COMMUNITY FINANCIAL CORP /MD/
Form 10-Q
August 08, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d)**

OF THE SECURITIES EXCHANGE ACT OF 1934

For the Quarterly Period Ended June 30, 2018

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d)**

OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______ to ______

Commission File Number 001-36094

The Community Financial Corporation

(Exact name of registrant as specified in its charter)

Maryland (State of other jurisdiction of incorporation or organization)	52-1652138 (I.R.S. Employer Identification No.)
3035 Leonardtown Road, Waldorf, Maryland (Address of principal executive offices)	20601 (Zip Code)

(301) 645-5601

(Registrant's telephone number, including area code)

Not applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of “large accelerated filer,” “accelerated filer,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one):

Large Accelerated Filer ¨	Accelerated Filer x
Non-accelerated Filer ¨ (Do not check if a smaller reporting company)	Smaller Reporting Company ¨

Emerging growth company ¨

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the

Exchange Act. ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes ¨ No x

As of August 3, 2018, the registrant had 5,575,090 shares of common stock outstanding.

THE COMMUNITY FINANCIAL CORPORATION

FORM 10-Q

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PART 1 - FINANCIAL INFORMATION - ITEM 1 – FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS

(dollars in thousands, except per share amounts)	(Unaudited) June 30, 2018	December 31, 2017
Assets		
Cash and due from banks	$ 16,718	$ 13,315
Interest-bearing deposits with banks	3,667	2,102
Securities available for sale (AFS), at fair value	79,026	68,164
Securities held to maturity (HTM), at amortized cost	100,842	99,246
Equity securities carried at fair value through income	4,367	-
Non-marketable equity securities held in other financial institutions	249	121
Federal Home Loan Bank (FHLB) stock - at cost	4,311	7,276
Loans receivable	1,291,537	1,151,130
Less: allowance for loan losses	(10,725)	(10,515)
Net loans	1,280,812	1,140,615
Goodwill	10,603	-
Premises and equipment, net	22,472	21,391
Premises and equipment held for sale	600	-
Other real estate owned (OREO)	8,305	9,341
Accrued interest receivable	4,786	4,511
Investment in bank owned life insurance	35,843	29,398
Core deposit intangible	3,186	-
Net deferred tax assets	6,624	5,922
Other assets	3,877	4,559
Total Assets	$ 1,586,288	$ 1,405,961
Liabilities and Stockholders' Equity		
Deposits		
Non-interest-bearing deposits	$ 214,249	$ 159,844
Interest-bearing deposits	1,109,619	946,393
Total deposits	1,323,868	1,106,237
Short-term borrowings	36,500	87,500
Long-term debt	30,467	55,498
Guaranteed preferred beneficial interest in junior subordinated debentures (TRUPs)	12,000	12,000
Subordinated notes - 6.25%	23,000	23,000
Accrued expenses and other liabilities	13,207	11,769
Total Liabilities	1,439,042	1,296,004
Stockholders' Equity		
	56	46

Common stock - par value $.01; authorized - 15,000,000 shares; issued 5,574,511 and 4,649,658 shares, respectively		
Additional paid in capital	84,106	48,209
Retained earnings	66,021	63,648
Accumulated other comprehensive loss	(2,182)	(1,191)
Unearned ESOP shares	(755)	(755)
Total Stockholders' Equity	147,246	109,957
Total Liabilities and Stockholders' Equity	$ 1,586,288	$ 1,405,961

See notes to Consolidated Financial Statements

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CONSOLIDATED STATEMENTS OF INCOME (Unaudited)

(dollars in thousands, except per share amounts)	Three Months Ended June 30, 2018	2017	Six Months Ended June 30, 2018	2017
Interest and Dividend Income				
Loans, including fees	$ 14,483	$ 12,410	$ 29,209	$ 24,380
Interest and dividends on investment securities	1,211	973	2,306	1,919
Interest on deposits with banks	60	12	132	18
Total Interest and Dividend Income	15,754	13,395	31,647	26,317
Interest Expense				
Deposits	2,405	1,403	4,361	2,671
Short-term borrowings	217	283	500	430
Long-term debt	721	776	1,485	1,609
Total Interest Expense	3,343	2,462	6,346	4,710
Net Interest Income	12,411	10,933	25,301	21,607
Provision for loan losses	400	376	900	756
Net Interest Income After Provision For Loan Losses	12,011	10,557	24,401	20,851
Noninterest Income				
Loan appraisal, credit, and miscellaneous charges	7	9	60	56
Gain on sale of assets	1	47	1	47
Net (losses) gains on sale of OREO	(8)	9	(8)	36
Net gains on sale of investment securities	-	133	-	133
Unrealized loss on equity securities	(78)	-	(78)	-
Income from bank owned life insurance	224	194	450	385
Service charges	747	660	1,499	1,270
Total Noninterest Income	893	1,052	1,924	1,927
Noninterest Expense				
Salary and employee benefits	5,129	4,198	10,176	8,511
Occupancy expense	739	658	1,505	1,311
Advertising	180	140	339	248
Data processing expense	782	634	1,465	1,211
Professional fees	426	360	778	680
Merger and acquisition costs	741	238	3,609	255
Depreciation of premises and equipment	202	204	401	403
Telephone communications	69	45	168	96
Office supplies	41	28	81	60
FDIC Insurance	113	161	311	327
OREO valuation allowance and expenses	229	145	343	340
Core deposit intangible amortization	199	-	404	-
Other	891	719	1,828	1,467
Total Noninterest Expense	9,741	7,530	21,408	14,909

Income before income taxes	3,163	4,079	4,917	7,869
Income tax expense	828	1,536	1,361	2,984
Net Income	$ 2,335	$ 2,543	$ 3,556	$ 4,885
Earnings Per Common Share				
Basic	$ 0.42	$ 0.55	$ 0.64	$ 1.05
Diluted	$ 0.42	$ 0.55	$ 0.64	$ 1.05
Cash dividends paid per common share	$ 0.10	$ 0.10	$ 0.20	$ 0.20

See notes to Consolidated Financial Statements

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands)	2018	2017	2018	2017
Net Income	$ 2,335	$ 2,543	$ 3,556	$ 4,885
Net unrealized holding (losses) gains arising during period, net of tax (benefit) expense of $(108) and $206, and$(376) and $289, respectively.	(284)	318	(991)	445
Reclassification adjustment for gains included in net income, net of tax benefit of $- and $(3) and $- and $(3), respectively.	-	(6)	-	(6)
Comprehensive Income	$ 2,051	$ 2,855	$ 2,565	$ 5,324

See notes to Consolidated Financial Statements

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CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(dollars in thousands)	Six Months Ended June 30, 2018	2017
Cash Flows from Operating Activities		
Net income	$ 3,556	$ 4,885
Adjustments to reconcile net income to net cash provided by operating activities		
Provision for loan losses	900	756
Depreciation and amortization	831	806
Net loss (gains) on the sale of OREO	8	(36)
Gains on sales of investment securities	-	(133)
Unrealized loss on equity securities	78	-
Gain on sale of assets	(1)	(47)
Net amortization of premium/discount on investment securities	166	199
Net accretion of merger accounting adjustments	(477)	-
Amortization of core deposit intangible	404	-
Increase in OREO valuation allowance	283	313
Increase in cash surrender value of bank owned life insurance	(446)	(386)
Decrease (increase) in deferred income tax benefit	314	(616)
Decrease (increase) in accrued interest receivable	143	(233)
Stock based compensation	238	284
Compensation expense due to excess of fair market value over cost of leveraged ESOP shares released	21	-
Increase in net deferred loan costs	(35)	(456)
Decrease in accrued expenses and other liabilities	(114)	(4,887)
Decrease in other assets	1,024	751
Net Cash Provided by Operating Activities	6,893	1,200
Cash Flows from Investing Activities		
Purchase of AFS investment securities	(20,550)	(7,653)
Proceeds from redemption or principal payments of AFS investment securities	3,812	3,369
Purchase of HTM investment securities	(8,360)	(10,082)
Proceeds from maturities or principal payments of HTM investment securities	9,735	8,905
Proceeds from sale of HTM investment securities	-	3,569
Proceeds from sale of AFS investment securities	34,919	3,702
Net decrease (increase) of FHLB and FRB stock	3,169	(510)
Loans originated or acquired	(144,067)	(182,660)
Principal collected on loans	143,993	126,878
Purchase of premises and equipment	(480)	(638)
Proceeds from sale of OREO	982	903
Acquisition net cash acquired	32,411	-
Proceeds from disposal of asset	1,292	387
Net Cash Provided by (Used in) Investing Activities	56,856	(53,830)

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CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)

(continued)

	Six Months Ended June 30,	
(dollars in thousands)	2018	2017
Cash Flows from Financing Activities		
Net increase in deposits	$ 18,404	$ 48,981
Proceeds from long-term debt	-	10,000
Payments of long-term debt	(25,032)	(10,030)
Net (decrease) increase in short term borrowings	(51,000)	9,500
Exercise of stock options	-	137
Dividends paid	(1,086)	(901)
Repurchase of common stock	(67)	-
Net Cash (Used in) Provided by Financing Activities	(58,781)	57,687
Increase in Cash and Cash Equivalents	$ 4,968	$ 5,057
Cash and Cash Equivalents - January 1	15,417	11,263
Cash and Cash Equivalents - June 30	$ 20,385	$ 16,320
Supplemental Disclosures of Cash Flow Information		
Cash paid during the period for		
Interest	$ 3,403	$ 4,700
Income taxes	$ 2,549	$ 3,450
Supplemental Schedule of Non-Cash Operating Activities		
Issuance of common stock for payment of compensation	$ 321	$ 203
Transfer from loans to OREO	$ 101	$ 2,772
Financed amount of sale of OREO	$ -	$ 200
Business Combination Non-Cash Disclosures		
Assets acquired in business combination (net of cash received)	$ 192,259	$ -
Liabilities assumed in business combination	$ 200,660	$ -

See notes to Consolidated Financial Statements

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(UNAUDITED)

NOTE 1 – BASIS OF PRESENTATION AND NATURE OF BUSINESS

Basis of Presentation

The consolidated financial statements of The Community Financial Corporation (the "Company") and its wholly owned subsidiary, Community Bank of the Chesapeake (the "Bank"), and the Bank's wholly owned subsidiary, Community Mortgage Corporation of Tri-County, included herein are unaudited.

The consolidated financial statements reflect all adjustments consisting only of normal recurring accruals that, in the opinion of management, are necessary to present fairly the Company's financial condition, results of operations, and cash flows for the periods presented. Certain information and note disclosures normally included in financial statements prepared in accordance with accounting principles generally accepted in the United States of America have been condensed or omitted pursuant to the rules and regulations of the Securities and Exchange Commission. The Company believes that the disclosures are adequate to make the information presented not misleading. The balances as of December 31, 2017 have been derived from audited financial statements. There have been two additions to the Company's accounting policies as disclosed in the 2017 Annual Report as well as the adoption of new accounting standards section included in Note 1. The results of operations for the three and six months ended June 30, 2018 are not necessarily indicative of the results of operations to be expected for the remainder of the year or any other period.

