California BanCorp

# CONSOLIDATED FINANCIAL STATEMENTS

AS OF DECEMBER 31, 2017 AND 2016

AND FOR THE YEARS THEN ENDED

AND

INDEPENDENT AUDITOR'S REPORT

Crowe Horwath

**Crowe Horwath LLP**
Independent Member Crowe Horwath International

INDEPENDENT AUDITOR'S REPORT

The Shareholders and Board of Directors
California BanCorp
Oakland, California

## Report on the Financial Statements

We have audited the accompanying consolidated financial statements of California BanCorp, which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

## Management's Responsibility for the Financial Statements

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

## Auditor's Responsibility

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

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

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

## Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of California BanCorp as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Crowe Horwath LLP

Crowe Horwath LLP

San Francisco, California
March 23, 2018

# California BanCorp

## CONSOLIDATED BALANCE SHEETS

### December 31, 2017 and 2016

| | 2017 | 2016 |
|---|---|---|
| **ASSETS** | | |
| Cash and due from banks | $ 20,991,112 | $ 10,489,633 |
| Interest bearing deposits in banks | 64,961,569 | 76,928,001 |
| Total cash and cash equivalents | 85,952,681 | 87,417,634 |
| Investment securities (Note 3) | | |
| Available-for-sale, at estimated fair value | 13,001,878 | 15,561,837 |
| Loans, less allowance for loan losses of $9,300,000 in 2017 and $7,525,000 in 2016 (Notes 4, 5, 10 and 11) | 723,464,904 | 619,984,453 |
| Premises and equipment, net (Note 6) | 2,885,534 | 2,574,870 |
| Bank owned life insurance (BOLI) | 16,433,095 | 15,987,184 |
| Deferred income taxes, net | 4,537,656 | 6,152,143 |
| Core Deposit Intangible (Note 7) | 446,774 | 502,621 |
| Goodwill (Note 7) | 7,350,465 | 7,350,465 |
| Accrued interest receivable and other assets | 12,397,436 | 9,311,371 |
| Total assets | $ 866,470,423 | $ 764,842,578 |
| **LIABILITIES AND SHAREHOLDERS' EQUITY** | | |
| Deposits: | | |
| Non-interest bearing | $ 314,516,053 | $ 284,674,085 |
| Interest bearing (Note 8) | 445,857,359 | 365,372,728 |
| Total deposits | 760,373,412 | 650,046,813 |
| FHLB Advances (Note 10) | - | 29,000,000 |
| Long-term debt (Note 10) | 11,000,000 | - |
| Subordinated debt, $5,000,000 face amount (less unamortized debt issuance cost of $57,144 and $74,316, at December 31, 2017 and 2016, respectively) (Note 10) | 4,942,856 | 4,925,684 |
| Accrued interest payable and other liabilities (Note 15) | 5,411,488 | 4,300,428 |
| Total liabilities | 781,727,756 | 688,272,925 |
| Commitments and contingencies (Note 11) | | |
| Shareholders' equity (Notes 12 and 13): | | |
| Preferred Stock – no par value: 10,000,000 shares authorized, no shares outstanding (Note 17) | - | - |
| Common stock - no par value; 40,000,000 shares authorized; 6,416,295 and 5,871,752 issued and outstanding in 2017 and 2016, respectively | 76,935,565 | 68,750,160 |
| Retained earnings | 7,804,361 | 7,820,983 |
| Accumulated other comprehensive income (loss), net of taxes (Note 3) | 2,741 | (1,490) |
| Total shareholders' equity | 84,742,667 | 76,569,653 |
| Total liabilities and shareholders' equity | $ 866,470,423 | $ 764,842,578 |

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

# California BanCorp

## CONSOLIDATED STATEMENTS OF INCOME
### For the Years Ended December 31, 2017 and 2016

| | 2017 | 2016 |
|---|---|---|
| Interest income: | | |
| Interest and fees on loans | $ 33,771,736 | $ 28,588,884 |
| Interest on investment securities | 275,310 | 316,178 |
| Interest on interest bearing deposits in banks | 645,603 | 343,795 |
| Total interest income | 34,692,649 | 29,248,857 |
| Interest expense: | | |
| Interest on deposits (Note 8) | 2,440,905 | 1,426,591 |
| Interest on borrowings and subordinated debt (Note 10) | 718,411 | 672,422 |
| Total interest expense | 3,159,316 | 2,099,013 |
| Net interest income before provision for loan losses | 31,533,333 | 27,149,844 |
| Provision for loan losses (Note 5) | 2,393,165 | 1,403,151 |
| Net interest income after provision for loan losses | 29,140,168 | 25,746,693 |
| Non-interest income: | | |
| Service charges and other fees | 1,983,913 | 1,737,488 |
| Net gains on sales of loans | 258,879 | 311,176 |
| Net losses on sales of investment securities (Note 3) | - | (2,050) |
| Earnings on BOLI | 434,123 | 452,736 |
| Other | 414,511 | 558,569 |
| Total non-interest income | 3,091,426 | 3,057,919 |
| Non-interest expenses: | | |
| Salaries and employee benefits (Notes 4 and 15) | 12,342,860 | 12,164,221 |
| Occupancy and equipment (Notes 6 and 11) | 2,458,132 | 2,323,840 |
| Holding company formation and merger related | 269,774 | 376,858 |
| Other (Note 16) | 5,874,508 | 5,524,284 |
| Total non-interest expenses | 20,945,274 | 20,389,203 |
| Income before provision for income taxes | 11,286,319 | 8,415,409 |
| Provision for income taxes (Note 9) | 5,658,901 | 3,222,472 |
| Net Income | 5,627,418 | 5,192,937 |
| Preferred stock dividend | - | (151,861) |
| Income to common shareholders | $ 5,627,418 | $ 5,041,076 |
| Earnings per common share: | | |
| Basic | $ 0.89 | $ 0.84 |
| Diluted | $ 0.85 | $ 0.80 |
| Weighted average number of common shares outstanding – basic | 6,298,971 | 6,023,563 |
| Weighted average number of common shares outstanding – diluted | 6,642,508 | 6,294,885 |

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

# California BanCorp

## CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
### For the Years Ended December 31, 2017 and 2016

| | 2017 | 2016 |
|---|---|---|
| Net Income | $ 5,627,418 | $ 5,192,937 |
| Other comprehensive income (loss): | | |
| Unrealized gains (losses) on available-for-sale investment securities: | | |
| Unrealized holding gains (losses) arising during year | 7,175 | (64,057) |
| Reclassification adjustment for losses included in net income | - | 2,050 |
| Tax effect | (2,944) | 25,422 |
| Total other comprehensive income (loss) | 4,231 | (36,585) |
| Total comprehensive income | $ 5,631,649 | $ 5,156,352 |

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

# California BanCorp

## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
### For the Years Ended December 31, 2017 and 2016

| | Preferred Stock – Series C | | Common Stock | | | | |
|---|---|---|---|---|---|---|---|
| | Shares | Amount | Shares | Amount | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total Shareholders' Equity |
| Balance, December 31, 2015 | 11,000 | $10,949,443 | 5,537,837 | $64,123,095 | $ 2,830,463 | $ 35,095 | $77,938,096 |
| Share-based compensation expense (Note 12) | - | - | - | 182,557 | - | - | 182,557 |
| Preferred stock dividends (Note 17) | - | - | - | - | (151,860) | - | (151,860) |
| Preferred stock redemption (Note 17) | (11,000) | (10,949,443) | - | - | (50,557) | - | (11,000,000) |
| Issuance of common stock (Note 13) | - | - | 296,297 | 3,981,762 | - | - | 3,981,762 |
| Net income | - | - | - | - | 5,192,937 | - | 5,192,937 |
| Stock options exercised | - | - | 25,000 | 291,141 | - | - | 291,141 |
| Stock grants issued and related compensation expense | - | - | 12,618 | 171,605 | - | - | 171,605 |
| Other comprehensive loss | - | - | - | - | - | (36,585) | (36,585) |
| Balance, December 31, 2016 | - | $ - | 5,871,752 | $68,750,160 | $ 7,820,983 | $ (1,490) | $76,569,653 |
| Share-based compensation expense (Note 12) | - | - | - | 226,048 | - | - | 226,048 |
| Cash paid in lieu of fractional shares (Note 13) | - | - | - | - | (1,982) | - | (1,982) |
| Net income | - | - | - | - | 5,627,418 | - | 5,627,418 |
| Stock options exercised | - | - | 228,963 | 2,089,055 | - | - | 2,089,055 |
| Stock dividend declared on August 7, 2017 (Note 13) | - | - | 303,407 | 5,642,058 | (5,642,058) | - | - |
| Stock grants issued and related compensation expense | - | - | 12,173 | 228,244 | - | - | 228,244 |
| Other comprehensive income | - | - | - | - | - | 4,231 | 4,231 |
| Balance, December 31, 2017 | - | $ - | 6,416,295 | $76,935,565 | $ 7,804,361 | $ 2,741 | $84,742,667 |

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

# California BanCorp

## CONSOLIDATED STATEMENTS OF CASH FLOWS
### For the Years Ended December 31, 2017 and 2016

| | 2017 | 2016 |
|---|---|---|
| Cash flows from operating activities: | | |
| Net Income | $ 5,627,418 | $ 5,192,937 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 2,393,165 | 1,403,151 |
| Deferred tax provision | 1,615,359 | 145,793 |
| Depreciation | 736,869 | 210,577 |
| Deferred loan origination costs, net | (700,977) | (884,565) |
| Net accretion on discount of purchased loans | (425,724) | (680,690) |
| Amortization of premiums on investment securities, net | 65,256 | 112,087 |
| Share-based compensation expense, net | 454,292 | 354,162 |
| Increase in cash surrender value of life insurance | (434,113) | (454,812) |
| Discounts on retained portion of sold loans, net of accretion | 48,969 | 252,935 |
| Loss on sale of investment securities, net | - | 2,050 |
| Gain on sale of loans, net | (258,879) | (311,176) |
| Amortization of deposit intangible | 55,847 | 55,847 |
| Increase in accrued interest receivable and other assets | (1,039,720) | 716,435 |
| Increase in accrued interest payable and other liabilities | 1,128,225 | 487,498 |
| Net cash provided by operating activities | 9,265,987 | 6,602,229 |
| Cash flows from investing activities: | | |
| Proceeds from sales of available-for-sale investment securities | - | 10,146,259 |
| Proceeds from calls and maturities of available-for-sale investment securities | - | 2,800,000 |
| Proceeds from principal payments on available-for-sale investment securities | 2,501,878 | 3,102,278 |
| Net increase in loans | (109,393,040) | (111,914,087) |
| Proceeds from sale of loans | 4,856,035 | 4,646,588 |
| Purchase of low income tax credit investments | (1,689,654) | (2,069,343) |
| Purchases of premises and equipment | (1,047,533) | (434,794) |
| Purchase of bank-owned life insurance policies | (11,798) | (30,082) |
| Purchase of Federal Home Loan Bank stock | (360,500) | (205,448) |
| Net cash used in investing activities | (105,144,612) | (93,958,629) |
| Cash flows from financing activities: | | |
| Net increase in demand, interest bearing and savings deposits | 103,347,341 | 98,056,485 |
| Net increase in time deposits | 6,979,258 | 9,806,447 |
| Repayment of FHLB Advances | (29,000,000) | - |
| Redemption of preferred stock | - | (11,000,000) |
| Proceeds from issuance of senior notes | 11,000,000 | - |
| Proceeds from issuance of subordinated debt, net | - | 4,925,684 |
| Proceeds from exercised stock options | 2,089,055 | 291,141 |
| Payment of dividends on preferred stock | - | (151,860) |
| Cash paid in lieu of fraction shares | (1,982) | - |
| Issuance of common stock, net of offering costs | - | 3,981,762 |

(Continued)

# California BanCorp

## CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)
**For the Years Ended December 31, 2017 and 2016**

| | 2017 | 2016 |
|---|---|---|
| Net cash provided by financing activities | 94,413,672 | 105,909,659 |
| Increase in cash and cash equivalents | (1,464,953) | 18,553,259 |
| Cash and cash equivalents at beginning of year | 87,417,634 | 68,864,375 |
| Cash and cash equivalents at end of year | $ 85,952,681 | $ 87,417,634 |
| Supplemental disclosure of cash flow information: | | |
| Cash paid during the year for: | | |
| Interest | $ 3,227,082 | $ 2,021,694 |
| Income taxes | 2,140,000 | 1,752,000 |

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

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### General

California BanCorp (the "Company") was approved as a state chartered corporation on August 31, 2017. The Company, whose common stock is traded on the OTCQX under the ticker symbol, "CALB" and is headquartered in Oakland, California, was formed to acquire 100% of the voting equity of California Bank of Commerce (the "Bank") and commenced operation as a small bank holding company on August 31, 2017. This transaction was treated as an internal reorganization as all shareholders of the Bank became shareholders of the Company. The reorganization represented an exchange of shares between entities under common control, and, as a result, assets and liabilities of the Bank were recognized at their carrying amounts in the accounts of the Company. Subsequent to the reorganization, the Bank continued its operations as previously conducted, but as a wholly-owned subsidiary, collectively known as the "Company". The Company has no operations other than ownership of the Bank.

