ANNUAL REPORT
2016

ESTABLISHED 1910

Photo courtesy of Austin Walmsley

Peoples Bancorp, Inc.
and Subsidiary
The Peoples Bank,
Fleetwood, Athey, Macbeth & McCown, Inc.
Chestertown, Maryland

106 years of "Peoples" Serving People

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PEOPLES BANCORP, INC.

DIRECTORS

E. Jean Anthony
Chestertown, Maryland

Robert W. Clark, Jr.
Betterton, Maryland

LaMonte E. Cooke
Chestertown, Maryland

R. Allen Davis
Galena, Maryland

Gary B. Fellows
Millington, Maryland

Patricia Joan O. Horsey
Chestertown, Maryland

Martha F. Rasin
Annapolis, Maryland

Stefan R. Skipp
Arnold, Maryland

Elizabeth A. Strong
Chestertown, Maryland

William G. Wheatley
Worton, Maryland

OFFICERS

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Co-Chairperson of Bank Board

Stefan R. Skipp
Co-Chairperson of Bank Board

William G. Wheatley
Executive Vice President & CLO
Chairman of Bancorp Board

Ralph W. Dowling
President & CEO

Richard C. Fleetwood, Jr.
President of FAM & M, Inc.

H. Lawrence Lyons
Executive Vice President &
Chief Operating Officer & Cashier

Randall M. Robey
Executive Vice President & CFO

Marion P. "Chip" Everett, Jr.
Senior Vice President

Terri L. Garvey
Senior Vice President

Nancy L. Greenwood
Senior Vice President & CCO

Stephanie L. Usilton
Senior Vice President & HRO &
Secretary of the Board

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Vice President of FAM&M, Inc.

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Vice President

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Vice President

Ina P. Reed
Vice President & Controller

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Vice President

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Assistant Vice President

Harriet P. Creighton
Assistant Vice President

Katie E. DiSano
Assistant Vice President

Sheila M. Dwyer
Assistant Vice President

Patricia A. Heinefield
Assistant Vice President

Eva W. Hickman
Assistant Vice President

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Assistant Vice President

Jodi L. Richardson
Assistant Vice President

Carolyn L. Walls
Assistant Vice President

M. Kay McHenry
Assistant Secretary

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Assistant Cashier

Brandi C. Clark
Assistant Cashier

Donna H. Edwards
Assistant Cashier

Grace M. Eyler
Assistant Cashier

Mary Ann Landa
Assistant Cashier

Lori A. Larrimore
Assistant Cashier

Mary Chandler Obrecht
Assistant Cashier

Jennifer J. Teat
Assistant Cashier

Samantha M. Thompson
Assistant Cashier

OTHER PERSONNEL

Bonnie L. Allen
Kathleen E. Barnhart
Leigh A. Blackiston
Kathleen F. Bozarth
Kimberly Tanya Brilz
Roni Lynn Glenn
Lori A. Goad
Anjanette S. Graves
Margaret K. Hammer
Anita T. Hayes
Evetta D. Hopkins
Lisa M. Jefferson
Susan M. Joyner
Donna M. Lins
Tina P. Lusby
Maleena E. "Liz" Meekins
Jennifer L. Mancuso
Lorraine Susan Molano
Richard J. Newberry
Megan C. O'Connell
Brittany A. Patchett
Marcey Peet
Tracy A. Piasecki
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Clara M. Ross
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Lois Serio
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Heather M. Spofford
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Sharon L. Sutton
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Tyler G. Tilghman
Laurel A. Toth
Deanna P. Usilton
Karen A. Willis
Kimberly S. Wood
Daniel Zottarelli
Brenda J. Yoder

Greetings to our Shareholders,

As reflected by the information contained in this report, the Bank continues to progress on its plan to return to sound financial footing. While lingering legal and holding expenses associated with legacy problem assets continue to negatively impact core earnings, our bottom line improved significantly. We achieved a profit of $1,317,424 for the year ended December 31, 2016, up from $1,034,750 for the prior year, representing a 27% increase. Appropriately, the Board and I would like to acknowledge the efforts of our team of officers, Bank employees, and our insurance professionals at FAM&M for their contributions to this achievement.

Protecting and enhancing shareholder value remains our top strategic objective. The combination of enhanced profitability and reduction in problem assets over the last 48 months has resulted in a significant enhancement of shareholder value. With the resumption of dividend payments and the increase in value of the underlying stock, we have met or exceeded our initial goals. The over the counter (OTC) price for our stock (ticker symbol: PEBC) has increased from $21.00 to $23.75 over the last 12 months. We continue to work with broker/dealers in developing alternatives to expand the trading of our stock on the OTC market.

Despite great strides, our core earnings remain below our standards. In part, this relates to the cost of the previously referenced expenses associated with legacy problem assets; however, the primary reason for our earning challenges is directly attributable to the state of the real estate market in Kent County. Our ability to generate loans in our home market has been negatively impacted due to slow sales and prices lagging behind the regional and national markets. Our strategic plan to offset this challenge is diversification of our lending activity into adjacent, more robust markets.

Consistent with this strategy, the opening of our Easton Office at 204 N. Washington Street occurred during the third quarter of 2016. This expansion is already contributing to profitability. We have significantly exceeded projections in both loan and deposit levels.

Our community reputation continues to pay dividends. The Bank was again nominated for the "*2016 Community Service Award*" by the Kent County Chamber of Commerce, two years after winning the award. Additionally, due to our efforts and involvement in the community, the Bank recently was again selected as the "Favorite Bank" by Kent County News readers. Our numerous community service projects continue to enhance our stature within our markets.

Looking forward to the remainder of 2017, we anticipate continued additional improvements in core earnings and asset quality. In addition to maintaining and enhancing our dominant presence in Kent County, we are planning to continue to expand our business development efforts into Talbot and Queen Anne's Counties.

Our winning formula for success is directly dependent upon our utilization of both our competitive products and our level of personal service.

I close again with our thanks to you and our great customer base. I look forward to visiting with you at the upcoming shareholder meeting and appreciate your continued support.

Ralph Dowling

Ralph Dowling
President and CEO

Financial Highlights
Five years ended December 31, 2016

	2016	2015	2014	2013	2012
	(dollars in thousands except per share amounts)				
Deposits	**$216,757**	$202,315	$196,523	$201,174	$206,325
Investments, including stock	**37,576**	23,530	12,097	16,118	8,140
Loans (net of the allowance for loan losses)	**156,306**	146,667	134,817	138,019	164,423
Stockholders' equity	**23,574**	24,336	23,361	22,754	22,047
Assets	**254,661**	239,907	234,698	241,748	248,952
Net income (loss)	**1,317**	1,035	563	304	(2,616)
Return on average assets	**0.54%**	0.45%	0.24%	0.13%	-1.05%
Return on average equity	**5.47%**	4.42%	2.48%	1.38%	-11.64%
Earnings (loss) per share	**1.71**	1.33	0.72	0.39	(3.36)
Dividends per share	**0.68**	-	-	-	-
Book value per share	**32.34**	31.22	29.97	29.19	28.28
Number of shares outstanding	**728,918**	779,512	779,512	779,512	779,512

COMMITTEES

AUDIT COMMITTEE
E. Jean Anthony, Chairperson
Robert W. Clark, Jr.
Gary B. Fellows
Patricia Joan O. Horsey
Randall M. Robey, Advisor

CAPITAL COMMITTEE
Stefan R. Skipp, Chairperson
Patricia Joan O. Horsey
Martha F. Rasin
William G. Wheatley
Ralph Dowling, Advisor

GOVERNANCE/NOMINATING COMMITTEE
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R. Allen Davis
Gary B. Fellows
Martha F. Rasin

TRUSTEES OF THE PEOPLES BANK DEFINED BENEFIT PLAN
E. Jean Anthony, Chairperson
Elizabeth A. Strong
H. Lawrence Lyons

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Robert W. Clark, Jr.
Patricia Joan O. Horsey
Martha F. Rasin
Ralph Dowling, Advisor

PERSONNEL/COMPENSATION COMMITTEE
LaMonte E. Cooke, Chairperson
E. Jean Anthony
R. Allen Davis
Elizabeth A. Strong

RISK MANAGEMENT COMMITTEE
Robert W. Clark, Jr., Chairperson
E. Jean Anthony
Patricia Joan O. Horsey
LaMonte E. Cooke
Randall M. Robey, Advisor

ROWLES
& Company, LLP
Certified Public Accountants

The Board of Directors and Stockholders
Peoples Bancorp, Inc.
Chestertown, Maryland

Report of Independent Auditors

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Peoples Bancorp, Inc. and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and 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 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 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 audits to obtain reasonable assurance about whether the consolidated financial statements are free from 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 financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company'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 Company'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 Peoples Bancorp, Inc. and Subsidiary 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.