These consolidated financial statements should be read in conjunction with the consolidated financial statements and notes included in the Company's 2017 Annual Report on Form 10-K.

Nature of Business

The Company provides a variety of financial services to individuals and businesses through its offices in Southern Maryland and Annapolis and Fredericksburg, Virginia. Its primary deposit products are demand, savings and time deposits, and its primary lending products are commercial and residential mortgage loans, commercial loans, construction and land development loans, home equity and second mortgages and commercial equipment loans.

The Company's branches are located at its main office in Waldorf, Maryland, and branch offices in Waldorf, Bryans Road, Dunkirk, Leonardtown, La Plata, Charlotte Hall, Prince Frederick, Lusby, California, Maryland; and

Fredericksburg, Virginia. The Company maintains five loan production offices ("LPOs") in Annapolis, La Plata, Prince Frederick and Leonardtown, Maryland; and Fredericksburg, Virginia. The Leonardtown LPO is co-located with the branch.

The Company closed its Central Park Fredericksburg branch during the third quarter of 2017. This location continues to serve as a loan production office and the branch closure did not have a material effect on operations. The Company offered branch employees open positions.

On January 1, 2018, the Company completed the acquisition of County First Bank ("County First") after regulatory approval and County First shareholder approvals were obtained. The Company's asset increased to $1.6 billion during the first quarter of 2018. See *Note 2 – Business Combination and Goodwill* for additional information. The Company closed four of the five acquired County First branches in May of 2018 with the La Plata downtown branch remaining open. As of June 30, 2018, two branches have been sold and one branch remained as held for sale.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the consolidated financial statements and the reported amount of income and expenses during the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, real estate acquired in the settlement of loans, fair value of financial instruments, fair value of assets acquired and liabilities assumed in a business combination, evaluating other-than-temporary-impairment of investment securities and valuation of deferred tax assets.

Reclassifications

Certain amounts, previously reported, have been reclassified to state all periods on a comparable basis and had no effect on stockholders' equity or net income.

Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management performed an evaluation to determine whether there have been any subsequent events since the balance sheet date and determined that no subsequent events occurred requiring accrual or disclosure.

New Accounting Policy

See Note 1 – Summary of Significant Accounting Policies included in the Company's 2017 Annual Report on Form 10-K for a list of policies in effect as of December 31, 2017. The below summary is intended to provide updates or new policies required as a result of a new accounting standard or a change to the Company's operations or assets that require a new or amended policy.

Intangible Assets

Intangible assets consist of goodwill, core deposit intangible assets and other identifiable assets that result from business combinations. Goodwill and core deposit intangible assets are related to the acquisition of County First Bank on January 1, 2018. Goodwill represents the excess of the fair value of the consideration transferred over the fair value of the net assets acquired and liabilities assumed. Goodwill will be tested annually for impairment, during the fourth quarter or on an interim basis if circumstances dictate. If impairment exists, the amount of impairment would result in a charge to expense. Core deposit intangible assets represent the future earnings potential of acquired deposit relationships that are amortized over their estimated remaining useful lives.

Business Combinations

The Company accounts for business combinations under the acquisition method of accounting which requires purchased assets and liabilities assumed to be recorded at their respective fair values. In many cases, the fair values of assets acquired and liabilities assumed were determined by estimating the cash flows expected to result from those

assets and liabilities and discounting them at appropriate market rates. The Company determines the fair values of loans, core deposit intangible, and deposits with the assistance of a third-party vendor.

Loans acquired in business combinations are recorded in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) Topic 805, “Business Combinations.” Accordingly, acquired loans are segregated between purchase credit impaired (“PCI”) loans (ASC 310-30) and Non-PCI loans (ASC-310-20) and are recorded at fair value without the carryover of the related allowance for loan losses. The excess of expected cash flows above the fair value of the majority of loans will be accreted to interest income over the remaining lives of the loans in accordance with FASB ASC 310-20.

The estimated fair values are subject to refinement as additional information relative to the closing date fair values becomes available through the measurement period. While additional significant changes to the closing date fair values are not expected, any information relative to the changes in these fair values will be evaluated to determine if such changes are due to events and circumstances that existed as of the acquisition date. During the measurement period, any such changes will be recorded as part of the closing date fair value.

Purchase Credit Impaired “PCI” Loans

Loans purchased with evidence of credit deterioration since origination and for which it is probable that all contractually required payments will not be collected are considered credit impaired. Evidence of credit quality deterioration as of the purchase date may include statistics such as internal risk grade, past due and nonaccrual status, recent borrower credit scores and recent loan-to-value (“LTV”) percentages. Purchased credit-impaired (“PCI”) loans are initially measured at fair value, which includes estimated future credit losses expected to be incurred over the life of the loan. Accordingly, the associated allowance for credit losses related to these loans is not carried over at the acquisition date. We estimate the cash flows expected to be collected at acquisition using specific credit review of certain loans, quantitative credit risk, interest rate risk and prepayment risk models, and qualitative economic and environmental assessments, each of which incorporate our best estimate of current key relevant factors, such as property values, default rates, loss severity and prepayment speeds.

Under the accounting guidance for PCI loans, the excess of the total cash flows expected to be collected over the estimated fair value is referred to as the accretable yield and is recognized in interest income over the remaining life of the loan, or pool of loans, in situations where there is a reasonable expectation about the timing and amount of cash flows to be collected. The difference between the contractually required payments and the cash flows expected to be collected at acquisition, considering the impact of prepayments, is referred to as the nonaccretable difference and is available to absorb future charge-offs.

In addition, subsequent to acquisition, we periodically evaluate our estimate of cash flows expected to be collected. These evaluations require the continued usage of key assumptions and estimates, similar to the initial estimate of fair value. Estimates of cash flows for PCI loans require significant judgment given the impact of property value changes, changing loss severities, prepayment speeds and other relevant factors. Decreases in the expected cash flows will generally result in a charge to the provision for loan losses resulting in an increase to the allowance for loan losses. Significant increases in the expected cash flows will generally result in an increase in interest income over the remaining life of the loan, or pool of loans. Disposals of loans, which may include sales of loans to third parties, receipt of payments in full or part from the borrower or foreclosure of the collateral, result in removal of the loan from the PCI loan portfolio at its carrying amount.

At June 30, 2018, PCI loans represent loans acquired from County First, that were deemed credit impaired at the time of acquisition. PCI loans that had been classified as nonperforming loans by County First are no longer classified as nonperforming so long as, at acquisition and quarterly re-estimation periods, we believe we will fully collect the new carrying value of these loans. It is important to note that judgment regarding the timing and amount of cash flows to be collected is required to classify PCI loans as performing, even if the loan is contractually past due.

Revenue from Contracts with Customers

The Company records revenue from contracts with customers in accordance with Accounting Standards Codification (“ASC”) Topic 606, “Revenue from Contracts with Customers.” On January 1, 2018, the Company adopted Accounting Standards Update (“ASU”) 2014-09 and all subsequent ASUs that modified ASU 2014-09, which have been codified in ASC Topic 606, Under Topic 606, the Company must identify the contract with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price to the performance obligations in the contract, and recognize revenue when (or as) the Company satisfies a performance obligation. Significant revenue has not been recognized in the current reporting period that results from performance obligations satisfied in previous periods.

The Company’s primary sources of revenue are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of Topic 606. The Company evaluated the nature of its contracts with customers and determined that further disaggregation of revenue from contracts with customers into more granular categories beyond what is presented in the Consolidated Statements of Income was not necessary. The Company generally fully satisfies its performance obligations on its contracts with customers as

services are rendered and the transaction prices are typically fixed; charged either on a periodic basis or based on activity. Adoption of the amendments to the revenue recognition principles, did not materially change our accounting policies. The following is a discussion of revenues within the scope of the new guidance:

- Service fees on deposit accounts - The Company earns fees from its deposit clients for various transaction-based activities, account maintenance, and overdraft or non-sufficient funds ("NSF"). Transaction based fees, which include services such as stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the client's request. Account maintenance fees, which relate primarily to monthly maintenance and account management, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft and NSF fees are recognized at the point in time that the overdraft occurs or the NSF item is presented. Service charges on deposits are withdrawn from the client's account balance.

- ATM and debit card income - The Company earns interchange fees from debit cardholder transactions conducted through the payment networks. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

- Revenues from the sale of Other Real Estate Owned - ASC 606 required us to estimate income from the sale of OREO property that is under contract at year end. As a result, the Company could recognize revenue earlier under ASC 606 than under previous guidance. At June 30, 2018 there were no contracts for the sale of OREO property.

The Company's revenue recognition pattern for revenue streams within the scope of ASU did not change significantly from previous practice and was immaterial to our financial statements for the three and six months ended June 30, 2018.

Accounting Standards

New Accounting Standards - Issued and Effective

ASU 2014-09 – Revenue from Contracts with Customers (Topic 606). The FASB issued ASU 2014-09 in May 2014. The core principle of the amendments in this update is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled to receive in exchange for those goods and services. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements and related disclosures as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09. The Company's revenue recognition pattern for revenue streams within the scope of ASU 2014-09, including but not limited to service charges on deposit accounts and gains or losses on the sale of other real estate owned, did not change significantly from current practice. The standard permits the use of either the full retrospective or modified retrospective transition method. The Company elected to use the modified retrospective transition method which requires application of ASU 2014-09 to uncompleted contracts at the date of adoption however, periods prior to the date of adoption will not be retrospectively revised as the impact of the ASU on uncompleted contracts at the date of adoption was not material.

ASU 2016-01 - Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial

liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. The Company's management engaged a third-party expert in the field of valuation and reporting to assist management in the development of a process to ensure adequate documentation of financial controls and analysis performed in its review of "exit pricing" of the fair values of loans, deposits and other financial instruments. ASU 2016-01 was effective on January 1, 2018 and did not have a significant impact on the Company's consolidated financial statements. See Notes 13 and 14 for further information regarding the valuations.

ASU 2018-02 "Income Statement - Reporting Comprehensive Income" (Topic 220). ASU 2018-02. On December 22, 2017, the Tax Cuts and Job Act (Tax Act) was signed into law. Under current U.S. GAAP, deferred tax assets and liabilities are to be adjusted for the effect of a change in tax laws or rates with the effect included in income from continuing operations in the reporting period that includes the enactment date. This accounting treatment resulted in the tax effect of items within accumulated other comprehensive income (loss) not reflecting the appropriate tax rate. This ASU allows stranded tax effects resulting from the Tax Act to be reclassified from accumulated other comprehensive income (loss) to retained earnings. The Company early adopted this guidance during the quarter ended December 31, 2017, resulting in a reclassification of $196,000 from accumulated other comprehensive loss to retained earnings to adjust the tax effect of items within accumulated other comprehensive loss to reflect the newly enacted federal corporate income tax rate.

