# FSB
## Community Bankshares, Inc.

April 22, 2015

Dear Shareholder,

Continued uncertainty related to short term interest rates caused the past year to be fraught with challenges both in managing loan production and in generating deposits to fund balance sheet growth for your Fairport Savings Bank (FSB). By judiciously pricing our certificate of deposit portfolio and by attracting greater core deposits we lowered our cost of funds and continued our net interest margin improvement. Aggressive loan sales into the secondary market improved our non-interest income dramatically. On balance, as reflected below, the investment we have made to build our loan and deposit franchises is leading to very positive results.

- Total assets increased by $8.5 million, or 3.6% from $237.5 million at December 31, 2013 to $246.0 million at December 31, 2014.

- Net Loans receivable grew by $11.8 million, or 6.7% from $177.0 million at December 31, 2013 to $188.8 million at December 31, 2014.

- Deposits decreased by $4.7 million, or 2.6%, to $175.3 million at December 31, 2014 from $180.0 million at December 31, 2013. Although time deposits decreased by $9.3 million, our core deposits increased $4.7 million as we continue to focus on full service long term customer relationships.

- Net income increased by $369 thousand from $291 thousand in 2013 to $660 thousand in 2014.

- The net interest margin increased to 2.95% for the year ended December 31, 2014 from 2.79% for the year ended December 31, 2013.

- The credit quality of our loan portfolio remained strong with one non-performing residential mortgage loan, one non-performing home equity line of credit, and no impaired loans at year end 2014.

In the coming year we will expand our commercial loan capacity and begin to originate residential mortgages in the Buffalo, New York market. The commercial loan initiative will provide much needed balance sheet diversification while the Buffalo market entry reflects our continuing appetite for mortgage loan growth. The evolution of the regulatory environment in which we operate continues to present us with myriad challenges and uncertainties.

As we enhance our loan origination capacity and raise our goals for loan growth we continue to employ the same conservative underwriting standards that have helped us to maintain our outstanding loan portfolio. Loans we choose to hold in our portfolio and loans that we sell into the secondary market receive the same diligent review for underwriting.

The Board of Directors, the FSB staff members, and I appreciate the continued confidence you have shown in us and in our commitment to building a bank that is driven by long term value objectives.

Sincerely,

Dana C. Gavenda
President and Chief Executive Officer

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# MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

## Overview

Our results of operations depend primarily on our net interest income and, to a lesser degree, other income. Net interest income is the difference between the interest income we earn on our interest-earning assets, consisting primarily of loans, investment securities and other interest-earning assets (primarily cash and cash equivalents), and the interest paid on our interest-bearing liabilities, consisting primarily of savings accounts, NOW accounts, money market accounts, time deposits and borrowings. Other income consists primarily of realized gains on sales of loans and securities, mortgage fee income, fees and service charges from deposit products, fee income from our financial services subsidiary, earnings on bank owned life insurance and miscellaneous other income. Our results of operations also are affected by our provision for loan losses and other expense. Other expense consists primarily of salaries and employee benefits, occupancy expense, equipment expense, electronic banking, data processing costs, mortgage fees and taxes, advertising, directors' fees, FDIC premium expense, audit and tax services, and other miscellaneous expenses.

Our results of operations also may be affected significantly by general and local economic and competitive conditions, changes in market interest rates, government policies and actions of regulatory authorities.

For the year ended December 31, 2014, we had net income of $660,000 compared to net income of $291,000 for the year ended December 31, 2013. The year over year increase in earnings of $369,000 was attributable to an increase in net interest income and an increase in other income, partially offset by an increase in other expense, an increase in provision for loan losses, and an increase in income taxes. The increase in net interest income is reflective of the Company's ability to restructure its asset earning mix with a significantly higher volume of loans and lower investment balances, and reduce its overall interest expense, primarily borrowing costs in this low interest rate environment. The increase in other income was primarily attributable to a considerable increase in gain on sale of loans, partially offset with a decrease in realized gain on sale of securities, service fee income, mortgage fee income and bank owned life insurance income comparing the same periods of 2014 and 2013. The increase in other expense was primarily attributable to increases in salaries and employee benefits, and occupancy expenses related to a new mortgage origination office in Greece, New York which opened in 2014, directors fees, mortgage fees and taxes, FDIC premium expense, data processing expense, electronic banking, and other miscellaneous expenses, partially offset with decreases in advertising, equipment expense, and audit and tax services comparing the same two periods of 2014 and 2013. The increase in provision for loan losses was attributable to adding an appropriate amount for loan losses to ensure adequate reserves based on, among other factors, additional growth in the loan portfolio and economic conditions in our market comparing 2014 to 2013.

The credit quality of the Bank's loan portfolio remains strong and significantly better than peers. At December 31, 2014, the Bank had one non-performing residential mortgage loan for $56,000 and one non-performing home equity line of credit for $18,000 and at December 31, 2013 the Bank had the same non-performing residential mortgage loan for $56,000. We recorded a $127,000 provision for loan losses for the year ended December 31, 2014 compared to a $90,000 provision for loan losses for the year ended December 31, 2013. The allowance for loan losses was $653,000, or 0.34% of loans outstanding, at December 31, 2014 compared to $526,000, or 0.30% of loans outstanding, at December 31, 2013. Management has evaluated the Bank's loan loss reserve and believes it is adequately funded at December 31, 2014 based on the credit quality of the current loan portfolio attributable to conservative underwriting standards, the diligence of our loan collection process, and the stability of the local economy.

The Company has reviewed its investment securities portfolio totaling $39.4 million at December 31, 2014, and concluded that no other-than-temporary impairment charges were required.

Consolidated stockholders' equity at December 31, 2014 was $21.2 million, or 8.6%, of consolidated assets. At December 31, 2014 the Bank was considered well capitalized, the highest standard and capital rating as defined by the Bank's regulator.

## Critical Accounting Policies

Critical accounting policies are defined as those that involve significant judgments and uncertainties, and could potentially result in materially different results under different assumptions and conditions. We believe that the most critical accounting policies upon which our financial condition and results of operations depend, involve the most complex subjective decisions or assessments including our policies with respect to our allowance for loan losses, other-than-temporary impairment of investment securities, and deferred tax assets.

***Allowance for Loan Losses.*** The allowance for loan losses is the amount estimated by management as necessary to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. The amount of the allowance is based on significant estimates, and the ultimate losses may vary from such estimates as more information becomes available or conditions change. The methodology for determining the allowance for loan losses is considered a critical accounting policy by management due to the high degree of judgment involved, the subjectivity of the assumptions used and the potential for changes in the economic environment that could result in changes to the amount of the recorded allowance for loan losses.

As a substantial percentage of our loan portfolio is collateralized by real estate, appraisals of the underlying value of property securing loans are critical in determining the amount of the allowance required for specific loans. Assumptions are instrumental in determining the value of properties. Overly optimistic assumptions or negative changes to assumptions could significantly affect the valuation of a property securing a loan and the related allowance determined. Management carefully reviews the assumptions supporting such appraisals to determine that the resulting values reasonably reflect amounts realizable on the related loans.