Rowles & Company, LLP

Baltimore, Maryland
February 28, 2017

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443-725-5395 Fax 443-725-5074
Website: www.Rowles.com

CONSOLIDATED BALANCE SHEETS

ASSETS	**DECEMBER 31,**	
	2016	2015
Cash and due from banks	**$ 49,685,967**	$ 58,579,879
Securities available for sale	**36,874,318**	22,774,214
Securities held to maturity (fair value of **$127** and $58,862)	**127**	59,322
Federal Home Loan Bank and CBB Financial Corp. stock, at cost	**701,100**	696,300
Loans, less allowance for loan losses of **$4,303,583** and $5,183,007	**156,306,289**	146,666,702
Premises and equipment	**5,757,395**	4,383,255
Accrued interest receivable	**490,106**	524,661
Deferred income taxes	**1,929,393**	2,415,622
Other real estate owned	**1,995,826**	2,991,492
Goodwill	**272,932**	272,932
Intangible assets	**-**	55,000
Other assets	**647,345**	487,557
	$254,660,798	$239,906,936

LIABILITIES AND STOCKHOLDERS' EQUITY

	2016	2015
Deposits		
Noninterest bearing checking	**$ 69,541,575**	$ 57,469,558
Savings and NOW	**69,658,150**	62,396,833
Money market	**15,287,991**	15,013,048
Other time	**62,269,748**	67,435,506
	216,757,464	202,314,945
Securities sold under repurchase agreements	**2,180,252**	1,254,358
Federal Home Loan Bank advances	**10,000,000**	10,000,000
Accrued interest payable	**136,201**	156,283
Other liabilities	**2,012,486**	1,845,293
	231,086,403	215,570,879
Stockholders' equity		
Common stock, par value $10 per share; authorized 1,000,000 shares; issued and outstanding **728,918** and 779,512 shares	**7,289,180**	7,795,120
Additional paid-in capital	**2,212,550**	2,920,866
Retained earnings	**14,917,414**	14,130,058
Accumulated other comprehensive income		
Unrealized gain (loss) on securities available for sale	**(68,918)**	20,064
Unfunded liability for defined benefit plan	**(775,831)**	(530,051)
	23,574,395	24,336,057
	$254,660,798	$239,906,936

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF INCOME

	YEARS ENDED DECEMBER 31,	
	2016	2015
Interest and dividend revenue		
Loans, including fees	**$7,179,942**	$7,291,335
U.S. government agency securities	**336,682**	399,997
Other	**268,291**	132,967
Total interest and dividend revenue	**7,784,915**	7,824,299
Interest expense		
Deposits	**579,534**	746,551
Borrowed funds	**445,516**	447,848
Total interest expense	**1,025,050**	1,194,399
Net interest income	**6,759,865**	6,629,900
Provision for loan losses	**(900,000)**	(600,000)
Net interest income after provision for loan losses	**7,659,865**	7,229,900
Noninterest revenue		
Service charges on deposit accounts	**720,402**	711,597
Insurance commissions	**1,862,531**	1,714,653
Gain on sale of other real estate owned	**252,142**	72,493
Other noninterest revenue	**234,411**	241,327
Total noninterest revenue	**3,069,486**	2,740,070
Noninterest expense		
Salaries	**3,952,605**	3,694,890
Employee benefits	**983,403**	994,252
Occupancy	**502,620**	486,186
Furniture and equipment	**337,087**	378,229
Data processing and correspondent fees	**596,644**	589,343
Other real estate owned expense	**502,387**	338,564
Professional fees	**391,846**	395,960
Other operating	**1,368,538**	1,474,066
Total noninterest expense	**8,635,130**	8,351,490
Income before income taxes	**2,094,221**	1,618,480
Income tax expense	**776,797**	583,730
Net income	**$1,317,424**	$1,034,750
Earnings per common share - basic and diluted	**$ 1.71**	$ 1.33

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME

	YEARS ENDED DECEMBER 31,	
	2016	2015
Net income	**$1,317,424**	$1,034,750
Other comprehensive income (loss)		
Unrealized loss on investment securities available for sale	**(146,943)**	(16,404)
Income tax relating to unrealized loss on investment securities available for sale	**57,961**	4,640
	(88,982)	(11,764)
Change in underfunded status of defined benefit plan	**(405,878)**	(66,255)
Income tax relating to change in underfunded status of defined benefit plan	**160,098**	18,742
	(245,780)	(47,513)
Total other comprehensive loss	**(334,762)**	(59,277)
Total comprehensive income	**$ 982,662**	$ 975,473

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
YEARS ENDED DECEMBER 31, 2016 and 2015

	Common stock Shares	Common stock Par value	Additional paid-in capital	Retained earnings	Accumulated other comprehensive income	Total stockholders' equity
Balance, December 31, 2014	779,512	$7,795,120	$2,920,866	$13,095,308	$(450,710)	$23,360,584
Net income	-	-	-	1,034,750	-	1,034,750
Change in underfunded status of defined benefit plan net of income taxes of $18,742	-	-	-	-	(47,513)	(47,513)
Unrealized loss on investment securities available for sale net of income taxes of $4,640	-	-	-	-	(11,764)	(11,764)
Balance, December 31, 2015	779,512	7,795,120	2,920,866	14,130,058	(509,987)	24,336,057
Net income	**-**	**-**	**-**	**1,317,424**	**-**	**1,317,424**
Change in underfunded status of defined benefit plan net of income taxes of $160,098	**-**	**-**	**-**	**-**	**(245,780)**	**(245,780)**
Unrealized loss on investment securities available for sale net of income taxes of $57,961	**-**	**-**	**-**	**-**	**(88,982)**	**(88,982)**
Repurchase of stock	**(50,594)**	**(505,940)**	**(708,316)**	**-**	**-**	**(1,214,256)**
Cash dividend, $0.68 per share	**-**	**-**	**-**	**(530,068)**	**-**	**(530,068)**
Balance, December 31, 2016	**728,918**	**$7,289,180**	**$2,212,550**	**$14,917,414**	**$(844,749)**	**$23,574,395**

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS

	YEARS ENDED DECEMBER 31,	
	2016	2015
Cash flows from operating activities		
Interest received	**$ 7,992,919**	$ 8,091,408
Fees and commissions received	**2,819,997**	2,667,577
Interest paid	**(1,045,132)**	(1,219,503)
Cash paid to suppliers and employees	**(8,502,348)**	(8,087,919)
Income taxes paid	**(72,508)**	(48,036)
	1,192,928	1,403,527
Cash flows from investing activities		
Proceeds from maturities and calls of investment securities		
Held to maturity	**1,760,880**	839
Available for sale	**10,776,943**	22,279,693
Purchase of investment securities		
Held to maturity	**(1,701,685)**	(58,446)
Available for sale	**(25,195,910)**	(34,484,107)
(Purchase) redemption of Federal Home Loan Bank stock	**(4,800)**	121,300
Loans made, net of principal collected	**(9,139,463)**	(11,314,028)
Purchase of premises, equipment, and software	**(1,653,380)**	(225,710)
Proceeds from the sale of COLI	**-**	470,081
Improvements to other real estate owned	**-**	(3,561)
Proceeds from sale of premises and equipment	**2,000**	-
Proceeds from sale of other real estate owned	**1,444,486**	1,003,881
	(23,710,929)	(22,210,058)
Cash flows from financing activities		
Net increase (decrease) in		
Time deposits	**(5,165,758)**	(5,187,637)
Other deposits	**19,608,277**	10,979,181
Securities sold under repurchase agreements	**925,894**	(1,459,192)
Repurchase of stock	**(1,214,256)**	-
Dividends paid	**(530,068)**	-
	13,624,089	4,332,352
Net decrease in cash and cash equivalents	**(8,893,912)**	(16,474,179)
Cash and cash equivalents at beginning of year	**58,579,879**	75,054,058
Cash and cash equivalents at end of year	**$49,685,967**	$58,579,879

The accompanying notes are an integral part of these consolidated financial statements.

CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)

	YEARS ENDED DECEMBER 31,	
	2016	2015
Reconciliation of net income to net cash provided by operating activities		
Net income	**$1,317,424**	$1,034,750
Adjustments to reconcile net income to net cash provided by operating activities		
Amortization of premiums and accretion of discounts	**171,919**	218,204
Provision for loan losses	**(900,000)**	(600,000)
Depreciation and software amortization	**304,433**	344,460
Amortization of intangible assets	**55,000**	55,000
Write-down of other real estate owned	**201,668**	89,500
Gain on sale of other real estate owned	**(252,142)**	(72,493)
Loss on sale of premises and equipment	**2,648**	-
Decrease (increase) in		
Accrued interest receivable	**34,555**	24,967
Deferred income taxes	**704,289**	539,780
Other assets	**(189,629)**	(76,760)
Deferred origination costs, net	**1,530**	23,938
Increase (decrease) in		
Accrued interest payable	**(20,082)**	(25,104)
Other liabilities	**(238,685)**	(152,715)
	$1,192,928	$1,403,527

Non cash transactions		
Transfer of foreclosed loans to other real estate owned	**$ 398,346**	$ 40,315

The accompanying notes are an integral part of these consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies

The accounting and reporting policies reflected in the accompanying financial statements of Peoples Bancorp, Inc. and its subsidiary, The Peoples Bank, a Maryland commercial bank (the "Bank") and its subsidiaries, Fleetwood, Athey, MacBeth & McCown, Inc., an insurance agency (the "Insurance Subsidiary") and PB Land Trust, a trust to maintain foreclosed real estate owned by the company (the "Land Trust"), conform to accounting principles generally accepted in the United States of America ("GAAP") and to general practices within the banking industry. As used in these notes, unless the context requires otherwise, the term "the Company" refers collectively to Peoples Bancorp, Inc., the Bank, the Insurance Subsidiary, and the Land Trust.

Principles of consolidation

The consolidated financial statements include the accounts of the Peoples Bancorp, Inc. and the Bank, the Insurance Subsidiary, and the Land Trust. Intercompany balances and transactions have been eliminated.

Nature of business

Peoples Bancorp, Inc. and its subsidiary operate primarily in Kent, Cecil, Queen Anne's and Talbot Counties, Maryland. The Bank, which operates out of a main office and six branches, offers deposit services and loans to individuals, small businesses, associations, and government entities. Other services include direct deposit of payroll and social security checks, automatic drafts from accounts, automated teller machine services, cash management services, safe deposit boxes, money orders, travelers cheques, and on-line banking with bill payment service. In July the Bank opened a branch in Easton, Maryland expanding the Bank's service area to Talbot County.

The Insurance Subsidiary operates from one location in Kent County and one in Cecil County. They provide a full range of insurance products to businesses and consumers. Product lines include property, casualty, life, marine, long-term care and health insurance.

Use of estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions may affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and cash equivalents

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are sold for one-day periods.

Investment securities

As securities are purchased, management determines if the securities should be classified as held to maturity or available for sale. Securities which management has the intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost which is cost adjusted for amortization of premiums and accretion of discounts to maturity, or over the expected life in the case of mortgage-backed securities. Amortization and accretion are recorded using the interest method. Securities which may be sold before maturity are classified as available for sale and carried at fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Gains and losses on the sale of securities are determined using the specific identification method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies (Continued)

Federal Home Loan Bank stock and CBB Financial Corp. stock

Federal Home Loan Bank stock and CBB Financial Corp. stock are carried at cost. As a member of the Federal Home Loan Bank, the Bank is required to purchase stock based on its total assets. Additional stock is purchased and redeemed based on the outstanding Federal Home Loan Bank advances to the Bank.

Loans and allowance for loan losses

Loans are stated at their outstanding unpaid principal balance adjusted for deferred origination costs, deferred origination fees, and the allowance for loan losses.

Interest on loans is accrued based on the principal amounts outstanding. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method. The accrual of interest is discontinued when it is not reasonable to expect collection of interest under the original terms. As a result of management's ongoing review of the loan portfolio, loans are classified as nonaccrual when it is not reasonable to expect collection of interest under the original terms. These loans are classified as nonaccrual even though the presence of collateral or the borrower's financial strength may be sufficient to provide for ultimate repayment. Interest on nonaccrual loans is recognized only when received. A loan is generally placed in nonaccrual status when it is specifically determined to be impaired or it becomes 90 days or more past due. When a loan is placed in nonaccrual status, all interest that had been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest revenue. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. A loan will be returned to accrual status when all of the principal and interest amounts contractually due are brought current and management believes that future principal and interest amounts contractually due are reasonably assured, which belief is typically evidenced by a sustained period (at least six months) of repayment performance by the borrower.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes a loan is uncollectible. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral, changes in lending practices and policies, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies (Continued)

Loans and allowance for loan losses (Continued)

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the collateral value, if the loan is collateral dependent, or the discounted cash flows of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision 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, management believes 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. Impairment is measured on a loan-by-loan basis. Reserves are determined using the net present value of cash flows, or if the loan is collateral dependent, the fair value of the collateral less cost to sell.

As a general rule, a loan, or a portion thereof, is deemed uncollectible and is charged-off as and when required by bank regulatory guidelines, which provide that the loan, or portion thereof, should be charged-off when the Company becomes aware of the loss. The Company becomes aware of a loss upon the occurrence of one or more triggering events, including, among other things, the receipt of new information about the borrower's intent and/or ability to repay the loan, the severity of delinquency, the borrower's bankruptcy, the detection of fraud, or the borrower's death.

Premises and equipment

Premises and equipment are recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated useful lives of three to ten years for furniture and equipment, ten to forty years for premises, and three years for software.

Other real estate owned

Real estate acquired through foreclosure is recorded at the lower of cost or fair value on the date acquired. In general, cost equals the Company's investment in the property at the time of foreclosure. Losses incurred at the time of acquisition of the property are charged to the allowance for loan losses. Subsequent reductions in the estimated value of the property are included in other operating expense.

Goodwill and intangible assets

The Company recorded goodwill of $273,000 and other intangible assets of approximately $550,000 as the result of the acquisition of the Insurance Subsidiary in 2007.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill is not ratably amortized into the income statement over an estimated life, but rather is tested at least annually for impairment. Intangible assets that have finite lives are amortized over their estimated useful lives and are also subject to impairment testing. The Company's intangible assets have finite lives and are amortized on a straight-line basis over periods not exceeding 10 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Summary of Significant Accounting Policies (Continued)

Income taxes

The provision for income taxes includes taxes payable for the current year and deferred income taxes. Deferred income taxes are provided for the temporary differences between financial and taxable income.

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

Per share data

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding, adjusted for the dilutive effect of stock-based awards. The weighted average number of shares outstanding were 769,255 and 779,512 for 2016 and 2015 respectively. There were no dilutive common stock equivalents outstanding in 2016 or 2015.

Subsequent Events

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2016 through February 28, 2017, the date these financial statements were available to be issued, for items that should potentially be recognized or disclosed in these financial statements. No significant subsequent events were identified that would affect the presentation of the financial statements.

2. Cash and Due From Banks

The Bank normally carries balances with other banks that exceed the federally insured limit. The average balances carried in excess of the limit, including unsecured federal funds sold to the same banks, were $8,256,360 for 2016 and $8,056,911 for 2015.

Deposits held in noninterest-bearing transaction accounts are aggregated with any interest-bearing deposits the owner may hold in the same category. The combined total is insured up to $250,000.