ASU 2016-15 - Statement of Cash Flows (Topic 230) – "Classification of Certain Cash Receipts and Cash Payments." ASU 2016-15 is intended to reduce diversity in practice in how eight particular transactions are classified in the statement of cash flows. ASU 2016-15 is effective for interim and annual reporting periods beginning after December 15, 2017. Entities will be required to apply the guidance retrospectively. If it is impracticable to apply the guidance retrospectively for an issue, the amendments related to that issue would be applied prospectively. As this guidance only affects the classification within the statement of cash flows, ASU 2016-15 did not have a material impact on the Company's Consolidated Financial Statements. There were no material reclassifications to the Company's cash flow statement for the six months endedJune 30, 2018 and 2017, respectively.

ASU 2016-16, "Income Taxes (Topic 740) - Intra-Entity Transfers of Assets Other Than Inventory." ASU 2016-16 provides guidance stating that an entity should recognize the income tax consequences of an intra-entity transfer of an asset other than inventory when the transfer occurs. ASU 2016-16 was effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

ASU 2016-18, "Statement of Cash Flows (Topic 230) - Restricted Cash." ASU 2016-18 requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. ASU 2016-18 was effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

ASU 2017-01, "Business Combinations (Topic 805) - Clarifying the Definition of a Business." ASU 2017-01 clarifies the definition and provides a more robust framework to use in determining when a set of assets and activities constitutes a business. ASU 2017-01 is intended to provide guidance when evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. ASU 2017-01 was effective for us on January 1, 2018 and did not have a significant impact on our financial statements as the transaction to acquire County First was already clearly within the scope of ASC 805, "Business Combinations."

ASU 2017-05, "Other Income - Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20) - Clarifying the Scope of Asset Derecognition Guidance and Accounting for Partial Sales of Nonfinancial Assets." ASU 2017-05 clarifies the scope of Subtopic 610-20 and adds guidance for partial sales of nonfinancial assets, including partial sales of real estate. Historically, U.S. GAAP contained several different accounting models to evaluate whether the transfer of certain assets qualified for sale treatment. ASU 2017-05 reduces the number of potential accounting models that might apply and clarifies which model does apply in various circumstances. ASU 2017-05 was effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

ASU 2017-09, "Compensation - Stock Compensation (Topic 718) - Scope of Modification Accounting."
ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. Under ASU 2017-09, an entity will not apply modification accounting to a share-based payment award if all of the following are the same immediately before and after the change: (i) the award's fair value, (ii) the award's vesting conditions and (iii) the award's classification as an equity or liability instrument. ASU 2017-09 was effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

New Accounting Standards - Issued, But Not Yet Effective

ASU 2016-02 - Leases (Topic 842). In February 2016, the FASB amended existing guidance that requires lessees recognize the following for all leases (with the exception of short term leases) at the commencement date (1) a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Leases will be classified as either finance or operating with classification affecting the pattern of expense recognition in the income statement. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. This ASU was subsequently amended by ASU 2018-11, Targeted Improvements, which provides entities with an additional transition method when adopting the new lease standard.

Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach.

The Company is currently evaluating the impact of this new accounting standard on the consolidated financial statements. Based on leases outstanding at June 30, 2018, the Company does not expect the updates to have a material impact on the income statement but does anticipate an increase in assets and liabilities. The Company will continue to evaluate the potential impact of ASU 2016-02 during 2018. This new standard will be effective for the Company beginning January 1, 2019.

ASU 2016-13 - Financial Instruments - Credit Losses (Topic 326) - Measurement of Credit Losses on Financial Instruments. ASU No. 2016-13 significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. The standard will replace today's "incurred loss" approach with an "expected loss" model. The new model, referred to as the current expected credit loss ("CECL") model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes, but is not limited to, loans, leases, held-to-maturity securities, loan commitments, and financial guarantees. The CECL model does not apply to available-for-sale ("AFS") debt securities. For AFS debt securities with unrealized losses, entities will measure credit losses in a manner similar to what they do today, except that the losses will be recognized as allowances rather than reductions in the amortized cost of the securities. As a result, entities will recognize improvements to estimated credit losses immediately in earnings rather than as interest income over time, as they do today. The ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. ASU 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the allowance for loan and lease losses. In addition, entities will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination. Entities will apply the standard's provisions as a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach).

The Company has formed a CECL committee that is assessing data and system needs in order to evaluate the impact of adopting the new standard. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective. We expect the adoption will result in a material increase to the allowance for loan losses balance. At this time, the impact is being evaluated.

ASU No. 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019, early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. This new standard will be effective for us beginning January 1, 2020.

ASU 2017-04, "Intangibles - Goodwill and Other (Topic 350) - Simplifying the Test for Goodwill Impairment." ASU 2017-04 eliminates Step 2 from the goodwill impairment test which required entities to compute the implied fair value of goodwill. Under ASU 2017-04, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value; however, the loss

recognized should not exceed the total amount of goodwill allocated to that reporting unit. ASU 2017-04 will be effective for us on January 1, 2020, with earlier adoption permitted and is not expected to have a significant impact on our financial statements.

ASU 2017-08, "Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20) - Premium Amortization on Purchased Callable Debt Securities." ASU 2017-08 shortens the amortization period for certain callable debt securities held at a premium to require such premiums to be amortized to the earliest call date unless applicable guidance related to certain pools of securities is applied to consider estimated prepayments. Under prior guidance, entities were generally required to amortize premiums on individual, non-pooled callable debt securities as a yield adjustment over the contractual life of the security. ASU 2017-08 does not change the accounting for callable debt securities held at a discount. ASU 2017-08 will be effective for us on January 1, 2019, with early adoption permitted. We are currently evaluating the potential impact of ASU 2017-08 on our financial statements.

ASU 2017-12, Derivatives and Hedging (Topic 815) - Targeted Improvements to Accounting for Hedging Activities." ASU 2017-12 amends the hedge accounting recognition and presentation requirements in ASC 815 to improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities to better align the entity's financial reporting for hedging relationships with those risk management activities and to reduce the complexity of and simplify the application of hedge accounting.
ASU 2017-12 will be effective for us on January 1, 2019 and is not expected to have a significant impact on our financial statements.

NOTE 2 – BUSINESS COMBINATION AND GOODWILL

Business Combinations

Generally, acquisitions are accounted for under the acquisition method of accounting in accordance with Accounting Standards Codification ("ASC") 805, "Business Combinations." Both the purchased assets and liabilities assumed are recorded at their respective acquisition date fair values. Determining the fair value of assets and liabilities, especially the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are preliminary and subject to refinement for up to one year after the closing date of the acquisition as additional information regarding fair values becomes available.

County First Bank

On January 1, 2018, the Company completed its previously announced merger of County First Bank with and into the Bank, with the Bank as the surviving bank (the "Merger") pursuant to the Agreement and Plan of Merger, dated as of July 31, 2017, by and among the Company, the Bank and County First. Pursuant to the Merger Agreement, at the effective time of the Merger (the "Effective Time"), each share of common stock, par value $1.00 per share, of County First issued and outstanding immediately prior to the Effective Time was converted into the right to receive 0.9543 shares of Company common stock and $2.20 in cash (the "Merger Consideration"). The $2.20 in cash represents the sum of (a) $1.00 in cash consideration (the "Cash Consideration") plus (b) $1.20 in Contingent Cash Consideration that was determined before the completion of the Merger in accordance with the terms of the Merger Agreement. The aggregate merger consideration consisted of 918,526 shares of the Company's common stock and $2.1 million in cash. Based upon the $38.78 per share price of the Company's common stock, the transaction value was $37.7 million.

County First had five branch offices in La Plata, Waldorf, New Market, Prince Frederick and California, Maryland. The Bank kept the La Plata branch open and consolidated the remaining four branches with legacy Community Bank of the Chesapeake branch offices in May of 2018.

The assets acquired and liabilities assumed from County First were recorded at their fair value as of the closing date of the merger. Goodwill of $10.3 million was recorded at the time of the acquisition. As a result of refinements to the fair value mark on premises and equipment and deferred taxes, goodwill as indicated below is $10.6 million at June 30, 2018 which is $327,000 more than the goodwill estimated at the time of acquisition.

The following table summarizes the consideration paid by the Company in the merger with County First and the amounts of the assets acquired and liabilities assumed recognized at the acquisition date:

(dollars in thousands)	As Recorded by County First	Fair Value and Other Merger Related Adjustments	As Recorded by the Company
Consideration Paid			
Cash			$ 2,122
Common shares issued			35,620
Fair Value of Total Consideration Transferred			$ 37,742
Recognized amounts of identifiable assets acquired and liabilities assumed			
Cash and cash equivalents	$ 34,409	$ -	$ 34,409
Securities	38,861	(619)	38,242
Loans, net of allowance	142,404	(1,655)	140,749
Premises and equipment	2,980	325	3,305
Core deposit intangibles	-	3,590	3,590
Interest receivable	513	(12)	501
Bank owned life insurance	6,275	-	6,275
Deferred tax asset	639	(378)	261
Other assets	586	-	586
Total assets acquired	$ 226,667	$ 1,251	$ 227,918
Deposits	$ 199,210	$ 18	$ 199,228
Other liabilities	1,449	103	1,552
Total liabilities assumed	$ 200,659	$ 121	$ 200,780
Net identifiable assets acquired	$ 26,008	$ 1,130	$ 27,138
Goodwill resulting from acquisition			$ 10,604

The following table presents certain pro forma information as if County First had been acquired on January 1, 2017. These results combine the historical results of County First in the Company's consolidated statement of income and, while certain adjustments were made for the estimated impact of certain fair value adjustments and other acquisition-related activity, they are not indicative of what would have occurred had the acquisition taken place on January 1, 2017. Merger and acquisition costs of $741,000 and $3.6 million (pre-tax) are included in the Company's consolidated statements of income for the three and six months ended June 30, 2018. The Company has not segregated County First earnings after the acquisition date as the bank's operations have been merged into Community Bank of the Chesapeake and it would be impractical to do so. There are no assumptions about what merger related costs would have been in the proforma information below, only actual expenses are included in net income. Furthermore, additional expenses related to systems conversions and other costs of integration are expected to be recorded during 2018. Additionally, the Company expects to achieve further operating cost savings and other business

synergies as a result of the acquisition which are not reflected in the pro forma amounts below:

(dollars in thousands, except per share amounts)	**Proforma Results for the Six Months Ended June 30, 2017**			
	The Community Financial Corporation Actual	County First Actual	Proforma June 30, 2017	Actual Results Six Months Ended June 30, 2018
Total revenues (net interest income plus noninterest income)	$ 23,534	$ 4,260	$ 27,794	$ 27,227
Net income	4,885	641	5,526	3,556
Basic earnings per common share	$ 1.05	$ 0.70	$ 1.00	$ 0.64

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NOTE 3 – INCOME TAXES

The Company files a consolidated federal income tax return with its subsidiaries. Deferred tax assets and liabilities are determined using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is determined based on the tax effects of the temporary differences between the book and tax bases of the various balance sheet assets and liabilities and gives current recognition to changes in tax rates and laws and when it is considered more likely than not that deferred tax assets will be realized. It is the Company's policy to recognize accrued interest and penalties related to unrecognized tax benefits as a component of tax expense.