Management performs a quarterly evaluation of the adequacy of the allowance for loan losses. We consider a variety of factors in establishing this estimate including, but not limited to, current economic conditions, delinquency statistics, geographic concentrations, the adequacy of the underlying collateral, the financial strength of the borrower, results of internal loan reviews and other relevant factors. This evaluation is inherently subjective as it requires material estimates by management that may be susceptible to significant change based on changes in economic and real estate market conditions.

The evaluation has specific, general, and unallocated components. The specific component relates to loans that are deemed to be impaired and classified as special mention, substandard, doubtful, or loss. For such loans that are also classified as impaired, an allowance is generally established when the collateral value of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Actual loan losses may be significantly more than the allowance we have established which could have a material negative effect on our financial results.

***Other-Than-Temporary Impairment of Investment Securities.*** When the fair value of a held to maturity or available for sale security is less than its amortized cost basis, an assessment is made at the balance sheet date as to whether other-than-temporary impairment ("OTTI") is present.

The Company considers numerous factors when determining whether a potential OTTI exists and the period over which the debt security is expected to recover. The principal factors considered are (1) the length of time and the extent to which the fair value has been less than amortized cost basis, (2) the financial condition of the issuer (and guarantor, if any) and adverse conditions specifically related to the security industry or geographic area, (3) failure of the issuer of the security to make scheduled interest or principal payments, (4) any changes to the rating of a security by a rating agency, and (5) the presence of credit enhancements, if any, including the guarantee of the federal government or any of its agencies.

For debt securities, OTTI is considered to have occurred if (1) the Company intends to sell the security, (2) it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, or (3) if the present value of expected cash flows is not sufficient to recover the entire amortized cost basis or carrying value.

In determining whether OTTI has occurred for equity securities, the Company considers the applicable factors described above and the intent and ability of the Company to retain its investment in the issuer for the period of time sufficient to allow for any anticipated recovery in fair value.

For debt securities, credit-related OTTI is recognized in earnings while noncredit-related OTTI on securities not expected to be sold is recognized in other comprehensive income (loss).

Credit-related OTTI is measured as the difference between the present value of an impaired security's expected cash flows and its amortized cost basis or carrying value. Noncredit-related OTTI is measured as the difference between the fair value of the security and its amortized costs less any credit-related losses recognized. For securities classified as held to maturity, the amount of OTTI recognized in other comprehensive income (loss) is accreted to the credit-adjusted expected cash flow amounts of the securities over future periods. For equity securities, the entire amount of OTTI is recognized in income.

***Deferred Tax Assets.*** The deferred tax assets and liabilities represent the future tax return consequences of the temporary differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

**Business Summary**

Our business has traditionally focused on originating one-to-four family residential real estate mortgage loans and home equity lines of credit for retention in our portfolio and offering retail deposit accounts insured by the Federal Deposit Insurance Corporation. Our primary market area consists of Monroe County and the surrounding upstate New York counties of Livingston, Ontario, Orleans and Wayne. In the low interest rate environment experienced throughout 2014 and 2013, management decided to sell a portion of the fixed-rate residential real estate loans that we originated in order to manage interest rate risk. The low interest rate environment in 2014 and 2013 has resulted in management's decision to decrease investment securities and to reposition the funds available from the decrease in the investment portfolio into higher-yielding assets, primarily one-to-four-family mortgage loans in 2014. The increase in the loan portfolio balances in 2014 did increase loan interest income despite lower yields on the loan portfolio. Due to moderately higher yields in the overall investment securities portfolio in 2014 compared to 2013 investment securities interest income has increased despite a decrease in balances. The decrease in balances in mortgage-backed securities in 2014 compared to 2013, has resulted in slightly higher yields, however decreased mortgage-backed securities income. Despite the decrease in the balances in cash and cash equivalents, primarily interest-earning deposits at the Federal Reserve Bank and Federal Home Loan Bank, in 2014 compared to 2013, moderately higher yields resulted in the equivalent income on interest bearing demand deposits. The Company continues to maintain a strong liquidity position in anticipation of funding loan commitments in the first quarter of 2015. The Company's net interest margin for the year ended December 31, 2014 increased 16 basis points to 2.95% from 2.79% for the year ended December 31, 2013, due to a decrease in the cost of interest-bearing liabilities of 8 basis points from 0.88% to 0.80% in addition to an increase in the average yield on our interest-earning assets of 8 basis points from 3.67% to 3.75%. The yield on interest-bearing liabilities continues to be positively impacted by a decrease in the yield on borrowings, mainly new FHLB advances, together with a modest decrease in yield on interest-bearing deposit accounts in this low interest rate environment. The increase in yield on interest-earning assets is primarily due to the increase in yield on total investments.

Net loans receivable increased $11.8 million, or 6.7%, to $188.8 million at December 31, 2014 from $177.0 million at December 31, 2013. The Bank originated $74.0 million of residential mortgage loans, sold $47.3 million in the secondary market and brokered $916,000 of USDA/Rural Housing loans as a balance sheet management strategy during 2014 to reduce interest rate risk in a potentially rising interest rate environment. The Bank sold these loans at a gain of $1.4 million which was recorded in other income in 2014. At December 31, 2014, the Bank had $59.2 million in mortgage loans sold and will realize servicing income on these loans as long as these loans have outstanding balances. At December 31, 2014, the Bank had $3.0 million in loans held for sale comprised of one-to-four family residential fixed rate conventional, FHA, and VA mortgage loans originated and closed by the Bank in the fourth quarter of 2014 that have been committed for sale in the secondary market and will be delivered and sold in the first quarter of 2015.

Total deposits decreased by $4.7 million, or 2.6%, to $175.3 million at December 31, 2014 from $180.0 million at December 31, 2013. Certificates of Deposit, including Individual Retirement Accounts, decreased by $9.3 million as a result of management's prudent pricing of lower rates for non-relationship customers in the continued low interest rate environment partially offset with an increase in core deposits including checking, savings, and money market accounts of $4.7 million as the Company continues to focus on full service long term client relationships. In 2015, we intend to grow our deposits with competitive products and pricing, excellent customer service and targeted marketing activities in an effort to encourage new customers to experience our products and services.

Federal Home Loan Bank advances increased by $10.9 million, or 29.6%, to $47.9 million at December 31, 2014 from $37.0 million at December 31, 2013, as a result of management's decision to opportunistically increase long term wholesale borrowings at rates further out on the yield curve in this low interest rate environment.

**Business Strategy**

Our business strategy is to operate as a well-capitalized community bank that is dedicated to providing exceptional personal service to our customers. We will continue to focus our efforts to be the primary provider of financial services to families and individuals in our market area.

