

**Bank of Ocean City**

Financial Statements

December 31, 2017

# Bank of Ocean City

## Table of Contents

	<u>Page</u>
Report of Independent Auditors	1
Financial Statements	
Balance Sheets	2
Statements of Income	3
Statements of Comprehensive Income	4
Statements of Changes in Stockholders' Equity	5
Statements of Cash Flows	6 - 7
Notes to Financial Statements	8 - 27

The Board of Directors and Stockholders  
Bank of Ocean City  
Ocean City, Maryland

## **Report of Independent Auditors**

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

We have audited the accompanying financial statements of Bank of Ocean City, which comprise the balance sheets as of December 31, 2017, 2016, and 2015, and the related 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 financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

### ***Auditor's Responsibility***

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

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

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

### ***Opinion***

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Bank of Ocean City as of December 31, 2017, 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  
March 2, 2018

# Bank of Ocean City

## Balance Sheets

December 31,	2017	2016	2015
Assets			
Cash and due from banks	\$ 6,806,326	\$ 6,166,592	\$ 5,680,358
Interest-bearing deposits in other financial institutions	4,336,252	14,418,169	21,421,100
Federal funds sold	<u>6,232,908</u>	<u>6,586,503</u>	<u>7,634,877</u>
Cash and cash equivalents	17,375,486	27,171,264	34,736,335
Certificates of deposit in other financial institutions	4,570,505	8,070,362	19,062,831
Restricted stock at cost	352,650	347,800	310,500
Investment securities available for sale	1,473,172	1,292,694	1,078,679
Investment securities held to maturity (approximate fair value of \$75,425,532, \$77,500,386, and \$69,239,932)	76,739,489	79,084,050	69,552,171
Loans, less allowance for loan losses of \$1,707,309, \$1,456,314, and \$1,359,234	207,156,137	175,836,303	153,896,606
Premises and equipment	8,056,022	7,863,209	6,531,373
Accrued interest receivable	837,150	730,082	617,827
Deferred income taxes	-	-	24,308
Prepaid income taxes	-	147,518	24,377
Foreclosed real estate	-	-	200,000
Other assets	<u>790,542</u>	<u>277,997</u>	<u>268,694</u>
	<u>\$317,351,153</u>	<u>\$300,821,279</u>	<u>\$286,303,701</u>
Liabilities and Stockholders' Equity			
Deposits			
Noninterest-bearing	\$ 94,285,012	\$ 89,079,928	\$ 75,399,293
Interest-bearing	<u>189,162,660</u>	<u>179,829,526</u>	<u>181,200,922</u>
Total deposits	283,447,672	268,909,454	256,600,215
Accrued interest payable	32,335	29,075	35,938
Dividend payable	409,186	399,210	393,507
Deferred compensation payable	729,063	781,485	830,248
Deferred income taxes	69,309	114,510	-
Income taxes payable	35,871	-	-
Other liabilities	<u>396,205</u>	<u>366,243</u>	<u>401,801</u>
	<u>285,119,641</u>	<u>270,599,977</u>	<u>258,261,709</u>
Stockholders' equity			
Common stock, par value \$1 per share; authorized 800,000 shares; issued and outstanding 560,529 shares at December 31, 2017, and 570,300 shares at December 31, 2016, and 2015	560,529	570,300	570,300
Surplus	10,018,361	10,667,450	10,667,450
Undivided profits	20,585,668	18,201,461	16,151,748
Accumulated other comprehensive income	<u>1,066,954</u>	<u>782,091</u>	<u>652,494</u>
	<u>32,231,512</u>	<u>30,221,302</u>	<u>28,041,992</u>
	<u>\$317,351,153</u>	<u>\$300,821,279</u>	<u>\$286,303,701</u>

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

# Bank of Ocean City

## Statements of Income

Years Ended December 31,	2017	2016	2015
<b>Interest and dividend revenue</b>			
Loans, including fees	\$ 9,598,633	\$8,677,075	\$7,859,814
U.S. government agency securities	977,197	967,278	817,283
U.S. Treasury securities	38,857	38,858	35,175
State and municipal securities	14,875	16,662	19,309
Federal funds sold and interest-bearing deposits	347,845	266,509	153,161
Mortgage-backed securities	65,993	1,147	-
Equity securities	37,166	35,908	32,661
Total interest and dividend revenue	<u>11,080,566</u>	10,003,437	8,917,403
<b>Deposit interest expense</b>			
	<u>955,173</u>	942,703	862,011
Net interest income	<b>10,125,393</b>	9,060,734	8,055,392
<b>Provision for loan losses</b>			
	<u>203,591</u>	59,934	(7,862)
Net interest income after provision for loan losses	<u>9,921,802</u>	9,000,800	8,063,254
<b>Noninterest revenue</b>			
Service charges on deposit accounts	443,626	460,251	491,177
Card services	263,364	215,519	207,679
Casualty gain	-	-	32,843
Gain (loss) on disposition of premises and equipment	2,000	(2,834)	-
Loss on sale of foreclosed real estate	-	(29,394)	-
Other revenue	198,166	173,264	186,084
Total noninterest revenue	<u>907,156</u>	816,806	917,783
<b>Noninterest expenses</b>			
Salaries	2,721,223	2,478,806	2,430,796
Employee benefits	680,342	653,941	663,205
Occupancy	485,052	433,216	406,710
Furniture and equipment	216,354	215,348	218,248
Data processing	601,261	660,514	561,831
Other operating	1,289,561	1,316,901	1,267,431
Total noninterest expenses	<u>5,993,793</u>	5,758,726	5,548,221
Income before income taxes	<b>4,835,165</b>	4,058,880	3,432,816
Income taxes	<u>1,723,970</u>	1,467,382	1,260,809
<b>Net income</b>	<u>\$ 3,111,195</u>	<u>\$2,591,498</u>	<u>\$2,172,007</u>
Earnings per common share	<u>\$ 5.48</u>	<u>\$ 4.54</u>	<u>\$ 3.79</u>

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

# Bank of Ocean City

## Statements of Comprehensive Income

Years Ended December 31,	2017	2016	2015
<b>Net income</b>	<b><u>\$ 3,111,195</u></b>	<b><u>\$ 2,591,498</u></b>	<b><u>\$ 2,172,007</u></b>
<b>Other comprehensive income (loss)</b>			
Unrealized gain (loss) on investment securities available for sale	<b>180,478</b>	214,015	(147,550)
Income tax relating to unrealized gain (loss) on investment securities available for sale	<b><u>(71,190)</u></b>	<u>(84,418)</u>	<u>58,201</u>
Other comprehensive income (loss)	<b><u>109,288</u></b>	<u>129,597</u>	<u>(89,349)</u>
<b>Total comprehensive income</b>	<b><u><u>\$ 3,220,483</u></u></b>	<b><u><u>\$ 2,721,095</u></u></b>	<b><u><u>\$ 2,082,658</u></u></b>