	The Three Months Ended June 30,		The Six Months Ended June 30,	
	2018	2017	2018	2017
Current income tax expense	$ 980	$ 1,769	$ 1,460	$ 3,567
Deferred income tax expense (benefit)	(152)	(233)	(99)	(583)
Income tax expense as reported	$ 828	$ 1,536	$ 1,361	$ 2,984
Effective tax rate	26.2 %	37.7 %	27.7 %	37.9 %

Net deferred tax assets totaled $6.6 million at June 30, 2018 and $5.9 million at December 31, 2017. No valuation allowance for deferred tax assets was recorded at June 30, 2018 as management believes it is more likely than not that deferred tax assets will be realized against deferred tax liabilities and projected future taxable income.

The effective income tax rates differed from the statutory federal and state income tax rates during 2018 and 2017, respectively, primarily due to the effect of merger related expenses, tax-exempt loans, life insurance policies, the income tax effects associated with stock-based compensation and certain non-deductible expenses for state income taxes.

The Tax Cuts and Jobs Act was enacted on December 22, 2017, as more fully discussed in the 2017 Form 10-K. Among other things, the new law established a new, flat corporate federal statutory income tax rate of 21%. As a result of the new law, we recognized a provisional net tax expense of $2.7 million in the fourth quarter of 2017. We will continue to analyze certain aspects of the new law and refine our calculations based on this analysis and future tax positions taken, which could affect the measurement of these assets and liabilities or give rise to new deferred tax amounts. There has been no change to the provisional net tax expense we recorded during the fourth quarter of 2017 for the three and six months ended June 30, 2018.

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NOTE 4 - ACCUMULATED OTHER COMPREHENSIVE INCOME (LOSS)

The following tables present the components of comprehensive income for the three and six months ended June 30, 2018 and 2017. The Company's comprehensive gains and losses and reclassification adjustments were solely for securities for the three and six months ended June 30, 2018 and 2017. Reclassification adjustments are recorded in non-interest income.

	Three Months Ended June 30, 2018			Three Months Ended June 30, 2017		
(dollars in thousands)	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains (losses) arising during period	$ (392)	$ (108)	$ (284)	$ 524	$ 206	$ 318
Reclassification adjustments	-	-	-	(9)	(3)	(6)
Other comprehensive (loss) income	$ (392)	$ (108)	$ (284)	$ 515	$ 203	$ 312

	Six Months Ended June 30, 2018			Six Months Ended June 30, 2017		
(dollars in thousands)	Before Tax	Tax Effect	Net of Tax	Before Tax	Tax Effect	Net of Tax
Net unrealized holding gains arising during period	$ (1,367)	$ (376)	$ (991)	$ 734	$ 289	$ 445
Reclassification adjustments		$ -	-	(9)	(3)	(6)
Other comprehensive (loss) income	$ (1,367)	$ (376)	$ (991)	$ 725	$ 286	$ 439

The following table presents the changes in each component of accumulated other comprehensive loss, net of tax, for the three and six months ended June 30, 2018 and 2017.

	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
(dollars in thousands)	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses	Net Unrealized Gains And Losses

Beginning of period	$ (1,898)	$ (801)	$ (1,191)	$ (928)
Other comprehensive gains (losses), net of tax before reclassifications	(284)	318	(991)	445
Amounts reclassified from accumulated other comprehensive loss	-	(6)	-	(6)
Net other comprehensive (loss) income	(284)	312	(991)	439
End of period	$ (2,182)	$ (489)	$ (2,182)	$ (489)

The FASB issued ASU 2018-02 allowing companies to reclassify stranded tax effects resulting from the Tax Cuts and Job Act from accumulated other comprehensive income (loss) to retained earnings. The Company early adopted this guidance during the quarter ended December 31, 2017 and utilizing the portfolio method reclassified $196,000 from accumulated other comprehensive loss to retained earnings to eliminate the stranded tax effects.

NOTE 5 - EARNINGS PER SHARE ("EPS")

Basic earnings per common share represent income available to common shareholders, divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may have been issued by the Company related to outstanding stock options and were determined using the treasury stock method. The Company has not granted any stock options since 2007 and all outstanding options expired on July 17, 2017.

As of June 30, 2018, and 2017, there were no options, which were excluded from the calculation as their effect would be anti-dilutive, because the exercise price of the options was greater than the average market price of the common shares. Basic and diluted earnings per share have been computed based on weighted-average common and common equivalent shares outstanding as follows:

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands)	2018	2017	2018	2017
Net Income	$2,335	$2,543	$3,556	$4,885
Average number of common shares outstanding	5,551,123	4,632,911	5,549,428	4,630,647
Dilutive effect of common stock equivalents	-	2,572	-	3,073
Average number of shares used to calculate diluted EPS	5,551,123	4,635,483	5,549,428	4,633,720
Earnings Per Common Share				
Basic	$0.42	$0.55	$0.64	$1.05
Diluted	0.42	0.55	0.64	1.05

NOTE 6 - STOCK-BASED COMPENSATION

The Company has stock-based incentive arrangements to attract and retain key personnel. In May 2015, the 2015 Equity Compensation Plan (the "Plan") was approved by shareholders, which authorizes the issuance of restricted stock, stock appreciation rights, stock units and stock options to the Board of Directors and key employees. Compensation expense for service-based awards is recognized over the vesting period. Performance-based awards are recognized based on a vesting schedule and the probability of achieving goals specified at the time of the grant. The 2015 Plan replaced the 2005 Equity Compensation Plan.

Stock-based compensation expense totaled $134,000 and $238,000, respectively, for the three and six months ended June 30, 2018 and $171,000 and $284,000, respectively, for the three and six months ended June 30, 2017. Stock-based compensation expense consisted of the vesting of grants of restricted stock.

The Company has not granted any stock options since 2007 and all outstanding options expired on July 17, 2017. The fair value of the Company's outstanding employee stock options were estimated on the date of grant using the Black-Scholes option pricing model. The Company estimated expected market price volatility and expected term of the options based on historical data and other factors. The exercise price for options granted is set at the discretion of the committee administering the Plan but is not less than the market value of the shares as of the date of grant. An option's maximum term is 10 years and the options vest at the discretion of the committee. Aggregate intrinsic value represents the difference between the Company's closing stock price on the last trading day of the period and the exercise price multiplied by the number of options outstanding.

The following table below summarize option activity and outstanding and exercisable options at and for the year ended December 31, 2017.

(dollars in thousands, except per share amounts)	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value	Weighted-Average Contractual Life Remaining In Years
Outstanding at January 1, 2017	15,081	$ 27.70	$ -	
Exercised	(14,231)	27.70	134	
Expired	(350)	27.70	-	
Forfeited	(500)	27.70	-	
Outstanding at December 31, 2017	-	$ -	$ -	-
Exercisable at December 31, 2017	-	$ -	$ -	-

The Company granted restricted stock in accordance with the Plan. The vesting period for outstanding granted restricted stock is between three and five years. As of June 30, 2018 and December 31, 2017, unrecognized stock compensation expense was $605,000 and $521,000, respectively. The following tables summarize the unvested restricted stock awards outstanding at June 30, 2018 and December 31, 2017, respectively.

	Restricted Stock	
	Number of Shares	**Weighted Average Grant Date Fair Value**
Nonvested at January 1, 2018	32,809	$ 22.61
Granted	8,662	37.13
Vested	(17,607)	21.85
Cancelled	(326)	26.11
Nonvested at June 30, 2018	23,538	$ 28.38

	Restricted Stock	
	Number of Shares	**Weighted Average Grant**

		Date Fair Value
Nonvested at January 1, 2017	47,881	$ 20.41
Granted	6,752	30.20
Vested	(21,738)	20.13
Cancelled	(86)	20.75
Nonvested at December 31, 2017	32,809	$ 22.61

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NOTE 7 - GUARANTEED PREFERRED BENEFICIAL INTEREST IN JUNIOR SUBORDINATED DEBENTURES ("TRUPs")

On June 15, 2005, Tri-County Capital Trust II ("Capital Trust II"), a Delaware business trust formed, funded and wholly owned by the Company, issued $5.0 million of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 1.70%. The Trust used the proceeds from this issuance, along with the $155,000 for Capital Trust II's common securities, to purchase $5.2 million of the Company's junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These capital securities qualify as Tier I capital and are presented in the Consolidated Balance Sheets as "Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures." Both the capital securities of Capital Trust II and the junior subordinated debentures are scheduled to mature on June 15, 2035, unless called by the Company.

On July 22, 2004, Tri-County Capital Trust I ("Capital Trust I"), a Delaware business trust formed, funded and wholly owned by the Company, issued $7.0 million of variable-rate capital securities in a private pooled transaction. The variable rate is based on the 90-day LIBOR rate plus 2.60%. The Trust used the proceeds from this issuance, along with the Company's $217,000 capital contribution for Capital Trust I's common securities, to purchase $7.2 million of the Company's junior subordinated debentures. The interest rate on the debentures and the trust preferred securities is variable and adjusts quarterly. These debentures qualify as Tier I capital and are presented in the Consolidated Balance Sheets as "Guaranteed Preferred Beneficial Interests in Junior Subordinated Debentures." Both the capital securities of Capital Trust I and the junior subordinated debentures are scheduled to mature on July 22, 2034, unless called by the Company.

NOTE 8 – SUBORDINATED NOTES

On February 6, 2015 the Company issued $23.0 million of unsecured 6.25% fixed to floating rate subordinated notes due February 15, 2025 ("subordinated notes"). On February 13, 2015, the Company used proceeds of the offering to redeem all $20 million of the Company's outstanding preferred stock issued under the Small Business Lending Fund ("SBLF") program. The subordinated notes qualify as Tier 2 regulatory capital and replaced SBLF Tier 1 capital. The subordinated notes are not listed on any securities exchange or included in any automated dealer quotation system and there is no market for the notes. The notes are unsecured obligations and are subordinated in right of payment to all existing and future senior debt, whether secured or unsecured. The notes are not guaranteed obligations of any of the Company's subsidiaries.

Interest will accrue at a fixed per annum rate of 6.25% from and including the issue date to but excluding February 15, 2020. From and including February 15, 2020 to but excluding the maturity date interest will accrue at a floating rate equal to the three-month LIBOR plus 479 basis points. Interest is payable on the notes on February 15 and August 15 of each year, commencing August 15, 2015, through February 15, 2020, and thereafter February 15, May 15, August

15 and November 15 of each year through the maturity date or earlier redemption date.