Our business strategy is to grow and improve our profitability by:

- Continuing to emphasize the origination of residential real estate loans at our current origination offices in Canandaigua, Pittsford, Watertown, and Greece;
- Diversifying the balance sheet by growing our commercial loan portfolio which includes, commercial real estate, commercial & industrial, and SBA loans;
- Operating as a community-oriented retail financial institution with branch expansion primarily in eastern Monroe County, New York;
- Continuing to manage our interest rate risk;

- Aggressively marketing our core deposits; increasing our share of lower-cost checking accounts, cross selling our deposit products, and enhancing transaction convenience with wider ATM access at no cost to the customer;
- Expanding our technological services to our client base with mobile banking;
- Maintaining high asset quality;
- Increasing non-interest revenues; and
- Cost control of operating expenses.

We believe that these strategies will guide our business and provide shareholder value as we continue to grow our branch network. We intend to continue to pursue our business strategy, subject to changes necessitated by future market conditions and other factors. We intend to focus on the following:

- ***Retail-Oriented Community Financial Institution.*** Fairport Savings Bank was established in Fairport, New York in 1888 and has been operating continuously since that time. We are committed to meeting the financial needs of the communities we serve and we are dedicated to providing personalized quality service to our customers. We believe that we can be more effective than many of our competitors in serving our customers because of the ability of our senior management to promptly and effectively respond to customer requests and inquiries.

- ***Managing Our Interest Rate Risk.*** To improve our interest rate risk, in recent years we have reduced the fixed-rate loan originations added to our loan portfolio by selling select fixed-rate mortgages in the secondary market, investing a portion of funds received from loan payments and repayments in shorter term and intermediate term, liquid investment securities and securities classified as available for sale including U.S. Government agency debt obligations and mortgage-backed securities; emphasizing the marketing of our passbook, savings and checking accounts, money market accounts and increasing the duration whenever possible of our certificates of deposit; and taking longer duration Federal Home Loan Bank borrowings.

  If short-term interest rates remain low in 2015, we expect a decrease in our cost of funds on deposits and borrowings. This would positively affect the average cost of our interest-bearing liabilities as our certificates of deposit and borrowings mature and reprice at a lower cost to us. We have $64.0 million in certificate of deposit accounts (including individual retirement accounts) that are scheduled to mature during 2015. If we retain these deposits, it will most likely be at a slightly lower cost to us than their current contractual rate.

- ***Emphasizing Residential Real Estate Lending.*** Historically we have emphasized the origination of one-to-four family residential loans within Monroe

County and the surrounding counties of Livingston, Ontario, Orleans and Wayne. As of December 31, 2014, 89.5% of our loan portfolio consisted of one-to-four family residential loans, and 99.8% of our loan portfolio consisted of loans secured by real estate. The Company intends to continue to emphasize aggressive, yet prudent originations of loans secured by one-to-four family residential real estate. In addition to our five full service branches, we operate four mortgage loan origination offices located in Canandaigua, Pittsford, Watertown, and Greece, New York.

- ***Maintaining High Asset Quality.*** We believe that our high asset quality is a result of conservative underwriting standards, the diligence of our loan collection personnel and the stability of the local economy. At December 31, 2014, we had one non-performing residential mortgage loan for $56,000 and one home equity line of credit for $18,000, and at this date, our ratio of allowance for loan losses to non-performing loans was 882.0% and our ratio of allowance for loan losses to total loans was 0.34%. Because 99.8% of our loans are secured by real estate, and our level of non-performing loans has been low in recent periods, we believe that our allowance for loan losses is adequate to absorb the probable losses inherent in our loan portfolio. Management continues to actively monitor the performance of the loan portfolio.

## Comparison of Financial Condition at December 31, 2014, 2013 and 2012

| | At December 31, 2014 | At December 31, 2013 | At December 31, 2012 |
|---|---|---|---|
| | | (In thousands) | |
| **Selected Financial Condition Data:** | | | |
| Total assets | $ 245,960 | $ 237,474 | $ 215,981 |
| Cash and cash equivalents | 4,335 | 5,898 | 6,381 |
| Securities available for sale | 21,982 | 36,376 | 42,390 |
| Securities held to maturity | 17,402 | 6,928 | 7,058 |
| Loans held for sale | 2,961 | 1,309 | 2,521 |
| Loans, net | 188,830 | 177,001 | 147,515 |
| Deposits | 175,307 | 180,013 | 163,667 |
| Federal Home Loan Bank advances | 47,925 | 36,977 | 30,290 |
| Stockholders' equity | 21,204 | 19,595 | 20,781 |

| | For the Year Ended December 31, | | |
|---|---|---|---|
| | 2014 | 2013 | 2012 |
| | | (In thousands) | |
| **Selected Operating Data:** | | | |
| Interest and dividend income | $ 8,653 | $ 7,842 | $ 7,660 |
| Interest expense | 1,845 | 1,894 | 2,260 |
| Net interest income | 6,808 | 5,948 | 5,400 |
| Provision for loan losses | 127 | 90 | 40 |
| Net interest income after provision for loan losses | 6,681 | 5,858 | 5,360 |
| Other income | 2,581 | 2,496 | 2,577 |
| Other expense | 8,299 | 7,993 | 7,924 |
| Income before income taxes | 963 | 361 | 13 |
| Provision (benefit) for income taxes | 303 | 70 | (43) |
| Net income | $ 660 | $ 291 | $ 56 |

| | At or For the Year Ended December 31, | | |
|---|---|---|---|
| | 2014 | 2013 | 2012 |
| **Selected Financial Ratios and Other Data:** | | | |
| **Performance Ratios:** | | | |
| Return on average assets | 0.27% | 0.13% | 0.03% |
| Return on average equity | 3.15% | 1.42% | 0.27% |
| Interest rate spread (1) | 2.88% | 2.71% | 2.54% |
| Net interest margin (2) | 2.95% | 2.79% | 2.63% |
| Efficiency ratio (3) | 89.61% | 94.66% | 99.24% |
| Other income to average total assets | 1.07% | 1.12% | 1.19% |
| Other expense to average total assets | 3.44% | 3.57% | 3.66% |
| Average interest-earning assets to average interest-bearing liabilities | 109% | 109% | 109% |
| **Asset Quality Ratios:** | | | |
| Non-performing assets as a percent of total assets | 0.03% | 0.02% | 0.00% |
| Non-performing loans as a percent of total loans | 0.04% | 0.03% | 0.00% |
| Allowance for loan losses as a percent of non-performing loans | 882.0% | 939.29% | 0.00% |
| Allowance for loan losses as a percent of total loans | 0.34% | 0.30% | 0.29% |
| **Capital Ratios:** | | | |
| Total risk-based capital (to risk-weighted assets) | 15.19% | 15.28% | 17.23% |
| Tier 1 leverage (core) capital (to adjusted tangible assets) | 7.24% | 7.23% | 7.83% |
| Tangible capital (to tangible assets) | 7.24% | 7.23% | 7.83% |
| Tier 1 risk-based capital (to risk-weighted assets) | 14.65% | 14.82% | 16.79% |
| Average equity to average total assets | 8.69% | 9.17% | 9.64% |
| **Other Data:** | | | |
| Number of full service offices | 5 | 5 | 5 |

(1) Represents the difference between the weighted-average yield on interest-earning assets and the weighted-average cost of interest-bearing liabilities for the period.
(2) The net interest margin represents net interest income as a percent of average interest-earning assets for the period.
(3) The efficiency ratio represents other expense divided by the sum of net interest income and other income.