The Bank was approved as a state-chartered non-member bank on March 23, 2007, and commenced operations on July 17, 2007. The Bank is subject to regulation by the California Department of Business Oversight (the "CDBO") and the Federal Deposit Insurance Corporation (the "FDIC"). The Bank is headquartered in Lafayette, California and provides products and services to customers who are predominately small to middle-market businesses, professionals and not-for-profit organizations located in Contra Costa, Alameda, Santa Clara and surrounding counties.

Since the holding company reorganization was completed in 2017, the consolidated financial statements and related footnotes as of and for the year ended December 31, 2016, reflect only the financial condition and results of operations of the Bank.

On December 31, 2015, the Company completed its merger with Pan Pacific Bank ("PPB") with branch banking offices in Fremont and San Jose, California. The acquisition complements the Company's expansion strategy and enhances the Company's market presence in the San Francisco South Bay region.

### Basis of Presentation

The consolidated financial statements include the accounting and reporting policies of the Company conform with accounting principles generally accepted in the United States of America and prevailing practices within the banking industry. All significant intercompany transactions have been eliminated. The Company has no significant business activities other than its investment in the Bank.

### Principles of Consolidation

The consolidated financial statements include California BanCorp and its wholly owned subsidiary, California Bank of Commerce, collectively referred to as the Company. Intercompany transactions and balances are eliminated in consolidation.

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

Certain Reclassifications

Certain items in the consolidated financial statements for the years ended December 31, 2016 were reclassified to conform to the 2017 presentation. These reclassifications did not affect previously reported net income or shareholders' equity.

Subsequent Events

Management has reviewed all events occurring from December 31, 2017 through March 23, 2018 the date the consolidated financial statements were available to be issued.

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. These estimates and assumptions affect the reported amounts of assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

Cash and Cash Equivalents

For the purpose of the statement of cash flows, cash and cash equivalents consist of cash and due from banks, interest bearing deposits in banks with original maturities of 90 days or less and Federal funds sold. Generally, Federal funds are sold for one day periods. Cash flows from loans, deposits and other borrowings are presented on a net basis.

Investment Securities

Investment securities are classified into the following categories:

- Available-for-sale securities, reported at fair value, with unrealized gains and losses excluded from earnings and reported, net of taxes, as accumulated other comprehensive income (loss) within shareholders' equity.

- Held-to-maturity securities, which management has the positive intent and ability to hold, reported at amortized cost, adjusted for the accretion of discounts and amortization of premiums.

Management determines the appropriate classification of its investments at the time of purchase. Subsequent transfers between categories are accounted for at fair value.

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

Investment Securities (Continued)

Gains and losses on the sale of investment securities are computed using the specific identification method. Interest earned on investment securities is reported in interest income, net of applicable adjustments for accretion of discounts and amortization of premiums using the level yield method adjusted for changes in principal prepayment speeds.

An investment security is impaired when its carrying value is greater than its fair value. Investment securities that are impaired are evaluated on at least a quarterly basis and more frequently when economic or market conditions warrant such an evaluation to determine whether such a decline in their fair value is other than temporary. Management utilizes criteria such as the magnitude and duration of the decline and the intent and ability of the Company to retain its investment in the securities for a period of time sufficient to allow for an anticipated recovery in fair value, in addition to the reasons underlying the decline, to determine whether the loss in value is other than temporary. The term "other than temporary" is not intended to indicate that the decline is permanent, but indicates that the prospects for a near-term recovery of value is not necessarily favorable, or that there is a lack of evidence to support a realizable value equal to or greater than the carrying value of the investment. Once a decline in value is determined to be other than temporary, and management does not intend to sell the security or it is more likely than not that the Company will not be required to sell the security before recovery, only the portion of the impairment loss representing credit exposure is recognized as a charge to earnings, with the balance recognized as a charge to other comprehensive income. If management intends to sell the security or it is more likely than not that the Company will be required to sell the security before recovering its forecasted cost, the entire impairment loss is recognized as a charge to earnings.

Investment in Federal Home Loan Bank Stock

As a member of the Federal Home Loan Bank of San Francisco, the Bank is required to maintain an investment in the capital stock of the Federal Home Loan Bank (the "FHLB"). The investment is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value.

At December 31, 2017 and 2016, the Company's investment in FHLB stock totaled $2,731,200 and $2,370,700, respectively, and is included on the balance sheet in accrued interest receivable and other assets. Cash dividends are reported as non-interest income.

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

Investment in Other Bank Stocks

*Independent Bankers Financial Corporation*

The Independent Bankers Financial Corporation (the "IBFC"), the holding company for The Independent Banker's Bank, provides services exclusively to banks. At both December 31, 2017 and 2016, the Company's investment in IBFC stock totaled $88,242. The investment is carried at cost and is included on the balance sheet in accrued interest receivable and other assets.

*Pacific Coast Bankers' Bancshares*

The Pacific Coast Bankers' Bancshares ("PCBB"), the holding company for The Pacific Coast Banker's Bank, provides services exclusively to banks. At both December 31, 2017 and 2016, the Company's investment in PCBB stock totaled $380,000. The investment is carried at cost and is included on the balance sheet in accrued interest receivable and other assets. Cash dividends are reported as non-interest income.

Bank Owned Life Insurance

The Company has purchased life insurance policies on certain current and former executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Loans

Loans that management has the intent and ability to hold for the foreseeable future, or until maturity or payoff, are reported at the principal balances outstanding, net of deferred fees and costs, purchase premiums and discounts and the allowance for loan losses. Loans transferred from loans held for sale are carried at the lower of principal balance or market value at the date of transfer adjusted for accretion of discounts. Interest is accrued daily based upon outstanding loan balances. However, when, in the opinion of management, loans are considered to be impaired and the future collectability of interest and principal is in serious doubt, loans are placed on nonaccrual status and the accrual of interest income is suspended. Any interest accrued but unpaid is charged against income. Payments received are applied to reduce principal to the extent necessary to ensure collection. Subsequent payments on these loans, or payments received on nonaccrual loans for which the ultimate collectability of principal is not in doubt, are applied first to earned but unpaid interest and then to principal.

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

Loans (Continued)

Generally, loans are restored to accrual status when the obligation is brought current and has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The policy for placing loans on nonaccrual status, recording payments received on nonaccrual loans, resuming the accrual of interest and determining past due or delinquency status, does not differ by portfolio segment or class of financing receivable.

An impaired loan is measured based on the present value of expected future cash flows discounted at the loan's effective rate or, as a practical matter, at the loan's observable market price or the fair value of collateral less estimated costs to sell if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. All loans are evaluated and considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (including both principal and interest) in accordance with the contractual terms of the loan agreement. The policy for accounting for impaired loans, recognizing interest on impaired loans and recording payments on impaired loans is generally the same as that described above for nonaccrual loans, and does not differ by portfolio segment or class of financing receivable.

Substantially all loan origination fees, commitment fees, direct loan origination costs and purchase premiums and discounts on loans are deferred and recognized as an adjustment of yield, to be amortized to interest income over the contractual term of the loan. The unamortized balances of deferred fees and costs and purchase premiums and discounts are reported as a component of net loans.

The Company services loans that have been participated with other financial institutions totaling approximately $57,600,000 and $42,671,000, respectively, as of December 31, 2017 and 2016. The participated balances of these loans were sold without recourse and are not included on the Company's balance sheet.

Allowance for Loan Losses

The allowance for loan losses is an estimate of probable credit losses in the Company's loan portfolio that have been incurred as of the balance-sheet date. The allowance is established through a provision for loan losses which is charged to expense. Additions to the allowance are expected to maintain the adequacy of the total allowance after credit losses and loan growth. Credit exposures determined to be uncollectible are charged against the allowance. Cash received on previously charged off amounts is recorded as a recovery to the allowance. The policy for charging off loans and recording recoveries does not differ by portfolio segment or class of financing receivable. The overall allowance consists of two primary components, specific reserves related to individually identify impaired loans and general reserves for losses related to loans that are collectively evaluated for impairment.

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

Allowance for Loan Losses (Continued)

A restructuring of a debt constitutes a troubled debt restructuring (TDR) if the Company for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider. Restructured workout loans typically present an elevated level of credit risk as the borrowers are not able to perform according to the original contractual terms. Loans that are reported as TDRs are considered impaired and measured for impairment as described above.

The determination of the general reserve for loans that are collectively evaluated for impairment is based on estimates made by management, to include, but not limited to, consideration of historical losses by portfolio segment for the trailing four quarters, the loan risk rating, internal asset classifications, and qualitative factors to include economic trends in the Company's service areas, industry experience and trends, geographic concentrations, estimated collateral values, the Company's underwriting policies, the character of the loan portfolio, and probable losses inherent in the portfolio taken as a whole.

The Company maintains a separate allowance for each portfolio segment (loan type). These portfolio segments include commercial & industrial, real estate - construction & land, real estate - other, real estate - home equity lines of credit (“HELOC”) and installment & other. The allowance for loan losses attributable to each portfolio segment, which includes both impaired loans and loans that are not impaired, is combined to determine the Company's overall allowance, which is included on the balance sheet.

The Company assigns a risk rating to all loans and periodically, but not less than annually, performs reviews of all such loans to identify credit risks and to assess the overall collectability of the portfolio. These risk ratings are also subject to examination by independent specialists engaged by the Company and the Company's regulators. During these internal reviews, management monitors and analyzes the financial condition of borrowers and guarantors, trends in the industries in which borrowers operate and the fair values of collateral securing these loans. These credit quality indicators are used to assign a risk rating to each individual loan. The risk ratings can be grouped into five major categories, defined as follows:

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

Allowance for Loan Losses (Continued)

***Pass*** – A pass loan is a strong credit with no existing or known potential weaknesses deserving of management's close attention.

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

***Substandard*** – A substandard loan is not adequately protected by the current sound worth and paying capacity of the borrower or the value of the collateral pledged, if any. Loans classified as substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Well defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

***Doubtful*** – Loans classified doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

***Loss*** – Loans classified as loss are considered uncollectible and charged off immediately.

The general reserve component of the allowance for loan losses also consists of reserve factors that are based on management's assessment of the following for each portfolio segment: (1) risk ratings, (2) historical losses of the Company or its peers for the trailing four quarters and (3) other qualitative factors. These reserve factors are inherently subjective and are driven by the repayment risk associated with each portfolio segment described below.

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

Allowance for Loan Losses (Continued)

***Commercial & Industrial*** – Commercial loans generally possess a lower inherent risk of loss than real estate portfolio segments because these loans are generally underwritten to existing cash flows of operating businesses. Debt coverage is provided by business cash flows and economic trends influenced by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans.

***Real Estate - Construction & Land*** – Real estate construction loans (including land and development loans) generally possess a higher inherent risk of loss than other real estate portfolio segments. A major risk arises from the necessity to complete projects within specified cost and time lines. Trends in the construction industry significantly impact the credit quality of these loans, as demand drives construction activity. In addition, trends in real estate values significantly impact the credit quality of these loans, as property values determine the economic viability of construction projects.

***Real Estate - Other*** – Real estate mortgage loans generally possess a higher inherent risk of loss than other real estate portfolio segments, except land and construction loans. Adverse economic developments or an overbuilt market impact commercial real estate projects and may result in troubled loans. Trends in vacancy rates of commercial and residential properties impact the credit quality of these loans. High vacancy rates reduce operating revenues and the ability for properties to produce sufficient cash flow to service debt obligations.

***Real Estate - HELOC*** – The degree of risk in residential real estate lending depends primarily on the loan amount in relation to collateral value, the interest rate and the borrower's ability to repay in an orderly fashion. These loans generally possess a lower inherent risk of loss than other real estate portfolio segments. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating.

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

Allowance for Loan Losses (Continued)

***Installment & Other*** – An installment loan portfolio is usually comprised of a number of small loans scheduled to be amortized over a specific period. Most installment loans are made directly for consumer purchases, but business loans granted for the purchase of heavy equipment or industrial vehicles may also be included. Economic trends determined by unemployment rates and other key economic indicators are closely correlated to the credit quality of these loans. Weak economic trends indicate that the borrowers' capacity to repay their obligations may be deteriorating. SBA loans, guaranteed by U.S. Small Business Administration, are included in the “Other” category. The Company may choose to sell the conditional guarantee SBA loans which receives a premium at the time of the sale. The Company retained unguaranteed portion of the SBA loans. Loans in the “Other” category also include overdrafts on deposit accounts which are inconsequential.