The subordinated notes may be redeemed in whole or in part on February 15, 2020 or on any scheduled interest payment date thereafter and upon the occurrence of certain special events. The redemption price is equal to 100% of the principal amount of the subordinated notes to be redeemed plus accrued and unpaid interest to the date of redemption. Any partial redemption will be made pro rata among all holders of the subordinated notes. The subordinated notes are not subject to repayment at the option of the holders. The subordinated notes may be redeemed at any time, if (1) a change or prospective change in law occurs that could prevent the Company from deducting interest payable on the notes for U.S. federal income tax purposes, (2) a subsequent event occurs that precludes the notes from being recognized as Tier 2 Capital for regulatory capital purposes, or (3) the Company is required to register as an investment company under the Investment Company Act of 1940, as amended.

NOTE 9 - OTHER REAL ESTATE OWNED ("OREO")

OREO assets are presented net of the valuation allowance. The Company considers OREO as classified assets for regulatory and financial reporting. OREO carrying amounts reflect management's estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs. An analysis of the activity follows.

	Six Months Ended June 30,		**Years Ended December 31,**
(dollars in thousands)	2018	2017	2017
Balance at beginning of year	$ 9,341	$ 7,763	$ 7,763
Additions of underlying property	238	2,772	3,634
Disposals of underlying property	(991)	(1,068)	(1,456)
Valuation allowance	(283)	(313)	(600)
Balance at end of period	$ 8,305	$ 9,154	$ 9,341

During the six months ended June 30, 2018 and 2017, OREO additions were $238,000 and $2.8 million, respectively. During the six months ended June 30, 2018, additions of $238,000 were for $95,000 of capitalized costs to improve a development project and $143,000 for commercial real estate. During the six months ended June 30, 2017, additions of $2.8 million to OREO were related to the foreclosure of a stalled residential development project.

During the six months ended June 30, 2018 and 2017, there were OREO disposals of $991,000 and $1.1 million, respectively. The Company recognized net losses of $8,000 on disposals of multiple residential lots of $188,000, a commercial building of $476,000 and a commercial lot of $327,000 for the six months ended June 30, 2018. The Company recognized net gains of $36,000 on disposals of $1.1 million of four residential properties and multiple residential lots for the six months ended June 30, 2017. The Bank provided $200,000 in financing for one residential property and the three residential lots which were transferred from OREO to loans during the first quarter of 2017. The transaction qualified for full accrual sales treatment under ASC Topic 360-20-40 "Property Plant and Equipment – Derecognition".

The Company had no impaired loans and $122,000 of impaired loans secured by residential real estate for which formal foreclosure proceedings were in process as of June 30, 2018 and December 31, 2017, respectively.

Additions to the valuation allowances of $283,000 and $313,000 were taken to adjust properties to current appraised values for the six months ended June 30, 2018 and 2017, respectively. OREO carrying amounts reflect management's

estimate of the realizable value of these properties incorporating current appraised values, local real estate market conditions and related costs. Expenses applicable to OREO assets included the following.

	Three Months Ended June 30,		Six Months Ended June 30,	
(dollars in thousands)	2018	2017	2018	2017
Valuation allowance	$ 193	$ 117	$ 283	$ 313
Operating expenses	36	28	60	27
	$ 229	$ 145	$ 343	$ 340

NOTE 10 – SECURITIES

	June 30, 2018			
	Amortized	Gross Unrealized	Gross Unrealized	Estimated
(dollars in thousands)	Cost	Gains	Losses	Fair Value
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential Mortgage Backed Securities ("MBS")	$6,912	$ -	$ 317	$ 6,595
Residential Collateralized Mortgage Obligations ("CMOs")	62,811	13	2,120	60,704
U.S. Agency	12,314	-	587	11,727
Total securities available for sale	$82,037	$ 13	$ 3,024	$ 79,026
Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	$27,486	$ 94	$ 914	$ 26,666
Residential CMOs	54,099	83	1,531	52,651
U.S. Agency	11,130	4	407	10,727
Asset-backed securities issued by Others:				
Residential CMOs	569	-	45	524
Callable GSE Agency Bonds	5,013	-	126	4,887
Certificates of Deposit Fixed	1,545	-	-	1,545
U.S. government obligations	1,000	-	-	1,000
Total securities held to maturity	$100,842	$ 181	$ 3,023	$ 98,000
Equity securities carried at fair value through income				
CRA investment fund	$4,445	$ -	$ 78	$ 4,367
Non-marketable equity securities				
Other equity securities	$249	$ -	$ -	$ 249

	December 31, 2017			
(dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Securities available for sale (AFS)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	$7,265	$ -	$ 178	$ 7,087
Residential CMOs	45,283	12	1,158	44,137
U.S. Agency	12,863	-	346	12,517
Bond mutual funds	4,397	26	-	4,423
Total securities available for sale	$69,808	$ 38	$ 1,682	$ 68,164
Securities held to maturity (HTM)				
Asset-backed securities issued by GSEs and U.S. Agencies				
Residential MBS	$29,113	$ 135	$ 261	$ 28,987
Residential CMOs	54,805	62	845	54,022
U.S. Agency	8,660	-	235	8,425
Asset-backed securities issued by Others:				
Residential CMOs	651	-	52	599
Callable GSE Agency Bonds	5,017	-	43	4,974
U.S. government obligations	1,000	-	-	1,000
Total securities held to maturity	$99,246	$ 197	$ 1,436	$ 98,007
Non-marketable equity securities				
Other equity securities	$121	$ -	$ -	$ 121

At June 30, 2018, securities with an amortized cost of $35.5 million were pledged to secure certain customer deposits. At June 30, 2018, securities with an amortized cost of $3.6 million were pledged as collateral for advances from the Federal Home Loan Bank ("FHLB") of Atlanta.

At June 30, 2018, greater than 99% of the asset-backed securities and agency bond portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs and U.S. Agencies had an average life of 4.90 years and average duration of 4.27 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs and U.S. Agencies had an average life of 5.09 years and average duration of 4.41 years and are guaranteed by their issuer as to credit risk.

At December 31, 2017, securities with an amortized cost of $31.5 million were pledged to secure certain customer deposits. At December 31, 2017, securities with an amortized cost of $4.0 million were pledged as collateral for advances from the Federal Home Loan Bank ("FHLB") of Atlanta.

At December 31, 2017, greater than 99% of the asset-backed securities and agency bond portfolio was rated AAA by Standard & Poor's or the equivalent credit rating from another major rating agency. AFS asset-backed securities issued by GSEs and U.S. Agencies had an average life of 4.74 years and average duration of 4.22 years and are guaranteed by their issuer as to credit risk. HTM asset-backed securities issued by GSEs and U.S. Agencies had an average life of 4.95 years and average duration of 4.39 years and are guaranteed by their issuer as to credit risk.

Management believes that AFS securities with unrealized losses will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity. Because our intention is not to sell the investments and it is not more likely than not that the Company will be required to sell the investments, management considers the unrealized losses in the AFS portfolio to be temporary.

The Company intends to, and has the ability to, hold the HTM securities with unrealized losses until they mature, at which time the Company will receive full value for the securities. Because our intention is not to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, management considers the unrealized losses in the held-to-maturity portfolio to be temporary.

No charges related to other-than-temporary impairment were made during the six months ended June 30, 2018 and the year ended December 31, 2017.

During the six months ended June 30, 2018, there were no securities sold from the Company's legacy securities' portfolios. The Company liquidated most of the acquired County First securities immediately after the legal merger and retained only the certificates of deposit portfolio with an amortized cost of $1.5 million at June 30, 2018. During the six months ended June 30, 2017, the Company recognized net gains on the sale of securities of $133,000. The Company sold three AFS securities with aggregate carrying values of $3.6 million and six HTM securities with aggregate carrying values of $3.4 million, recognizing gains of $9,000 and $124,000, respectively.

During the year ended December 31, 2017 the Company recognized net gains on the sale of securities of $175,000. The Company sold three AFS securities with aggregate carrying values of $3.7 million and nine HTM securities with aggregate carrying values of $4.8 million, recognizing gains of $9,000 and $166,000, respectively.

The sale of HTM securities is permitted under ASC 320 "Investments - Debt Securities." ASC 320 permits the sale of HTM securities for certain changes in circumstances. The Company will dispose of HTM securities using the safe harbor rule that allows for the sale of HTM securities that have principal payments paid down to less than 15% of original purchased par. ASC 320 10-25-15 indicates that a sale of a debt security after a substantial portion of the principal has been collected is equivalent to holding the security to maturity. In addition, the Company may dispose of HTM securities under ASC 320-10-25-6 due to a significant deterioration in the issues' creditworthiness.

AFS Securities

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at June 30, 2018 were as follows:

June 30, 2018	Less Than 12 Months		More Than 12 Months		Total	
(dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	$40,374	$ 887	$37,911	$ 2,137	$78,285	$ 3,024
	$40,374	$ 887	$37,911	$ 2,137	$78,285	$ 3,024

At June 30, 2018, the AFS investment portfolio had an estimated fair value of $79.0 million on an amortized cost of $82.0 million. AFS asset-backed securities issued by GSEs are guaranteed by the issuer and AFS U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.87 years and an average duration of 4.25 years. Management believes that the securities will either recover in market value or be paid off as agreed.

Gross unrealized losses and estimated fair value by length of time that the individual AFS securities have been in a continuous unrealized loss position at December 31, 2017 were as follows:

December 31, 2017	Less Than 12 Months		More Than 12 Months		Total	
(dollars in thousands)	Fair Value	**Unrealized Loss**	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	$24,571	$ 328	$38,428	$ 1,354	$62,999	$ 1,682

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At December 31, 2017, the AFS investment portfolio had an estimated fair value of $68.3 million on an amortized cost of $69.9 million. AFS asset-backed securities issued by GSEs are guaranteed by the issuer and AFS U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. AFS asset-backed securities issued by GSEs and U.S. Agencies with unrealized losses had an average life of 4.71 years and an average duration of 4.20 years. Management believes that the securities will either recover in market value or be paid off as agreed.

HTM Securities

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at June 30, 2018 were as follows:

June 30, 2018	Less Than 12 Months		More Than 12 Months		Total	
(dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	33,218	961	42,074	1,891	75,292	2,852
Callable GSE Agency Bonds	4,887	126	-	-	4,887	126
Asset-backed securities issued by Others	-	-	524	45	524	45
	$38,105	$ 1,087	$42,598	$ 1,936	$80,703	$ 3,023

At June 30, 2018, the HTM investment portfolio had an estimated fair value of $98.0 million on an amortized cost of $100.8 million. Of these securities, $80.2 million were asset-backed securities or bonds issued by GSEs and U.S. Agencies and $524,000 were asset-backed securities issued by others.

HTM asset-backed securities issued by GSEs and GSE agency bonds are guaranteed by the issuer and HTM U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. The securities with unrealized losses had an average life of 4.96 years and an average duration of 4.33 years. Management believes that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. The securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. HTM asset-backed securities issued by others with unrealized losses had an average life of 3.15 years and an average duration of 2.57 years.