***Total Assets.*** Total assets increased $8.5 million, or 3.6%, to $246.0 million at December 31, 2014 from $237.5 million at December 31, 2013, reflecting increases in net loans receivable, investment in FHLB stock, Bank Owned Life Insurance ("BOLI"), securities held to maturity, loans held for sale, accrued interest receivable, and other assets, partially offset by decreases in cash and cash equivalents, securities available for sale, and premises and equipment. Net loans receivable increased $11.8 million, or 6.7%, to $188.8 million at December 31, 2014 from $177.0 million at December 31, 2013. In 2014 we increased our residential mortgage loans in the portfolio as an earnings strategy, despite selling $47.3 million in residential loans and correspondent FHA and VA mortgages to reduce interest rate risk. The mortgage loans serviced for others increased by $23.6 million, or 66.3%, to $59.2 million at December 31, 2014 compared to $35.6 million at December 31, 2013. Federal Home Loan Bank of New York stock increased by $443,000, or 22.1%, to $2.4 million at December 31, 2014, from $2.0 million at December 31, 2013 with the additional purchase of stock due to more FHLB borrowings in 2014. The bank owned life insurance cash surrender value increased by $84,000, or 2.4%, to $3.6 million at December 31, 2014 from $3.5 million at December 31, 2013. Other assets increased by $160,000,

or 20.1%, to $955,000 at December 31, 2014 from $795,000 at December 31, 2013 as a result of an increase in mortgage servicing rights at December 31, 2014.

Cash and cash equivalents decreased by $1.6 million, or 26.5%, to $4.3 million at December 31, 2014 from $5.9 million at December 31, 2013. Mortgage loans held for sale increased by $1.7 million, or 126.2%, to $3.0 million at December 31, 2014 compared to $1.3 million at December 31, 2013. Securities available for sale decreased by $14.4 million, or 39.6%, to $22.0 million at December 31, 2014 from $36.4 million at December 31, 2013. The decrease is primarily due to purchases of $3.1 million, net of maturities and calls of $2.0 million, $3.5 million in U.S. Government and agency obligations sales, $3.6 million in mortgage-backed securities principal repayments, $191,000 in SBA principal repayments, $144,000 in net amortization of premiums and accretion of discounts, and a $2.0 million increase in the fair value of securities available for sale, and $10 million transfer to HTM securities. During the second quarter of 2014, the Company transferred securities with an amortized cost of $10,000,000 from available for sale to held-to-maturity. The fair value of the securities transferred as of the date of the transfer was $9,628,490 with a net unrealized loss of $371,510. In accordance with ASC 320-10-15-10d, the unrealized loss amounts in accumulated other comprehensive loss are amortized simultaneously against interest income as the discount is accreted on the transferred securities. There is no effect on net income as the discount accretion offsets the accumulated other comprehensive loss amortization. Securities held to maturity increased $10.5 million, or 151.2%, to $17.4 million at December 31, 2014 from $6.9 million at December 31, 2013 due to transfer of $9.6 million from AFS securities, purchases of $1.6 million in state and municipal securities, net of $739,000 of principal repayments on mortgage-backed securities, and $21,000 in net amortization of premiums and accretion of discounts. Premises and equipment, net, decreased $212,000, or 7.0%, to $2.8 million at December 31, 2014 from $3.0 million a year earlier due to depreciation of office buildings, along with furniture, fixtures and equipment. Accrued interest receivable increased by $13,000, or 2.0%, to $655,000 at December 31, 2014 from $642,000 at December 31, 2013.

***Deposits and Borrowings.*** Total deposits decreased $4.7 million, or 2.6%, to $175.3 million at December 31, 2014 from $180.0 million at December 31, 2013. The decrease in our deposits reflects a $9.3 million decrease in certificates of deposit, including individual retirement accounts, partially offset with an increase of $35,000 in non-interest-bearing checking accounts, and a $4.6 million increase in interest-bearing transaction accounts. Total borrowings from the Federal Home Loan Bank of New York increased $10.9 million, or 29.6% to $47.9 million at December 31, 2014 from $37.0 million at December 31, 2013, as an alternative wholesale funding source in 2014.

***Stockholders' Equity.*** Stockholders' equity increased $1.6 million or 8.2%, to $21.2 million at December 31, 2014 from $19.6 million at December 31, 2013. The change resulted from an increase of $938,000 in accumulated other comprehensive income, a $29,000 increase from committed ESOP shares, and net income of $660,000, partially offset by the purchase of $18,000 of treasury stock from the ESOP. The Bank's capital ratios continue to classify Fairport Savings Bank as a well capitalized bank, the highest standard of capital rating as defined by the Bank's regulators.

***Comparison of Operating Results for the Years Ended December 31, 2014 and 2013***

***General.*** The net income of $660,000 for the year ended December 31, 2014 is an increase in earnings of $369,000 from net income of $291,000 for the year ended December 31, 2013. The year over year increase in earnings of $369,000 was attributable to an increase in net interest income of $860,000 and an $85,000 increase in other income, partially offset with an increase in other expense of $306,000, an increase in income taxes of $233,000, and a $37,000 increase in provision for loan losses.

***Interest and Dividend Income.*** Total interest and dividend income increased $811,000, or 10.3%, to $8.7 million for the year ended December 31, 2014 from $7.8 million for the year ended December 31, 2013. The interest and dividend income increase resulted from a $17.6 million increase year over year in average interest-earning assets, primarily loans, and an 8 basis point increase in the overall yield on interest-earning assets to 3.75% for 2014 from 3.67% for 2013 primarily due to the increase on yield on total investments.