Although management believes the allowance to be adequate, ultimate losses may vary from its estimates. At least quarterly, the Board of Directors reviews the adequacy of the allowance, including consideration of the relative risks in the portfolio, current economic conditions and other factors. If the Board of Directors and management determine that changes are warranted based on those reviews, the allowance is adjusted. In addition, the Bank's primary regulators, the FDIC and CDBO, as an integral part of their examination process, review the adequacy of the allowance. These regulatory agencies may require additions to the allowance based on their judgment about information available at the time of their examinations.

Acquired Loans

The Company acquired loans as a result of its acquisition of Pan Pacific Bank on December 31, 2015. Acquired loans are recorded at their estimated fair values at acquisition date, factoring in credit losses expected to be incurred over the life of the loan. Accordingly, an allowance for loan losses is not carried over or recorded for acquired loans as of the acquisition date.

The entire fair value discount accreted to interest income using an effective interest rate method for term loans, and on a straight line basis to interest income for revolving lines, as the timing and amount of cash flows under revolving lines are not predictable. Subsequent to acquisition, if the probable and estimable credit losses for non-purchased credit impaired loans exceed the amount of the remaining unaccreted discount, the excess is established as an allowance for loan losses.

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

Purchased Credit Impaired Loans

The Company acquired one loan in its merger with PPB that had evidence of credit quality deterioration subsequent to its origination and for which it was probable, at acquisition, that the Company would be unable to collect all contractually required payments (PCI loan). These loans are evaluated on an individual basis. Management has applied significant subjective judgment in determining which loans are PCI loans. Evidence of credit quality deterioration as of the purchase date may include data such as past due and nonaccrual status, risk grades and recent loan-to-value percentages. Revolving credit agreements (e.g., home equity lines of credit and revolving commercial loans) where the borrower had revolving privileges at acquisition date are not considered PCI loans because the timing and amount of cash flows cannot be reasonably estimated. This loan was paid off in full during 2016.

Allowance for Credit Losses on Off-Balance-Sheet Credit Exposures

The Company also maintains a separate allowance for off-balance-sheet commitments. Management estimates anticipated losses using historical data and utilization assumptions. The allowance for off-balance-sheet commitments is included in accrued interest payable and other liabilities on the balance sheet, and totaled $150,000 and $120,000 at December 31, 2017 and 2016, respectively.

Other Real Estate Owned

Other real estate owned ("OREO") consist of properties acquired through foreclosure. The Company values these properties at fair value less estimated costs to sell at the time it acquires them, which establishes the new cost basis. After it acquires them, the Company carries such properties at the lower of cost or fair value less estimated selling costs. If the Company records any income from the property after acquiring them, it includes this amount in other non-interest income. If the Company records any write-downs or there are any operating expense of such properties after acquiring them, it includes this amount in other non-interest expense.

At December 31, 2017 and 2016, the Company did not have any OREO.

Transfer of Financial Assets

Transfers of financial assets are accounted for as sales, when control over the assets has been surrendered. Control over transferred assets is deemed surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

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

Sales and Servicing of Government Guaranteed Loans

Included in the portfolio are loans which, in general, are 70 to 90 percent guaranteed by either the U.S. Department of Agriculture (the “USDA”) or the Small Business Administration (the "SBA"). The guaranteed portion of these loans may be sold to a third party, with the Company retaining the unguaranteed portion. The Company generally receives a premium in excess of the adjusted carrying value of the loan at the time of sale. The Company may be required to refund a portion of the sales premium if the borrower defaults or the loan prepays within ninety days of the settlement date. However, none of the premiums the Company had received were subject to these recourse provisions as of December 31, 2017 and 2016. There were no USDA and SBA loans held for sale at December 31, 2017 and 2016. The guaranteed portion of USDA and SBA loans sold, totaling approximately $16,068,000 and $17,587,000 were being serviced for others at December 31, 2017 and 2016, respectively.

Servicing rights acquired through 1) a purchase or 2) the origination of loans which are sold with servicing rights retained are recognized as separate assets or liabilities. Servicing assets or liabilities are initially recorded at fair value and are subsequently amortized in proportion to, and over the period of the related net servicing income or expense. Servicing assets are periodically evaluated for impairment. Fair values are estimated using discounted cash flows based on current market interest rates. For purposes of measuring impairment, servicing assets are stratified based on note rate and term. The amount of impairment recognized is the amount by which the servicing assets for a stratum exceed their fair value. Servicing assets totaling approximately $167,000 and $119,000 associated with loans previously sold which were included in accrued interest receivable and other assets at December 31, 2017 and 2016, respectively.

In addition, assets (accounted for as interest-only (IO) strips) are recorded at the fair value of the difference between note rates and rates paid to purchasers (the interest spread) and contractual servicing fees, if applicable. IO strips are carried at fair value with gains or losses recorded as a component of shareholders' equity, similar to available-for-sale investment securities. At December 31, 2017 and 2016 no IO strips were recorded.

The Company's investment in the loan is allocated between the retained portion of the loan, the servicing asset, the IO strip, and the sold portion of the loan based on their relative fair values on the date the loan is sold. The gain on the sold portion of the loan is recognized as income at the time of sale. The carrying value of the retained portion of the loan is discounted based on the estimated yield of a comparable non-guaranteed loan. Significant future prepayments of these loans will result in the recognition of additional amortization of related servicing assets and an adjustment to the carrying value of related IO strips.

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

Bank Premises and Equipment

Bank premises and equipment are carried at cost, less accumulated depreciation. Depreciation is determined using the straight-line method over the estimated useful lives of the related assets. The useful lives of furniture, fixtures and equipment are estimated to be 3 to 5 years. Leasehold improvements are amortized over the lesser of the respective lease term (including renewal periods that are reasonably assured) or their useful lives, which are generally 7 to 14 years.

Certain operating leases contain scheduled and specified rent increases or incentives in the form of tenant improvement allowances or credits. The scheduled rent increases are recognized on a straight-line basis over the lease term as an increase in the amount of rental expense recognized each period. Lease incentives are capitalized at the inception of the lease and amortized on a straight-line basis over the lease term as a reduction of rental expense. Amounts accrued in excess of amounts paid related to the scheduled rent increases and the unamortized deferred credits are included in accrued interest payable and other liabilities on the balance sheet.

When assets are sold or otherwise disposed of, the cost and related accumulated depreciation or amortization are removed from the accounts, and any resulting gain or loss is recognized in income for the period. The cost of maintenance and repairs is charged to expense as incurred. The Company evaluates premises and equipment for financial impairment as events or changes in circumstances indicate that the carrying amount of such assets may not be fully recoverable.

Business Combinations

The Company accounts for acquisitions of businesses using the acquisition method of accounting. Under the acquisition method, assets acquired and liabilities assumed are recorded at their estimated fair values at the date of acquisition. The Company utilizes various valuation techniques including discounted cash flow analyses to determine these fair values. Any excess of the purchase price over amounts allocated to the acquired assets, including identifiable intangible assets, and liabilities assumed is recorded as goodwill.

Goodwill and Other Intangible Assets

Goodwill resulted from the acquisition of PPB on December 31, 2015, and represents the excess of the purchase price over the fair value of acquired tangible asset and liabilities and identifiable intangible assets. Goodwill acquired in a purchase business combination and determined to have an indefinite useful life is not amortized, but tested for impairment at least annually or more frequently if events and circumstance exist that indicate a goodwill impairment test should be performed. The Company has selected December 31 as the date to perform the annual impairment test. The Company has one reporting unit to which all the goodwill is assigned. Goodwill is the only intangible asset with an indefinite life on the Company's balance sheet.

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

Goodwill and Other Intangible Assets (Continued)

Intangible assets with definite useful lives are amortized over their estimated lives to their estimated residual values. Intangible assets with definite useful lives consisted of core deposit intangible assets from the PPB acquisition. The core deposit intangible assets is being amortized on a straight line method over ten years.

Borrowings

The Bank issued subordinated debt during the second quarter of 2016. The subordinated debt was recorded net of related issuance costs of $86,578. The discount is being accreted to interest expense on a straight-line basis using a 5 year life.

The Company issued senior notes during the second quarter of 2017. The issuance costs for the senior notes were insignificant and were expensed in 2017.

Income Taxes

Deferred tax assets and liabilities are recognized for the tax consequences of temporary differences between the reported amount of assets and liabilities and their tax basis. Deferred tax assets and liabilities are adjusted for the effects of changes in tax laws and rates on the date of enactment. A valuation allowance is recognized if, based on the weight of available evidence, management believes it is more likely than not that some portion or all of the deferred tax assets will not be realized.

Accounting for Uncertainty in Income Taxes

The Company considers all tax positions recognized in its consolidated financial statements for the likelihood of realization. When tax returns are filed, it is highly certain that some positions taken would be sustained upon examination by the taxing authorities, while others are subject to uncertainly about the merits of the position taken or the amount of the position that would be ultimately sustained. The benefit of a tax position is recognized in the consolidated financial statements in the period during which, based on all available evidence, management believes it is more likely than not that the position will be sustained upon examination, including the resolution of appeals or litigation processes, if any. Tax positions taken are not offset or aggregated with other positions. Tax positions that meet the more-likely-than-not recognition threshold are measured as the largest amount of the tax benefit that is more than 50 percent likely of being realized upon settlement with the applicable taxing authority.

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

Accounting for Uncertainty in Income Taxes (Continued)

The portion of the benefits associated with tax positions taken that exceeds the amount measured as described above is reflected as a liability for unrecognized tax benefits in the accompanying balance sheet along with any associated interest and penalties that would be payable to the taxing authorities upon examination. Interest expense and penalties associated with unrecognized tax benefits, if any, are classified as income tax expense in the statement of income.

Stock Dividends

Stock dividends in excess of 20% requires no accounting entry because they are accounted for as stock splits by restating the shares outstanding in all prior presented to give effect to the shares issued in the split. Stock dividends for 20% or less are reported by transferring the fair value, as of the ex-dividend date, of the stock issued from retained earnings to common stock. Fractional share amounts are paid in cash with a reduction in retained earnings.

On August 7, 2017, the Company declared a 5% stock dividend that was payable on August 31, 2017 to shareholders of record as of the close of trading on August 18, 2017, with cash paid for any fractional shares. As a result of the stock dividend, the Company's issued and outstanding common shares increased from 6,112,888 common shares to 6,416,295 common shares. In addition, the Company paid $1,982 for fractional common shares on August 31, 2017. This transaction was recorded as of August 31, 2017 and resulted in an increase in common stock and a corresponding decrease of retained earnings in the amount of $5,642,057.

Earnings Per Share

Basic earnings per share (EPS), which excludes dilution, is computed by dividing net income by the weighted-average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock, such as stock options, result in the issuance of common stock which share in the earnings of the Company. The treasury stock method is applied to determine the dilutive effect of stock options and restricted stock in computing diluted earnings per share. There were 745,650 and 897,316 stock options outstanding at December 31, 2017 and 2016, respectively. Adjusted for stock dividend, there were 897,316 stock options from 854,587 stock options at December 31, 2016. There were 22,325 and 207,900 anti-dilutive stock options outstanding at December 31, 2017 and 2016, respectively that were excluded from the calculation of EPS. Adjusted for stock dividend, there were 207,900 anti-dilutive stock options outstanding from 198,000 anti-dilutive stock options at December 31, 2016.

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

Share-Based Compensation

The share-based compensation plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, the Company's operating results and government regulations. New shares are issued upon option exercise or restricted share grants. The Plan does not provide for the settlement of awards in cash.

For options, the Plan requires that the option price may not be less than the fair market value of the stock at the date the option is granted, and that the stock must be paid in full at the time the option is exercised.

Restricted stock awards are grants of shares of common stock that are subject to forfeiture until specific conditions or goals are met. Conditions may be based on continuing employment or achieving specified performance goals. During the period of restriction, participants holding restricted stock may have full voting and dividend rights. The restrictions lapse in accordance with a schedule or with other conditions determined by the Board of Directors.

The Company recognizes share-based compensation expense for the fair value of all stock options and restricted stock that are ultimately expected to vest as the requisite service is rendered and considering the probability of any performance criteria being achieved.