Gross unrealized losses and estimated fair value by length of time that the individual HTM securities have been in a continuous unrealized loss position at December 31, 2017 were as follows:

December 31, 2017	Less Than 12 Months		More Than 12 Months		Total	
(dollars in thousands)	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Losses
Asset-backed securities issued by GSEs and U.S. Agencies	$36,607	$ 254	$45,119	$ 1,130	$81,726	$ 1,384
Asset-backed securities issued by Others	-	-	599	52	599	52
	$36,607	$ 254	$45,718	$ 1,182	$82,325	$ 1,436

At December 31, 2017, the HTM investment portfolio had an estimated fair value of $98.0 million on an amortized cost of $99.2 million. Of these securities, $81.7 million were asset-backed securities issued by GSEs and U.S. Agencies and $599,000 were asset-backed securities issued by others.

HTM asset-backed securities issued by GSEs and GSE agency bonds are guaranteed by the issuer and HTM U.S. government agency securities and bonds are guaranteed by the full faith and credit of the U.S. government. The securities with unrealized losses had an average life of 5.02 years and an average duration of 4.43 years. Management believes that the securities will either recover in market value or be paid off as agreed. The Company intends to, and has the ability to, hold these securities to maturity.

HTM asset-backed securities issued by others are collateralized mortgage obligation securities. The securities have credit support tranches that absorb losses prior to the tranches that the Company owns. The Company reviews credit support positions on its securities regularly. HTM asset-backed securities issued by others with unrealized losses had an average life of 3.20 years and an average duration of 2.66 years.

Credit Quality of Asset-Backed Securities and Agency Bonds

The tables below present the Standard & Poor's ("S&P") or equivalent credit rating from other major rating agencies for AFS and HTM asset-backed securities issued by GSEs and U.S. Agencies and others or bonds issued by GSEs or U.S. government agencies at June 30, 2018 and December 31, 2017 by carrying value. The Company considers noninvestment grade securities rated BB+ or lower as classified assets for regulatory and financial reporting. GSE asset-backed securities and GSE agency bonds with S&P AA+ ratings were treated as AAA based on regulatory guidance.

June 30, 2018		December 31, 2017	
Credit Rating	Amount	Credit Rating	Amount
(dollars in thousands)			
AAA	$179,296	AAA	$162,337
BB	569	BB	651
B+	-	B+	-
Total	$179,865	Total	$162,988

NOTE 11 – LOANS

Loans consist of the following:

	June 30, 2018				December 31, 2017	
(dollars in thousands)	PCI	All other loans**	Total	% of Gross Loans	Total	% of Gross Loans
Commercial real estate	$1,503	$826,941	$828,445	64.20 %	$727,314	63.25 %
Residential first mortgages	470	162,621	163,090	12.64 %	170,374	14.81 %
Residential rentals	1,274	126,195	127,469	9.88 %	110,228	9.58 %
Construction and land development	272	28,375	28,647	2.22 %	27,871	2.42 %
Home equity and second mortgages	319	36,707	37,026	2.87 %	21,351	1.86 %
Commercial loans	-	57,519	57,519	4.46 %	56,417	4.91 %
Consumer loans	-	801	801	0.06 %	573	0.05 %
Commercial equipment	-	47,418	47,418	3.67 %	35,916	3.12 %
Gross loans	3,838	1,286,577	1,290,415	100.00%	1,150,044	100.00%
Net deferred costs (fees)	-	1,122	1,122	0.09 %	1,086	0.09 %
Total loans, net of deferred costs	$3,838	$1,287,699	$1,291,537		$1,151,130	
Less: allowance for loan losses	-	(10,725)	(10,725)	-0.83 %	(10,515)	-0.91 %
Net loans	$3,838	$1,276,974	$1,280,812		$1,140,615	

**All other loans include acquired Non-PCI pools.

At June 30, 2018 and December 31, 2017, the Bank's allowance for loan losses totaled $10.7 million and $10.5 million, or 0.83% and 0.91%, respectively, of loan balances. Allowance for loan loss percentage levels decreased in first six months of 2018, primarily due to the addition of County First loans, after consummation of the legal merger on January 1, 2018, for which no allowance was provided for in accordance with purchase accounting standards. Management's determination of the adequacy of the allowance is based on a periodic evaluation of the portfolio with consideration given to the overall loss experience, current economic conditions, size, growth and composition of the loan portfolio, financial condition of the borrowers and other relevant factors that, in management's judgment, warrant recognition in providing an adequate allowance.

Net deferred loan fees and premiums of $1.1 million at June 30, 2018 included net deferred fees paid by customers of $2.9 million offset by net deferred premiums paid for the purchase of residential first mortgages and deferred costs of $4.0 million. Net deferred loan fees and premiums of $1.1 million at December 31, 2017 included net deferred fees paid by customers of $2.8 million offset by net deferred premiums paid for the purchase of residential first mortgages

and deferred costs of $3.9 million.

Risk Characteristics of Portfolio Segments

Concentrations of Credit - Loans are primarily made within the Company's operating footprint of Southern Maryland, Annapolis Maryland and the greater Fredericksburg area of Virginia. Real estate loans can be affected by the condition of the local real estate market. Commercial and industrial loans can be affected by the local economic conditions. The commercial loan portfolio has concentrations in business loans secured by real estate and real estate development loans. At June 30, 2018 and December 31, 2017, the Company had no loans outstanding with foreign entities.

The Company manages its credit products and exposure to credit losses (credit risk) by the following specific portfolio segments (classes), which are levels at which the Company develops and documents its allowance for loan loss methodology. These segments are:

Commercial Real Estate ("CRE")

Commercial and other real estate projects include office buildings, retail locations, churches, other special purpose buildings and commercial construction. Commercial construction balances were 7.0% and 6.2% of the CRE portfolio at June 30, 2018 and December 31, 2017, respectively. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. The primary security on a commercial real estate loan is the real property and the leases that produce income for the real property. Loans secured by commercial real estate are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to 20 years.

Loans secured by commercial real estate are larger and involve greater risks than one-to four-family residential mortgage loans. Because payments on loans secured by such properties are often dependent on the successful operation or management of the properties, repayment of such loans may be subject to a greater extent to adverse conditions in the real estate market or the economy.

Residential First Mortgages

Residential first mortgage loans are generally long-term loans, amortized on a monthly basis, with principal and interest due each month. The contractual loan payment period for residential loans typically ranges from ten to 30 years. The Bank’s experience indicates that real estate loans remain outstanding for significantly shorter time periods than their contractual terms. Borrowers may refinance or prepay loans at their option, without penalty. The Bank’s residential portfolio has both fixed-rate and adjustable-rate residential first mortgages. During the six months ended June 30, 2018 and the year ended December 31, 2017, the Bank purchased residential first mortgages of $3.4 million and $25.5 million, respectively.

The annual and lifetime limitations on interest rate adjustments may limit the increases in interest rates on these loans. There are also credit risks resulting from potential increased costs to the borrower as a result of repricing of adjustable-rate mortgage loans. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower. The Bank’s adjustable rate residential first mortgage portfolio was $55.0 million or 4.3% of total gross loans of $1.29 billion at June 30, 2018 compared to $56.9 million or 5.0% of total gross loans of $1.15 billion at December 31, 2017.

Residential Rentals

Residential rental mortgage loans are amortizing, with principal and interest due each month. The loans are secured by income-producing 1-4 family units and apartments. As of June 30, 2018, and December 31, 2017, $99.9 million and $85.0 million, respectively, were 1-4 family units and $27.6 million and $25.2 million, respectively, were apartment buildings or multi-family units. Loans secured by residential rental properties are generally limited to 80% of the lower of the appraised value or sales price at origination and have an initial contractual loan payment period ranging from three to 20 years. The primary security on a residential rental loan is the property and the leases that produce income. During periods of rising interest rates, the risk of default on adjustable-rate mortgage loans may increase due to the upward adjustment of interest cost to the borrower. The Bank’s adjustable rate residential rental portfolio was $99.1 million or 7.7% of total gross loans of $1.29 billion at June 30, 2018 compared to $93.4 million or 8.1% of total gross loans of $1.15 billion at December 31, 2017.

Loans secured by residential rental properties involve greater risks than 1-4 family residential mortgage loans. Although, there are similar risk characteristics shared with commercial real estate loans, the balances for the loans secured by residential rental properties are generally smaller. Because payments on loans secured by residential rental properties are often dependent on the successful operation or management of the properties, repayment of these loans

may be subject to a greater extent to adverse conditions in the rental real estate market or the economy than similar owner-occupied properties.

Construction and Land Development

The Bank offers loans for the construction of one-to-four family dwellings. Generally, these loans are secured by the real estate under construction as well as by guarantees of the principals involved. In addition, the Bank offers loans to acquire and develop land, as well as loans on undeveloped, subdivided lots for home building.

A decline in demand for new housing might adversely affect the ability of borrowers to repay these loans. Construction and land development loans are inherently riskier than providing financing on owner-occupied real estate. The Bank's risk of loss is affected by the accuracy of the initial estimate of the market value of the completed project as well as the accuracy of the cost estimates made to complete the project. In addition, the volatility of the real estate market has made it increasingly difficult to ensure that the valuation of land associated with these loans is accurate. During the construction phase, a number of factors could result in delays and cost overruns. If the estimate of construction costs proves to be inaccurate, the Bank may be required to advance funds beyond the amount originally committed to permit completion of the development. If the estimate of value proves to be inaccurate, a project's value might be insufficient to assure full repayment. As a result of these factors, construction lending often involves the disbursement of substantial funds with repayment dependent, in part, on the success of the project rather than the ability of the borrower or guarantor to repay principal and interest. If the Bank forecloses on a project, there can be no assurance that the Bank will be able to recover all of the unpaid balance of, and accrued interest on, the loan as well as related foreclosure and holding costs.

Home Equity and Second Mortgage Loans

The Bank maintains a portfolio of home equity and second mortgage loans. These products contain a higher risk of default than residential first mortgages as in the event of foreclosure, the first mortgage would need to be paid off prior to collection of the second mortgage. This risk is heightened as the market value of residential property has not fully returned to pre-financial crisis levels and interest rates began to increase in 2017.

Commercial Loans

The Bank offers commercial loans to its business customers. The Bank offers a variety of commercial loan products including term loans and lines of credit. Such loans are generally made for terms of five years or less. The Bank offers both fixed-rate and adjustable-rate loans under these product lines. When making commercial business loans, the Bank considers the financial condition of the borrower, the borrower's payment history of both corporate and personal debt, the projected cash flows of the business, the viability of the industry in which the borrower operates, the value of the collateral, and the borrower's ability to service the debt from income. These loans are primarily secured by equipment, real property, accounts receivable or other security as determined by the Bank.

Commercial loans are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself.

Consumer Loans

Consumer loans consist of loans secured by automobiles, boats, recreational vehicles and trucks. The Bank also makes home improvement loans and offers both secured and unsecured personal lines of credit. Consumer loans entail greater risk from other loan types due to being secured by rapidly depreciating assets or the reliance on the borrower's continuing financial stability.