Interest income on loans, including fees, increased $795,000, or 11.5%, to $7.7 million for 2014 from $6.9 million for 2013, reflecting an increase in the average balance of loans to $184.4 million for 2014 from $161.9 million for 2013, despite a modest 9 basis point lower average yield. The average yield on loans decreased to 4.18% for 2014 from 4.27% for 2013, reflecting decreases in market interest rates on loan products. Interest income on taxable investment securities increased $54,000 to $574,000 in 2014 from $520,000 in 2013. The average balance of investment securities decreased $1.4 million, or 6.0%, to $22.1 million from $23.5 million, while the average yield on investment securities increased to 2.60% from 2.22%. Interest income on mortgage-backed securities decreased $50,000 to $291,000 in 2014, from $341,000 in 2013, reflecting an increase in the average yield on mortgage-backed securities of 1 basis point to 1.56% in 2014 from 1.55% in 2013, while the average balance of mortgage-backed securities decreased $3.3 million, or 15.1%, to $18.6 million from $22.0 million. Interest income on federal funds sold was $5,000 for both 2014 and 2013. The average balance of federal funds sold decreased by $793,000 for the year, while the average yield increased by 3 basis points to 0.17% for 2014 from 0.14% for 2013. Interest income on state and municipal securities increased $12,000 to $72,000 in 2014, from $60,000 in 2013. The average balance of state and municipal securities increased by $628,000, or 20.3%, to $3.7 million from $3.1 million, while the average yield increased by 1 basis point to 2.95% in 2014, from 2.94% in 2013.

***Total Interest Expense.*** Total interest expense decreased $49,000, or 2.6%, to $1.8 million for the year ended December 31, 2014 from $1.9 million for the year ended December 31, 2013. The decrease in total interest expense resulted from a 9 basis point decrease in the average cost of interest-bearing liabilities to 0.87% for 2014 from 0.96% for 2013, as a result of lower market interest rates paid on deposits and less interest paid in FHLB borrowings expense, despite a $16.2 million increase in the average balance of interest-bearing liabilities.

Interest expense on deposits increased $16,000, or 1.3%, to $1.2 million for 2014 and 2013. The deposits decreased to 0.71% in the weighted average rate we paid on deposits for 2014 from 0.74% for 2013 in response to lower market interest rates. The average balance on transaction accounts, traditionally our lower cost of deposit accounts, increased by $2.8 million to $80.7 million for 2014 from $77.9 million for 2013, with a decrease in average cost of transaction

accounts of 4 basis points to 0.28% in 2014 from 0.32% in 2013. Additionally, the average balance of certificates of deposit (including individual retirement accounts) traditionally our higher yielding deposit cost, increased by $8.7 million to $98.1 million in 2014 from $89.4 million in 2013 with a decrease in the cost of certificates of deposit accounts by 6 basis points to 1.01% in 2014 from 1.07% in 2013.

At December 31, 2014, we had $64.0 million of certificates of deposits, including individual retirement accounts, which are scheduled to mature during 2015. Based on current market interest rates, we expect that the cost of these deposits will continue to decrease.

Interest expense on Federal Home Loan Bank advances decreased $65,000, or 9.5%, to $621,000 for the year ended December 31, 2014 from $686,000 for the year ended December 31, 2013. The decreased interest expense was caused by decreased cost of these funds from 1.97% to 1.55%, despite a $5.3 million increase in our average balance of Federal Home Loan Bank advances totaling $40.1 million for 2014 compared to $34.8 million for 2013.

***Net Interest Income.*** Net interest income increased $860,000, or 14.5%, to $6.8 million for the year ended December 31, 2014 from $5.9 million for the year ended December 31, 2013. The increase in net interest income was primarily attributable to a 17 basis point increase in our interest rate spread to 2.88% for 2014 from 2.71% for 2013, and an increase in our net interest margin of 16 basis points to 2.95% for 2014 from 2.79% for 2013. The increase in both interest rate spread and net interest margin is primarily due to substantially higher average balances in loans year over year, together with an increase in yield on overall investment balances. The yield on interest-bearing liabilities continues to be positively impacted by a considerable decrease in yield on borrowings, together with a modest decrease in the yield on interest-bearing deposits. While these short-term market interest rates (used as a guide to price our deposits) have decreased, longer-term market interest rates (used as a guide to price our longer-term loans) have also decreased. In 2014, rates on our deposits and borrowings re-priced downward faster than the rates on our loans and investments. This resulted in a reduction in our cost of funds and positively impacted our interest rate spread which in turn had a positive effect on net interest income. Interest expense decreased modestly as a result of lower market interest rates being paid on all deposit accounts, and also FHLB advance expense with new borrowings with lower interest rates replacing maturing borrowings in 2014.

***Provision for Loan Losses.*** We establish provisions for loan losses which are charged to operations in order to maintain the allowance for loan losses at a level we consider necessary to absorb credit losses inherent in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. In determining the level of the allowance for loan losses, we consider past and current loss experience, evaluations of real estate collateral, current economic conditions, volume and type of lending, adverse situations that may affect a borrower's ability to repay a loan, and the levels of nonperforming and other classified loans. The amount of the allowance is based on estimates and the ultimate losses may vary from such estimates as more information becomes available or conditions change. We assess the allowance for loan losses on a quarterly basis and make provisions for loan losses in order to maintain the allowance.

Based on our evaluation of the above factors, we recorded a $127,000 provision for loan losses for the year ended December 31, 2014 compared to a $90,000 provision for loan losses for

the year ended December 31, 2013. The rationale for the increase in 2014 was the result of additional general provisions deemed necessary to support an increased balance of loans receivable as well as a potentially weaker economy. The allowance for loan losses was $653,000, or 0.34% of net loans outstanding, at December 31, 2014 compared to $526,000, or 0.30% of net loans outstanding, at December 31, 2013. In 2014 and 2013, we had no loss on foreclosed real estate.

***Other Income***. Other income increased by $85,000 or 3.4%, to $2.6 million for 2014 from $2.5 million for 2013. The increase in other income resulted primarily from increases in realized gain on sale of loans, partially offset by decreases in realized gain on sale of securities, bank owned life insurance income, deposit service fees, and mortgage fee income. A substantial portion of the year over year increase was in realized gain on sale of loans associated with efficiencies in our secondary market sales process providing an opportunity to sell more mortgage loans in 2014 compared to sales in 2013. Gain on sale of loans increased $232,000 or 19.5% to $1.4 million in 2014 from $1.2 million in 2013. The primary decrease in other income was due to realized gain on sale of securities as the result of fewer sales of available for sale securities resulting in lower gain on sales of securities comparing 2014 to 2013. Realized gain on sales of securities decreased by $73,000, or 96.1% to $3,000 in 2014 compared to 76,000 in 2013. Mortgage fee income decreased by $41,000, or 7.1% to $538,000 in 2014 compared to $579,000 in 2013. Bank owned life insurance decreased by $12,000, or 12.5% to $84,000 in 2014 from $96,000 in 2013. Deposit service fees decreased by $22,000, or 11.2% to $174,000 in 2014 from $196,000 in 2013.

***Other Expense***. Other expense increased $306,000, or 3.8%, to $8.3 million in 2014 from $8.0 million in 2013. The $306,000 increase in other expense was the result of increases in salaries and employee benefits of $322,000, occupancy of $26,000, data processing costs of $6,000, electronic banking of $8,000, directors' fees of $28,000, FDIC premium expense of $6,000, mortgage fees and taxes of $21,000, and other miscellaneous expense of $14,000, partially offset by decreases in audit and taxes of $20,000, advertising of $69,000, and equipment of $36,000. The increase in other expense was primarily attributable to the new mortgage origination office in Greece, New York and continued investment in the loan origination division with increased salary costs associated with additional staff, additional occupancy, and mortgage fees and taxes deemed necessary in order to successfully grow our loan portfolio to increase interest income and earnings.