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

## Bank of Ocean City

### Statements of Changes in Stockholders' Equity

	Common stock		Surplus	Undivided profits	Accumulated other comprehensive income	Total stockholders' equity
	Shares	Par value				
<b>Balance, December 31, 2014</b>	<b>575,000</b>	<b>\$575,000</b>	<b>\$10,897,750</b>	<b>\$14,516,498</b>	<b>\$ 741,843</b>	<b>\$26,731,091</b>
Net income	-	-	-	2,172,007	-	2,172,007
Unrealized loss on investment securities available for sale, net of income taxes of \$(58,201)	-	-	-	-	(89,349)	(89,349)
Stock repurchase	(4,700)	(4,700)	(230,300)	-	-	(235,000)
Cash dividend, \$0.94 per share	-	-	-	(536,757)	-	(536,757)
<b>Balance, December 31, 2015</b>	<b>570,300</b>	<b>570,300</b>	<b>10,667,450</b>	<b>16,151,748</b>	<b>652,494</b>	<b>28,041,992</b>
Net income	-	-	-	2,591,498	-	2,591,498
Unrealized gain on investment securities available for sale, net of income taxes of \$84,418	-	-	-	-	129,597	129,597
Cash dividend, \$0.95 per share	-	-	-	(541,785)	-	(541,785)
<b>Balance, December 31, 2016</b>	<b>570,300</b>	<b>570,300</b>	<b>10,667,450</b>	<b>18,201,461</b>	<b>782,091</b>	<b>30,221,302</b>
Net income	-	-	-	3,111,195	-	3,111,195
Unrealized gain on investment securities available for sale, including net income taxes of \$71,190	-	-	-	-	109,288	109,288
Reclassification due to the adoption of ASU No. 2018-02	-	-	-	(175,575)	175,575	-
Stock repurchase	(9,771)	(9,771)	(649,089)	-	-	(658,860)
Cash dividend, \$0.98 per share	-	-	-	(551,413)	-	(551,413)
<b>Balance, December 31, 2017</b>	<b><u>560,529</u></b>	<b><u>\$560,529</u></b>	<b><u>\$10,018,361</u></b>	<b><u>\$20,585,668</u></b>	<b><u>\$1,066,954</u></b>	<b><u>\$32,231,512</u></b>

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

# Bank of Ocean City

## Statements of Cash Flows

Years Ended December 31,	2017	2016	2015
<b>Cash flows from operating activities</b>			
Interest received	\$10,969,026	\$ 9,877,594	\$ 8,878,498
Fees and commissions received	907,156	878,428	854,940
Interest paid	(951,913)	(949,566)	(851,353)
Proceeds from sale of loans held for sale	-	-	1,305,327
Origination of loans held for sale	-	-	(897,000)
Cash paid to suppliers and employees	(6,223,463)	(5,618,621)	(5,185,993)
Income taxes paid	(1,656,972)	(1,536,123)	(1,204,804)
Cash provided by operating activities	<u>3,043,834</u>	<u>2,651,712</u>	<u>2,899,615</u>
<b>Cash flows from investing activities</b>			
(Purchases) redemptions of certificates of deposit, net	3,499,857	10,992,469	(17,059,607)
Proceeds from matured investment securities held to maturity	6,351,583	44,184,901	44,520,000
Purchase of investment securities held to maturity	(4,002,550)	(53,703,192)	(62,955,820)
Purchase of restricted stock, net	(13,000)	(37,300)	(18,700)
Loans made, net of principal repayments	(31,523,425)	(21,999,631)	(13,598,108)
Purchase of foreclosed real estate	-	-	(230,000)
Proceeds from sale of foreclosed real estate	-	163,806	-
Insurance proceeds for premises and equipment	-	-	38,662
Purchases of premises, equipment, and software	(489,998)	(1,590,993)	(326,966)
Cash used by investing activities	<u>(26,177,533)</u>	<u>(21,989,940)</u>	<u>(49,630,539)</u>
<b>Cash flows from financing activities</b>			
Net increase (decrease) in			
Time deposits	(4,872,515)	(9,666,682)	10,201,613
Other deposits	19,410,733	21,975,921	29,919,565
Repurchase of common stock	(658,860)	-	(235,000)
Dividends paid	(541,437)	(536,082)	(534,250)
Cash provided by financing activities	<u>13,337,921</u>	<u>11,773,157</u>	<u>39,351,928</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>(9,795,778)</b>	<b>(7,565,071)</b>	<b>(7,378,996)</b>
Cash and cash equivalents at beginning of year	<u>27,171,264</u>	<u>34,736,335</u>	<u>42,115,331</u>
<b>Cash and cash equivalents at end of year</b>	<b><u>\$17,375,486</u></b>	<b><u>\$27,171,264</u></b>	<b><u>\$34,736,335</u></b>

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



## Bank of Ocean City

### Statements of Cash Flows (Continued)

Years Ended December 31,	2017	2016	2015
<b>Reconciliation of net income to net cash provided by operating activities</b>			
Net income	\$3,111,195	\$2,591,498	\$2,172,007
<b>Adjustments to reconcile net income to net cash provided by operating activities</b>			
Amortization of investment premiums and accretion of discounts	(4,472)	(13,588)	136
Provision for loan losses	203,591	59,934	(7,862)
Depreciation and amortization	299,185	256,323	255,754
(Gain) loss on disposal of premises and equipment	(2,000)	2,834	-
(Gain) loss on sale of foreclosed real estate	-	29,394	-
Write-down of foreclosed real estate	-	6,800	30,000
Write-down of restricted stock	8,150	-	-
Casualty gain	-	-	(32,843)
Deferred income taxes	(73,731)	54,400	12,863
Deferred tax liability adjustment for change in corporate income tax rate	(42,660)	-	-
Decrease (increase) in			
Loans held for sale	-	-	408,327
Accrued interest receivable	(107,068)	(112,255)	(39,041)
Other assets and prepaid income taxes	(329,156)	(132,444)	162,451
Increase (decrease) in			
Accrued interest payable	3,260	(6,863)	10,658
Other liabilities and deferred compensation payable	(22,460)	(84,321)	(72,835)
 Cash provided by operating activities	 <u>\$3,043,834</u>	 <u>\$2,651,712</u>	 <u>\$2,899,615</u>
<b>Noncash investing activity</b>			
Real estate acquired through foreclosure	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 230,000</u>

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

# Bank of Ocean City

## Notes to Financial Statements

### 1. Summary of Significant Accounting Policies

The accounting and reporting policies reflected in the financial statements conform to accounting principles generally accepted in the United States of America and to general practices within the banking industry. Management makes estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions may affect the reported amounts of revenue and expenses during the reporting period. Actual results could differ from these estimates.

#### ***Business***

Bank of Ocean City provides a full range of banking services to customers located primarily in Worcester County, Maryland, Sussex County, Delaware, and the surrounding areas.

#### ***Cash and cash equivalents***

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

#### ***Certificates of deposit in other financial institutions***

Certificates of deposit in other financial institutions mature within one year and are carried at cost.