Banks are required to carry noninterest-bearing cash reserves at specified percentages of deposit balances. The Bank's normal amount of cash on hand and on deposit with other banks is sufficient to satisfy the reserve requirements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Investment Securities

Investment securities are summarized as follows:

December 31, 2016	Amortized cost	Unrealized gains	Unrealized losses	Fair value
Available for sale				
U.S. government agency	**$ 31,001,014**	**$ -**	**$ 185,414**	**$ 30,815,600**
Mortgage-backed securities	**5,987,115**	**76,602**	**4,999**	**6,058,718**
	$ 36,988,129	**$ 76,602**	**$ 190,413**	**$ 36,874,318**
Held to maturity				
Mortgage-backed securities	**$ 127**	**$ -**	**$ -**	**$ 127**
December 31, 2015				
Available for sale				
U.S. government agency	$ 15,027,488	$ 2,180	$ 25,778	$ 15,003,890
Mortgage-backed securities	7,713,594	73,823	17,093	7,770,324
	$ 22,741,082	$ 76,003	$ 42,871	$ 22,774,214
Held to maturity				
State, County & Municipal securities	$ 58,446	$ -	$ 475	$ 57,971
Mortgage-backed securities	876	15	-	891
	$ 59,322	$ 15	$ 475	$ 58,862

Contractual maturities and the amount of pledged securities are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities are paid monthly.

	Available for sale		Held to maturity	
December 31, 2016	Amortized cost	Fair value	Amortized cost	Fair value
Maturing				
Within one year	**$ 5,005,892**	**$ 5,004,460**	**$ -**	**$ -**
Over one to five years	**25,995,122**	**25,811,140**	**-**	**-**
	$ 31,001,014	**$ 30,815,600**	**$ -**	**$ -**
Pledged securities	**$ 3,675,543**	**$ 3,670,754**	**$ -**	**$ -**
December 31, 2015				
Maturing				
Over one to five years	$ 15,027,488	$ 15,003,890	$ 58,446	$ 57,971
Pledged securities	$ 3,341,392	$ 3,337,686	$ -	$ -

Investments are pledged to secure the deposits of federal and local governments and as collateral for repurchase agreements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Investment Securities (Continued)

Securities in a continuous unrealized loss position at December 31, 2016 and 2015, are as follows:

	Less than 12 months		12 months or longer		Total	
December 31, 2016	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value
Available for sale						
U.S. government agency	**$ 185,414**	**$30,815,600**	**$ -**	**$ -**	**$ 185,414**	**$30,815,600**
Mortgage-backed securities	**3,976**	**1,180,899**	**1,023**	**1,113,447**	**4,999**	**2,294,346**
	$ 189,390	**$31,996,499**	**$ 1,023**	**$1,113,447**	**$ 190,413**	**$33,109,946**
December 31, 2015						
Available for sale						
U.S. government agency	$ 25,778	$ 7,981,710	$ -	$ -	$ 25,778	$ 7,981,710
Mortgage-backed securities	17,093	2,327,545	-	-	17,093	2,327,545
	$ 42,871	$10,309,255	$ -	$ -	$ 42,871	$10,309,255
Held to maturity						
State, County & Municipal securities	$ 475	$ 57,971	$ -	$ -	$ 475	$ 57,971

All unrealized losses on securities as of December 31, 2016 and 2015, are considered to be temporary losses. Each security will be redeemed at face value at, or prior to, maturity. In most cases, the temporary impairment in value is caused by market interest rate fluctuations.

There were no sales of securities in 2016 or 2015.

4. Loans and Allowance for Loan Losses

Major classifications of loans as of December 31, are as follows:

	2016	2015
Real estate		
Residential	**$ 75,135,181**	$ 69,667,681
Commercial	**48,369,362**	43,529,874
Other	**17,881,451**	19,216,049
Construction and land development	**7,182,993**	8,962,526
Commercial	**11,146,044**	9,332,928
Consumer	**880,875**	1,125,155
	160,595,906	151,834,213
Deferred costs, net of deferred fees	**13,966**	15,496
Allowance for loan losses	**(4,303,583)**	(5,183,007)
	$156,306,289	$146,666,702

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

Loan Origination/Risk Management

The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, loan delinquencies and nonperforming and potential problem loans.

Residential real estate loans are underwritten subject to the borrower's ability and willingness to repay, and a loan-to-value ratio of offered collateral of not more than 80% of the appraised value of the collateral.

Real Estate Loans

Real estate loans are broken into the following categories: Residential; Commercial; Construction and Land Development; and Other Loans.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans, in addition to those of real estate loans. These loans are assessed primarily based on cash flow and secondarily on the underlying real estate collateral. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral and cash flow. With respect to loans to developers and builders that are secured by non-owner occupied properties that the Company may originate from time to time, the Company generally requires the borrower to have had an existing relationship with the Company and have a proven record of success.

Construction, including land development, loans are underwritten based on financial analyses of the developers and property owners, and estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

Commercial Loans

Commercial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and to prudently expand its business. The Company's management examines current and projected cash flows to determine the ability of the borrower to repay its obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis.

Consumer Loans

The Company originates consumer loans. To monitor and manage consumer loan risk, underwriting policies and procedures are developed and modified as needed. The Company believes that its monitoring activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk.

The Company obtains an independent loan review from a third-party vendor that reviews and evaluates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

The rate repricing and maturity distribution of the loan portfolio at December 31, is as follows:

	2016
Within ninety days	$ 12,355,319
Over ninety days to one year	14,980,427
Over one year to five years	82,846,235
Over five years	50,413,925
	$ 160,595,906
Variable rate loans included in above	$ 23,022,226

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

The following table illustrates total impaired loans segmented by those with and without a related allowance as of December 31, 2016 and 2015.

Total Impaired Loans Segmented by With and Without a Related Allowance Recorded

December 31, 2016

Description of Loans	Number of loans	Recorded Investment	Unpaid Contractual Balance	Related Allowance	Interest Income Recognized	Average Recorded Investment
With Related Allowance Recorded						
Residential real estate	7	$ 889,721	$ 1,200,616	$303,443	$ 22,955	$ 1,047,858
Commercial real estate	-	-	-	-	-	-
Other real estate	-	-	-	-	-	-
Construction and land development	2	52,714	71,247	20,090	469	54,572
Commercial loans	-	-	-	-	-	-
Consumer loans	-	-	-	-	-	-
	9	942,435	1,271,863	323,533	23,424	1,102,430
With No Related Allowance Recorded						
Residential real estate	33	3,023,486	5,005,475	-	194,533	4,076,605
Commercial real estate	11	4,125,215	5,097,664	-	158,058	4,496,822
Other real estate	6	1,331,396	1,752,123	-	94,610	1,612,093
Construction and land development	1	2,790	15,665	-	310	14,269
Commercial loans	2	202,710	267,276	-	12,291	241,528
Consumer loans	1	14,376	14,439	-	844	15,246
	54	8,699,973	12,152,642	-	460,646	10,456,563
TOTAL						
Residential real estate	40	3,913,207	6,206,091	303,443	217,488	5,124,463
Commercial real estate	11	4,125,215	5,097,664	-	158,058	4,496,822
Other real estate	6	1,331,396	1,752,123	-	94,610	1,612,093
Construction and land development	3	55,504	86,912	20,090	779	68,841
Commercial loans	2	202,710	267,276	-	12,291	241,528
Consumer loans	1	14,376	14,439	-	844	15,246
Total impaired loans	63	$9,642,408	$13,424,505	$323,533	$ 484,070	$11,558,993

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

Total Impaired Loans Segmented by With and Without a Related Allowance Recorded

December 31, 2015

Description of Loans	Number of loans	Recorded Investment	Unpaid Contractual Balance	Related Allowance	Interest Income Recognized	Average Recorded Investment
With Related Allowance Recorded						
Residential real estate	9	$1,186,290	$ 1,468,624	$318,851	$ 62,353	$ 1,330,651
Commercial real estate	-	-	-	-	-	-
Other real estate	-	-	-	-	-	-
Construction and land development	1	20,289	23,375	1,689	-	20,011
Commercial loans	1	2,685	10,360	2,685	636	8,767
Consumer loans	-	-	-	-	-	-
	11	1,209,264	1,502,359	323,225	62,989	1,359,429
With No Related Allowance Recorded						
Residential real estate	32	3,077,153	4,773,509	-	207,355	4,019,614
Commercial real estate	8	1,976,511	2,714,165	-	130,479	2,321,478
Other real estate	6	1,398,750	1,767,995	-	98,145	1,654,011
Construction and land development	1	36,136	47,656	-	-	46,360
Commercial loans	2	214,169	278,177	-	12,934	251,889
Consumer loans	1	16,141	16,211	-	938	16,921
	50	6,718,860	9,597,713	-	449,851	8,310,273
TOTAL						
Residential real estate	41	4,263,443	6,242,133	318,851	269,708	5,350,265
Commercial real estate	8	1,976,511	2,714,165	-	130,479	2,321,478
Other real estate	6	1,398,750	1,767,995	-	98,145	1,654,011
Construction and land development	2	56,425	71,031	1,689	-	66,371
Commercial loans	3	216,854	288,537	2,685	13,570	260,656
Consumer loans	1	16,141	16,211	-	938	16,921
Total impaired loans	61	$7,928,124	$11,100,072	$323,225	$ 512,840	$ 9,669,702

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

The following table summarizes activity in the allowance for loan losses and allocations based on loans that are individually evaluated for impairment and loan balances collectively evaluated for impairment.