Management estimates the fair value of each option award as of the date of grant using a Black-Scholes-Merton option pricing formula. Expected volatility is based on historical volatility of similar entities over a preceding period commensurate with the expected term of the option because the Company's common stock has been publicly traded for a shorter period than the expected term for the options. The “simplified” method described in the Securities and Exchange Commission’s Staff Accounting Bulletin No. 110 is used to determine the expected term of option awards. The risk-free rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of grant. Expected dividend yield was not considered in the option pricing formula since the Company has not paid common stock dividends and has no current plans to do so in the future. The fair value of restricted stock awards is based on the value of the underlying shares at the date of the grant. Management makes estimates regarding pre-vesting forfeitures that will impact total compensation expense recognized under the Plan.

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

Comprehensive Income

Comprehensive income is a more inclusive financial reporting methodology that includes disclosure of other comprehensive income or loss that historically has not been recognized in the calculation of net income. Sources of other comprehensive income or loss include unrealized gains and losses on available-for-sale investment securities. Total comprehensive income and components of other comprehensive income, or loss, are presented in the statement of comprehensive income.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates.

New Accounting Standards

In May 2014, the FASB issued guidance on Revenue from Contracts with Customers. The guidance supersedes and replaces nearly all existing revenue recognition guidance, including industry-specific guidance, establishes a new control based revenue recognition model, changes the basis for deciding when revenue is recognized over time or at a point in time, provides new and more detailed guidance on specific topics and expands and improves disclosures about revenue. In addition, this amendment specifies the accounting for some costs to obtain or to fulfill a contract with a customer. This guidance is effective for fiscal years, and interim periods within those years, beginning after December 15, 2016. This guidance was deferred in Revenue from Contracts with Customers (Topic 606).

In August 2015, the FASB issued guidance on Revenue from Contracts with Customers (Topic 606). The guidance deferred the effective date of the above-mentioned guidance on Revenue from Contracts with Customers. This guidance is effective for public business entities for fiscal year beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted the revenue recognition guidance on January 1, 2018 using the modified retrospective approach. A significant amount of the Company's revenues are derived from interest income on financial assets, which are excluded from the scope of the amended guidance. The Company has not identified any significant change in the timing of revenue recognition and disclosure requirement on the consolidated financial statements.

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

New Accounting Standards (Continued)

In January 2016, the FASB issued guidance on Recognition and Measurement of Financial Assets and Financial Liabilities. The guidance intend to improve the recognition and measurement of financial instrument. The update intends to enhance the reporting model for financial instruments to provide users of financial instruments with more decision-useful information and addresses certain aspects of the recognition, measurement, presentation, and disclosure of financial instruments. This guidance is effective for all entities that hold financial assets and liabilities for fiscal year beginning after December 15, 2017. This guidance will primarily impact the Company's disclosure of the fair value of loans, which will be required to be calculated using exit price methodology. The Company is currently evaluating the impact of this new accounting standard and does not expect adoption of this standard to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued guidance on Accounting for Leases. The guidance clarifies the recognition of a right-to-use asset and lease liability on the statement of financial position for those leases previously classified as operating leases under the old guidance. The update maintains two classification of leases: Finance Leases (which replaces capital leases) and Operating Leases. If certain criteria at lease commencement are met, the lease would be classify as a finance lease. This guidance is effective for public business entities for fiscal year beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact of this new accounting standard does not expect adoption of this standard to have a material impact on the consolidated financial statements.

In March 2016, the FASB issued guidance on Compensation – Stock Compensation: Improvements to Employee Share-Based Payment Accounting. The guidance was issued to simplifying the accounting for share-based payment award transactions including (a) income tax consequences; (b) classification of awards as either equity or liabilities; (c) classification on the statement of cash flows; and (d) policy election to estimate the number of awards that are expected to vest or account for forfeitures when they occur. This guidance is effective for public entities for fiscal years beginning after December 15, 2016. The amount of the impact on the effective tax rate will be determined by the number of stock options exercised and the stock price of the Company when the stock options are exercised. The Company has recorded excess tax benefits in its income tax expense in the income statement. Prospectively, excess tax benefits will be reported as operating activities in the statement of cash flow. The Company has adopted this new accounting standard in 2017 and as a result has recorded excess tax benefits totaling $407,452 as part of tax expense. The Company continues to estimate forfeitures at grant date and at each reporting period, rather than as incurred.

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

New Accounting Standards (Continued)

In June 2016, the FASB issued guidance on Financial Instruments – Credit Losses. The guidance is to replace the incurred loss model with an expected loss model, which is referred to as the current expected credit loss (CECL) model. The CECL model is applicable to the measurement of credit losses on financial assets measured at amortized cost, including loan receivables, held-to maturity debt securities, and reinsurance receivables. It also applies to off-balance sheet credit exposures not accounted for as insurance (loan commitments, standby letters of credit, financial guarantees, and other similar instruments) and net investments in leases recognized by a lessor. This guidance will not have a significant impact to the Company's debt securities and purchased credit impaired assets. This guidance is effective for the Company for the fiscal year beginning after December 15, 2020. The Company is currently evaluating the impact of this new accounting standard on the consolidated financial statements.

In August 2016, the FASB issued guidance on Statement of Cash Flow – Classification of Certain Cash Receipts and Cash Payments. The guidance address the diversity in how certain cash receipt and cash payments are presented and classified in the statement of cash flows. This guidance is effective for public business entities for fiscal year beginning after December 15, 2017, and including interim period within fiscal year beginning on January 1, 2018. The Company is currently evaluating the impact of this new accounting standard on the consolidated financial statements and does not expect adoption of this standard to have material impact on the Company's consolidated financial statements.

In November 2016, the FASB issued guidance on Statement of Cash Flow – Restricted Cash. The guidance amended existing guidance to require that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and restricted cash. Therefore, amounts generally described as restricted cash 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. This guidance is effective for public entities for fiscal year beginning after December 15, 2017, and including interim period within those fiscal period. The Company is currently evaluating the impact of this new accounting standard and does not expect adoption of this standard to have material impact on the Company's consolidated financial statements.

In January 2017, the FASB issued guidance on Business Combinations – Clarifying the Definition of a Business. The guidance clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or business. This guidance is effective for all entities for fiscal year beginning after December 15, 2017 and including interim period within those fiscal period. The Company is currently evaluating the impact of this new accounting standard and does not expect adoption of this standard to have material impact on the consolidated financial statements.

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

New Accounting Standards (Continued)

In January 2017, the FASB issued guidance on Intangibles – Goodwill and Other – Simplifying the Test of Goodwill Impairment. The guidance simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. The amendment requires an entity to perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and recognizing an impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value, not to exceed the total amount of goodwill allocated to that reporting unit. This guidance is effective for all entities for fiscal year beginning after December 15, 2019. Early adoption is permitted for interim for annual goodwill impairment test performed on testing date after January 1, 2017. The Company has adopted this new accounting standard and it did not have a material impact to the consolidated financial statements.

In March 2017, the FASB issued guidance on Receivables—Nonrefundable Fees and Other Costs - Premium Amortization on Purchased Callable Debt Securities. The guidance will require the premium on callable debt securities to be amortized to the earliest call date. The amortization period for callable debt securities purchased at a discount would not be impacted. This guidance is effective for public entities for fiscal year beginning after December 15, 2018, and including interim period within those fiscal period. The Company is currently evaluating the impact of this new accounting standard and does not expect adoption of this standard to have material impact on the consolidated financial statements.

In February 2018, the FASB issued guidance on Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income. The guidance permits a company to reclassify the income tax effects of the Tax Cuts and Job Act of 2017 from accumulative other comprehensive income to retained earnings. This guidance is effective for public entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company is currently evaluating the impact of this new accounting standard and does not expect adoption of this standard to have material impact on the consolidated financial statements.

### 2. FAIR VALUE MEASUREMENTS

Fair Value Hierarchy

The Company groups its assets and liabilities measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. Valuations within these levels are based upon:

Level 1 – Quoted market prices for identical instruments traded in active exchange markets.

Level 2 – Quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable or can be corroborated by observable market data.

Level 3 – Model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect the Company's estimates of assumptions that market participants would use on pricing the asset or liability. Valuation techniques include management judgment and estimation which may be significant.

Management monitors the availability of observable market data to assess the appropriate classification of financial instruments within the fair value hierarchy. Changes in economic conditions or model-based valuation techniques may require the transfer of financial instruments from one fair value level to another. In such instances, the transfer is reported at the beginning of the reporting period.

Management evaluates the significance of transfers between levels based upon the nature of the financial instrument and size of the transfer relative to total assets, total liabilities or total earnings.

## 2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at December 31, 2017 and December 31, 2016 are as follows:

| | Carrying Amount | Fair Value Measurements at December 31, 2017 Using: Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|---|
| Financial assets | | | | | |
| Cash and cash equivalents | $ 85,952,681 | $ 85,952,681 | $ - | $ - | $ 85,952,681 |
| Securities available-for-sale | 13,001,878 | - | 13,001,878 | - | 13,001,878 |
| Loans, net | 723,464,904 | - | - | 733,815,000 | 733,815,000 |
| FHLB stock | 2,731,200 | N/A | N/A | N/A | N/A |
| IBFC stock | 88,242 | N/A | N/A | N/A | N/A |
| PCBB stock | 380,000 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 2,624,201 | - | 59,959 | 2,564,242 | 2,624,201 |
| Financial liabilities | | | | | |
| Deposits | $ 760,373,412 | $ 664,240,000 | $ 95,956,000 | $ - | $ 760,197,000 |
| Long-term debt | 11,000,000 | - | - | 11,072,000 | 11,072,000 |
| Subordinated debt | 4,942,856 | - | - | 4,986,000 | 4,986,000 |
| Accrued interest payable | 115,036 | - | 53,838 | 61,198 | 115,036 |

| | Carrying Amount | Fair Value Measurements at December 31, 2016 Using: Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|---|
| Financial assets | | | | | |
| Cash and cash equivalents | $ 87,417,634 | $ 87,417,634 | $ - | $ - | $ 87,417,634 |
| Securities available-for-sale | 15,561,837 | - | 15,561,837 | - | 15,561,837 |
| Loans, net | 619,984,453 | - | - | 621,325,000 | 621,325,000 |
| FHLB stock | 2,370,700 | N/A | N/A | N/A | N/A |
| IBFC stock | 88,242 | N/A | N/A | N/A | N/A |
| PCBB stock | 380,000 | N/A | N/A | N/A | N/A |
| Accrued interest receivable | 2,138,182 | - | 46,816 | 2,091,366 | 2,138,182 |
| Financial liabilities | | | | | |
| Deposits | $ 650,046,813 | $ 560,673,000 | $ 88,969,000 | $ - | $ 649,642,000 |
| FHLB Advances | 29,000,000 | - | 29,026,000 | - | 29,026,000 |
| Subordinated debt | 4,925,684 | - | - | 4,942,000 | 4,942,000 |
| Accrued interest payable | 101,193 | - | 12,264 | 88,929 | 101,193 |

These estimates do not reflect any premium or discount that could result from offering the Company's entire holdings of a particular financial instrument for sale at one time, nor do they attempt to estimate the value of anticipated future business related to the instruments. In addition, the tax ramifications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in any of these estimates.

## 2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value of Financial Instruments (Continued)

The methods and assumptions used to estimate fair values are described as follows:

*Cash and Cash Equivalents* – The carrying amounts of cash and short-term instruments approximate fair values and are classified as Level 1.

*Investment Securities* – Since quoted prices are generally not available for identical securities, fair values are calculated based on market prices of similar securities on similar dates, resulting in Level 2 classification.

*FHLB, IBFC, PCBB Stocks* – It is not practical to determine the fair value of these correspondent bank stocks due to restrictions placed on their transferability.

*Loans* – Fair values of loans are estimated as follows: For variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values resulting in Level 3 classification. Fair values for other loans are estimated using discounted cash flow analyses, using interest rates currently being offered for loans with similar terms to borrowers of similar credit quality resulting in Level 3 classification. The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of the valuation, and management's expertise and knowledge of the client and client's business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly. The methods utilized to estimate the fair value of loans do not necessarily represent an exit price.

*Deposits* – The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in Level 1 classification. The carrying amounts of variable rate and fixed-term money market accounts approximate their fair values at the reporting date resulting in Level 1 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in Level 2 classification.

## 2. FAIR VALUE MEASUREMENTS (Continued)

Fair Value of Financial Instruments (Continued)

*FHLB Advances* – Fair values for FHLB Advances are estimated using discounted cash flow analyses using interest rates offered at each reporting date by correspondent banks for advances with similar maturities resulting in Level 2 classification.

*Senior Notes* – Fair values for senior notes are estimated using a discounted cash flow calculation based on current rates for similar types of debt which may be unobservable, and considering recent trading activity of similar instruments in market which can be inactive and accordingly are classified within in Level 3 classification.

*Subordinated Debt* – Fair values for subordinated debt are estimated using discounted cash flow calculation based on current rates for similar types of debt which may be unobservable, and considering recent trading activity of similar instruments in market which can be inactive and accordingly are classified within in Level 3 classification.