#### ***Restricted stock***

Restricted stock includes the Bank's investment in Federal Home Loan Bank of Atlanta stock, in the amount of **\$270,800**, \$257,800, and \$220,500, as of December 31, 2017, 2016, and 2015, respectively. As a member of the Federal Home Loan Bank, the Bank is required to purchase stock based on its total assets. The stock is recorded at cost on the balance sheet. The remaining balance of restricted stock represents investments in the common stock of two bankers' banks. During the year ended December 31, 2017, the Bank recognized an other than temporary impairment of **\$8,150** related to one of the restricted bankers' bank stocks.

#### ***Investment securities owned***

Management has classified all debt securities as held to maturity. Equity securities are classified as available for sale. 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 recorded at amortized cost, which is cost adjusted for amortization of premiums and accretion of discounts to maturity. Available for sale securities are recorded at fair value with unrealized gains and losses included in stockholders' equity on an after-tax basis. Premiums are amortized and discounts are accreted using the interest method.

Gains and losses on disposal are determined using the specific-identification method.

#### ***Loans and allowance for loan losses***

Loans are stated at face value less the allowance for loan losses. Interest on loans is accrued based on the principal amounts outstanding. The accrual of interest is discontinued when any portion of the principal or interest is 90 days past due and collateral is insufficient to discharge the debt in full. If collection of principal is evaluated as doubtful, all payments are applied to principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with contractual terms for a reasonable period of time, and the ultimate collectability of the total contractual principal and interest is no longer in doubt.

# Bank of Ocean City

## Notes to Financial Statements (Continued)

### 1. Summary of Significant Accounting Policies (Continued)

#### *Loans and allowance for loan losses* (Continued)

The Bank maintains an allowance that is adequate to provide for probable loan losses based on management's review and analysis of the loan portfolio as well as prevailing and anticipated economic conditions. The allowance consists of specific and general components. For loans that are classified as impaired, an allowance is established when the collateral value or the discounted cash flows of the impaired loan is lower than the carrying value of that loan. The general component covers pools of nonclassified loans and is based on historical loss experience adjusted for qualitative factors. There may be an unallocated component of the allowance, which reflects the margin of imprecision inherent in the underlying assumptions used in the methods for estimating specific and general losses in the portfolio. If the current economy or real estate market were to suffer a severe downturn, the estimate for uncollectible loans would need to be increased. Loan losses are charged to the allowance when management believes that collectability is unlikely. Collections of loans previously charged off are added to the allowance at the time of recovery.

Loans are considered impaired when, based on current information, management considers it unlikely that collection of principal and interest payments will be made according to contractual terms. Generally, loans are not reviewed for impairment until the accrual of interest has been discontinued, or they have been classified as substandard.

#### *Premises and equipment*

Premises and equipment are recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over the estimated useful lives of the assets. Expenditures for maintenance, repairs, and minor replacements are charged to operating expenses as incurred.

#### *Foreclosed real estate*

Real estate acquired through foreclosure is recorded at the lower of cost or fair value on the date acquired. In general, cost equals the Bank'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.

#### *Income taxes*

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

In December 2017, the President of the United States signed the Tax Cuts and Jobs Act of 2017. While a reduction in the federal corporate income tax rate from 34% to 21% will take effect in 2018, the enactment of the law in 2017 required the Bank to revalue its deferred tax assets and liabilities as of December 31, 2017. The Bank recorded a net income tax benefit of \$42,660 related to this revaluation as a reduction of income tax expense. Of this amount, \$175,575 of benefit was attributable to the Bank's deferred tax liability for unrealized gains on available for sale securities. In addition to adjusting the deferred tax liability for this benefit, the Bank recorded an adjustment to accumulated other comprehensive income with a transfer from undivided profits.

#### *Reclassification*

Certain amounts in the financial statements of prior years have been reclassified to conform with the current classifications.

#### *Subsequent events*

The Bank has evaluated events and transactions subsequent to December 31, 2017 through March 2, 2018, the date these financial statements were available to be issued. No significant subsequent events were identified that would affect the presentation of the financial statements.

# Bank of Ocean City

## Notes to Financial Statements (Continued)

### 2. Cash and Due From Banks

The Bank normally carries balances with other banks that exceed the federally insured limit. The average balance carried in excess of the limit, including unsecured federal funds sold to the same banks, was approximately **\$12,835,213** for 2017, \$15,595,659 for 2016, and \$14,883,969 for 2015.

Deposits held in noninterest-bearing transaction accounts are aggregated with any interest-bearing deposits the owner may hold in the same ownership 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.

### 3. Earnings Per Common Share

Earnings per common share are determined by dividing net income by the average number of shares outstanding. There were **567,757** average shares outstanding during the year ended December 31, 2017, 570,300 average shares outstanding during the year ended December 31, 2016, and 572,375 average shares outstanding during the year ended December 31, 2015. There are no dilutive shares.

### 4. Investment Securities

Investment securities are summarized as follows:

<b>December 31, 2017</b>	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<i>Available for sale</i>				
Equity securities	<u>\$ 1,156</u>	<u>\$1,472,016</u>	<u>\$ -</u>	<u>\$ 1,473,172</u>
<i>Held to maturity</i>				
U.S. Treasury	\$ 2,999,112	\$ -	\$ 6,732	\$ 2,992,380
U.S. government agency	67,972,786	-	1,270,514	66,702,272
State and municipal	<u>401,266</u>	<u>7,448</u>	<u>-</u>	<u>408,714</u>
	<u>71,373,164</u>	<u>7,448</u>	<u>1,277,246</u>	<u>70,103,366</u>
Mortgage-backed securities	<u>5,366,325</u>	<u>-</u>	<u>44,159</u>	<u>5,322,166</u>
	<u>\$76,739,489</u>	<u>\$ 7,448</u>	<u>\$1,321,405</u>	<u>\$75,425,532</u>
<hr/>				
December 31, 2016				
<i>Available for sale</i>				
Equity securities	<u>\$ 1,156</u>	<u>\$ 1,291,538</u>	<u>\$ -</u>	<u>\$ 1,292,694</u>
<i>Held to maturity</i>				
U.S. Treasury	\$ 2,997,755	\$ 7,737	\$ 2,562	\$ 3,002,930
U.S. government agency	73,966,311	9,700	1,622,557	72,353,454
State and municipal	<u>402,192</u>	<u>16,244</u>	<u>-</u>	<u>418,436</u>
	<u>77,366,258</u>	<u>33,681</u>	<u>1,625,119</u>	<u>75,774,820</u>
Mortgage-backed securities	<u>1,717,792</u>	<u>7,774</u>	<u>-</u>	<u>1,725,566</u>
	<u>\$ 79,084,050</u>	<u>\$ 41,455</u>	<u>\$ 1,625,119</u>	<u>\$ 77,500,386</u>

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 4. Investment Securities (Continued)

December 31, 2015	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<i>Available for sale</i>				
Equity securities	\$ 1,156	\$ 1,077,523	\$ -	\$ 1,078,679
<i>Held to maturity</i>				
U.S. Treasury	\$ 2,996,413	\$ 9,895	\$ 5,139	\$ 3,001,169
U.S. government agency	65,961,262	26,480	365,064	65,622,678
State and municipal	594,496	21,589	-	616,085
	<u>\$ 69,552,171</u>	<u>\$ 57,964</u>	<u>\$ 370,203</u>	<u>\$ 69,239,932</u>