December 31, 2016	Residential Real Estate	Commercial Real Estate	Other Real Estate	Construction and Land Development	Commercial	Consumer	Overdraft	Unallocated	Total
Allowance for loan losses									
Beginning balance	**$1,835,359**	**$ 680,929**	**$191,578**	**$ 770,810**	**$ 245,322**	**$ 9,278**	**$ 268**	**$1,449,463**	**$5,183,007**
Charge-offs	**(198,758)**	**-**	**-**	**(11,376)**	**-**	**(306)**	**(816)**	**-**	**(211,256)**
Recoveries	**99,376**	**35,168**	**-**	**11,900**	**77,056**	**7,805**	**527**	**-**	**231,832**
Provision	**9,206**	**238,814**	**21,216**	**(666,025)**	**(73,444)**	**(5,422)**	**637**	**(424,982)**	**(900,000)**
Ending balance	**$1,745,183**	**$ 954,911**	**$212,794**	**$ 105,309**	**$ 248,934**	**$11,355**	**$ 616**	**$1,024,481**	**$4,303,583**
Ending balance allocated to:									
Loans individually evaluated for impairment	**$ 303,443**	**$ -**	**$ -**	**$ 20,090**	**$ -**	**$ -**	**$ -**	**$ -**	**$ 323,533**
Loans collectively evaluated for impairment	**1,441,740**	**954,911**	**212,794**	**85,219**	**248,934**	**11,355**	**616**	**1,024,481**	**3,980,050**
	$1,745,183	**$ 954,911**	**$212,794**	**$ 105,309**	**$ 248,934**	**$11,355**	**$ 616**	**$1,024,481**	**$4,303,583**

December 31, 2015	Residential Real Estate	Commercial Real Estate	Other Real Estate	Construction and Land Development	Commercial	Consumer	Overdraft	Unallocated	Total
Allowance for loan losses									
Beginning balance	$1,274,669	$ 938,778	$164,499	$ 525,518	$ 353,017	$ 8,694	$ 769	$2,160,724	$5,426,668
Charge-offs	(190,988)	(20,486)	-	(196)	(94)	(17,110)	(692)	-	(229,566)
Recoveries	172,387	186,992	-	8,363	212,844	5,023	296	-	585,905
Provision	579,291	(424,355)	27,079	237,125	(320,445)	12,671	(105)	(711,261)	(600,000)
Ending balance	$1,835,359	$ 680,929	$191,578	$ 770,810	$ 245,322	$ 9,278	$ 268	$1,449,463	$5,183,007
Ending balance allocated to:									
Loans individually evaluated for impairment	$ 318,851	$ -	$ -	$ 1,689	$ 2,685	$ -	$ -	$ -	$ 323,225
Loans collectively evaluated for impairment	1,516,508	680,929	191,578	769,121	242,637	9,278	268	1,449,463	4,859,782
	$1,835,359	$ 680,929	$191,578	$ 770,810	$ 245,322	$ 9,278	$ 268	$1,449,463	$5,183,007

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

As part of the on-going monitoring of the quality of the Bank's loan portfolio, management tracks certain credit quality indicators. The Bank risk rates all loans. Loans are risk rated based on the scale below:

Grade 1 through 4 – These grades include "pass grade" loans to borrowers of acceptable credit quality and risk.

Grade 5 – This grade includes loans that are on Management's "watch list" and is intended to be utilized on a temporary basis for pass grade borrowers where a significant risk-modifying action is anticipated in the near future.

Grade 6 – This grade is for "Other Assets Especially Mentioned" or "Special Mention" in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation. This grade may include loans not fully secured where a specific valuation allowance may be necessary.

Grade 7 through 9 – This grade includes "Substandard" loans, in accordance with regulatory guidelines, for which accrual of interest may have stopped. This grade includes loans that are past due or not fully secured where a specific valuation allowance may be necessary.

The following table illustrates classified loans by class. Classified loans included loans in Risk Grades 5, 6, and 7 through 9.

December 31, 2016	Pass	Pass/Watch	Special Mention	Substandard	Total
Residential real estate	**$ 64,007,889**	**$ 6,315,058**	**$ 1,673,061**	**$ 3,139,173**	**$ 75,135,181**
Commercial real estate	**37,800,261**	**5,722,991**	**788,884**	**4,057,226**	**48,369,362**
Other real estate	**16,789,570**	**673,759**	**-**	**418,122**	**17,881,451**
Construction and land development	**7,082,091**	**-**	**-**	**100,902**	**7,182,993**
Commercial	**10,304,292**	**272,529**	**323,222**	**246,001**	**11,146,044**
Consumer	**879,375**	**500**	**1,000**	**-**	**880,875**
	$136,863,478	**$12,984,837**	**$ 2,786,167**	**$ 7,961,424**	**$160,595,906**

December 31, 2015	Pass	Pass/Watch	Special Mention	Substandard	Total
Residential real estate	$ 57,050,318	$ 5,733,664	$ 1,988,777	$ 4,894,922	$ 69,667,681
Commercial real estate	31,019,701	7,502,481	3,454,188	1,553,504	43,529,874
Other real estate	16,461,958	2,302,979	-	451,112	19,216,049
Construction and land development	7,704,348	-	1,154,766	103,412	8,962,526
Commercial	7,935,234	866,319	265,755	265,620	9,332,928
Consumer	1,116,868	7,287	1,000	-	1,125,155
	$121,288,427	$16,412,730	$ 6,864,486	$ 7,268,570	$151,834,213

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

The following table analyzes the age of past due loans, including both accruing and nonaccruing loans, segregated by class of loans as of December 31, 2016 and 2015.

December 31, 2016	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans
Residential real estate	**$534,499**	**$119,346**	**$ 993,005**	**$1,646,850**	**$ 73,488,331**	**$ 75,135,181**
Commercial real estate	**318,467**	**-**	**2,762,056**	**3,080,523**	**45,288,839**	**48,369,362**
Other real estate	**-**	**-**	**-**	**-**	**17,881,451**	**17,881,451**
Construction and land development	**-**	**-**	**55,503**	**55,503**	**7,127,490**	**7,182,993**
Commercial loans	**13,772**	**-**	**-**	**13,772**	**11,132,272**	**11,146,044**
Consumer loans	**-**	**-**	**-**	**-**	**880,875**	**880,875**
Total	**$866,738**	**$119,346**	**$3,810,564**	**$4,796,648**	**$155,799,258**	**$160,595,906**

December 31, 2015	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans
Residential real estate	$258,772	$558,756	$1,095,642	$1,913,170	$ 67,754,511	$ 69,667,681
Commercial real estate	-	-	520,950	520,950	43,008,924	43,529,874
Other real estate	-	-	-	-	19,216,049	19,216,049
Construction and land development	-	-	56,425	56,425	8,906,101	8,962,526
Commercial loans	-	2,000	-	2,000	9,330,928	9,332,928
Consumer loans	-	-	-	-	1,125,155	1,125,155
Total	$258,772	$560,756	$1,673,017	$2,492,545	$149,341,668	$151,834,213

Loans on which the accrual of interest has been discontinued or reduced, and the interest that would have been accrued at December 31, are as follows:

	2016	2015
Residential real estate	**$2,689,435**	$3,301,220
Commercial real estate	**3,114,834**	918,992
Other real estate	**124,154**	155,211
Construction and land development	**55,503**	56,425
Commercial loans	**797**	5,515
Consumer loans	**-**	-
Total	**$5,984,723**	$4,437,363
Interest not accrued on nonaccrual loans	**$ 334,553**	$ 237,831

There were no loans over 90 days past due and accruing at December 31, 2016 and 2015.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

A loan will be returned to accrual status when all of the principal and interest amounts contractually due are brought current and management believes that future principal and interest amounts contractually due are reasonably assured, which belief is typically evidenced by a sustained period (at least six months) of repayment performance by the borrower.