***Income Tax Expense***. Income tax expense was $303,000 for 2014, an increase of $233,000 compared to income tax expense of $70,000 for 2013. The effective tax rate was 31.5% in 2014 compared to 19.4% in 2013. The increase was primarily due to the ratio of permanent tax differences to pretax income going from (12)% in 2013 to (4)% in 2014. The Company's lower effective tax rate compared to statutory rates for 2014 and 2013, resulted from a reduction in income tax expense due to the increase in cash surrender value of our bank-owned life insurance and municipal bond interest income, which are tax exempt for Federal income tax purposes.

***Average balances and yields***. The following table sets forth average balance sheets, average yields and costs and certain other information at and for the years indicated. All average balances are daily average balances. Non-accrual loans were included in the computation of

average balances, but have been reflected in the table as loans carrying a zero yield. The yields set forth below include the effect of deferred fees, discounts and premiums that are accreted or amortized to interest income or interest expense.

| | For the Years Ended December 31, | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2014 | | | 2013 | | | 2012 | | |
| | Average Balance | Interest Income/ Expense | Yield/ Cost | Average Balance | Interest Income/ Expense | Yield/ Cost | Average Balance | Interest Income/ Expense | Yield/ Cost |
| **Interest-earning assets:** | | | | | | | | | |
| Loans | $ 184,449 | $ 7,711 | 4.18% | $ 161,940 | $ 6,916 | 4.27% | $ 138,721 | $ 6,488 | 4.68% |
| Federal funds sold | 3,041 | 5 | 0.17 | 3,884 | 5 | 0.14 | 4,812 | 6 | 0.12 |
| Investment securities | 22,060 | 574 | 2.60 | 23,458 | 520 | 2.22 | 32,160 | 582 | 1.81 |
| Mortgage-backed securities | 18,638 | 291 | 1.56 | 21,962 | 341 | 1.55 | 27,679 | 526 | 1.90 |
| State and municipal securities (1) | 3,715 | 110 | 2.95 | 3,088 | 91 | 2.94 | 2,969 | 88 | 2.96 |
| Total interest-earning assets | 231,903 | 8,691 | 3.75 | 214,332 | 7,873 | 3.67 | 206,341 | 7,690 | 3.73 |
| Noninterest-earning assets | 9,055 | | | 9,327 | | | 9,831 | | |
| Total assets | $ 240,958 | | | $ 223,659 | | | $ 216,172 | | |
| **Interest-bearing liabilities:** | | | | | | | | | |
| NOW accounts | $ 22,930 | 38 | 0.17 | $ 19,455 | 37 | 0.19 | $ 15,225 | 37 | 0.24 |
| Passbook savings | 29,530 | 114 | 0.39 | 31,036 | 130 | 0.42 | 35,803 | 181 | 0.51 |
| Money market savings | 22,614 | 76 | 0.34 | 22,309 | 81 | 0.36 | 23,443 | 83 | 0.35 |
| Individual retirement accounts | 13,105 | 165 | 1.26 | 15,005 | 212 | 1.42 | 16,441 | 281 | 1.71 |
| Certificates of deposit | 84,988 | 831 | 0.98 | 74,423 | 748 | 1.01 | 73,780 | 922 | 1.25 |
| Federal Home Loan Bank advances | 40,085 | 621 | 1.55 | 34,802 | 686 | 1.97 | 24,685 | 756 | 3.06 |
| Total interest-bearing liabilities | 213,252 | 1,845 | 0.87% | 197,030 | 1,894 | 0.96% | 189,377 | 2,260 | 1.19% |
| **Noninterest-bearing liabilities:** | | | | | | | | | |
| Demand deposits | 5,653 | | | 5,118 | | | 4,649 | | |
| Other | 1,124 | | | 995 | | | 1,303 | | |
| Total liabilities | 220,029 | | | 203,143 | | | 195,329 | | |
| Stockholders' equity | 20,929 | | | 20,516 | | | 20,843 | | |
| Total liabilities and stockholders' equity | $ 240,958 | | | $ 223,659 | | | $ 216,172 | | |
| Net interest income | | $ 6,846 | | | $ 5,979 | | | $ 5,430 | |
| Interest rate spread (2) | | | 2.88% | | | 2.71% | | | 2.54% |
| Net interest-earning assets (3) | $ 18,651 | | | $ 17,302 | | | $ 16,964 | | |
| Net interest margin (4) | | 2.95% | | | 2.79% | | | 2.63% | |
| Average interest-earning assets to average interest-bearing liabilities | 109% | | | 109% | | | 109% | | |

(1) Tax-exempt interest income is presented on a tax equivalent basis using a 34% federal tax rate.
(2) Interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing liabilities.
(3) Net interest-earning assets represent total interest-earning assets less total interest-bearing liabilities.
(4) Net interest margin represents net interest income divided by total interest-earning assets.

## Rate/Volume Analysis

The following table presents the effects of changing rates and volumes on our net interest income for the years indicated. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to both rate and volume, which cannot be segregated, have been allocated proportionately, based on the changes due to rate and the changes due to volume.

| | For the Years Ended December 31, 2014 vs. 2013 | | | For the Years Ended December 31, 2013 vs. 2012 | | |
|---|---|---|---|---|---|---|
| | Increase (Decrease) Due to | | | Increase (Decrease) Due to | | |
| | Volume | Rate | Net | Volume | Rate | Net |
| | (In thousands) | | | (In thousands) | | |
| **Interest-earning assets:** | | | | | | |
| Loans | $ 937 | $ (142) | $ 795 | $ 898 | $ (470) | $ 428 |
| Federal funds sold | 0 | 0 | 0 | (7) | 6 | (1) |
| Investment securities | (32) | 86 | 54 | (381) | 319 | (62) |
| Mortgage-backed securities | (52) | 2 | (50) | (98) | (87) | (185) |
| State and municipal securities | 12 | 0 | 12 | 0 | 3 | 3 |
| Total interest-earning assets | 865 | (54) | 811 | 412 | (229) | 183 |
| **Interest-bearing liabilities:** | | | | | | |
| NOW accounts | 5 | (3) | 2 | 0 | 0 | 0 |
| Passbook savings | (6) | (10) | (16) | (22) | (29) | (51) |
| Money market savings | 2 | (7) | (5) | (5) | 3 | (2) |
| Individual retirement accounts | (25) | (23) | (48) | (23) | (46) | (69) |
| Certificates of deposit | 84 | (2) | 82 | 432 | (606) | (174) |
| Federal Home Loan Bank advances | 158 | (222) | (64) | 477 | (547) | (70) |
| Total interest-bearing liabilities | 218 | (267) | (49) | 859 | (1,225) | (366) |
| Net change in net interest income | $ 647 | $ 213 | $ 860 | $ (447) | $ 996 | $ 549 |

## Management of Market Risk

***General***. The majority of our assets and liabilities are monetary in nature. Consequently, our most significant form of market risk is interest rate risk. Our assets, consisting primarily of mortgage loans, have longer maturities than our liabilities, consisting primarily of deposits. As a result, a principal part of our business strategy is to manage interest rate risk and limit the exposure of our net interest income to changes in market interest rates. Accordingly, we have an asset/liability management committee which is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate, given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the guidelines approved by the Board of Directors.