*Accrued Interest Receivable* – The carrying amounts of accrued interest receivable approximate fair value resulting in a Level 2 classification for accrued interest receivable on investment securities and a Level 3 classification for accrued interest receivable on loans since investment securities are generally classified using Level 2 inputs and loans are generally classified using Level 3 inputs.

*Accrued Interest Payable* – The carrying amounts of accrued interest payable approximate fair value resulting in a Level 2 classification, since accrued interest payable is from deposits that are generally classified using Level 2 inputs.

*Off Balance Sheet Instruments* – Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

## 2. FAIR VALUE MEASUREMENTS (Continued)

Assets Recorded at Fair Value

The following tables present information about the Company's assets and liabilities measured at fair value on a recurring and nonrecurring basis:

*Recurring Basis*

The Company is required or permitted to record the following assets at fair value on a recurring basis.

| Description | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| December 31, 2017 | | | | |
| Available-for-sale investment securities | | | | |
| Debt securities: | | | | |
| Mortgage-backed securities - residential | $ 10,493,487 | $ - | $ 10,493,487 | $ - |
| Corporate bonds | 2,508,390 | - | *2,508,390* | - |
| Total assets measured at fair value on a recurring basis | $ 13,001,877 | $ - | $ 13,001,877 | $ - |

| Description | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| December 31, 2016 | | | | |
| Available-for-sale investment securities | | | | |
| Debt securities: | | | | |
| Mortgage-backed securities - residential | $ 13,058,717 | $ - | $ 13,058,717 | $ - |
| Corporate bonds | 2,503,120 | - | 2,503,120 | - |
| Total assets measured at fair value on a recurring basis | $ 15,561,837 | $ - | $ 15,561,837 | $ - |

Fair values for available-for-sale investment securities are based on quoted market prices for exact or similar securities. During the years ended December 31, 2017 and 2016, there were no significant transfers in or out of Levels 1 and 2 and there were no changes in the valuation techniques used.

*Non-recurring Basis*

The Company may be required, from time to time, to measure certain assets at fair value on a non-recurring basis. These include assets that are measured at the lower of cost or market value that were recognized at fair value which was below cost at the reporting date. There were no assets or liabilities measured at fair value on a non-recurring basis as of December 31, 2017 and 2016.

## 3. INVESTMENT SECURITIES

The following table summarizes the amortized cost and fair value of securities available-for-sale at December 31, 2017 and 2016 and the corresponding amounts of gross unrealized gains and losses:

| | December 31, 2017 | | | |
|---|---|---|---|---|
| *Available-for-Sale* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities - residential | $ 10,493,904 | $ 14,835 | $ (15,251) | $ 10,493,488 |
| Corporate bonds | 2,503,326 | 5,064 | - | 2,508,390 |
| Total available-for-sale | $ 12,997,230 | $ 19,899 | $ (15,251) | $ 13,001,878 |

| | December 31, 2016 | | | |
|---|---|---|---|---|
| *Available-for-Sale* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Estimated Fair Value |
| Mortgage-backed securities - residential | $ 13,058,982 | $ 32,214 | $ (32,479) | $ 13,058,717 |
| Corporate bonds | 2,505,382 | 2,118 | (4,380) | 2,503,120 |
| Total available-for-sale | $ 15,564,364 | $ 34,332 | $ (36,859) | $ 15,561,837 |

Net unrealized gains on available-for-sale investment securities totaling $4,648 were recorded, net of $1,906 in deferred tax assets, as accumulated other comprehensive income within shareholders' equity at December 31, 2017. Net unrealized holding gains arising during the year ended December 31, 2017 totaled $7,175.

Net unrealized loss on available-for-sale investment securities totaling $2,527 were recorded, net of $1,037 in deferred tax assets, as accumulated other comprehensive loss within shareholders' equity at December 31, 2016. Net unrealized holding losses arising during the year ended December 31, 2016 totaled $64,057.

There were no available-for-sale investment securities which matured during the year ended December 31, 2017. There were no available-for-sale investment securities that were called during the year ended December 31, 2017 and 2016. There were no proceeds from the sale of available-for-sale investment securities for the year ended December 31, 2017.

There were two available-for-sale investment securities which matured during the year ended December 31, 2016 totaling $2,800,000. Proceeds and gross realized loss from the sale of available-for-sale investment securities for the year ended December 31, 2016 totaled $10,146,259 and $2,050, respectively.

## 3. INVESTMENT SECURITIES (Continued)

The amortized cost and fair value of debt securities as of December 31, 2017 are shown by contractual maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

| | Amortized Cost | Fair Value |
|---|---|---|
| Available-for-sale | | |
| Within one year | $ - | $ - |
| One to five years | 2,503,326 | 2,508,390 |
| Five to ten years | - | - |
| Mortgage-backed securities not due at a single maturity date | 10,493,904 | 10,493,487 |
| Total | $ 12,997,230 | $ 13,001,877 |

At December 31, 2017, investment securities with amortized costs totaling $7,371,354 and estimated fair values totaling $7,377,387 were pledged to secure borrowing arrangements in place with the Wells Fargo Bank. (See Note 10)

At December 31, 2016, investment securities with amortized costs totaling $9,082,463 and estimated fair values totaling $9,067,002 were pledged to secure borrowing arrangements in place with the Wells Fargo Bank. (See Note 10)

At December 31, 2017, the Company's investment security portfolio consisted of 15 securities, five of which were in an unrealized loss position at year end. All of the securities in a loss position were Mortgage-Backed-Securities. Management believes that changes in the market value of its Mortgage-Backed-Securities and corporate securities since purchase are primarily attributable to changes in interest rates and relative illiquidity and not credit quality. Because the Company has the ability and intent to hold those investments until a recovery of fair value, which may be at maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2017.

At year-end 2016, there were no holdings of securities of any one issuer, other than the U.S. Government Agencies, in an amount greater than 2.0% of shareholder's equity.

## 3. INVESTMENT SECURITIES (Continued)

The following table summarizes securities with unrealized losses at December 31, 2017 and December 31, 2016, aggregated by major security type and length of time in a continuous unrealized loss position:

| | Less Than 12 Months | | 12 Months or Longer | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| December 31, 2017 | | | | | | |
| Mortgage-backed securities - residential | $ 4,286,175 | $ 15,251 | $ - | $ - | $ 4,286,175 | $ 15,251 |
| Total available-for-sale | $ 4,286,175 | $ 15,251 | $ - | $ - | $ 4,286,175 | $ 15,251 |
| December 31, 2016 Available-for-sale | | | | | | |
| Mortgage-backed securities - residential | $ 5,854,224 | $ 32,479 | $ - | $ - | $ 5,854,224 | $ 32,479 |
| Corporate bonds | - | - | 1,499,020 | 4,380 | 1,499,020 | 4,380 |
| Total available-for-sale | $ 5,854,224 | $ 32,479 | $ 1,499,020 | $ 4,380 | $ 7,353,244 | $ 36,859 |

## 4. LOANS

Outstanding loans are summarized below:

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Commercial & Industrial | $ 329,030,432 | $ 253,619,468 |
| Real estate - Construction & Land | 41,264,748 | 31,908,291 |
| Real Estate - Other | 344,817,073 | 324,894,759 |
| Real Estate - HELOC | 3,618,113 | 4,218,442 |
| Installment and Other | 11,206,703 | 10,741,635 |
| | 729,937,069 | 625,382,595 |
| Deferred loan origination costs, net | 2,827,835 | 2,126,858 |
| Allowance for loan losses | (9,300,000) | (7,525,000) |
| | $ 723,464,904 | $ 619,984,453 |

Salaries and employee benefits totaling $4,679,873 and $4,055,022 were deferred as loan origination costs for the years ended December 31, 2017 and 2016, respectively.

Loans with carrying values totaling approximately $396,043,952 were pledged to secure borrowing arrangements at December 31, 2017 (see Note 10).

## 5. ALLOWANCE FOR LOAN LOSSES

The following table shows the changes in and allocation of the allowance for loan losses for the years ended December 31, 2017 and 2016 by portfolio segment, as well as the balances of the allowance for loan losses and loans by portfolio segment and impairment methodology:

| | Commercial & Industrial | Real Estate Construction & Land | Real Estate - Other | Real Estate HELOC | Installment & Other | Total |
|---|---|---|---|---|---|---|
| Allowance for Loan Losses December 31, 2017 | | | | | | |
| Balance at beginning of year | $ 4,045,894 | $ 590,880 | $ 2,826,058 | $ 44,487 | $ 17,681 | $ 7,525,000 |
| Provision for loan losses | 2,252,006 | 178,839 | (46,613) | (2,410) | 11,343 | 2,393,165 |
| Loans charged-off | (826,137) | - | - | - | - | (826,137) |
| Recoveries of loans previously charged-off | 57,972 | - | 150,000 | - | - | 207,972 |
| Ending balance allocated to portfolio segments | $ 5,529,735 | $ 769,719 | $ 2,929,445 | $ 42,077 | $ 29,024 | $ 9,300,000 |
| Ending balance: individually evaluated for impairment | $ 46,225 | $ - | $ - | $ - | $ - | $ 46,225 |
| Ending balance: collectively evaluated for impairment | $ 5,483,510 | $ 769,719 | $ 2,929,445 | $ 42,077 | $ 29,024 | $ 9,253,775 |

| | Commercial & Industrial | Real Estate Construction & Land | Real Estate - Other | Real Estate HELOC | Installment & Other | Total |
|---|---|---|---|---|---|---|
| Loans – December 31, 2017 Ending balance | $329,030,432 | $ 41,264,748 | $344,817,073 | $ 3,618,113 | $ 11,206,703 | $729,937,069 |
| Ending balance: individually evaluated for impairment | $ 4,809,411 | $ - | $ - | $ - | $ - | $ 4,809,411 |
| Ending balance: collectively evaluated for impairment | $324,221,021 | $ 41,264,748 | $344,817,073 | $ 3,618,113 | $ 11,206,703 | $725,127,658 |

## 5. ALLOWANCE FOR LOAN LOSSES (Continued)

| | Commercial & Industrial | Real Estate Construction & Land | Real Estate - Other | Real Estate HELOC | Installment & Other | Total |
|---|---|---|---|---|---|---|
| Allowance for Loan Losses December 31, 2016 | | | | | | |
| Balance at beginning of year | $ 3,736,622 | $ 139,433 | $ 1,949,471 | $ 42,388 | $ 7,086 | $ 5,875,000 |
| Provision for loan losses | 62,423 | 451,447 | 876,587 | 2,099 | 10,595 | 1,403,151 |
| Loans charged-off | - | - | - | - | - | - |
| Recoveries of loans previously charged-off | 246,849 | - | - | - | - | 246,849 |
| Ending balance allocated to portfolio segments | $ 4,045,894 | $ 590,880 | $ 2,826,058 | $ 44,487 | $ 17,681 | $ 7,525,000 |
| Ending balance: individually evaluated for impairment | $ 2,000 | $ - | $ - | $ - | $ - | $ 2,000 |
| Ending balance: collectively evaluated for impairment | $ 4,043,894 | $ 590,880 | $ 2,826,058 | $ 44,487 | $ 17,681 | $ 7,523,000 |

| | Commercial & Industrial | Real Estate Construction & Land | Real Estate - Other | Real Estate HELOC | Installment & Other | Total |
|---|---|---|---|---|---|---|
| Loans – December 31, 2016 | | | | | | |
| Ending balance | $253,619,468 | $ 31,908,291 | $324,894,759 | $ 4,218,442 | $ 10,741,635 | $625,382,595 |
| Ending balance: individually evaluated for impairment | $ 1,939,507 | $ - | $ 1,504,243 | $ - | $ - | $ 3,443,750 |
| Ending balance: collectively evaluated for impairment | $ 251,679,961 | $ 31,908,291 | $323,390,516 | $ 4,218,442 | $ 10,741,635 | $621,938,845 |

## 5. ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2017:

| | Credit Exposure Credit Risk Profile by Internally Assigned Grade | | | | | |
|---|---|---|---|---|---|---|
| | Commercial & Industrial | Real Estate Construction & Land | Real Estate - Other | Real Estate HELOC | Installment & Other | Total |
| Grade: | | | | | | |
| Pass | $ 318,972,321 | $ 41,264,748 | $ 341,423,391 | $ 3,618,113 | $ 11,206,703 | $ 716,485,276 |
| Special Mention | 3,825,998 | - | 1,841,555 | - | - | 5,667,553 |
| Substandard | 6,232,113 | - | 1,552,127 | - | - | 7,784,240 |
| Total | $ 329,030,432 | $ 41,264,748 | $ 344,817,073 | $ 3,618,113 | $ 10,206,703 | $ 729,937,069 |