The modification of terms on a loan (restructuring) is considered a "troubled debt restructuring" if it is done to accommodate a borrower who is experiencing financial difficulties. The lender may forgive principal, lower the interest rate or payment amount, or may modify the payment due dates or maturity date of the loan for a troubled borrower. The Company's troubled debt restructurings at December 31, 2016 and 2015, are set forth in the following tables:

TROUBLED DEBT RESTRUCTURINGS

December 31, 2016	Number of Contracts	Contract Balance	Paying as Agreed Under Modified Terms	Number of Past Due Contracts	Past Due 30 Days or More or Nonaccruing
Troubled debt restructurings					
Residential real estate	**36**	**$2,906,957**	**$ 1,659,040**	**20**	**$ 1,247,917**
Commercial real estate	**8**	**1,856,809**	**1,010,382**	**3**	**846,427**
Other real estate	**4**	**913,274**	**913,274**	**-**	**-**
Construction and land development	**1**	**18,955**	**-**	**1**	**18,955**
Commercial loans	**-**	**-**	**-**	**-**	**-**
Consumer loans	**1**	**14,376**	**14,376**	**-**	**-**
	50	**$5,710,371**	**$ 3,597,072**	**24**	**$ 2,113,299**

December 31, 2015	Number of Contracts	Contract Balance	Paying as Agreed Under Modified Terms	Number of Past Due Contracts	Past Due 30 Days or More or Nonaccruing
Troubled debt restructurings					
Residential real estate	37	$3,254,357	$ 1,720,631	24	$ 1,533,726
Commercial real estate	8	1,976,511	1,057,519	3	918,992
Other real estate	4	944,627	944,627	-	-
Construction and land development	1	20,289	-	1	20,289
Commercial loans	-	-	-	-	-
Consumer loans	1	16,141	16,141	-	-
	51	$6,211,925	$ 3,738,918	28	$ 2,473,007

In 2016 and 2015, there were no new troubled debt restructurings.

At December 31, 2016, formal foreclosure procedures were in process for eight loans totaling $2,905,795.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

Outstanding loan commitments, unused lines of credit, and letters of credit as of December 31, are as follows:

	2016	2015
Check loan lines of credit	**$ 480,097**	$ 466,321
Mortgage lines of credit and loan commitments	**9,577,397**	7,616,799
Other lines of credit and commitments	**14,401,837**	13,119,812
Undisbursed construction loan commitments	**2,304,009**	3,096,022
	$ 26,763,340	$ 24,298,954
Standby letters of credit	**$ 1,541,362**	$ 1,957,729

Loan commitments and lines of credit are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments generally have interest rates fixed at current market rates, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time.

Letters of credit are commitments issued to guarantee the performance of a customer to a third party.

Loan commitments, lines of credit, and letters of credit are made on the same terms, including collateral, as outstanding loans. The Bank's exposure to credit loss in the event of nonperformance by the borrower is represented by the contract amount of the commitment. Management is not aware of any fact that could cause the Bank to incur an accounting loss as a result of funding these commitments.

The Company lends to customers located primarily in and near Kent County, Queen Anne's County, Cecil County, and Talbot County, Maryland. Although the loan portfolio is diversified, its performance will be influenced by the economy of the region.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

5. Premises and Equipment

A summary of premises and equipment and related depreciation expense as of December 31, is as follows:

	2016	2015
Land	$ 2,658,141	$ 1,773,232
Premises	4,827,711	4,283,662
Furniture and equipment	2,488,802	2,423,907
	9,974,654	8,480,801
Accumulated depreciation	4,217,258	4,097,546
Net premises and equipment	$ 5,757,396	$ 4,383,255
Depreciation expense	$ 274,592	$ 292,555

Computer software included in other assets and the related amortization are as follows:

	2016	2015
Cost	$ 256,530	$ 250,574
Accumulated amortization	229,270	200,860
Net computer software	$ 27,260	$ 49,714
Amortization expense	$ 29,841	$ 51,905

6 Intangibles and Goodwill

The Company recorded a $550,000 intangible asset and $272,932 in goodwill in connection with the Insurance Subsidiary acquisition in 2007. The intangible asset is fully amortizable on a straight-line basis over 10 years for financial statement purposes and 15 years for income tax purposes. Goodwill is not amortized, but is annually evaluated for impairment.

Information relating to intangible assets at December 31, is as follows:

	2016	2015
Intangible asset	$ 550,000	$ 550,000
Accumulated amortization	(550,000)	(495,000)
Net intangible asset	$ -	$ 55,000
Amortization expense	$ 55,000	$ 55,000
Estimated amortization expense:		
2017	$ -	

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

7. Other Time Deposits

Maturities of other time deposits as of December 31, are as follows:

	2016	2015
Within one year	**$ 10,321,479**	$ 19,445,271
Over one to two years	**11,610,683**	6,451,531
Over two to three years	**13,076,168**	12,334,190
Over three to four years	**12,319,066**	13,525,516
Over four to five years	**14,932,631**	15,670,898
Over five years	**9,721**	8,100
	$ 62,269,748	$ 67,435,506

Included in other time deposits are certificates of deposit in amounts of $250,000 or more of $4,054,892 and $1,451,143 as of December 31, 2016 and 2015, respectively.

8. Securities Sold Under Repurchase Agreements

Securities sold under repurchase agreements represent borrowings from customers. The government agency securities that are the collateral for these agreements are owned by the Bank and are maintained in the custody of an unaffiliated bank. Additional information is as follows:

	2016	2015
Maximum month-end amount outstanding	**$ 3,668,547**	$ 5,085,851
Average amount outstanding	**1,542,732**	1,740,438
Average rate paid during the year	**0.23%**	0.41%
Investment securities underlying agreements at year-end		
Book value	**2,173,592**	2,842,794
Fair value	**2,170,072**	2,841,318

9. Notes Payable and Lines of Credit

The Bank may borrow up to approximately $29,988,000 from the Federal Home Loan Bank (the "FHLB") through any combination of notes or line of credit advances. Both the notes payable and the line of credit are secured by a floating lien on all of the Bank's real estate mortgage loans. As of December 31, 2016, the Bank had $19,988,293 of mortgage loans available to pledge as collateral to the FHLB. The Bank was required to purchase shares of capital stock in the FHLB as a condition to obtaining the line of credit.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

9. Notes Payable and Lines of Credit (Continued)

The Bank's borrowings from the Federal Home Loan Bank as of December 31, 2016 and 2015, are summarized as follows:

Maturity date	Interest rate	**2016 Balance**	2015 Balance
January 26, 2017	4.36%	**$ 5,000,000**	$ 5,000,000
August 2, 2017	4.34%	**5,000,000**	5,000,000
		$10,000,000	$10,000,000

The outstanding advances require interest payments quarterly with principal due at maturity.

In addition to the borrowing capacity available from the FHLB, the Bank has a line of credit of $8,000,000 in secured overnight federal funds at December 31, 2016. As of December 31, 2016, the Bank had pledged mortgage loans totaling $5,349,565 to the Federal Reserve Bank of Richmond to provide a borrowing capacity of $3,763,408 under its discount window program.

