state, or local income tax examinations by tax authorities for years before 2013.

## 10. COMMITMENTS AND CONTINGENT LIABILITIES

### Commitments

In the normal course of business, management makes various commitments that are not reflected in the accompanying consolidated financial statements. These commitments represent financial instruments with off-balance-sheet risk. The contract or notional amounts of those instruments comprise the following:

	December 31,	
	2016	2015
Commitments to extend credit	\$ 30,136,598	\$ 28,380,970
Letters of credit	815,830	817,413

The same credit policies are used in making commitments and conditional obligations as for on-balance-sheet instruments. Generally, collateral is required to support financial instruments with credit risk. The terms are typically for a one-year period with an annual renewal option subject to prior approval by management.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. These commitments consist primarily of available commercial and personal lines of credit, unfunded construction loans, and loans approved but not yet funded. The instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheet.

Standby letters of credit and financial guarantees represent conditional commitments issued to guarantee the performance of a customer to a third party. Fees earned from the issuance of these letters are recognized over the coverage period. For secured letters of credit, the collateral is typically real estate or Company deposit instruments.

### Contingent Liabilities

The Company is involved in various legal actions from the normal course of business activities. Management believes the liability, if any, arising from such actions will not have a material adverse effect on the Company's financial position.

## 11. EMPLOYEE BENEFITS

### Retirement Plan

The Company maintains a defined contribution 401(k) retirement plan that covers eligible employees. Eligible employees can contribute up to 100 percent of their compensation. The Bank makes a 3 percent non-elective contribution to all eligible participants as of the end of the plan year based on W-2 income for the same period. During 2016, the Company amended the plan to include a discretionary contribution provision allowing for a 50 percent match of employee's contributions up to a maximum of 6 percent. The discretionary contribution approved by the Board of Directors was 6 percent for the year ended December 31, 2016. Contributions to the plan for the years ended December 31, 2016 and 2015, amounted to \$111,218 and \$56,154, respectively.

### Director-Deferred Compensation Plan

The Bank has a deferred compensation plan for the benefit of members of the Board of Directors and certain officers. The plan provides all directors and certain officers with the ability to defer receipt of some or all of their director fees and bonuses. The deferrals, along with accumulated earnings, are payable at retirement. The Bank has purchased life insurance policies on each director and officer that are actuarially designed to offset the annual expenses associated with the plan. The Bank is the sole owner and beneficiary of all policies. The Bank accrues the estimated annual costs of the deferred amounts that will be payable at retirement. At December 31, 2016 and 2015, the accumulated liability was \$1,241,471 and \$1,285,340, respectively.

The components of net periodic pension cost for the director-deferred compensation plan that were recognized in noninterest expense on the Consolidated Statement of Income are as follows:

	For the Year Ended	
	December 31,	
	2016	2015
Components of net periodic pension cost:		
Service cost	\$ 64,970	\$ 95,300
Interest cost	36,063	42,918
Total net periodic pension cost	\$ 101,033	\$ 138,218

### Supplemental Executive Retirement Plan

The Company maintains a supplemental executive retirement plan ("SERP") for certain executives. At December 31, 2016 and 2015, the accumulated liability was \$270,168 and \$169,735, respectively. The expense for the years ended December 31, 2016 and 2015, was \$100,432 and \$51,501, respectively.

## 12. REGULATORY RESTRICTIONS

### Federal Reserve Cash Requirements

The Bank is required to maintain an average cash reserve balance in vault cash or with the Federal Reserve Bank. The required minimum balance was \$2,700,00 and \$1,733,000 at December 31, 2016 and 2015, respectively.

### Loans

Federal law prevents the Company from borrowing from the Bank unless the loans are secured by specific collateral. Further, such secured loans are limited in amount to 10 percent of the Bank's common stock and capital surplus.

## 12. REGULATORY RESTRICTIONS (Continued)

### Dividends

The Pennsylvania Banking Code restricts the availability of capital surplus for dividend purposes. At both December 31, 2016 and 2015, the Bank had a capital surplus of \$12,841,972, which was not available for distribution to the Company as dividends.

### Capital Requirements

Federal regulations require the Company and the Bank to maintain minimum amounts of capital. Specifically, each is required to maintain certain minimum dollar amounts and ratios of total, Tier 1, and common equity Tier 1 capital to risk-weighted assets and of Tier 1 capital to average total assets.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") established five capital categories ranging from "well capitalized" to "critically undercapitalized." Should any institution fail to meet the requirements to be considered "adequately capitalized," it would become subject to a series of increasingly restrictive regulatory actions.