The following table shows the loan portfolio allocated by management's internal risk ratings at December 31, 2016:

| | Credit Exposure Credit Risk Profile by Internally Assigned Grade | | | | | |
|---|---|---|---|---|---|---|
| | Commercial & Industrial | Real Estate Construction & Land | Real Estate - Other | Real Estate HELOC | Installment & Other | Total |
| Grade: | | | | | | |
| Pass | $ 250,025,459 | $ 30,405,969 | $ 322,758,447 | $ 4,218,442 | $ 10,741,635 | $ 618,149,952 |
| Special Mention | 2,579,074 | - | 632,069 | - | - | 3,211,143 |
| Substandard | 1,014,935 | 1,502,322 | 1,504,243 | - | - | 4,021,500 |
| Total | $ 253,619,468 | $ 31,908,291 | $ 324,894,759 | $ 4,218,442 | $ 10,741,635 | $ 625,382,595 |

The following table shows an aging analysis of the loan portfolio by the time past due at December 31, 2017:

| | 30-89 Days Past Due | 90 Days and Still Accruing | Nonaccrual | Total Past Due | Current | Total |
|---|---|---|---|---|---|---|
| Commercial & Industrial | $ - | $ - | $ 483,885 | $ 483,885 | $328,546,547 | $329,030,432 |
| Real Estate - Construction & Land | - | - | - | - | 41,264,748 | 41,264,748 |
| Real Estate - Other | 734,735 | - | - | 734,735 | 344,082,338 | 344,817,073 |
| Real Estate - HELOC | - | - | - | - | 3,618,113 | 3,618,113 |
| Installment & Other | - | - | - | - | 11,206,703 | 11,206,703 |
| Total | $ 734,735 | $ - | $ 483,885 | $ 1,218,620 | $728,718,449 | $729,937,069 |

## 5. ALLOWANCE FOR LOAN LOSSES (Continued)

The following table shows an aging analysis of the loan portfolio by the time past due at December 31, 2016:

| | 30-89 Days Past Due | 90 Days and Still Accruing | Nonaccrual | Total Past Due | Current | Total |
|---|---|---|---|---|---|---|
| Commercial & Industrial | $ - | $ | $ - | $ - | $253,619,468 | $253,619,468 |
| Real Estate - Construction & Land | - | - | - | - | 31,908,291 | 31,908,291 |
| Real Estate - Other | - | - | 739,878 | 739,878 | 324,154,881 | 324,894,759 |
| Real Estate - HELOC | - | - | - | - | 4,218,442 | 4,218,442 |
| Installment & Other | - | - | - | - | 10,741,635 | 10,741,635 |
| Total | $ - | $ - | $ 739,878 | $ 739,878 | $624,642,717 | $625,382,595 |

### Impaired Loans

The following table shows information related to impaired loans at and for the year ended December 31, 2017:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial & Industrial | $ 4,173,907 | $ 4,173,907 | $ 17,725 | $ 4,164,037 | $ 233,612 |
| With an allowance recorded: | | | | | |
| Commercial & Industrial | $ 635,504 | $ 635,504 | $ 28,500 | $ 642,349 | $ 34,192 |
| Total: | | | | | |
| Commercial & Industrial | $ 4,809,411 | $ 4,809,411 | $ 46,225 | $ 4,806,386 | $ 267,804 |

The following table shows information related to impaired loans at and for the year ended December 31, 2016:

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial & Industrial | $ 1,289,571 | $ 1,289,571 | $ - | $ 1,450,178 | $ 82,085 |
| Real Estate - Other | 1,504,243 | 1,746,777 | - | 1,534,921 | 39,724 |
| With an allowance recorded: | | | | | |
| Commercial & Industrial | $ 649,935 | $ 649,935 | $ 2,000 | $ 656,239 | $ 35,027 |
| Total: | | | | | |
| Commercial & Industrial | $ 1,939,506 | $ 1,939,506 | $ 2,000 | $ 2,106,417 | $ 117,112 |
| Real Estate - Other | 1,504,243 | 1,746,777 | - | 1,534,921 | 39,724 |

## 5. ALLOWANCE FOR LOAN LOSSES (Continued)

Interest forgone on nonaccrual loans totaled $28,445 and $92,533 for the years ended December 31, 2017 and 2016, respectively. There was no interest recognized on a cash-basis on impaired loans for the years ended December 31, 2017 and 2016.

The recorded investment in impaired loans in the tables above excludes accrued interest receivable and net deferred loan origination costs due to their immateriality.

Troubled Debt Restructurings

At December 31, 2017, the Company had a recorded investment of $1,877,681 and had allocated specific reserves totaling $46,225 related to loans with terms that had been modified in troubled debt restructurings. At December 31, 2016, the Company had a recorded investment of $2,158,561 and had allocated specific reserves totaling $2,000 related to loans with terms that had been modified in troubled debt restructurings. The Company has no commitment as of December 31, 2017 to customers with outstanding loans that are classified as troubled debt restructurings.

During the year ending December 31, 2017 and 2016, the terms of certain loans were modified as troubled debt restructurings. The modification of the terms of such loans included either a reduction of the stated interest rate of the loan, an extension of the maturity date at a stated rate of interest lower than the current market rate for new debt with similar risk, or a combination thereof.

During the year ending December 31, 2017 one modifications involved a 5 month extension of the maturity date. During the year ending December 31, 2016 each of the three modifications involved a 14 month extension of the maturity date.

The following table presents loans by class modified as troubled debt restructurings that occurred during the years ending December 31, 2017 and 2016:

| | Number of Loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
|---|---|---|---|
| 2017 | | | |
| Troubled Debt Restructurings: | | | |
| Commercial & industrial | 1 | $ 725,464 | $ 725,464 |
| 2016 | | | |
| Troubled Debt Restructurings: | | | |
| Commercial & industrial | 3 | $ 1,022,469 | $ 1,022,469 |

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

Troubled Debt Restructurings (Continued)

The 2017 troubled debt restructurings described above increased the allowance for loan losses by $15,725. The 2016 troubled debt restructurings described above increased the allowance for loan losses by $2,000.

There were no loans modified as troubled debt restructurings for which there was a payment default within twelve months following the modification during the year ending December 31, 2017 and 2016.

A loan is considered to be in payment default once it is 90 days contractually past due under the modified terms.

Purchased Credit Impaired Loans

The Company evaluated loans acquired in its merger with PPB in accordance with accounting guidance related to loans acquired with deteriorated credit quality (PCI loans). Acquired loans are considered PCI loans if there is evidence of deterioration of credit quality since origination and it is probable, at the acquisition date, that the Company will be unable to collect all contractually required payments receivable. At December 31, 2015, the Company determined one loan to be a PCI loan with an estimated fair value of $572,480. The contractual cash flows of this loan totaled $721,092 and the expected cash flows totaled $598,383, resulting in an accretable difference of $25,903 and a nonaccretable difference of $122,709. There was no allowance for loan losses on this loan, as it was recorded at its estimated fair value as of December 31, 2015. During the third quarter of 2016, this PCI loan was paid off.

### 6. PREMISES AND EQUIPMENT

Premises and equipment consisted of the following:

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Furniture, fixtures and equipment | $ 3,260,073 | $ 2,898,861 |
| Leasehold improvements | 3,024,318 | 2,337,997 |
| | 6,284,391 | 5,236,858 |
| Less accumulated depreciation and amortization | (3,398,857) | (2,661,988) |
| | $ 2,885,534 | $ 2,574,870 |

Depreciation and amortization included in occupancy and equipment expense totaled $736,869 and $210,577, respectively, for 2017 and 2016.

### 7. GOODWILL AND OTHER INTANGIBLE ASSETS

Goodwill

At December 31, 2017 and 2016, the Company's goodwill totaled $7,350,465 for both years.

The Company analyzes its goodwill for impairment on an annual basis and between annual tests in certain circumstances such as upon material adverse changes in legal, business, regulatory and economic factors. Impairment exists when a reporting unit's carrying value of goodwill exceeds its fair value, which is determined through a qualitative assessment.

If the qualitative assessment indicates it is more likely than not that the fair value of equity of a reporting unit is less than book value, than a quantitative two-step impairment test is required. Step 1 includes the determination of the carrying value of the Company's single reporting unit, including the existing goodwill and intangible assets, and estimating the fair value of the reporting unit. If the carrying amount of a reporting unit exceeds its fair value, the Company is required to perform a second step to the impairment test. Step 2 requires that the implied fair value of the reporting unit goodwill be compared to the carrying amount of that goodwill. If the carrying amount of the reporting unit goodwill exceeds the implied fair value of that goodwill, an impairment loss shall be recognized in an amount equal to that excess.

## 7. GOODWILL AND OTHER INTANGIBLE ASSETS (Continued)

Goodwill (Continued)

At December 31, 2017, the Company's reporting unit had positive equity and management determined there was no need for an impairment analysis because based on the qualitative analysis performed, the Company determined that it is more likely than not that the fair value of the reporting unit exceeded its reported book value of equity at December 31, 2017. As such, no impairment was indicated and no further testing was required.

Other Intangible Assets

The core deposit intangible ("CDI") is evaluated for impairment if events and circumstances indicate a possible impairment. The CDI is amortized on a straight line over an estimated life of 10 years.

CDI amortization expensed total $55,847 in both 2016 and 2017, respectively. The following table provides the estimated future amortization expense of core deposit intangibles:

| Year Ending December 31, | |
|---|---|
| 2018 | $ 55,847 |
| 2019 | 55,847 |
| 2020 | 55,847 |
| 2021 | 55,847 |
| 2022 | 55,847 |
| 2023 and after | 167,539 |
| Total | $ 446,774 |

Impairment testing of the intangible assets is performed at the individual asset level. The Company's intangibles are tested for recoverability whenever events or changes in circumstances indicate that their carrying amounts may not be recoverable. If such events or changes in circumstances are identified, an impairment loss is recognized only if the carrying amount of the intangible asset is not recoverable and exceeds its fair value. If an impairment loss exists, the carrying amount of the intangible asset is adjusted to a new cost basis. The new cost basis is then amortized over the remaining useful life of the asset.

Based on its assessment, the Company did not identify any events or changes in circumstances indicating that such intangible assets may not be recoverable at December 31, 2017 or 2016.

## 8. INTEREST-BEARING DEPOSITS

Interest-bearing deposits consisted of the following:

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Savings | $ 42,162,809 | $ 47,834,583 |
| Money market | 283,438,202 | 200,757,716 |
| Interest-bearing demand accounts | 23,902,959 | 27,406,298 |
| Time, $250,000 or more | 46,569,407 | 45,322,133 |
| Other time | 49,783,982 | 44,051,998 |
| | $ 445,857,359 | $ 365,372,728 |

Aggregate annual maturities of time deposits are as follows:

| Year Ending December 31, | |
|---|---|
| 2018 | $ 84,804,810 |
| 2019 | 10,488,965 |
| 2020 | 902,481 |
| 2021 | 157,133 |
| | $ 96,353,389 |

Interest expense recognized on interest-bearing deposits for the years ended December 31, 2017 and 2016 consisted of the following:

| | Year Ended December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Savings | $ 197,325 | $ 179,743 |
| Money market | 1,413,497 | 852,127 |
| Interest-bearing demand accounts | 17,349 | 15,105 |
| Time, $250,000 or more | 441,940 | 327,084 |
| Other time | 370,794 | 52,532 |
| | $ 2,440,905 | $ 1,426,591 |

## 9. INCOME TAXES

The provision for income taxes for the years ended December 31, 2017 and 2016 consisted of the following:

| | Federal | State | Total |
|---|---|---|---|
| 2017 | | | |
| Current | $ 3,088,495 | $ 955,047 | $ 4,043,542 |
| Change in Federal Income Tax Rate | 1,748,207 | - | 1,748,207 |
| Deferred | (182,162) | 49,314 | (132,848) |
| Provision for income taxes | $ 4,654,540 | $ 1,004,361 | $ 5,658,901 |

| | Federal | State | Total |
|---|---|---|---|
| 2016 | | | |
| Current | $ 2,083,312 | $ 993,367 | $ 3,076,679 |
| Deferred | 241,313 | (95,520) | 145,793 |
| Provision for income taxes | $ 2,324,625 | $ 897,847 | $ 3,222,472 |

The Company's reported amount of income tax expense differs from federal statutory rates in 2017 and 2016 due principally to California franchise taxes**,** merger expenses and the revaluation of deferred taxes reflected in tax from continuing operations due to enactment of the 2017 federal tax reform. The effective tax rate differs from the Federal statutory rate for the years ended December 31, 2017 and 2016 are as follow.