We intend to continue to manage our interest rate risk in order to control the exposure of our earnings and capital to changes in interest rates. As part of our ongoing asset-liability management, we intend to use the following strategies to manage our interest rate risk.

(i) invest in shorter to medium-term repricing and/or maturing securities whenever market allows;

(ii) emphasize the marketing of our passbook, savings and checking accounts and increasing the duration of our certificates of deposit;

(iii) sell a portion of our long-term, fixed-rate one-to-four family residential real estate mortgage loans; and

(iv) maintain a strong capital position.

In 2014, we sold $47.3 million of mortgage loan originations including $28.2 million of conventional conforming fixed-rate residential mortgages and $19.1 million of correspondent FHA and VA mortgage loans to improve our interest rate risk position in the event of increases in market interest rates. We intend to continue to originate and, subject to market conditions, sell a portion of our long term fixed-rate one-to-four family residential real estate loans.

Additionally, shortening the average maturity of our interest-earning assets by increasing our investments in shorter term loans, as well as loans with variable rates of interest, helps to better match the maturities and interest rates of our assets and liabilities, thereby reducing the exposure of our net interest income to changes in market interest rates. By following these strategies, we believe that we are better-positioned to react to changes in market interest rates.

**Interest Rate Risk Management**

Our earnings and the market value of our assets and liabilities are subject to fluctuations caused by changes in the level of interest rates. We manage the interest rate sensitivity of our interest-earning assets and interest-bearing liabilities in an effort to minimize the adverse effects of changes in the interest rate environment. The majority of our assets are long-term fixed-rate mortgage loans that do not reprice as quickly as our deposits, therefore we would experience a significant decrease in our net interest income in the event of an inversion of the yield curve. We expect that our net interest income will be positively affected as our certificates of deposit mature and reprice at a lower cost to us. We have $64.0 million in certificates of deposit accounts (including individual retirement accounts) that are scheduled to mature during 2015. If we retain these deposits it most likely will be at a lower average cost to us than their current contractual rates.

We have an Asset/Liability Management Committee to coordinate all aspects involving asset/liability management. The committee establishes and monitors the volume, maturities, pricing and mix of assets and funding sources with the objective of managing assets and funding sources to provide results that are consistent with liquidity, growth, risk limits and profitability goals.

**Liquidity and Capital Resources**

Liquidity is the ability to meet current and future financial obligations of a short-term nature. Our primary sources of funds consist of deposit inflows, loan repayments, advances from the Federal Home Loan Bank of New York, maturities and principal repayments of securities, and loan sales. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. Our asset/liability management committee is responsible for establishing and monitoring our liquidity targets and strategies in order to ensure that sufficient liquidity exists for meeting the borrowing needs and deposit withdrawals of our customers as well as unanticipated contingencies. We seek to maintain a liquidity ratio of 20.0% or greater. For the year ended December 31, 2014, our liquidity ratio averaged 33.3%. We believe that we have enough sources of liquidity to satisfy our short and long-term liquidity needs as of December 31, 2014.

We regularly adjust our investments in liquid assets based upon our assessment of:

(i) expected loan demand;

(ii) expected deposit flows;

(iii) yields available on interest-earning deposits and securities; and

(iv) the objectives of our asset/liability management program.

Excess liquid assets are invested generally in interest-earning deposits, short and intermediate-term securities and federal funds sold.

Our most liquid assets are cash and cash equivalents. The levels of these assets are dependent on our operating, financing, lending and investing activities during any given period. At December 31, 2014, cash and cash equivalents totaled $4.3 million.

Our cash flows are derived from operating activities, investing activities and financing activities as reported in our Consolidated Statements of Cash Flows included in our Consolidated Financial Statements.

At December 31, 2014, we had $5.2 million in loan commitments outstanding. In addition to commitments to originate loans, we had $12.2 million in unused lines of credit to borrowers. Certificates of deposit (including individual retirement accounts) comprised solely of certificates of deposits, due within one year of December 31, 2015 totaled $64.0 million, or 70.2% of our certificates of deposit (including individual retirement accounts) and 36.5% of total deposits. If these deposits do not remain with us, we will be required to seek other sources of funds, including loan sales, other deposit products, including certificates of deposit, and Federal Home Loan Bank advances. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on the certificates of deposit due on or before December 31, 2015. We believe, however, based on past experience that a significant portion of such deposits will remain with us. We have the ability to attract and retain deposits by adjusting the interest rates offered.

Liquidity management is both a daily and long-term function of business management. If we require funds beyond our ability to generate them internally, borrowing agreements exist with the Federal Home Loan Bank of New York, which provides an additional source of funds. Federal Home Loan Bank advances, gross of prepayment premiums, increased by $10.9 million to $47.9 million for the year ended December 31, 2014, compared to a net increase of $6.6 million to $37.0 million for the year ended December 31, 2013. At December 31, 2014, we had the ability to borrow approximately $139.2 million from the Federal Home Loan Bank of New York, of which $47.9 million had been advanced.

The Company also has a repurchase agreement with Raymond James Financial providing an additional $10.0 million in liquidity. Funds obtained under the repurchase agreement are secured by the Company's U.S Government and agency obligations. There were no advances outstanding under the repurchase agreement at December 31, 2014 or 2013.

Fairport Savings Bank is subject to various regulatory capital requirements, including a risk-based capital measure. The risk-based capital guidelines include both a definition of capital and a framework for calculating risk-weighted assets by assigning balance sheet assets and off-balance sheet items to broad risk categories. At December 31, 2014, Fairport Savings Bank exceeded all regulatory capital requirements. Fairport Savings Bank is considered "well capitalized" under regulatory guidelines. See "Supervision and Regulation—Federal Banking Regulation—Capital Requirements" and Note 12 of the Notes to the Consolidated Financial Statements.

**Off-Balance Sheet Arrangements**

In the ordinary course of business, Fairport Savings Bank is a party to credit-related financial instruments with off-balance sheet risk to meet the financing needs of our customers. These financial instruments include commitments to extend credit. We follow the same credit policies in making commitments as we do for on-balance sheet instruments.

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. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by us, is based on our credit evaluation of the customer.

At December 31, 2014 and 2013, we had $5.2 million and $7.6 million, respectively, of commitments to grant loans, and $12.2 million and $11.3 million, respectively, of unfunded commitments under lines of credit.