Investment securities with unrealized losses for continuous periods of less than 12 months and 12 months or longer are as follows:

	Less than 12 months		12 months or longer		Total	
	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
<b>December 31, 2017</b>						
<i>Held to maturity</i>						
U.S. Treasury	\$ 1,997,340	\$ 2,250	\$ 995,040	\$ 4,482	\$ 2,992,380	\$ 6,732
U.S. government agency	1,999,300	700	64,702,972	1,269,814	66,702,272	1,270,514
Mortgage-backed securities	5,322,166	44,159	-	-	5,322,166	44,159
	<u>\$ 9,318,806</u>	<u>\$ 47,109</u>	<u>\$ 65,698,012</u>	<u>\$ 1,274,296</u>	<u>\$ 75,016,818</u>	<u>\$ 1,321,405</u>

December 31, 2016

<i>Held to maturity</i>						
U.S. Treasury	\$ -	\$ -	\$ 996,290	\$ 2,562	\$ 996,290	\$ 2,562
U.S. government agency	50,529,860	1,456,613	13,813,894	165,944	64,343,754	1,622,557
	<u>\$ 50,529,860</u>	<u>\$ 1,456,613</u>	<u>\$ 14,810,184</u>	<u>\$ 168,506</u>	<u>\$ 65,340,044</u>	<u>\$ 1,625,119</u>

December 31, 2015

<i>Held to maturity</i>						
U.S. Treasury	\$ 993,050	\$ 5,139	\$ -	\$ -	\$ 993,050	\$ 5,139
U.S. government agency	38,660,138	302,786	8,936,060	62,278	47,596,198	365,064
	<u>\$ 39,653,188</u>	<u>\$ 307,925</u>	<u>\$ 8,936,060</u>	<u>\$ 62,278</u>	<u>\$ 48,589,248</u>	<u>\$ 370,203</u>

Management has the ability and intent to hold these investments until maturity. The decline in fair value is the result of changes in interest rates, not a deterioration of the credit standing of the issuers.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 4. Investment Securities (Continued)

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

	2017		2016		2015	
	Amortized cost	Fair value	Amortized cost	Fair value	Amortized cost	Fair value
Maturing						
Within one year	\$14,198,637	\$14,147,542	\$ 2,000,000	\$ 2,001,780	\$ 2,188,845	\$ 2,178,458
Over one to five years	52,175,343	51,123,624	63,367,221	62,293,930	58,370,847	58,114,434
Over five to ten years	4,999,184	4,832,200	11,999,037	11,479,110	8,992,479	8,947,040
Mortgage-backed securities	<u>5,366,325</u>	<u>5,322,166</u>	<u>1,717,792</u>	<u>1,725,566</u>	<u>-</u>	<u>-</u>
	<u>\$76,739,489</u>	<u>\$75,425,532</u>	<u>\$79,084,050</u>	<u>\$77,500,386</u>	<u>\$69,552,171</u>	<u>\$69,239,932</u>
Pledged securities	<u>\$15,992,075</u>	<u>\$15,814,940</u>	<u>\$15,990,075</u>	<u>\$15,890,349</u>	<u>\$13,994,990</u>	<u>\$13,958,740</u>

There were no sales of investment securities in 2017, 2016, and 2015.

Investments are pledged as of December 31, 2017, 2016, and 2015, as collateral for government deposits and Federal Reserve Bank borrowings.

#### 5. Loans and Allowance for Loan Losses

Major classifications of loans are as follows:

	2017	2016	2015
Real estate			
Residential	\$ 58,050,389	\$ 48,363,904	\$ 42,066,441
Commercial	113,712,987	93,636,580	87,764,178
Construction, land development, and land	18,039,490	19,497,335	13,178,678
Commercial	17,196,879	13,887,320	10,227,093
Consumer	<u>1,863,701</u>	<u>1,907,478</u>	<u>2,019,450</u>
	<u>208,863,446</u>	<u>177,292,617</u>	<u>155,255,840</u>
Allowance for loan losses	<u>1,707,309</u>	<u>1,456,314</u>	<u>1,359,234</u>
Loans, net	<u>\$207,156,137</u>	<u>\$175,836,303</u>	<u>\$153,896,606</u>

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 5. Loans and Allowance for Loan Losses (Continued)

The loan portfolio, as of December 31, 2017, 2016, and 2015, will mature or reprice as follows:

	2017	2016	2015
Within three months	<b>\$ 15,415,934</b>	\$ 16,020,491	\$ 11,327,737
After three months, within one year	<b>52,165,450</b>	53,261,811	54,616,691
After one year, within five years	<b>105,765,373</b>	68,608,416	52,607,552
After five years	<b>35,516,689</b>	39,401,899	36,703,860
	<b><u>\$208,863,446</u></b>	<u>\$177,292,617</u>	<u>\$155,255,840</u>

Transactions in the allowance for loan losses for the year ended December 31, 2017, 2016, and 2015, were as follows:

December 31, 2017	Beginning balance	Provision for loan losses	Charge offs	Recoveries	Ending balance	Allowance for loan losses ending balance evaluated		Outstanding loan balances evaluated	
						Individually	Collectively	Individually	Collectively
Real estate									
Residential	\$ 389,876	\$ 68,263	\$ -	\$ 1,200	\$ 459,339	\$ 45,005	\$ 414,334	\$346,001	\$ 57,704,388
Commercial	766,132	106,673	-	47,300	920,105	-	920,105	-	113,712,987
Construction, land development, and land	148,826	4,541	-	-	153,367	-	153,367	-	18,039,490
Commercial	94,058	25,974	-	-	120,032	-	120,032	-	17,196,879
Consumer	57,422	(3,886)	(8,618)	7,522	52,440	13,015	39,425	13,015	1,850,686
Unallocated	-	2,026	-	-	2,026	-	2,026	-	-
	<u>\$1,456,314</u>	<u>\$203,591</u>	<u>\$ (8,618)</u>	<u>\$ 56,022</u>	<u>\$1,707,309</u>	<u>\$ 58,020</u>	<u>\$1,649,289</u>	<u>\$359,016</u>	<u>\$208,504,430</u>
<hr/>									
December 31, 2016									
Real estate									
Residential	\$ 336,911	\$ 52,965	\$ -	\$ -	\$ 389,876	\$ 14,494	\$ 375,382	\$207,644	\$ 48,156,260
Commercial	767,042	(51,610)	-	50,700	766,132	12,183	753,949	82,783	93,553,797
Construction, land development, and land	102,077	46,749	-	-	148,826	-	148,826	-	19,497,335
Commercial	115,436	(22,080)	-	702	94,058	-	94,058	-	13,887,320
Consumer	36,012	35,666	(25,196)	10,940	57,422	17,423	39,999	17,383	1,890,095
Unallocated	1,756	(1,756)	-	-	-	-	-	-	-
	<u>\$1,359,234</u>	<u>\$ 59,934</u>	<u>\$ (25,196)</u>	<u>\$ 62,342</u>	<u>\$1,456,314</u>	<u>\$ 44,100</u>	<u>\$1,412,214</u>	<u>\$307,810</u>	<u>\$176,984,807</u>
<hr/>									
December 31, 2015									
Real estate									
Residential	\$ 388,188	\$ (85,469)	\$ -	\$ 34,192	\$ 336,911	\$ 19,000	\$ 335,911	\$212,440	\$ 41,854,001
Commercial	776,299	49,061	(76,543)	18,225	767,042	18,000	731,042	89,322	87,674,856
Construction, land development, and land	103,085	(1,008)	-	-	102,077	-	102,077	-	13,178,678
Commercial	85,338	30,098	-	-	115,436	-	115,436	-	10,227,093
Consumer	31,324	51,700	(48,538)	1,526	36,012	-	36,012	-	2,019,450
Unallocated	54,000	(52,244)	-	-	1,756	-	1,756	-	-
	<u>\$1,438,234</u>	<u>\$ (7,862)</u>	<u>\$(125,081)</u>	<u>\$ 53,943</u>	<u>\$1,359,234</u>	<u>\$ 37,000</u>	<u>\$1,322,234</u>	<u>\$301,762</u>	<u>\$154,954,078</u>