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Statutory Federal income tax rate | 34.0% | 34.0% |
| State income taxes, net of Federal tax benefit | 5.9 | 7.0 |
| Low income housing credits, net of investment losses | 0.4 | -2.0 |
| Earnings from bank owned life insurance | -1.3 | -1.8 |
| Merger expenses | 0.0 | 0.3 |
| Equity compensation | -3.6 | 0.0 |
| Deferred tax asset revaluation | 15.5 | 0.0 |
| Other, net | -0.8 | 0.8 |
| Effective tax rate | 50.1% | 38.3% |

## 9. INCOME TAXES (Continued)

The Company's 2017 results included the impact of the enactment of the Tax Cuts and Jobs Act, which was signed into law on December 22, 2017. The law includes significant changes to the U.S. corporate tax system, including a Federal corporate rate reduction from 34% to 21% effective December 22, 2017 for years beginning after December 31, 2017. As a result, the Company was required to re-measure, through income tax expense from continuing operations, its deferred tax assets and liabilities using the enacted tax rate at which it was expected to be recovered. The re-measurement of the net deferred tax asset resulted in additional income tax expense of approximately $1,748,000.

Deferred tax assets (liabilities) consisted of the following:

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Deferred tax assets: | | |
| Allowance for loan losses | $ 1,780,619 | $ 1,930,539 |
| State deferred tax asset | 1,545,465 | 1,483,014 |
| Accrued expenses | 499,355 | 768,598 |
| Organization costs | 161,226 | 241,911 |
| Share-based compensation | 107,840 | 303,352 |
| Deferred compensation | 140,122 | 191,567 |
| Net operating loss carryforward | 1,291,246 | 2,308,108 |
| Loan discounts | 260,082 | 644,305 |
| Unrealized loss on available-for-sale investment securities | 976 | 860 |
| Other | 163,755 | 212,166 |
| Total deferred tax assets | 5,950,686 | 8,084,420 |

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Deferred tax liabilities: | | |
| Deferred loan origination costs | (1,099,076) | (1,428,987) |
| Unrealized gain on available-for-sale investment securities | - | - |
| Core Deposit Intangible | (93,823) | (170,891) |
| Other | (220,131) | (332,399) |
| Total deferred tax liabilities | (1,413,030) | (1,932,277) |
| Net deferred tax assets | $ 4,537,656 | $ 6,152,143 |

### 9. INCOME TAXES (Continued)

As a result of the merger with PPB, at December 31, 2015, the Company had approximately $7,430,071 of net operating loss carryforwards for Federal income tax purposes which begin to expire in 2026. The Company had approximately $575,742 and $6,801,853 of net operating loss carryforwards for California income tax purposes which expire in 2018 and 2028 and thereafter, respectively. At December 31, 2017, net operating loss carryforwards for Federal and California income tax purposes totaled $6,148,790 and $6,098,067, and begin to expire in 2029, respectively. Pursuant to Sections 382 of the Internal Revenue Code, annual use of net operating loss carryforwards may be limited in the event of a change in ownership. Net operating losses acquired from PPB are subject to Section 382 annual limitations in the amount of approximately $640,000 per year.

The Company files income tax returns in the U.S Federal, California, and Virginia jurisdictions. There are currently no pending U.S. Federal or state income tax or non-U.S. income tax examinations by tax authorities. The Company is subject to tax examinations by U.S. Federal and state taxing authorities for tax returns filed for the years ended on or after December 31, 2014 for Federal purposes and December 31, 2013 for California purposes.

The Company is required to determine a valuation allowance if it is more likely than not that some portion, or all, of the deferred tax asset will not be realized. The Company will continue to evaluate both positive and negative evidence, including forecasts of future income, cumulative losses, applicable tax planning strategies, and assessments of current and future economic and business conditions. As of December 31, 2017 and 2016, there were no unrecognized tax benefits or interest and penalties accrued by the Company.

### 10. BORROWING ARRANGEMENTS

Under agreements with several correspondent banks, the Company can borrow up to $58,000,000. In a separate agreement, the Company can borrow up to $10,000,000 or the total market value of securities pledged to a correspondent bank under a repurchase agreement. At December 31, 2017 and 2016, there were no investment securities pledged to the correspondent bank under this agreement. There were no borrowings outstanding under these arrangements at December 31, 2017 and 2016.

The Company has a borrowing arrangement with the Federal Reserve Bank of San Francisco (FRB) under which advances are secured by portions of the Bank's loan and investment securities portfolios. The Company’s credit limit varies according to the amount and composition of the assets pledged as collateral. At December 31, 2017, amounts pledged and available borrowing capacity under such limits were approximately $230,632,000 and $163,734,000, respectively. There were no borrowings outstanding under this arrangement as of December 31, 2017 and 2016.

## 10. BORROWING ARRANGEMENTS (Continued)

The Company has a borrowing arrangement with the Federal Home Loan Bank (FHLB) under which advances are secured by portions of the Bank's loan portfolio. The Bank's credit limit varies according to its total assets and the amount and composition of the loan portfolio pledged as collateral. At December 31, 2017, amounts pledged and available borrowing capacity under such limits were approximately $165,412,000 and $101,487,000, respectively.

At December 31, 2016, there were $29,000,000 in borrowings outstanding under this arrangement at fixed interest rates ranging from 1.11% to 1.16%, which were paid off at maturity on February 7, 2017. The weighted average interest rate on these borrowings was 1.13% at December 31, 2016.

The Company issued $5,000,000 in subordinated debt on April 15, 2016. The subordinated debt has a fixed interest rate of 5.875% for the first 5 years. After the fifth year, the interest rate changes to a variable rate of Prime plus 2.00%. The subordinated debt was recorded net of related issuance costs of $86,578. On December 31, 2017 and 2016, the balances were $4,942,856 and $4,925,684, net of issuance cost, respectively.

The Company issued $11,000,000 in senior notes on June 30, 2017. The senior notes are secured by the Company's investment in the Bank. The senior notes consist of a $1,000,000 revolving line of credit with an interest rate of 4.650% for a one year term. The second senior note, in the amount of $10,000,000 with an interest rate of 4.650%, has a term of three years. Principal payments on the senior note of $10,000,000 will begin after the first year. The issuance costs for the senior notes were insignificant.

## 11. COMMITMENTS AND CONTINGENCIES

Operating Leases

The Company currently operates from six offices including three banking branches in Lafayette, Fremont and San Jose, California, and three loan production offices in Oakland, Walnut Creek and San Jose, California.

The Lafayette office lease, dated June, 2007, as amended, had a 90 month initial term from the date of occupancy in November 2007. The Company has executed several renewal amendments with a current leased premises of approximately 7,000 square feet. The current lease term is five years from October 2015 to September 2020 with one 60 month renewal option. This office is leased from an affiliated party. (See Note 14)

### 11. COMMITMENTS AND CONTINGENCIES (Continued)

Operating Leases (Continued)

The Company leases premises with approximately 15,600 square feet in Oakland, California for a loan production and administrative office. The lease for the Oakland loan production and administrative office is for an initial term of seven years, with a 60 month renewal option. The current term of the lease expires on January 31, 2023. In September 2017, an amendment was executed adding approximately 4,600 square feet with the same expiration date on January 31, 2023.

The Company leases premises with approximately 4,000 square feet in San Jose, California for a loan production office. The lease for the San Jose loan production office is for an initial term of seven years, with a 60 month renewal option. The current term of the lease expires on February 1, 2023.

The Company leases premises with approximately 8,500 square feet in Fremont, California as a branch office. The lease for the Fremont branch office was assumed in the merger with PPB and had an initial term of ten years, with a 84 month renewal option. The current term of the lease expires on June 30, 2022.

The Company leases premises with approximately 3,500 square feet in San Jose, California as a branch office. The lease for the San Jose branch office was assumed in the merger with PPB and had an initial term of 88 months. The current term of the lease expires on September 30, 2021.

The Company leases premises with approximately 3,900 square feet in Walnut Creek, California as a branch office. The lease for the Walnut Creek office is for an initial term of seven years, with a 60 month renewal option. The current term of the lease expires on November 1, 2022.

Future minimum lease payments are as follows:

| | Year Ending December 31, |
|---|---|
| 2018 | $ 1,485,628 |
| 2019 | 1,667,185 |
| 2020 | 1,624,934 |
| 2021 | 1,389,988 |
| 2022 | 1,226,030 |
| Thereafter | 83,303 |
| | $ 7,477,068 |

Rental expense included in occupancy and equipment expense totaled $1,450,495 and $1,371,168 for the years ended December 31, 2017 and 2016, respectively.

## 11. COMMITMENTS AND CONTINGENCIES (Continued)

Financial Instruments with Off-Balance-Sheet Risk

The Company is a party to financial instruments with off-balance-sheet risk in the normal course of business in order to meet the financing needs of its customers and to reduce its own exposure to fluctuations in interest rates.

The following financial instruments represent off-balance-sheet credit risk:

| | December 31, | |
|---|---|---|
| | 2017 | 2016 |
| Commitments to extend credit | $ 280,633,000 | $ 283,053,000 |
| Standby letters of credit | $ 5,239,000 | $ 4,679,000 |

The Company's exposure to credit loss in the event of nonperformance by the other party for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for loans included on the balance sheet.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the borrower. Collateral held varies, but may include accounts receivable, inventory, and deeds of trust on residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued to guarantee the performance of a client to a third party. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to clients. The fair value of the liability related to these standby letters of credit, which represents the fees received for issuing the guarantees, was not significant at December 31, 2017 and 2016. The Company recognizes these fees as revenue over the term of the commitment or when the commitment is used.

Commercial loan commitments represent approximately 75% of total commitments and are generally unsecured or secured by collateral other than real estate and have variable interest rates. Real estate related loan commitments represent approximately 22% of total commitments and are generally secured by property with a loan-to-value ratio not to exceed 75%. The majority of real estate related loan commitments also have variable interest rates.

## 11. COMMITMENTS AND CONTINGENCIES (Continued)

Significant Concentrations of Credit Risk

The Company grants real estate mortgage, real estate construction, commercial and installment loans to customers in the Company's geographic service area. Commercial & industrial loans and real estate loans represented 45% and 47% of total loans, respectively, at December 31, 2017. Although management believes such concentrations to have no more than the normal risk of collectability, a substantial decline in the economy in general, or a decline in real estate values in the Company's primary market area in particular, could have an adverse impact on collectability of these loans. Personal and business income represents the primary source of repayment for a majority of these loans.

Deposit Concentrations

At December 31, 2017 and 2016, there were no deposit relationships that exceeded 5% of total deposits.

Contingencies

The Company may be subject to legal proceedings and claims which arise in the ordinary course of business. In the opinion of management, the amount of ultimate liability with respect to such actions will not materially affect the financial position or results of operations of the Company.

Correspondent Banking Agreements

The Company maintains funds on deposit with other federally insured financial institutions under correspondent banking agreements. Insured financial institution deposits up to $250,000 are fully insured by the FDIC under the FDIC’s general deposit insurance rules. At December 31, 2017 and 2016, uninsured deposits at financial institutions were not significant.

### 12. SHARE-BASED COMPENSATION

Share-Based Compensation Plans

The Company declared a 5% stock dividend on August 7, 2017 which increased the number of shares of outstanding stock options and the number of shares of commons stock eligible for issuance under the Equity Incentive Plan.

The California BanCorp 2007 Equity Incentive Plan (the “2007 Plan”) permits the granting of stock options and restricted stock to directors, organizers and employees of the Company. Grants of options to the organizers during the start-up phase of the Company and to the Directors are considered non-qualified stock option awards. All other option grants are considered incentive stock option awards. The 2007 Plan does not have any shares available for future grant as of December 31, 2016.

The Company has issued the California BanCorp 2014 Equity Incentive Plan (the "2014 Plan"), which was approved by its shareholders and permits the grant of stock options and restricted stock for up to 404,235 shares of the Company's common stock, of which 114,681 shares were available for future grant at December 31, 2017. The Plan is designed to attract and retain employees and directors. Adjusted for stock dividend, the 2014 Plan was revised to 404,235 shares from 384,986 shares.

The Company has issued the California BanCorp 2017 Equity Incentive Plan (the "2017 Plan"), which was approved by its shareholders and permits the grant of stock options and restricted stock for up to 341,250 shares of the Company's common stock, of which 341,250 shares were available for future grant at December 31, 2017. Adjusted for stock dividend, the 2017 Plan was revised to 341,250 shares from 325,000 shares. The Plan is designed to attract and retain employees and directors. The amount, frequency, and terms of share-based awards may vary based on competitive practices, the Company's operating results and government regulations. New shares are issued upon option exercise or restricted share grants. Shares may also be granted under the 2017 Plan that vest immediately without restriction. The Plan does not provide for the settlement of awards in cash.