10. Income Taxes

The components of income tax expense are as follows:

	2016	2015
Current		
Federal	**$ 27,127**	$ -
State	**45,382**	43,950
	72,509	43,950
Deferred	**704,288**	539,780
	$ 776,797	$ 583,730

The components of the deferred income tax expense (benefit) are as follows:

Allowance for loan losses and bad debts	**$ 355,005**	$ 236,670
Prepaid pension costs	**86,093**	46,400
Depreciation and amortization	**(3,378)**	(18,118)
Nonaccrual interest	**(38,153)**	(13,736)
Deferred compensation	**77,906**	2,019
Foreclosed real estate impairment	**158,446**	9,365
Net operating loss (NOL) and alternative minimum tax (AMT) carryovers	**68,369**	277,180
	$ 704,288	$ 539,780

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

10. Income Taxes (Continued)

The components of the net deferred income tax asset are as follows:

	2016	2015
Deferred income tax assets		
Allowance for loan losses	**$ 762,543**	$ 1,117,548
Deferred compensation	**105,391**	183,297
Pension liability	**319,590**	245,585
Nonaccrual interest	**131,965**	93,812
Foreclosed real estate impairment	**277,356**	435,802
Unrealized loss on investment securities available for sale	**44,892**	-
Income tax carryovers	**290,410**	358,779
	1,932,147	2,434,823
Deferred income tax liabilities		
Depreciation and amortization	**2,754**	6,132
Unrealized gain on investment securities available for sale	**-**	13,069
	2,754	19,201
Net deferred income tax asset	**$1,929,393**	$ 2,415,622

A reconciliation of the provisions for income taxes from statutory federal rates to effective rates follows:

	2016	2015
Tax at statutory federal income tax rate	**34.0 %**	34.0 %
Tax effect of		
Tax-exempt income	**(2.7)**	(3.6)
State income taxes, net of federal benefit	**5.2**	5.0
Other, net	**0.6**	0.6
	37.1 %	36.0 %

The Company has a net operating loss carryover of $90,616 for federal income taxes that begins to expire in 2032 and an alternative minimum tax credit carryover of $157,403 that can be used when the regular federal income tax exceeds tax computed using the AMT formula. The Company has not recorded a valuation allowance against the net deferred tax asset, based on the Company's assessment that it is more likely than not that the deferred tax asset will be realized in future periods. In evaluating the Company's ability to realize its net deferred tax asset, the Company considers all available positive and negative evidence, including operating results, ongoing tax planning, and forecasts of future taxable income.

The Company does not have material uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Company remains subject to examination of income tax returns for the years ending after December 31, 2012.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

11. Profit Sharing Plan

The Company has a profit sharing plan qualifying under section 401(k) of the Internal Revenue Code that covers all of the Company's employees with one year of service who have attained age 21. The Company matches 50% of employee contributions to the Plan, up to a maximum of 6% of pay. The Company may make discretionary contributions to the Plan in amounts approved by its Board of Directors. Plan expenses, included in employee benefits expense for 2016 and 2015, were $80,844 and $76,899, respectively.

12. Pension

The Bank has a defined benefit pension plan covering substantially all of the employees of the Bank. Benefits are based on years of service and the employee's highest average rate of earnings for five consecutive years during the final ten full years before retirement. The Bank's funding policy is to contribute annually the maximum amount that can be deducted for income tax purposes, determined using the projected unit credit cost method. As of March 22, 2013, the Bank has frozen the plan. Participant benefits stopped accruing as of the date of the freeze.

The following table sets forth the financial status of the plan at December 31:

	2016	2015
Change in plan assets		
Fair value of plan assets at beginning of year	**$3,118,313**	$3,120,582
Actual return on plan assets	**195,466**	24,701
Employer contribution	**250,000**	138,312
Benefits paid	**(86,256)**	(165,282)
Fair value of plan assets at end of year	**3,477,523**	3,118,313
Change in benefit obligation		
Projected benefit obligation at beginning of year	**3,740,151**	3,781,342
Service cost	**-**	-
Interest cost	**166,366**	166,441
Benefits paid	**(86,256)**	(165,282)
Actuarial loss (gain)	**467,478**	(42,350)
Projected benefit obligation at end of year	**4,287,739**	3,740,151
Funded status	**(810,216)**	(621,838)
Unrecognized net loss	**1,281,200**	875,322
Prepaid pension expense included in other assets	**$ 470,984**	$ 253,484
Accumulated benefit obligation	**$4,287,739**	$3,740,151

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. Pension (Continued)

Net pension expense includes the following components:

	2016	2015
Service cost	**$ -**	$ -
Interest cost	**166,366**	166,441
Expected return on assets	**(173,811)**	(170,891)
Amortization of prior service cost	**-**	-
Amortization of loss	**39,945**	25,377
Net pension expense	**$ 32,500**	$ 20,927

Assumptions used in the accounting for net pension expense were:

Discount rates	**4.50%**	4.50%
Rate of increase in compensation level	**N/A**	N/A
Long-term rate of return on assets	**5.50%**	5.50%

The Bank intends to contribute approximately $250,000 to the plan in 2017.

The plan's assets are allocated as follows at December 31:

	2016	2015
Equity securities	**39 %**	52 %
Fixed income securities	**61 %**	48 %
	100 %	100 %

The fair value of plan assets are considered to be valued using level 1 inputs.

Projected benefits expected to be paid from the plan are as follows:

Year	Amount
2017	$ 774,136
2018	79,819
2019	174,288
2020	235,149
2021	365,090
2022-2028	1,493,414

The long-term rate of return on assets assumption considers the current earnings on assets of the plan as well as the effects of asset diversification. The plan's investment strategy is to earn a reasonable return while safeguarding the benefits promised to employees. All assets of the plan are maintained in mutual funds with MML Investor services.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

13. Other Operating Expenses

Other operating expenses consist of the following:

	2016	2015
Advertising	**$ 57,261**	$ 51,858
Deposit services	**168,657**	160,864
Directors' fees	**136,242**	169,878
Insurance	**96,785**	110,844
Office supplies and printing	**96,042**	77,755
Postage	**103,023**	97,266
Public relations and contributions	**108,161**	73,895
Regulatory assessments	**186,302**	323,255
Telephone	**61,120**	55,445
Other	**354,945**	353,006
	$ 1,368,538	$ 1,474,066

14. Related-Party Transactions

In the normal course of banking business, loans are made to officers and directors of the Company as well as to companies and individuals affiliated with those officers and directors. The terms of these transactions are substantially the same as the terms provided to other borrowers entering into similar loan transactions. In the opinion of management, these loans are consistent with sound banking practices, are within regulatory lending limitations, and do not involve more than normal credit risk.

A summary of these loans is as follows:

	2016	2015
Beginning loan balances	**$ 2,729,268**	$ 2,603,276
Advances	**153,435**	1,637,286
Repayments	**(1,076,480)**	(978,151)
Change in related parties	**(7,314)**	(533,143)
Ending loan balances	**$ 1,798,909**	$ 2,729,268

In addition to the outstanding balances listed above, the officers and directors and their related interests had $494,731 and $2,379,973 in unused loans committed but not funded as of December 31, 2016 and 2015, respectively.

Deposits from officers and directors and their related interests were $4,071,412 and $7,057,534 as of December 31, 2016 and 2015, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. Capital Standards

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

The Basel III Capital Rules became effective for the Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the following table) of Common Equity Tier 1 capital, Tier 1 capital, and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

In connection with the adoption of the Basel III Capital Rules, the Bank elected to opt-out of the requirement to include accumulated other comprehensive income in Common Equity Tier 1 capital. Common Equity Tier 1 capital for the Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities and subject to transition provisions.

Under the revised prompt corrective action requirements, as of January 1, 2015, insured depository institutions are required to meet the following in order to qualify as "well capitalized:" (1) a common equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8%; (3) a total risk-based capital ratio of 10%; and (4) a Tier 1 leverage ratio of 5%. Management believes that, as of December 31, 2015, the Bank met all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were fully in effect.

The implementation of the capital conservation buffer began on January 1, 2016, at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to the Bank.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of December 31, 2016 and 2015, for the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2016 and 2015, based on the phase-in provisions of the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. Capital Standards (Continued)

As of December 31, 2016, the most recent notification from the FDIC has categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain ratios as set forth in the table. There have been no conditions or events since that notification that management believes have changed the Bank's category.

The FDIC, through formal or informal agreement, has the authority to require an institution to maintain higher capital ratios than those provided by statute, to be categorized as well capitalized under the regulatory framework for prompt corrective action.