# Bank of Ocean City

## Notes to Financial Statements (Continued)

### 5. Loans and Allowance for Loan Losses (Continued)

Past due loans, segregated by age and class of loans, as of December 31, 2017, 2016, and 2015, were as follows:

	Loans			Total past due loans	Current loans	Total loans	Accruing	Nonaccrual loans	Nonaccrual
	Loans 30-59 days past due	Loans 60-89 days past due	Loans 90 or more days past due				loans 90 or more days past due		interest not accrued
<b>December 31, 2017</b>									
Real estate									
Residential	\$ 489,779	\$ 337,703	\$ -	\$ 827,482	\$ 57,222,907	\$ 58,050,389	\$ -	\$ -	\$ -
Commercial	165,372	-	-	165,372	113,547,615	113,712,987	-	-	-
Construction, land development, and land	45,496	-	43,728	89,224	17,950,266	18,039,490	43,728	-	-
Commercial	199,945	26,093	-	226,038	16,970,841	17,196,879	-	-	-
Consumer	5,091	-	-	5,091	1,858,610	1,863,701	-	-	-
	<u>\$ 905,683</u>	<u>\$ 363,796</u>	<u>\$ 43,728</u>	<u>\$ 1,313,207</u>	<u>\$ 207,550,239</u>	<u>\$ 208,863,446</u>	<u>\$ 43,728</u>	<u>\$ -</u>	<u>\$ -</u>
<b>December 31, 2016</b>									
Real estate									
Residential	\$3,432,111	\$ 11,160	\$ 22,213	\$ 3,465,484	\$ 44,898,420	\$ 48,363,904	\$ 22,213	\$ -	\$ -
Commercial	176,588	-	-	176,588	93,459,992	93,636,580	-	-	-
Construction, land development, and land	48,241	62,958	-	111,199	19,386,136	19,497,335	-	-	-
Commercial	5,374	83,957	-	89,331	13,797,989	13,887,320	-	-	-
Consumer	830	-	-	830	1,906,648	1,907,478	-	-	-
	<u>\$3,663,144</u>	<u>\$ 158,075</u>	<u>\$ 22,213</u>	<u>\$ 3,843,432</u>	<u>\$ 173,449,185</u>	<u>\$ 177,292,617</u>	<u>\$ 22,213</u>	<u>\$ -</u>	<u>\$ -</u>
<b>December 31, 2015</b>									
Real estate									
Residential	\$ 915,687	\$ -	\$ -	\$ 915,687	\$ 41,150,754	\$ 42,066,441	\$ -	\$ -	\$ -
Commercial	121,748	-	-	121,748	87,642,430	87,764,178	-	-	-
Construction, land development, and land	534,999	-	80,782	615,781	12,562,897	13,178,678	-	80,782	4,989
Commercial	41,861	-	-	41,861	10,185,232	10,227,093	-	-	-
Consumer	4,209	271	-	4,480	2,014,970	2,019,450	-	-	-
	<u>\$1,618,504</u>	<u>\$ 271</u>	<u>\$ 80,782</u>	<u>\$ 1,699,557</u>	<u>\$ 153,556,283</u>	<u>\$ 155,255,840</u>	<u>\$ -</u>	<u>\$ 80,782</u>	<u>\$4,989</u>



## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 5. Loans and Allowance for Loan Losses (Continued)

Impaired loans include loans that have been assessed for impairment, although management may determine that the loan does not require a specific reserve. Impaired loans as of December 31, 2017, 2016, and 2015, were as follows:

<b>December 31, 2017</b>	Unpaid contractual principal balance	Recorded investment with no allowance	Recorded investment with allowance	Total recorded investment	Related allowance	Average recorded investment	Interest recognized
Real estate							
Residential	\$346,001	\$ -	\$346,001	\$346,001	\$45,005	\$352,898	\$37,024
Commercial	-	-	-	-	-	-	-
Construction, land development, and land	-	-	-	-	-	-	-
Commercial	-	-	-	-	-	-	-
Consumer	<u>13,015</u>	<u>-</u>	<u>13,015</u>	<u>13,015</u>	<u>13,015</u>	<u>15,047</u>	<u>1,218</u>
	<u><u>\$359,016</u></u>	<u><u>\$ -</u></u>	<u><u>\$359,016</u></u>	<u><u>\$359,016</u></u>	<u><u>\$58,020</u></u>	<u><u>\$367,945</u></u>	<u><u>\$38,242</u></u>
December 31, 2016							
Real estate							
Residential	\$ 207,644	\$ -	\$ 207,644	\$ 207,644	\$ 14,494	\$ 209,824	\$ 13,170
Commercial	82,783	-	82,783	82,783	12,183	85,951	6,930
Construction, land development, and land	-	-	-	-	-	-	-
Commercial	-	-	-	-	-	-	-
Consumer	<u>17,383</u>	<u>-</u>	<u>17,383</u>	<u>17,383</u>	<u>17,423</u>	<u>9,124</u>	<u>610</u>
	<u><u>\$ 307,810</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 307,810</u></u>	<u><u>\$ 307,810</u></u>	<u><u>\$ 44,100</u></u>	<u><u>\$ 304,899</u></u>	<u><u>\$ 20,710</u></u>
December 31, 2015							
Real estate							
Residential	\$ 212,440	\$ -	\$ 212,440	\$ 212,440	\$ 19,000	\$ 216,163	\$ 14,761
Commercial	89,322	-	89,322	89,322	18,000	92,725	7,687
Construction, land development, and land	-	-	-	-	-	-	-
Commercial	-	-	-	-	-	-	-
Consumer	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>	<u>-</u>
	<u><u>\$ 301,762</u></u>	<u><u>\$ -</u></u>	<u><u>\$ 301,762</u></u>	<u><u>\$ 301,762</u></u>	<u><u>\$ 37,000</u></u>	<u><u>\$ 308,888</u></u>	<u><u>\$ 22,448</u></u>

The Bank was not committed to advance any funds in connection with impaired loans at December 31, 2017, 2016, or 2015.