Effective January 1, 2015, the Company and the Bank became subject to the final rules issued by the Federal Reserve and the OCC and subsequently adopted by the FDIC, establishing a new comprehensive capital framework for banking organizations. The new capital framework substantially revised the risk-based capital requirements in comparison to the prior rules, which were in effect through December 31, 2014. The Basel III Capital Rules introduced a new capital measure, "Common Equity Tier 1"; increased the minimum requirements for Tier 1 capital ratio as well as the minimum to be considered well capitalized under prompt corrective action; and introduced the "capital conservation buffer," which will be phased in over a four-year period. 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 Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under U.S. GAAP, regulatory reporting requirements, and regulatory capital standards. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of total, Tier 1 capital and common equity Tier 1 (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2016, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2016 and 2015, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage, and common equity Tier 1 ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

## 12. REGULATORY RESTRICTIONS (Continued)

### Capital Requirements (Continued)

The Bank's actual capital ratios are presented in the following table that shows the Bank met all regulatory capital requirements. The capital position of the Company does not differ significantly from the Bank's capital position.

	December 31,			
	2016		2015	
	Amount	Ratio	Amount	Ratio
<u>Total capital</u>				
<u>(to risk-weighted assets)</u>				
Actual	\$ 25,740,218	14.09 %	\$ 23,568,347	13.81 %
For capital adequacy purposes	14,615,520	8.00	13,649,040	8.00
To be well capitalized	18,269,400	10.00	17,061,300	10.00
<u>Tier 1 capital</u>				
<u>(to risk-weighted assets)</u>				
Actual	\$ 24,001,192	13.14 %	\$ 22,255,142	13.04 %
For capital adequacy purposes	10,961,640	6.00	10,236,780	6.00
To be well capitalized	14,615,520	8.00	13,649,040	8.00
<u>Common equity</u>				
<u>(to risk-weighted assets)</u>				
Actual	\$ 24,001,192	13.14 %	\$ 22,255,142	13.04 %
For capital adequacy purposes	8,221,230	4.50	7,677,585	4.50
To be well capitalized	11,875,110	6.50	11,089,845	6.50
<u>Tier 1 capital</u>				
<u>(to average assets)</u>				
Actual	\$ 24,001,192	7.92 %	\$ 22,255,142	7.75 %
For capital adequacy purposes	12,118,200	4.00	11,485,040	4.00
To be well capitalized	15,147,750	5.00	14,356,300	5.00

### 13. FAIR VALUE MEASUREMENTS

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value. The three broad levels of pricing are as follows:

- Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.
- Level II: Pricing inputs are other than the quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities includes items for which quoted prices are available but traded less frequently and items that are fair-valued using other financial instruments, the parameters of which can be directly observed.
- Level III: Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

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

The following tables present the assets reported on the Consolidated Balance Sheet at their fair value as of December 31, 2016 and 2015, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

	December 31, 2016			
	Level I	Level II	Level III	Total
Assets:				
Negotiable certificates of deposit	\$ -	\$ 5,672,430	\$ -	\$ 5,672,430
U.S. government agency securities	-	22,163,865	-	22,163,865
Small Business Administration loan pools	-	5,823,810	-	5,823,810
Corporate bonds	-	1,754,941	-	1,754,941
Obligations of state and political subdivisions	-	9,721,259	-	9,721,259
Mortgage-backed securities in government-sponsored entities	-	4,737,616	-	4,737,616
	December 31, 2015			
	Level I	Level II	Level III	Total
Assets:				
Negotiable certificates of deposit	\$ -	\$ 6,114,535	\$ -	\$ 6,114,535
U.S. government agency securities	-	35,156,663	-	35,156,663
Mortgage-backed securities in government-sponsored entities	-	13,737,243	-	13,737,243

### 13. FAIR VALUE MEASUREMENTS (Continued)

The following tables present the assets measured on a nonrecurring basis on the Consolidated Balance Sheet at their fair value as of December 31, 2016 and 2015, by level within the fair value hierarchy.

Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loan include quoted market prices for identical assets classified as Level I inputs and observable inputs, employed by certified appraisers, for similar assets classified as Level II inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level III inputs.

Other real estate owned (“OREO”) is measured at fair value, less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value, less cost to sell. For the year ended December 31, 2015, the Bank did not hold any OREO properties acquired through foreclosure.