### 12. SHARE-BASED COMPENSATION (Continued)

Stock Option Awards

For the years ended December 31, 2017 and 2016, the compensation cost recognized for stock option awards was $226,048 and $182,557, respectively.

A summary of option activity under the 2007 Plan, 2014 Plan and 2017 Plan for the years ended December 31, 2017 and 2016 is presented below:

| Options | Shares | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term (Years) | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2016 | 840,616 | $ 8.68 | | |
| Granted | 86,100 | $ 11.11 | | |
| Exercised | (26,250) | $ 7.36 | | |
| Forfeited or canceled | (3,150) | $ 13.19 | | |
| Outstanding December 31, 2016 | 897,316 | $ 9.12 | | |
| Granted | 90,053 | $ 10.46 | | |
| Exercised | (240,116) | $ 7.80 | | |
| Forfeited or canceled | (1,603) | $ 13.19 | | |
| Outstanding December 31, 2017 | 745,650 | $ 9.70 | 4.59 | $ 8,984,806 |
| Vested or expected to vest at December 31, 2017 | 726,051 | $ 9.63 | 4.74 | $ 8,796,669 |
| Exercisable at December 31, 2017 | 537,554 | $ 8.44 | 2.96 | $ 7,148,828 |

## 12. SHARE-BASED COMPENSATION (Continued)

Stock Option Awards (Continued)

As of December 31, 2017, the unrecognized compensation cost related to non-vested stock option awards totaled $1,335,828. That cost is expected to be amortized on a straight-line basis over a weighted average period of 2.89 years and will be adjusted for subsequent changes in estimated forfeitures. The intrinsic value of options exercised during the years ended December 31, 2017 and 2016 totaled $2,300,840 and $150,450, respectively.

The following information relates to stock option grants granted during the years ended December 31, 2017 and 2016:

| | 2017 | 2016 |
|---|---|---|
| Weighted average grant date fair value per share of options granted | $ 11.58 | $ 5.98 |
| Significant fair value assumptions: | | |
| Expected term in years | 6 years | 6 years |
| Expected annual volatility | 25.09% | 33.93% |
| Expected annual dividend yield | 0% | 0% |
| Risk-free interest rate | 1.95% | 1.23% |

Stock Awards

Eleven stock awards totaling 12,173 shares were granted and issued during the year ended December 31, 2017. These stock awards were fully vested upon grant. The grant date fair value of these awards was $18.75 per share, or $228,244 which was recorded as compensation expense for the year ended December 31, 2017.

Eleven stock awards totaling 13,249 shares were granted and issued during the year ended December 31, 2016. Adjusted for stock dividend, the stock awards was revised to 13,249 shares from 12,618 shares. These stock awards were fully vested upon grant. The grant date fair value of these awards was $13.60 per share, or $12.95 after adjusted for stock dividend, or $171,605 which was recorded as compensation expense for the year ended December 31, 2016.

## 13. SHAREHOLDERS' EQUITY

Common Stock Offering

On May 17, 2016, the Company issued 296,297 shares of its common stock totaling $3,981,762, net of issuance costs of $18,238, for general corporate purposes. Adjusted for stock dividend, the issuance was revised to 311,112 shares from 296,297 shares.

Dividends

Upon declaration by the Board of Directors, all shareholders of record will be entitled to receive dividends. The California Financial Code restricts the total dividend payment of any state banking association in any calendar year to the lesser of (1) the Company's retained earnings or (2) the Company's net income for its last three fiscal years, less distributions made to shareholders during the same three-year period.

Stock Dividend

On August 7, 2017, the Company declared a 5% stock dividend that was payable on August 31, 2017 to shareholders of record as of the close of trading on August 18, 2017, with cash paid for any fractional shares. As a result of the stock dividend, the Company’s issued 303,407 shares of its common stock. These transactions were recorded as of August 31, 2017 and resulted in an increase in common stock and a corresponding decrease of retained earnings in the amount of $5,642,057. In addition, the Company paid $1,982 for fractional common shares on August 31, 2017.

Disclosure of share and per share data for all periods presented have been retroactively adjusted to reflect the effect of the stock dividends.

Regulatory Capital

The Company is subject to certain regulatory capital requirements administered by the FDIC. Failure to meet these minimum capital requirements can initiate certain mandatory and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's consolidated financial statements.

Under capital adequacy guidelines, the Company must meet specific capital guidelines that involve quantitative measures of their assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. These quantitative measures are established by regulation and require that minimum amounts and ratios of total capital, Tier 1 capital and common equity Tier 1 (“CET1”) capital to risk-weighted assets and of Tier 1 capital to average assets be maintained. Capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

### 13. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital (Continued)

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, the Company must hold a capital conservation buffer above the adequately capitalized risk-based ratios. The implementation of the capital conservation buffer began on January 1, 2016 at 0.625% and will be phased in over a four-year period (increasing by 0.625% on each subsequent January 1, until it reaches 2.5% on January 1, 2019). Thus, when fully phased-in on January 1, 2019, the Bank will be required to maintain this additional capital conservation buffer of 2.5% of CET1. At December 31, 2017, the capital conversion buffer requirement was 1.250%.

The Bank is also subject to additional capital guidelines under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 leverage and common equity Tier 1 risk-based ratios as set forth in the table on the following page. As of December 31, 2017 and 2016, the most recent notification from the FDIC categorized the Bank as well capitalized under these guidelines. There are no conditions or events since that notification that management believes have changed the Bank's category. Management believes that the Bank met all capital adequacy requirements as of December 31, 2017 and 2016.

## 13. SHAREHOLDERS' EQUITY (Continued)

Regulatory Capital (Continued)

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio |
| **Common Equity Tier 1 Risk Based Capital Ratio** | | | | |
| California Bank of Commerce | $ 87,234,000 | 10.09% | $ 67,410,000 | 8.96% |
| To be "Well-Capitalized" under prompt corrective action regulation | $ 56,221,000 | 6.50% | $ 48,920,000 | 6.50% |
| Required for capital adequacy purposes (including capital conservation buffer) | $ 49,734,000 | 5.75% | $ 38,572,000 | 5.125% |
| **Leverage Ratio** | | | | |
| California Bank of Commerce | $ 87,234,000 | 9.92% | $ 67,410,000 | 8.78% |
| To be "Well-Capitalized" under prompt corrective action regulation | $ 43,974,000 | 5.00% | $ 38,383,000 | 5.00% |
| Required for capital adequacy purposes | $ 35,179,000 | 4.00% | $ 30,706,000 | 4.00% |
| **Tier 1 Risk-Based Capital Ratio** | | | | |
| California Bank of Commerce | $ 87,234,000 | 10.09% | $ 67,410,000 | 8.96% |
| To be "Well-Capitalized" under prompt corrective action regulation | $ 69,195,000 | 8.00% | $ 60,210,000 | 8.00% |
| Required for capital adequacy purposes (including capital conservation buffer) | $ 62,708,000 | 7.25% | $ 49,861,000 | 6.625% |
| **Total Risk-Based Capital Ratio** | | | | |
| California Bank of Commerce | $101,627,000 | 11.75% | $ 79,981,000 | 10.63% |
| To be "Well-Capitalized" under prompt corrective action regulation | $ 86,494,000 | 10.00% | $ 75,262,000 | 10.00% |
| Required for capital adequacy purposes (including capital conservation buffer) | $ 80,007,000 | 9.25% | $ 64,913,000 | 8.625% |

## 14. RELATED PARTY TRANSACTIONS

The Company enters into transactions with related parties, including Directors, executive officers and affiliates.

The following is a summary of the aggregate activity involving related party borrowers during the years ended December 31, 2017 and 2016:

| | |
|---|---|
| Balance, January 1, 2016 | $ 9,572,363 |
| Disbursements | 7,075,549 |
| Amounts repaid | (8,762,311) |
| Balance, December 31, 2016 | 7,885,601 |
| Disbursements | 7,658,302 |
| Amounts repaid | (7,934,052) |
| Balance, December 31, 2017 | $ 7,609,851 |
| Undisbursed commitments to related parties, December 31, 2017 | $ 11,160,000 |

At December 31, 2017 and 2016, the Company's deposits from related parties totaled approximately $35,738,098 and $25,431,000, respectively.

The Company also leases its Lafayette office from a company owned by a member of the Board of Directors. Rental payments under this agreement totaled $371,123 for the year ended December 31, 2017 and $370,150 for the year ended December 31, 2016.

## 15. EMPLOYEE BENEFIT PLANS

Profit Sharing Plan

In 2007, the Company adopted the California Bank of Commerce Profit Sharing 401(k) Plan. All full-time employees 21 years of age or older with 3 months of service are eligible to participate in the 401(k) Plan. Eligible employees may elect to make tax deferred contributions up to the maximum amount allowed by law. The Company may make additional contributions to the plan at the discretion of the Board of Directors. Bank contributions may vest at a rate of 20% annually for all employees. The Company made a fully vested contribution to the 401(k) Plan for the year ended December 31, 2017 in the amount of $438,982. The Company made a fully vested contribution to the 401(k) Plan for the year ended December 31, 2016 in the amount of $373,000.

## 15. EMPLOYEE BENEFIT PLANS (Continued)

Salary Continuation and Retirement Plan

The Board of Directors approved a salary continuation plan for certain executives during 2007 and 2014. Under the Plan, once executives reach age 65, the Company is obligated to provide executives with annual benefits after retirement. The estimated present value of these future benefits is accrued from the effective date of the plan based on a discount rate of 4.0%.

The expense recognized under this plan for the years ended December 31, 2017 and 2016 totaled $128,815 and $141,672, respectively. Accrued compensation payable under the salary continuation plan totaled $667,247 and $563,432 at December 31, 2017 and 2016, respectively, and is included in accrued interest payable and other liabilities on the Company's balance sheet.

## 16. OTHER EXPENSES

Other expenses for the years ended December 31, 2017 and 2016 consisted of the following:

| | 2017 | 2016 |
|---|---|---|
| Outsourced data processing and electronic banking | $ 857,971 | $ 737,884 |
| Director's stock-based and other compensation | 734,079 | 689,615 |
| Professional fees | 651,643 | 525,242 |
| Advertising, promotion and business development | 612,616 | 619,046 |
| Computer network and internet support | 597,820 | 860,553 |
| Regulatory fees | 523,677 | 451,808 |
| Loan processing | 515,136 | 399,954 |
| Telecommunications | 300,761 | 209,439 |
| Correspondent bank service charges | 255,433 | 197,643 |
| Company insurance | 101,851 | 103,530 |
| Provision for unfunded loan commitments | 30,000 | - |
| Other operating expenses | 693,521 | 729,570 |
| Total other expenses | $ 5,874,508 | $ 5,524,284 |

## 17. PREFERRED STOCK

Small Business Lending Fund (“SBLF”)

On September 15, 2011, as part of the Small Business Lending Fund (“SBLF”), the Company entered into a Small Business Lending Fund Securities Purchase Agreement (“SBLF Purchase Agreement”) with the United States Department of the Treasury (“Treasury”). Under the SBLF Purchase Agreement, the Company issued 11,000 shares of Senior Non-Cumulative Perpetual Preferred Stock, Series C (the "Series C Preferred") to the Treasury. The preferred stock series C shares qualify as Tier 1 capital and will pay quarterly dividends. The initial and current dividend as of December 31, 2015 was 1%. The dividend rate was fixed at 1% until March 15, 2016. After this date, the dividend rate increased to 9%.

The Company repurchased 5,500 shares of Series C Preferred stock on April 15, 2016 and 5,500 shares of Series C Preferred stock on May 19, 2016. There was no Series C Preferred stock outstanding at December 31, 2016.

## 18. QUALIFIED AFFORDABLE HOUSING PROJECT INVESTMENTS

The Company invests in low income housing investments with gross commitments (including amounts funded and unfunded) of $8,467,600 and $7,967,000 at December 31, 2017 and 2016, respectively. During 2017, the Company added a new investment with a commitment balance of $500,000 and had $1,689,654 in capital calls. Total commitments remaining for future capital call were $2,196,455 and $3,386,109, at December 31, 2017 and 2016. The investment balances were $4,241,748 and $3,366,164 at December 31, 2017 and 2016, respectively. These balances are reflected in the accrued interest receivable and other assets line on the balance sheets.

For the years ended December 31, 2017 and 2016, the Company recognized amortization expense of $161,710 and $179,100, respectively, which was included within income tax expense on the statements of income.

For tax purposes, the Company recorded tax credit and other benefits of $1,037,294 and $770,638 for the years ended December 31, 2017 and 2016, respectively. Amortization of the low income housing investment totaled $875,585 and $591,538 for the years ended December 31, 2017 and 2016.

California BanCorp

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