Commercial Equipment Loans

These loans consist primarily of fixed-rate, short-term loans collateralized by a commercial customer's equipment or secured by real property, accounts receivable, or other security as determined by the Bank. When making commercial equipment loans, the Bank considers the same factors it considers when underwriting a commercial business loan. Commercial loans are of higher risk and typically are made on the basis of the borrower's ability to make repayment from the cash flows of the borrower's business. As a result, the availability of funds for the repayment of commercial loans may depend substantially on the success of the business itself. In the case of business failure, collateral would need to be liquidated to provide repayment for the loan. In many cases, the highly specialized nature of collateral equipment would make full recovery from the sale of collateral problematic.

Non-accrual and Aging Analysis of Current and Past Due Loans

Non-accrual loans as of June 30, 2018 and December 31, 2017 were as follows:

	June 30, 2018					
(dollars in thousands)	90 or Greater Days Delinquent	Number of Loans	Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
Commercial real estate	$9,219	9	$ 800	3	$ 10,019	12
Residential first mortgages	522	2	487	1	1,009	3
Residential rentals	84	1	697	3	781	4
Construction and land development	-	-	-	-	-	-
Home equity and second mortgages	36	1	118	1	154	2
Commercial loans	898	2	-	-	898	2
Consumer loans	-	-	1	1	1	1
Commercial equipment	1,588	5	42	1	1,630	6
	$12,347	20	$ 2,145	10	$ 14,492	30

(dollars in thousands)	December 31, 2017 90 or Greater Days Delinquent	Number of Loans	Non-accrual Only Loans	Number of Loans	Total Non-accrual Loans	Total Number of Loans
Commercial real estate	$1,148	4	$ 839	3	$ 1,987	7
Residential first mortgages	478	3	507	1	985	4
Residential rentals	84	1	741	3	825	4
Construction and land development	-	-	-	-	-	-
Home equity and second mortgages	134	3	123	1	257	4
Commercial loans	172	2	-	-	172	2
Consumer loans	-	-	-	-	-	-
Commercial equipment	467	3	-	-	467	3
	$2,483	16	$ 2,210	8	$ 4,693	24

Non-accrual loans (90 days or greater delinquent and non-accrual only loans) increased $9.8 million from $4.7 million or 0.41% of total loans at December 31, 2017 to $14.5 million or 1.12% of total loans at June 30, 2018. Non-accrual loans can be current but classified as non-accrual due to customer operating results or payment history. All interest accrued but not collected from loans that are placed on non-accrual or charged-off is reversed against interest income. In accordance with the Company's policy, interest income is recognized on a cash basis or cost-recovery method, until qualifying for return to accrual status.

At June 30, 2018, non-accrual loans of $14.5 million included 30 loans, of which $11.7 million, or 80% represented 11 loans and two customer relationships. At December 31, 2017, non-accrual loans of $4.7 million included 24 loans, of which $3.3 million, or 71% represented 10 loans and five customer relationships. During the six months ended June 30, 2018, non-accrual loans increased $9.8 million primarily as a result of one well-secured classified relationship of $10.3 million that was placed on non-accrual during the second quarter of 2018, which resulted in the reversal of approximately $120,000 of interest income. During the year ended December 31, 2017 non-accrual loans decreased $3.0 million due to the foreclosure of a stalled residential development project. The Bank is working with a construction manager to stabilize and market the project. Before the foreclosure, the loans in this relationship were troubled debt restructures ("TDRs"). Additionally, during the third quarter of 2017, non-accrual loans decreased $607,000 due to the foreclosure of a commercial office building.

Non-accrual loans included no TDRs at June 30, 2018 and one TDR totaling $769,000 at December 31, 2017. This loan was classified solely as non-accrual for the calculation of financial ratios. Loan delinquency (90 days or greater delinquent and 31-89 days delinquent) increased $1.2 million from $11.7 million, or 1.02% of loans, at December 31, 2017 to $12.9 million, or 1.00% of loans, at June 30, 2018.

Non-accrual loans on which the recognition of interest has been discontinued, which did not have a specific allowance for impairment, amounted to $13.0 million and $3.8 million at June 30, 2018 and December 31, 2017, respectively. Interest due but not recognized on these balances at June 30, 2018 and December 31, 2017 was $252,000 and $85,000, respectively. Non-accrual loans with a specific allowance for impairment on which the recognition of interest has been discontinued amounted to $1.5 million and $876,000 at June 30, 2018 and December 31, 2017, respectively. Interest due but not recognized on these balances at June 30, 2018 and December 31, 2017 was $75,000 and $100,000, respectively.

The Company considers a loan to be past due or delinquent when the terms of the contractual obligation are not met by the borrower. PCI loans are included as a single category in the table below as management believes, regardless of their age, there is a lower likelihood of aggregate loss related to these loan pools. Additionally, PCI loans are discounted to allow for the accretion of income on a level yield basis over the life of the loan based on expected cash flows. Regardless of payment status, the associated discount on these loan pools results in income recognition.

Past due and PCI loans as of June 30, 2018 and December 31, 2017 were as follows:

	June 30, 2018						
(dollars in thousands)	31-60 Days	61-89 Days	90 or Greater Days	Total Past Due	PCI Loans	Current	Total Loan Receivables
Commercial real estate	$ 74	$ 85	$ 9,219	$ 9,378	$ 1,503	$ 817,564	$ 828,445
Residential first mortgages	-	71	522	593	470	162,027	163,090
Residential rentals	14	-	84	98	1,274	126,097	127,469
Construction and land dev.	-	-	-	-	272	28,375	28,647
Home equity and second mtg.	202	30	36	268	319	36,439	37,026
Commercial loans	-	-	898	898	-	56,621	57,519
Consumer loans	-	-	-	-	-	801	801
Commercial equipment	58	48	1,588	1,694	-	45,724	47,418
Total	$ 348	$ 234	$ 12,347	$ 12,929	$ 3,838	$ 1,273,648	$ 1,290,415

	December 31, 2017						
(dollars in thousands)	31-60 Days	61-89 Days	90 or Greater Days	Total Past Due	PCI Loans	Current	Total Loan Receivables
Commercial real estate	$ -	$ 6,711	$ 1,148	$ 7,859	$ -	$ 719,455	$ 727,314
Residential first mortgages	-	68	478	546	-	169,828	170,374
Residential rentals	-	207	84	291	-	109,937	110,228
Construction and land dev.	-	-	-	-	-	27,871	27,871
Home equity and second mtg.	19	18	134	171	-	21,180	21,351
Commercial loans	892	299	172	1,363	-	55,054	56,417
Consumer loans	-	1	-	1	-	572	573
Commercial equipment	1,012	-	467	1,479	-	34,437	35,916
Total	$ 1,923	$ 7,304	$ 2,483	$ 11,710	$ -	$ 1,138,334	$ 1,150,044

Impaired Loans and Troubled Debt Restructures ("TDRs")

Impaired loans, including TDRs, at June 30, 2018 and 2017 and at December 31, 2017 were as follows:

(dollars in thousands)	June 30, 2018 Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Quarter Average Recorded Investment	Quarter Interest Income Recognized	YTD Average Recorded Investment	YTD Interest Income Recognized
Commercial real estate	$26,804	$ 24,923	$ 1,569	$ 26,492	$ 182	$ 26,609	$ 214	$ 26,695	$ 469
Residential first mortgages	2,473	2,434	-	2,434	-	2,480	26	2,490	53
Residential rentals	1,430	1,396	-	1,396	-	1,440	18	1,450	35
Construction and land dev.	729	-	729	729	210	729	10	729	20
Home equity and second mtg.	303	213	86	299	7	304	3	306	7
Commercial loans	2,792	1,892	900	2,792	458	2,793	32	2,793	52
Consumer loans	2	1	1	2	1	2	-	2	-
Commercial equipment	1,645	1,021	622	1,643	508	1,661	13	1,692	29
Total	$36,178	$ 31,880	$ 3,907	$ 35,787	$ 1,366	$ 36,018	$ 316	$ 36,157	$ 665

(dollars in thousands)	December 31, 2017 Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	YTD Average Recorded Investment	YTD Interest Income Recognized
Commercial real estate	$33,180	$ 30,921	$ 2,008	$ 32,929	$ 370	$ 33,575	$ 1,379
Residential first mortgages	2,455	1,978	459	2,437	2	2,479	91
Residential rentals	2,389	1,981	395	2,376	18	2,432	111
Construction and land dev.	729	-	729	729	163	729	26
Home equity and second mtg.	317	317	-	317	-	318	12
Commercial loans	3,010	2,783	168	2,951	168	3,048	137
Commercial equipment	1,538	1,048	467	1,515	303	1,578	73
Total	$43,618	$ 39,028	$ 4,226	$ 43,254	$ 1,024	$ 44,159	$ 1,829

(dollars in thousands)	June 30, 2017 Unpaid Contractual Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance	Quarter Average Recorded Investment	Quarter Interest Income Recognized	YTD Average Recorded Investment	YTD Interest Income Recognized
Commercial real estate	$20,277	$ 13,079	$ 6,987	$ 20,066	$ 693	$ 20,186	$ 198	$ 20,274	$ 417
Residential first mortgages	2,294	1,823	468	2,291	11	2,299	21	2,311	49
Residential rentals	2,758	2,286	400	2,686	23	2,693	27	2,731	56
Construction and land dev.	981	252	729	981	163	980	4	980	7
Home equity and second mtg.	109	109	-	109	-	110	1	111	2
Commercial loans	3,063	2,804	169	2,973	169	2,974	23	2,986	46
Commercial equipment	638	108	491	599	417	617	6	625	11
Total	$30,120	$ 20,461	$ 9,244	$ 29,705	$ 1,476	$ 29,859	$ 280	$ 30,018	$ 588

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TDRs, included in the impaired loan schedules above, as of June 30, 2018 and December 31, 2017 were as follows:

	June 30, 2018		December 31, 2017	
(dollars in thousands)	Dollars	Number of Loans	Dollars	Number of Loans
Commercial real estate	$ 8,396	8	$ 9,273	9
Residential first mortgages	517	2	527	2
Residential rentals	218	1	221	1
Construction and land development	729	2	729	2
Commercial loans	4	1	4	1
Commercial equipment	-	-	36	1
Total TDRs	$ 9,864	14	$ 10,790	16
Less: TDRs included in non-accrual loans	-	-	(769)	(1)
Total accrual TDR loans	$ 9,864	14	$ 10,021	15

TDRs decreased $926,000 due to principal paydowns and payoffs for the six months ended June 30, 2018. There were no TDRs added during the six months ended June 30, 2018. The Company had specific reserves of $393,000 on three TDRs totaling $2.3 million at June 30, 2018. The Company had specific reserves of $413,000 on seven TDRs totaling $3.0 million at December 31, 2017. During the year ended December 31, 2017, TDR disposals, which included payoffs and refinancing decreased by seven loans totaling $3.9 million, of which $3.0 million related to the foreclosure of the stalled residential development project. TDR loan principal curtailment was $385,000 for the year ended December 31, 2017. There were no TDRs added during the year ended December 31, 2017.