	December 31, 2016			
	Level I	Level II	Level III	Total
Impaired loans	\$ -	\$ -	\$ 924,294	\$ 924,294
Other real estate owned	-	-	23,500	23,500

	December 31, 2015			
	Level I	Level II	Level III	Total
Impaired loans	\$ -	\$ -	\$ 1,294,994	\$ 1,294,994

The following tables provide information describing the valuation processes used to determine nonrecurring fair value measurements categorized within Level III of the fair value hierarchy:

	December 31, 2016			
	Quantitative Information About Level III Fair Value Measurements			
	Fair Value	Valuation Techniques	Unobservable Input	Range (Weighted Average)
Impaired loans	\$ 924,294	Appraisal of collateral	(1) Appraisal adjustments	(2) 7% (7%)
Other real estate owned	23,500	Appraisal of collateral	(1) Appraisal adjustments	(2) 7% (7%)

	December 31, 2015			
	Quantitative Information About Level III Fair Value Measurements			
	Fair Value	Valuation Techniques	Unobservable Input	Range (Weighted Average)
Impaired loans	\$ 1,294,994	Appraisal of collateral	(1) Appraisal adjustments	(2) 7% (7%)

- (1) Fair value is generally determined through independent appraisals of the underlying collateral, which include various Level III inputs which are not identifiable.
- (2) Appraisals may be adjusted by management for qualitative factors such as economic conditions, aging, and/or estimated liquidation expenses incurred when selling the collateral. The range and weighted average of appraisal adjustments and liquidation expenses are presented as a percentage of the appraisal.

### 13. FAIR VALUE MEASUREMENTS (Continued)

The estimated fair values of the Company's financial instruments are as follows:

	December 31, 2016				
	Carrying Value	Fair Value	Level I	Level II	Level III
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 12,975,401	\$ 12,975,401	\$ 12,975,401	\$ -	\$ -
Certificates of deposit with other banks	11,636,011	11,753,011	-	-	11,753,011
<b>Investment securities:</b>					
Available for sale	49,873,921	49,873,921	-	49,873,921	-
Held to maturity	24,723,393	24,246,623	-	24,246,623	-
Net loans	201,852,908	201,692,908	-	-	201,692,908
Accrued interest receivable	945,997	945,997	945,997	-	-
Restricted investments in bank stock	1,092,900	1,092,900	1,092,900	-	-
Cash surrender value of life insurance	6,345,509	6,345,509	6,345,509	-	-
<b>Financial liabilities:</b>					
Deposits	\$ 265,693,757	\$ 266,787,189	\$ 183,797,177	\$ -	\$ 82,990,012
Short-term borrowings	9,172,400	9,172,400	9,172,400	-	-
FHLB advances - long-term	3,357,522	3,363,522	-	-	3,363,522
Accrued interest payable	193,304	193,304	193,304	-	-

	December 31, 2015				
	Carrying Value	Fair Value	Level I	Level II	Level III
<b>Financial assets:</b>					
Cash and cash equivalents	\$ 10,198,196	\$ 10,198,196	\$ 10,198,196	\$ -	\$ -
Certificates of deposit with other banks	7,949,000	7,997,000	-	-	7,997,000
<b>Investment securities:</b>					
Available for sale	55,008,441	55,008,441	-	55,008,441	-
Held to maturity	15,099,671	15,167,045	-	15,167,045	-
Net loans	191,386,705	191,113,748	-	-	191,113,748
Accrued interest receivable	778,805	778,805	778,805	-	-
Restricted investments in bank stock	633,600	633,600	633,600	-	-
Cash surrender value of life insurance	6,193,265	6,193,265	6,193,265	-	-
<b>Financial liabilities:</b>					
Deposits	\$ 253,198,642	\$ 254,017,061	\$ 170,949,728	\$ -	\$ 83,067,333
FHLB advances - long-term	5,000,000	5,073,000	-	-	5,073,000
Accrued interest payable	185,683	185,683	185,683	-	-

### 13. FAIR VALUE MEASUREMENTS (Continued)

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract that creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas or simulation modeling. As many of these assumptions result from judgments made by management based upon estimates that are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

As certain assets such as deferred tax assets and premises and equipment are not considered financial instruments, the estimated fair value of financial instruments would not represent the full value of the Company.

The Company employed simulation modeling in determining the estimated fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

#### **Cash and Cash Equivalents, Accrued Interest Receivable, Restricted Investments in Bank Stock, Short-Term Borrowings, and Accrued Interest Payable**

The fair value is equal to the current carrying value.