# Bank of Ocean City

## Notes to Financial Statements (Continued)

### 5. Loans and Allowance for Loan Losses (Continued)

#### *Credit quality indicators*

As part of the ongoing monitoring of the credit quality of the Bank's loan portfolio, management tracks certain credit quality indicators including trends related to the risk grade of loans, the level of classified loans, net charge-offs, nonperforming loans, and the general economic conditions in the Bank's market.

The Bank utilizes a risk grading matrix to assign a risk grade to each of its loans. A description of the general characteristics of loans characterized as watch list or classified is as follows:

#### *Pass/Watch*

Loans graded as Pass/Watch are secured by generally acceptable assets which reflect above-average risk. The loans warrant closer scrutiny by management than is routine, due to circumstances affecting the borrower, the borrower's industry, or the overall economic environment. Borrowers may reflect weaknesses such as inconsistent or weak earnings, break even or moderately deficit cash flow, thin liquidity, minimal capacity to increase leverage, or volatile market fundamentals or other industry risks. Such loans are typically secured by acceptable collateral, at or near appropriate margins, with realizable liquidation values.

#### *Special mention*

A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the Bank's credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Borrowers may exhibit poor liquidity and leverage positions resulting from generally negative cash flow or negative trends in earnings. Access to alternative financing may be limited to finance companies for business borrowers and may be unavailable for commercial real estate borrowers.

#### *Substandard*

A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard loans have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Borrowers may exhibit recent or unexpected unprofitable operations, an inadequate debt service coverage ratio, or marginal liquidity and capitalization. These loans require more intense supervision by Bank management.

#### *Doubtful*

A doubtful loan has all the weaknesses inherent as a substandard loan with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 5. Loans and Allowance for Loan Losses (Continued)

The following tables present the December 31, 2017, 2016, and 2015, balances of loans by risk grade.

<b>December 31, 2017</b>	Pass/ Watch	Special Mention	Substandard	Doubtful	Total
Real estate					
Residential	\$ 6,981	\$ -	\$ 772,834	\$ -	\$ 779,815
Commercial	-	-	168,710	-	168,710
Construction, land development, and land	-	-	89,224	-	89,224
Commercial	-	-	3,647	-	3,647
Consumer	-	-	-	-	-
	<u>\$ 6,981</u>	<u>\$ -</u>	<u>\$ 1,034,415</u>	<u>\$ -</u>	<u>\$ 1,041,396</u>
<hr/>					
December 31, 2016					
Real estate					
Residential	\$ 230,194	\$ -	\$ 801,185	\$ -	\$ 1,031,379
Commercial	-	-	259,371	-	259,371
Construction, land development, and land	-	48,241	-	-	48,241
Commercial	-	-	7,486	-	7,486
Consumer	-	-	18,514	-	18,514
	<u>\$ 230,194</u>	<u>\$ 48,241</u>	<u>\$ 1,086,556</u>	<u>\$ -</u>	<u>\$ 1,364,991</u>
<hr/>					
December 31, 2015					
Real estate					
Residential	\$ 143,682	\$ -	\$ 596,284	\$ -	\$ 739,966
Commercial	-	-	271,561	-	271,561
Construction, land development, and land	-	50,361	-	-	50,361
Commercial	-	-	2,794	-	2,794
Consumer	508	203,113	-	-	203,621
	<u>\$ 144,190</u>	<u>\$ 253,474</u>	<u>\$ 870,639</u>	<u>\$ -</u>	<u>\$ 1,268,303</u>

Classified loans also include certain loans that have been modified in troubled debt restructurings (TDRs) where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Bank's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 5. Loans and Allowance for Loan Losses (Continued)

The status of TDRs as of December 31, 2017, 2016, and 2015, follows:

<b>December 31, 2017</b>	Number of contracts	Pre-modification recorded investment	December 31, 2016 recorded investment		Total
			Performing	Nonperforming	
Real estate					
Residential	3	\$ 379,095	\$ 148,578	\$ 197,423	\$ 346,001
Commercial	-	-	-	-	-
Construction, land development, and land	-	-	-	-	-
Commercial	-	-	-	-	-
Consumer	1	19,100	13,015	-	13,015
	4	\$ 398,195	\$ 161,593	\$ 197,423	\$ 359,016

December 31, 2016	Number of contracts	Pre-modification recorded investment	December 31, 2016 recorded investment		Total
			Performing	Nonperforming	
Real estate					
Residential	4	\$ 532,245	\$ 504,796	\$ -	\$ 504,796
Commercial	-	-	-	-	-
Construction, land development, and land	-	-	-	-	-
Commercial	-	-	-	-	-
Consumer	1	19,100	17,383	-	17,383
	5	\$ 551,345	\$ 522,179	\$ -	\$ 522,179

December 31, 2015	Number of contracts	Pre-modification recorded investment	December 31, 2015 recorded investment		Total
			Performing	Nonperforming	
Real estate					
Residential	4	\$ 1,059,123	\$ 1,105,924	\$ -	\$ 1,105,924
Commercial	-	-	-	-	-
Construction, land development, and land	-	-	-	-	-
Commercial	-	-	-	-	-
Consumer	-	-	-	-	-
	4	\$ 1,059,123	\$ 1,105,924	\$ -	\$ 1,105,924

The Bank did not classify any loans as TDRs during 2017. The Bank classified one consumer loan totaling \$19,100 as a TDR during 2016. The Bank classified one residential real estate loan totaling \$151,796 as a TDR during 2015. There were no loans secured by 1-4 family residential properties in the process of foreclosure at December 31, 2017, 2016, or 2015.

The Bank lends to customers located primarily in the Delmarva region. Although the loan portfolio is diversified, its performance will be influenced by the economy of the region.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 6. Credit Commitments

The following credit commitments are outstanding as of December 31:

	2017	2016	2015
Mortgage and other loans	\$ 3,715,000	\$ 5,133,000	\$ 17,947,353
Construction loans	5,657,909	5,846,580	5,849,981
Lines of credit	<u>13,822,083</u>	<u>12,311,304</u>	<u>15,271,771</u>
	<u>\$ 23,194,992</u>	<u>\$ 23,290,884</u>	<u>\$ 39,069,105</u>
 Standby letters of credit	 <u>\$ 564,695</u>	 <u>\$ 869,598</u>	 <u>\$ 1,133,488</u>

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 fixed interest 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 accounting loss the Bank will incur by funding these commitments.