	Actual		Minimum capital adequacy		To be well capitalized	
(in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2016						
Tier 1 leverage ratio	**$23,601**	**9.300%**	**$10,115**	**4.000%**	**$12,644**	**5.000%**
Tier 1 capital (to risk-weighted assets)	**$23,601**	**15.800%**	**$ 9,903**	**6.625%**	**$11,958**	**8.000%**
Common equity tier 1 capital ratio (to risk-weighted assets)	**$23,601**	**15.800%**	**$ 7,661**	**5.125%**	**$ 9,716**	**6.500%**
Total capital ratio (to risk-weighted assets)	**$25,501**	**17.100%**	**$12,892**	**8.625%**	**$14,948**	**10.000%**
December 31, 2015						
Tier 1 leverage ratio	$23,802	10.100%	$ 9,455	4.000%	$11,819	5.000%
Tier 1 capital (to risk-weighted assets)	$23,802	17.100%	$ 8,369	6.000%	$11,159	8.000%
Common equity tier 1 capital ratio (to risk-weighted assets)	$23,802	17.100%	$ 6,277	4.500%	$ 9,067	6.500%
Total capital ratio (to risk-weighted assets)	$25,591	18.300%	$11,159	8.000%	$13,949	10.000%

Tier 1 capital consists of common stock, additional paid capital, and undivided profits less disallowed deferred tax assets. Total capital includes a limited amount of the allowance for loan losses. In calculating risk-weighted assets, specified risk percentages are applied to each category of asset and off-balance sheet items.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

16. Other Real Estate Owned

Activity in other real estate owned is as follows:

	2016	2015
Beginning of year balance	**$ 2,991,492**	$ 3,968,504
Additions and improvements	**398,346**	43,876
Write downs	**(201,668)**	(89,500)
Proceeds from sales	**(1,444,486)**	(1,003,881)
Gain (loss) on sales	**252,142**	72,493
End of year balance	**$ 1,995,826**	$ 2,991,492

17. Fair Value Measures

The fair value of an asset or a liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. FASB ASC valuation techniques include the assumptions that market participants would use in pricing an asset or a liability. FASB ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 inputs – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

Level 2 inputs – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

Level 3 inputs – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. Fair Value Measures (Continued)

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the issuer's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Although management believes the Company's valuation methodologies are appropriate and consistent with those used by other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and, therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally coincides with the Company's monthly and quarterly valuation process.

Fair value measured on a recurring basis

The Company measures securities available for sale at fair value on a recurring basis. The following table summarizes securities available for sale measured at fair value on a recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value. If quoted prices are available in an active market for identical securities, securities are classified within Level 1 of the hierarchy. If quoted market prices are not available, the fair values are estimated using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. The Company has categorized its securities available for sale as follows:

December 31, 2016	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
Available for sale				
U.S. government agency	**$ -**	**$30,815,600**	**$ -**	**$30,815,600**
Mortgage-backed securities	**-**	**6,058,718**	**-**	**6,058,718**
	$ -	**$36,874,318**	**$ -**	**$36,874,318**
December 31, 2015				
Available for sale				
U.S. government agency	$ -	$15,003,890	$ -	$15,003,890
Mortgage-backed securities	-	7,770,324	-	7,770,324
	$ -	$22,774,214	$ -	$22,774,214

The fair values of investment securities are determined using market quotations, pricing models, quoted prices of securities with similar characteristics or discounted cash flows.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. Fair Value Measures (Continued)

Fair values on a nonrecurring basis

The Company's foreclosed real estate and impaired loans are measured at fair value on a nonrecurring basis, which means that the assets are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of reduced property value).

Other real estate owned measured at fair value on a nonrecurring basis is reported at the fair value of the property, assuming that the sale prices of the properties will be their current appraised values. Appraised values are estimated using Level 3 inputs based on observable market data and current property tax assessments. Impaired loans were measured at fair value during the same period and are reported at the fair value of the loan's collateral. Fair value is generally determined using Level 3 inputs based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds.

December 31, 2016	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
Other real estate owned	**$ -**	**$ -**	**$ 1,995,826**	**$ 1,995,826**
Impaired loans	**-**	**-**	**9,318,875**	**9,318,875**
	$ -	**$ -**	**$ 11,314,701**	**$ 11,314,701**
December 31, 2015				
Other real estate owned	$ -	$ -	$ 2,991,492	$ 2,991,492
Impaired loans	-	-	7,604,899	7,604,899
	$ -	$ -	$ 10,596,391	$ 10,596,391

FASB ASC Topic 825 requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or nonrecurring basis.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. Fair Value Measures (Continued)

The Company does not measure the fair value of any of its other financial assets or liabilities on a recurring or nonrecurring basis. The fair value of financial instruments and the carrying value of the instruments are as follows:

	December 31, 2016		December 31, 2015	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Investment securities held to maturity	**$ 127**	**$ 127**	$ 59,322	$ 58,862
Federal Home Loan Bank and CBB Financial Corp. stock	**701,100**	**701,100**	696,300	696,300
COLI and mutual funds	**-**	**-**	-	-
Loans, net	**156,306,289**	**156,674,394**	146,666,702	146,893,972
Financial liabilities				
Noninterest-bearing deposits	**$ 69,541,575**	**$ 69,541,575**	$ 57,469,558	$ 57,469,558
Interest-bearing deposits	**147,215,889**	**146,422,551**	144,845,387	144,011,176
Short-term borrowings	**2,180,252**	**2,180,252**	1,254,358	1,254,358
Federal Home Loan Bank advances	**10,000,000**	**10,134,592**	10,000,000	10,462,863

The fair value of investment securities held to maturity are determined using market quotations, pricing models, quoted prices of securities with similar characteristics or discounted cash flows.

The fair value of fixed-rate loans is estimated to be the present value of scheduled payments discounted using interest rates currently in effect. The fair value of variable-rate loans, including loans with a demand feature, is estimated to equal the carrying amount of the loan. The valuation of loans is adjusted for probable loan losses.

The fair value of interest-bearing checking, savings, and money market deposit accounts is equal to the carrying amount. The fair value of fixed-maturity time deposits and borrowings is estimated based on interest rates currently offered for deposits and borrowings of similar remaining maturities.

It is not practicable to estimate the fair value of outstanding loan commitments, unused lines of credit, and letters of credit.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

18. Parent Company Financial Information

The balance sheets, statements of income, and statements of cash flows for Peoples Bancorp, Inc. (Parent Only) follow:

Balance Sheets	December 31, 2016	2015
Assets		
Cash	**$ 288,395**	$ 386,408
Investment in Bank Subsidiary	**23,284,541**	23,959,734
Other assets	**8,817**	3,261
Total assets	**$ 23,581,753**	$ 24,349,403
Liabilities and Stockholders' Equity		
Other liabilities	**$ 7,358**	$ 13,346
Total liabilities	**7,358**	13,346
Stockholders' equity		
Common stock	**7,289,180**	7,795,120
Additional paid-in capital	**2,212,550**	2,920,866
Retained earnings	**14,917,414**	14,130,058
Accumulated other comprehensive income (loss)	**(844,749)**	(509,987)
Total stockholders' equity	**23,574,395**	24,336,057
Total liabilities and stockholders' equity	**$ 23,581,753**	$ 24,349,403

Statements of Income	Years Ended December 31, 2016	2015
Interest revenue	**$ 374**	$ 414
Dividends from Bank Subsidiary	**1,675,000**	-
Equity in undistributed income of Bank Subsidiary	**(340,430)**	1,041,085
	1,334,944	1,041,499
Expenses		
Professional fees	**9,708**	-
Other	**16,629**	10,012
	26,337	10,012
Income before income tax benefit	**1,308,607**	1,031,487
Income tax (benefit)	**(8,817)**	(3,263)
Net income	**$ 1,317,424**	$ 1,034,750

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

18. Parent Company Financial Information (Continued)

Statements of Cash Flows	Years Ended December 31, **2016**	2015
Cash flows from operating activities		
Interest and dividends received	**$ 1,675,374**	$ 414
Cash paid for operating expenses	**(29,063)**	(106,307)
	1,646,311	(105,893)
Cash flows from financing activities		
Dividends paid	**(530,068)**	-
Stock repurchase	**(1,214,256)**	-
	(1,744,324)	-
Net increase (decrease) in cash	**(98,013)**	(105,893)
Cash at beginning of year	**386,408**	492,301
Cash at end of year	**$ 288,395**	$ 386,408
Reconciliation of net income to net cash provided by operating activities		
Net income	**$ 1,317,424**	$ 1,034,750
Adjustments to reconcile net income to net cash provided by operating activities		
Undistributed net income of subsidiary	**340,431**	(1,041,085)
(Increase) decrease in other assets	**(5,556)**	-
Increase (decrease) in other liabilities	**(5,988)**	(99,558)
	$ 1,646,311	$ (105,893)

106 YEARS
OF
INDEPENDENT
COMMUNITY BANKING

MEMBER F.D.I.C.

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