#### **Certificates of Deposit with Other Banks**

The fair values of certificates of deposit with other banks are based on the discounted value of contractual cash flows. The discount rates are estimated using rates currently offered for similar instruments with similar remaining maturities.

#### **Investment Securities Available for Sale and Held to Maturity**

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

#### **Net Loans**

The fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality. Where quoted market prices were available, primarily for certain residential mortgage loans, such market rates were utilized as estimates for fair value.

### 13. FAIR VALUE MEASUREMENTS (Continued)

#### Net Loans (Continued)

Acquired loans are recorded at fair value on the date of acquisition. The fair values of loans with evidence of credit deterioration (impaired loans) are recorded net of a non-accretable difference and, if appropriate, an accretable yield. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is the non-accretable difference, which is included in the carrying amount of acquired loans.

#### Deposits and FHLB Advances – Long-Term

The fair values of certificates of deposit and FHLB advances – long-term are based on the discounted value of contractual cash flows. The discount rates are estimated using rates currently offered for similar instruments with similar remaining maturities. Demand, savings, and money market deposits are valued at the amount payable on demand as of year-end.

#### Cash Surrender Value of Life Insurance

The fair value is equal to the cash surrender value of the life insurance policies.

#### Commitments to Extend Credit

These financial instruments are generally not subject to sale, and estimated fair values are not readily available. The carrying value, represented by the net deferred fee arising from the unrecognized commitment, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure. The contractual amounts of unfunded commitments are presented in Note 10.

### 14. ACCUMULATED OTHER COMPREHENSIVE LOSS

The following tables present the changes in accumulated other comprehensive loss by component net of tax for the years ended December 31, 2016 and 2015:

	Net Unrealized Gains (Losses) on Investment Securities (a)
Accumulated other comprehensive loss, January 1, 2016	\$ (187,855)
Other comprehensive loss before reclassification	(266,486)
Amount reclassified from accumulated other comprehensive loss	<u>(8,351)</u>
Total other comprehensive loss	<u>(274,837)</u>
Accumulated other comprehensive loss, December 31, 2016	<u>\$ (462,692)</u>
	Net Unrealized Gains (Losses) on Investment Securities (a)
Accumulated other comprehensive loss, January 1, 2015	\$ (74,233)
Other comprehensive loss before reclassification	(67,198)
Amount reclassified from accumulated other comprehensive loss	<u>(46,424)</u>
Total other comprehensive loss	<u>(113,622)</u>
Accumulated other comprehensive loss, December 31, 2015	<u>\$ (187,855)</u>

(a) All amounts are net of tax. Amounts in parentheses indicate debits.

#### 14. ACCUMULATED OTHER COMPREHENSIVE LOSS (Continued)

The following table presents significant amounts reclassified out of accumulated other comprehensive loss for the periods ended December 31, 2016 and 2015:

<u>Details about other comprehensive loss</u>	<u>Amount Reclassified from Accumulated Other Comprehensive Loss (a)</u>		<u>Affected line item in the Consolidated Statement of Income</u>
	<u>2016</u>	<u>2015</u>	
Unrealized losses on available for sale securities	\$ 12,653	\$ 70,340	Investment securities gains
	<u>(4,302)</u>	<u>(23,916)</u>	Income taxes
	<u>\$ 8,351</u>	<u>\$ 46,424</u>	

(a) All amounts are net of tax. Amounts in parentheses indicate debits to net income.

#### 15. BUSINESS COMBINATION

##### Agreement and Plan of Merger

On March 27, 2015, the Company closed on a merger transaction pursuant to which GNB Financial Services, Inc. acquired FNBM Financial Corporation in a stock and cash transaction. The acquisition extended the Company's footprint in central Pennsylvania.

FNBM Financial Corporation ("FNBM") was the \$76 million holding company of The First National Bank of Minersville ("First National"), a federally chartered stock savings bank headquartered in Minersville, Pennsylvania, with one location.

Under the terms of the merger agreement, FNBM shareholders received, at the election of the shareholder, either 4.7684 shares of GNB Common Stock or \$276.57 in cash, for their shares of FNBM stock for a total purchase price of \$13,653,299. As a result of the acquisition, FNBM merged with and into a wholly owned subsidiary of GNB Financial Services, Inc. and The First National Bank of Minersville merged with and into The Gratz Bank.