Allowance for Loan Losses

The following tables detail activity in the allowance for loan losses at and for the three and six months ended June 30, 2018 and 2017, respectively. An allocation of the allowance to one category of loans does not prevent the Company from using that allowance to absorb losses in a different category.

	June 30, 2018				
(dollars in thousands)	Beginning Balance	Charge-offs	Recoveries	Provisions	Ending Balance
Three Months Ended					
Commercial real estate	$6,664	$ -	$ 4	$ (105)	$6,563
Residential first mortgages	937	(76)	-	(124)	737
Residential rentals	459	-	-	10	469
Construction and land development	482	-	-	16	498
Home equity and second mortgages	118	-	5	(19)	104
Commercial loans	1,045	(88)	-	246	1,203
Consumer loans	7	-	-	-	7
Commercial equipment	759	-	9	376	1,144
	$10,471	$ (164)	$ 18	$ 400	$10,725
Purchase Credit Impaired**	$-	$ -	$ -	$ -	$-
Six Months Ended					
Commercial real estate	$6,451	$ (236)	$ 6	$ 342	$6,563
Residential first mortgages	1,144	(113)	-	(294)	737
Residential rentals	512	-	-	(43)	469
Construction and land development	462	-	-	36	498
Home equity and second mortgages	162	(7)	14	(65)	104
Commercial loans	1,013	(88)	-	278	1,203
Consumer loans	7	(1)	-	1	7
Commercial equipment	764	(299)	34	645	1,144
	$10,515	$ (744)	$ 54	$ 900	$10,725
Purchase Credit Impaired**	$-	$ -	$ -	$ -	$-

** There is no allowance for loan loss on the PCI portfolios. A more detailed rollforward schedule will be presented if an allowance is required.

(dollars in thousands)	June 30, 2017 Beginning Balance	Charge-offs	Recoveries	Provisions	Ending Balance
Three Months Ended					
Commercial real estate	$5,179	$ -	$ 4	$ 902	$6,085
Residential first mortgages	1,428	-	-	(128)	1,300
Residential rentals	354	(42)	-	23	335
Construction and land development	891	(25)	-	(146)	720
Home equity and second mortgages	76	(1)	-	37	112
Commercial loans	789	-	-	25	814
Consumer loans	5	-	-	-	5
Commercial equipment	1,387	-	13	(337)	1,063
	$10,109	$ (68)	$ 17	$ 376	$10,434
Six Months Ended					
Commercial real estate	$5,212	$ -	$ 9	$ 864	$6,085
Residential first mortgages	1,406	-	-	(106)	1,300
Residential rentals	362	(42)	-	15	335
Construction and land development	941	(25)	-	(196)	720
Home equity and second mortgages	138	(1)	-	(25)	112
Commercial loans	794	-	1	19	814
Consumer loans	3	(2)	-	4	5
Commercial equipment	1,004	(146)	24	181	1,063
	$9,860	$ (216)	$ 34	$ 756	$10,434

The following tables detail loan receivable and allowance balances disaggregated on the basis of the Company's impairment methodology at June 30, 2018 and 2017 and December 31, 2017.

(dollars in thousands)	June 30, 2018				December 31, 2017			June 30, 2017	
	Ending balance: individually evaluated for impairment	Ending balance: collectively evaluated for impairment	Purchase Credit Impaired	Total	Ending balance: individually evaluated for impairment	Ending balance: collectively evaluated for impairment	Total	Ending balance: individually evaluated for impairment	Ending balance: collectivel evaluated for impairmen
Loan Receivables:									
Commercial real estate	$26,492	$800,450	$1,503	$828,445	$32,929	$694,385	$727,314	$20,066	$693,723
Residential first mortgages	2,434	160,186	470	163,090	2,437	167,937	170,374	2,291	179,095
Residential rentals	1,396	124,799	1,274	127,469	2,376	107,852	110,228	2,686	100,675
Construction and land development	729	27,646	272	28,647	729	27,142	27,871	981	31,622
Home equity and second mortgages	299	36,408	319	37,026	317	21,034	21,351	109	20,738
Commercial loans	2,792	54,727	-	57,519	2,951	53,466	56,417	2,973	52,050
Consumer loans	2	799	-	801	-	573	573	-	412
Commercial equipment	1,643	45,775	-	47,418	1,515	34,401	35,916	599	33,990
	$35,787	$1,250,790	$3,838	$1,290,415	$43,254	$1,106,790	$1,150,044	$29,705	$1,112,30
Allowance for loan losses:									
Commercial real estate	$182	$6,381	$-	$6,563	$370	$6,081	$6,451	$693	$5,392
Residential first mortgages	-	737	-	737	2	1,142	1,144	11	1,289
Residential rentals	-	469	-	469	18	494	512	23	312
Construction and land development	210	288	-	498	163	299	462	163	557
Home equity and second mortgages	7	97	-	104	-	162	162	-	112
Commercial loans	458	745	-	1,203	168	845	1,013	169	645
Consumer loans	1	6	-	7	-	7	7	-	5
Commercial equipment	508	636	-	1,144	303	461	764	417	646
	$1,366	$9,359	$-	$10,725	$1,024	$9,491	$10,515	$1,476	$8,958

During the fourth quarter of 2016, the Company expanded its factor scoring categories from three levels to five levels to capture additional movements in qualitative factors used to calculate the general allowance of each portfolio segment. No additional qualitative factors were added to the Company's methodology as part of this change. There were no material changes to the existing allowance for loan losses by portfolio segment or in the aggregate as a result of the change.

Credit Quality Indicators

Credit quality indicators as of June 30, 2018 and December 31, 2017 were as follows:

Credit Risk Profile by Internally Assigned Grade

(dollars in thousands)	Commercial Real Estate 6/30/2018	12/31/2017	Construction and Land Dev. 6/30/2018	12/31/2017	Residential Rentals 6/30/2018	12/31/2017
Unrated	$ 75,916	$ 75,581	$ 2,175	$ 1,775	$ 30,827	$ 28,428
Pass	725,402	619,604	25,471	25,367	95,246	80,279
Special mention	582	-	272	-	-	-
Substandard	26,545	32,129	729	729	1,396	1,521
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	$ 828,445	$ 727,314	$ 28,647	$ 27,871	$ 127,469	$ 110,228

(dollars in thousands)	Commercial Loans 6/30/2018	12/31/2017	Commercial Equipment 6/30/2018	12/31/2017	Total Commercial Portfolios 6/30/2018	12/31/2017
Unrated	$ 14,441	$ 14,356	$ 12,273	$ 10,856	$ 135,632	$ 130,996
Pass	40,296	39,118	33,544	23,581	919,959	787,949
Special mention	-	-	-	-	854	-
Substandard	2,782	2,943	1,498	1,479	32,950	38,801
Doubtful	-	-	103	-	103	-
Loss	-	-	-	-	-	-
Total	$ 57,519	$ 56,417	$ 47,418	$ 35,916	$ 1,089,498	$ 957,746

(dollars in thousands)	Non-Commercial Portfolios ** 6/30/2018	12/31/2017	Total All Portfolios 6/30/2018	12/31/2017
Unrated	$ 148,482	$ 152,616	$ 284,114	$ 283,612
Pass	50,826	38,081	970,785	826,030
Special mention	-	96	854	96
Substandard	1,609	1,505	34,559	40,306
Doubtful	-	-	103	-
Loss	-	-	-	-
Total	$ 200,917	$ 192,298	$ 1,290,415	$ 1,150,044

** Non-commercial portfolios are generally evaluated based on payment activity but may be risk graded if part if a larger commercial relationship or are credit impaired (e.g., non-accrual loans, TDRs).

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Credit Risk Profile Based on Payment Activity

dollars in	Residential First Mortgages		Home Equity and Second Mtg.		Consumer Loans	
(thousands)	6/30/2018	12/31/2017	6/30/2018	12/31/2017	6/30/2018	12/31/2017
Performing	$ 162,569	$ 169,896	$ 36,990	$ 21,217	$ 801	$ 573
Nonperforming	521	478	36	134	-	-
Total	$ 163,090	$ 170,374	$ 37,026	$ 21,351	$ 801	$ 573

A risk grading scale is used to assign grades to commercial relationships, which include commercial real estate, residential rentals, construction and land development, commercial loans and commercial equipment loans. Loans are graded at inception, annually thereafter when financial statements are received and at other times when there is an indication that a credit may have weakened or improved. Only commercial loan relationships with an aggregate exposure to the Bank of $1,000,000 or greater are subject to being risk rated.

Home equity and second mortgages and consumer loans are evaluated for creditworthiness in underwriting and are monitored based on borrower payment history. Residential first mortgages are evaluated for creditworthiness during credit due diligence before being purchased. Residential first mortgages, home equity and second mortgages and consumer loans are classified as unrated unless they are part of a larger commercial relationship that requires grading or are troubled debt restructures or nonperforming loans with an Other Assets Especially Mentioned (“OAEM”) or higher risk rating due to a delinquent payment history.

Management regularly reviews credit quality indicators as part of its individual loan reviews and on a monthly and quarterly basis. The overall quality of the Bank’s loan portfolio is assessed using the Bank’s risk grading scale, the level and trends of net charge-offs, nonperforming loans and delinquencies, the performance of troubled debt restructured loans and the general economic conditions in the Company’s geographical market. This review process is assisted by frequent internal reporting of loan production, loan quality, concentrations of credit, loan delinquencies and nonperforming and potential problem loans. Credit quality indicators and allowance factors are adjusted based on management’s judgment during the monthly and quarterly review process. Loans subject to risk ratings are graded on a scale of one to ten. The Company considers loans classified substandard, doubtful and loss as classified assets for regulatory and financial reporting.

Ratings 1 thru 6 - Pass

Ratings 1 thru 6 have asset risks ranging from excellent low risk to adequate. The specific rating assigned considers customer history of earnings, cash flows, liquidity, leverage, capitalization, consistency of debt service coverage, the nature and extent of customer relationship and other relevant specific business factors such as the stability of the industry or market area, changes to management, litigation or unexpected events that could have an impact on risks.

Rating 7 - OAEM (Other Assets Especially Mentioned) – Special Mention

These credits, while protected by the financial strength of the borrowers, guarantors or collateral, have reduced quality due to economic conditions, less than adequate earnings performance or other factors which require the lending officer to direct more than normal attention to the credit. Financing alternatives may be limited and/or command higher risk interest rates. OAEM loans are the first adversely classified assets on our watch list. These relationships will be reviewed at least quarterly.

Rating 8 - Substandard

Substandard assets are assets that are inadequately protected by the sound worth or paying capacity of the borrower or of the collateral pledged. These assets have a well-defined weakness or weakne