#### 7. Premises and Equipment

A summary of premises and equipment and the related depreciation is as follows:

	Estimated useful lives	2017	2016	2015
Land		\$ 3,789,458	\$ 3,545,673	\$ 3,534,140
Buildings and improvements	5 - 40 years	5,516,354	5,393,576	4,081,806
Furniture and equipment	3 - 20 years	<u>2,083,336</u>	<u>1,983,526</u>	<u>1,963,882</u>
		<u>11,389,148</u>	10,922,775	9,579,828
Accumulated depreciation		<u>3,333,126</u>	<u>3,059,566</u>	<u>3,048,455</u>
Net premises and equipment		<u>\$ 8,056,022</u>	<u>\$ 7,863,209</u>	<u>\$ 6,531,373</u>
 Depreciation expense		 <u>\$ 299,185</u>	 <u>\$ 256,323</u>	 <u>\$ 255,754</u>

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 7. Premises and Equipment (Continued)

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

	Estimated useful lives	2017	2016	2015
Cost	3 years	\$ 52,998	\$ 52,998	\$ 52,998
Accumulated amortization		<u>52,998</u>	<u>52,998</u>	<u>52,998</u>
Net computer software		<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Amortization expense		<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>

#### 8. Lease Commitments

The Bank leased a branch office building. The lease had a five-year term beginning January 1, 2009. The Bank exercised a five-year renewal option beginning January 1, 2014. The Bank abandoned the leased space in October 2016 when the Fenwick branch was opened and has no remaining obligation to the landlord as of December 31, 2017.

Rent expense for 2017, 2016, and 2015 was **\$76,895**, \$50,248, and \$49,977, respectively.

#### 9. Interest-Bearing Deposits

Major classifications of interest-bearing deposits are as follows:

	2017	2016	2015
Money market	\$ 86,630,594	\$ 78,233,214	\$ 77,659,178
Savings and NOW	65,223,611	59,375,324	51,645,102
Certificates of deposit, \$250,000 or more	5,145,873	6,013,834	14,848,155
Other time deposits	<u>32,162,582</u>	<u>36,207,154</u>	<u>37,048,487</u>
	<u>\$189,162,660</u>	<u>\$179,829,526</u>	<u>\$181,200,922</u>

Maturities of time deposits are as follows:

	2017
Within one year	\$ 13,846,334
One year to within two years	6,531,066
Two years to within three years	5,344,316
Three years to within four years	5,516,063
Four years to within five years	5,914,489
Five years and longer	<u>156,187</u>
Total	<u>\$ 37,308,455</u>

# Bank of Ocean City

## Notes to Financial Statements (Continued)

### 10. Available Lines of Credit

The Bank has available lines of credit of \$9,500,000 in overnight federal funds and an \$8,000,000 secured federal funds facility from other banks. The Bank also has access to certificate of deposit funding through a financial network. The funding is limited to 15% of the Bank's assets, or approximately \$50,705,850 as of December 31, 2017.

As of December 31, 2017, the Bank has pledged investment securities to the Federal Reserve Bank of Richmond to provide a borrowing capacity totaling approximately \$4,898,778 under its discount window program. There were no outstanding advances under this facility at December 31, 2017.

### 11. Related-Party Transactions

In the normal course of banking business, loans are made to senior management and directors of the Bank. 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:

	2017	2016	2015
Beginning of year balance	\$ 4,112,017	\$2,887,263	\$8,309,177
Advances	307,500	2,142,900	408,904
Repayments	(796,152)	(918,146)	(4,114,838)
Change in related parties	-	-	(1,715,980)
End of year balance	<u>\$ 3,623,365</u>	<u>\$4,112,017</u>	<u>\$2,887,263</u>

Deposits from senior management and directors and their related interests were **\$8,251,089** as of December 31, 2017, \$5,010,513 as of December 31, 2016, and \$7,159,666 as of December 31, 2015.

During the years ended December 31, 2016 and 2015, a director's law firm provided professional services to the Bank. The Bank paid \$1,980 and \$10,487, respectively, for these services. The Bank did not make any payments to the director's law firm during the year ended December 31, 2017.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 12. Other Operating Expenses

Other operating expenses consist of the following:

	2017	2016	2015
Communications	\$ 161,511	\$ 168,770	\$ 187,236
Director and secretary fees	150,400	147,600	119,492
FDIC insurance	137,810	158,605	166,993
Professional fees	123,445	92,722	103,141
Supplies	99,032	95,805	81,037
Charitable contributions	79,474	112,809	55,145
Postage and freight	59,190	55,365	56,616
Dues and subscriptions	49,667	41,846	38,681
Advertising	44,844	39,786	42,534
Software amortization and licenses	43,338	37,442	35,549
Correspondent bank fees	43,325	43,776	42,133
Education	41,347	43,624	44,335
Armored car and courier	36,372	34,720	32,109
Insurance	32,356	31,017	29,672
Loan processing fees	6,365	28,588	32,709
Foreclosed real estate write-down	-	6,800	30,000
Other	181,085	177,626	170,049
	<u>\$ 1,289,561</u>	<u>\$ 1,316,901</u>	<u>\$ 1,267,431</u>

#### 13. Retirement Plans

In 2006, the Bank adopted a nonqualified retirement plan for a retired executive. The plan specified an annual salary deferral of \$70,099 through retirement, plus interest of 6% annually on the balance deferred. The Bank has a separate nonqualified retirement plan for another retired executive. The expense related to the two plans was \$44,480, \$48,139, and \$50,621 for the years ended December 31, 2017, 2016, and 2015, respectively.

The Bank has a money purchase retirement plan, which covers essentially all employees. The contributions to the Plan were \$136,819, \$116,667, and \$117,404 for the years ended December 31, 2017, 2016, and 2015, respectively. The Bank makes matching and discretionary contributions in accordance with the Plan document.



## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 14. Income Taxes

The components of income tax expense are as follows:

	2017	2016	2015
Current			
Federal	\$ <b>1,545,232</b>	\$ 1,183,808	\$ 1,052,215
State	<u>295,129</u>	<u>229,174</u>	<u>195,731</u>
	<b>1,840,361</b>	1,412,982	1,247,946
Change in corporate income tax rate	<b>(42,660)</b>	-	-
Deferred	<u>(73,731)</u>	<u>54,400</u>	<u>12,863</u>
	<b>\$ 1,723,970</b>	<b>\$ 1,467,382</b>	<b>\$ 1,260,809</b>

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

Provision for loan losses	\$ <b>(80,306)</b>	\$ (23,641)	\$ 3,101
Foreclosed real estate write-down	-	11,834	(11,834)
Deferred casualty gain	-	-	14,718
Depreciation	<b>(14,078)</b>	45,005	(13,168)
Nonaccrual interest	-	1,968	1,790
Nonqualified retirement plans	<u>20,653</u>	<u>19,234</u>	<u>18,256</u>
	<b>\$ (73,731)</b>	<b>\$ 54,400</b>	<b>\$ 12,863</b>

The components of the net deferred tax asset (liability) are as follows:

Deferred tax assets			
Allowance for loan losses	\$ <b>233,488</b>	\$ 254,387	\$ 230,746
Foreclosed real estate write-downs	-	-	11,834
Nonaccrual interest	-	-	1,968
Nonqualified retirement plans	<u>200,620</u>	<u>308,257</u>	<u>327,491</u>
	<b>434,108</b>	<u>562,644</u>	<u>572,039</u>
Deferred tax liabilities			
Deferred casualty gain	<b>10,268</b>	14,718	14,718
Depreciation	<b>88,087</b>	152,989	107,984
Unrealized gain on investment securities available for sale	<u>405,062</u>	<u>509,447</u>	<u>425,029</u>
	<b>503,417</b>	<u>677,154</u>	<u>547,731</u>
Net deferred tax asset (liability)	<b>\$ (69,309)</b>	<b>\$ (114,510)</b>	<b>\$ 24,308</b>

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 14. Income Taxes (Continued)

A reconciliation of the provision for income taxes from the statutory federal income tax rate to the effective income tax rates follows:

	2017	2016	2015
Tax at statutory federal income tax rate	<b>34.0 %</b>	34.0 %	34.0 %
Tax effect of			
Tax-exempt income	<b>(1.2)</b>	(1.6)	(1.2)
State income tax, net of federal benefit	<b>3.8</b>	3.7	3.8
Change in corporate income tax rate	<b>(0.9)</b>	3.7	3.8
Other	<b>-</b>	0.1	0.1
Income tax expense	<b>35.7 %</b>	39.9 %	40.5 %

The Bank does not have material uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Bank remains subject to examination for income tax returns for the years ending after December 31, 2013.

#### 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 table below) 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, if any, 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%.

The implementation of the capital conservation buffer began on January 1, 2016, at the 0.625% level and is to 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. Management believes that, as of December 31, 2017, 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.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 15. Capital Standards (Continued)

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, 2017, 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, 2017, 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.

As of December 31, 2017, 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.

(in thousands)	Actual		Minimum capital adequacy		To be well capitalized	
<b>December 31, 2017</b>	Amount	Ratio	Amount	Ratio	Amount	Ratio
Tier 1 leverage ratio	<b>\$31,164</b>	<b>9.49%</b>	<b>\$13,132</b>	<b>4.00%</b>	<b>\$16,415</b>	<b>5.00%</b>
Tier 1 capital (to risk-weighted assets)	<b>\$31,164</b>	<b>14.32%</b>	<b>\$15,780</b>	<b>7.25%</b>	<b>\$17,412</b>	<b>8.00%</b>
Common equity tier 1 capital ratio (to risk-weighted assets)	<b>\$31,164</b>	<b>14.32%</b>	<b>\$12,515</b>	<b>5.75%</b>	<b>\$14,147</b>	<b>6.50%</b>
Total capital ratio (to risk-weighted assets)	<b>\$33,533</b>	<b>15.41%</b>	<b>\$20,133</b>	<b>9.25%</b>	<b>\$21,765</b>	<b>10.00%</b>
<b>December 31, 2016</b>						
Tier 1 leverage ratio	\$ 29,439	9.23%	\$ 12,757	4.00%	\$ 15,946	5.00%
Tier 1 capital (to risk-weighted assets)	\$ 29,439	15.33%	\$ 12,723	6.63%	\$ 15,364	8.00%
Common equity tier 1 capital ratio (to risk-weighted assets)	\$ 29,439	15.33%	\$ 9,843	5.13%	\$ 12,483	6.50%
Total capital ratio (to risk-weighted assets)	\$ 31,476	16.39%	\$ 16,564	8.63%	\$ 19,205	10.00%
<b>December 31, 2015</b>						
Tier 1 leverage ratio	\$ 27,390	9.27%	\$ 11,816	4.00%	\$ 14,770	5.00%
Tier 1 capital (to risk-weighted assets)	\$ 27,390	15.87%	\$ 10,357	6.00%	\$ 13,807	8.00%
Common equity tier 1 capital ratio (to risk-weighted assets)	\$ 27,390	15.87%	\$ 7,767	4.50%	\$ 11,220	6.50%
Total capital ratio (to risk-weighted assets)	\$ 29,234	16.94%	\$ 13,809	8.00%	\$ 17,261	10.00%

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 16. Fair Value Measurements

Generally accepted accounting principles define fair value, establish a framework for measuring fair value, expand disclosures about fair value, and establish a hierarchy for determining fair value measurement. The hierarchy includes three levels and is based upon the valuation techniques used to measure assets and liabilities. The three levels are as follows:

Level 1 – Inputs to the valuation method are quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2 – Inputs to the valuation method include quoted prices for similar assets and liabilities in active markets, and inputs that are observable for the asset or liability, either directly or indirectly, for substantially the full term of the financial instrument; and

Level 3 – Inputs to the valuation method are unobservable and significant to the fair value measurement.

#### *Fair value measurements on a recurring basis*

Securities available for sale are the only instruments that are measured at fair value on a recurring basis. The Bank has categorized its securities available for sale as follows as of December 31, 2017, 2016, and 2015:

<b>December 31, 2017</b>	Total	Level 1 inputs	Level 2 inputs	Level 3 inputs
Equity securities	<u>\$1,473,172</u>	<u>\$1,473,172</u>	<u>\$ -</u>	<u>\$ -</u>
<hr/>				
December 31, 2016				
Equity securities	<u>\$ 1,292,694</u>	<u>\$ 1,292,694</u>	<u>\$ -</u>	<u>\$ -</u>
<hr/>				
December 31, 2015				
Equity securities	<u>\$ 1,078,679</u>	<u>\$ 1,078,679</u>	<u>\$ -</u>	<u>\$ -</u>

#### *Fair value measurements on a nonrecurring basis*

Impaired loans are generally measured based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values since the market for impaired loans is not active. As of December 31, 2017, 2016, and 2015, the fair values consist of recorded loan balances net of any specific valuation allowances.

## Bank of Ocean City

### Notes to Financial Statements (Continued)

#### 16. Fair Value Measurements (Continued)

Foreclosed real estate is measured at fair value less cost to sell. The fair value of foreclosed real estate is based on offers and/or appraisals. Cost to sell the real estate is based on standard market factors. The Bank has categorized its foreclosed real estate as Level 3. Transactions in foreclosed real estate during the years ended December 31, 2017, 2016, and 2015, are as follows:

	2017	2016	2015
Beginning of year balance	\$ -	\$ 200,000	\$ -
Improvements and additions	-	-	230,000
Write-downs	-	(6,800)	(30,000)
Proceeds from sale	-	(163,806)	-
Loss on sale	-	(29,394)	-
End of year balance	\$ -	\$ -	\$ 200,000

The Bank has categorized its impaired loans and foreclosed real estate as follows:

	Total	Level 1 inputs	Level 2 inputs	Level 3 inputs
<b>December 31, 2017</b>				
Impaired loans	\$ 300,996	\$ -	\$ -	\$ 300,996
Foreclosed real estate	-	-	-	-
December 31, 2016				
Impaired loans	\$ 263,710	\$ -	\$ -	\$ 263,710
Foreclosed real estate	-	-	-	-
December 31, 2015				
Impaired loans	\$ 264,762	\$ -	\$ -	\$ 264,762
Foreclosed real estate	200,000	-	-	200,000