The acquired assets and assumed liabilities were measured at estimated fair values. Management made significant estimates and exercised significant judgment in accounting for the acquisition. Management measured loan fair values based on loan file reviews, appraised collateral values, expected cash flows, and historical loss factors of First National. The Company also recorded an identifiable intangible asset representing the core deposit base of First National based on management's evaluation of the cost of such deposits relative to alternative funding sources. Management used significant estimates including the average lives of depository accounts, future interest rate levels, and the cost of servicing various depository products. Management used market quotations to determine the fair value of investment securities. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as additional information regarding the closing date fair values become available.

## 15. BUSINESS COMBINATION (Continued)

### Agreement and Plan of Merger (Continued)

The business combination resulted in the acquisition of loans with and without evidence of credit quality deterioration. First National's loans were deemed impaired at the acquisition date if the Company did not expect to receive all contractually required cash flows due to concerns about credit quality. Such loans were fair valued and the difference between contractually required payments at the acquisition date and cash flows expected to be collected was recorded as a non-accretable difference. At the acquisition date, the Company recorded \$838,603 of purchased credit-impaired loans subject to a non-accretable difference of \$469,804. The method of measuring carrying value of purchased loans differs from loans originated by the Company (originated loans), and, as such, the Company identifies purchased loans and purchased loans with a credit quality discount and originated loans at amortized cost.

First National's loans without evidence of credit deterioration were fair valued by discounting both expected principal and interest cash flows using an observable discount rate for similar instruments that a market participant would consider in determining fair value. Additionally, consideration was given to management's best estimates of default rates and payment speeds. At acquisition, First National's loan portfolio without evidence of deterioration totaled \$38,305,725 and was recorded at a fair value of \$38,141,895.

The following condensed statement reflects the fair values assigned to FNBM's net assets as of the acquisition date:

Total purchase price		\$	13,653,299
Net assets acquired:			
Cash	9,201,414		
Investment securities available for sale	27,093,494		
Restricted investments in back stock	72,500		
Loans	38,572,528		
Bank-owned life insurance	9,144		
Premises and equipment, net	758,847		
Accrued interest receivable	214,760		
Core deposit intangibles	381,641		
Other real estate owned	35,000		
Other assets	548,689		
Deposits	(64,903,632)		
Accrued interest payable	(13,706)		
Other liabilities	(369,902)		
			<u>11,600,777</u>
Goodwill resulting from merger		\$	<u>2,052,522</u>

## 15. BUSINESS COMBINATION (Continued)

### Agreement and Plan of Merger (Continued)

Results of operations for FNBM Financial Corporation prior to the acquisition date are not included in the Consolidated Statement of Income for the year ended December 31, 2015. The following table presents financial information regarding the former FNBM Financial Corporation operations included in the Consolidated Statement of Income from the date of acquisition through December 31, 2015.

	Actual From Acquisition Date Through December 31, 2015
Net interest income	\$ 997,559
Noninterest income	707,609
Net income	1,041,398

In addition, the following table presents unaudited pro forma information as if the acquisition of FNBM Financial Corporation had occurred on January 1, 2015, under the "Pro Forma" columns. The table below has been prepared for comparative purposes only and is not necessarily indicative of the actual results that would have been attained had the acquisition occurred as of the beginning of the periods presented, nor is it indicative of future results. Furthermore, the unaudited pro forma information does not reflect management's estimate of any revenue-enhancing opportunities nor anticipated cost savings as a result of the integration and consolidation of the acquisition. Merger and acquisition integration costs and amortization of fair value adjustments net of the related income tax effects are included in the amounts below.

	<u>Pro Forma (Unaudited)</u>	
	For the Years Ended December 31,	
	<u>2016</u>	<u>2015</u>
Net interest income	\$ 9,233,850	\$ 9,505,067
Noninterest income	1,500,600	1,870,558
Net income	2,915,755	2,490,133
Pro forma earnings per share:		
Basic	3.75	3.36
Diluted	3.75	3.36

## 16. STOCK DIVIDEND

On February 10, 2016, the Company declared a 25 percent stock dividend to shareholders on record as of March 21, 2016, and payable on April 5, 2016, resulting in the issuance of an additional 155,333 shares of common stock. As a result of the stock dividend, common stock was increased by \$776,665, retained earnings were decreased by \$8,213,441 and additional paid-in capital was increased by \$7,424,918. Fractional shares were paid in cash and totaled \$11,858. All average shares outstanding and all per-share amounts included in the consolidated financial statements are based on the increased number of shares after giving retroactive effects to the stock dividend.

## **17. SUBSEQUENT EVENTS**

Management has reviewed events occurring through March 10, 2017, the date the financial statements were issued, and no subsequent events have occurred requiring accrual or disclosure.