For additional information, see Note 11 of the Notes to our Consolidated Financial Statements.

**Impact of Inflation and Changing Prices**

Our consolidated financial statements and related notes have been prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP").

GAAP generally requires the measurement of financial position and operating results in terms of historical dollars without consideration for changes in the relative purchasing power of money over time due to inflation. The impact of inflation is reflected in the increased cost of our operations. Unlike industrial companies, our assets and liabilities are primarily monetary in nature. As a result, changes in market interest rates have a greater impact on performance than the effects of inflation.

**Market for Common Stock**

FSB Community Bankshares, Inc.'s common stock is quoted on the OTCQB under the trading symbol "FSBC."

The following table sets forth the high and low trading prices for shares of our common stock for the periods indicated. We did not pay any cash dividends to our stockholders in 2014 or in 2013. As of December 31, 2014, there were 1,785,000 and 1,780,086 shares of our common stock issued and outstanding, respectively of which 946,050 shares, or 53.0%, were held by FSB Community Bankshares, MHC, our mutual holding company. On such date our shares were held by approximately 135 holders of record.

| Year Ended December 31, 2014 | High | Low |
|---|---|---|
| Fourth quarter | $ 10.40 | $ 7.95 |
| Third quarter | 9.00 | 7.95 |
| Second quarter | 8.00 | 7.50 |
| First quarter | 8.20 | 7.15 |

| Year Ended December 31, 2013 | High | Low |
|---|---|---|
| Fourth quarter | $ 8.60 | $ 8.05 |
| Third quarter | 9.49 | 8.25 |
| Second quarter | 9.50 | 8.00 |
| First quarter | 9.13 | 7.00 |

## STOCKHOLDER INFORMATION

| ANNUAL MEETING | TRANSFER AGENT |
|---|---|
| The Annual Meeting of Stockholders will be held at 2:00 p.m., New York time on Wednesday, May 27, 2015 at the Perinton Community Center located at 1350 Turk Hill Road, Fairport, New York 14450. | Computershare Investor Services<br>P.O. Box 30170<br>College Station, TX 77842-3170<br>www.computershare.com/investor<br><br>If you have any questions concerning your stockholder account, please call our transfer agent, noted above, at (800) 368-5948. This is the number to call if you require a change of address or need records or information about lost certificates. |
| STOCK LISTING | ANNUAL REPORT |
| The Company's Common Stock is quoted on the OTCQB under the symbol “FSBC.” | A copy of the Company's Annual Report for the year ended December 31, 2014 will be furnished without charge to stockholders as of the record date, upon written request to the Secretary, FSB Community Bankshares, Inc., 45 South Main Street, Fairport, New York 14450. |
| SPECIAL COUNSEL | INDEPENDENT AUDITOR |
| Luse Gorman Pomerenk & Schick, P.C.<br>5335 Wisconsin Avenue, N.W., Suite 780<br>Washington, D.C. 20015 | Bonadio & Co., LLP<br>115 Solar Street, Suite 100<br>Syracuse, New York 13204 |

Bonadio & Co., LLP
Certified Public Accountants

## INDEPENDENT AUDITOR'S REPORT

March 25, 2015

To the Board of Directors and Stockholders of
FSB Community Bankshares, Inc.:

We have audited the accompanying consolidated financial statements of FSB Community Bankshares, Inc. and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2014 and 2013, and the related consolidated statements of income, comprehensive income (loss), stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

**Management's Responsibility for the Financial Statements**
Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of 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 FSB Community Bankshares, Inc. and Subsidiary as of December 31, 2014 and 2013, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

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## Consolidated Balance Sheets
**December 31, 2014 and 2013**

| | 2014 | 2013 |
|---|---|---|
| | (Dollars in Thousands, except share and per share data) | |
| **Assets** | | |
| Cash and due from banks | **$ 1,191** | $ 1,215 |
| Interest bearing demand deposits | **3,144** | 4,683 |
| Cash and Cash Equivalents | **4,335** | 5,898 |
| Securities available for sale | **21,982** | 36,376 |
| Securities held to maturity (fair value 2014 $17,783; 2013 $7,146) | **17,402** | 6,928 |
| Investment in FHLB stock | **2,449** | 2,006 |
| Loans held for sale | **2,961** | 1,309 |
| Loans, net of allowance for loan losses (2014 $653; 2013 $526) | **188,830** | 177,001 |
| Bank owned life insurance | **3,555** | 3,471 |
| Accrued interest receivable | **655** | 642 |
| Premises and equipment, net | **2,836** | 3,048 |
| Other assets | **955** | 795 |
| **Total Assets** | **$245,960** | $237,474 |
| **Liabilities and Stockholders' Equity** | | |
| **Liabilities** | | |
| Deposits: | | |
| Non-interest-bearing | **$ 5,710** | $ 5,675 |
| Interest bearing | **169,597** | 174,338 |
| Total Deposits | **175,307** | 180,013 |
| Borrowings | **47,925** | 36,977 |
| Official bank checks | **458** | 606 |
| Other liabilities | **1,066** | 283 |
| **Total Liabilities** | **224,756** | 217,879 |
| **Stockholders' Equity** | | |
| Preferred stock, no par value; 1,000,000 shares authorized, no shares issued and outstanding | **-** | - |
| Common stock; $0.10 par value; 10,000,000 shares authorized; 1,785,000 shares issued; 1,780,086 and 1,782,125 shares outstanding in 2014 and 2013, respectively | **179** | 179 |
| Paid-in capital | **7,239** | 7,245 |
| Retained earnings | **14,472** | 13,812 |
| Accumulated other comprehensive loss | **(226)** | (1,164) |
| Treasury stock at cost, 2014-4,914 shares, 2013-2,875 shares | **(40)** | (22) |
| Unearned ESOP shares – at cost | **(420)** | (455) |
| **Total Stockholders' Equity** | **21,204** | 19,595 |
| **Total Liabilities and Stockholders' Equity** | **$245,960** | $237,474 |

See accompanying notes to consolidated financial statements

## Consolidated Statements of Income

**Years Ended December 31, 2014 and 2013**

| | 2014 | 2013 |
|---|---|---|
| | (Dollars in Thousands, Except Per Share Data) | |
| **Interest and Dividend Income** | | |
| Loans | **$7,711** | $6,916 |
| Securities - taxable | **574** | 520 |
| Securities - tax exempt | **72** | 60 |
| Mortgage-backed securities | **291** | 341 |
| Other | **5** | 5 |
| **Total Interest and Dividend Income** | **8,653** | 7,842 |
| **Interest Expense** | | |
| Deposits | **1,224** | 1,208 |
| Borrowings | **621** | 686 |
| **Total Interest Expense** | **1,845** | 1,894 |
| **Net Interest Income** | **6,808** | 5,948 |
| **Provision for loan losses** | **127** | 90 |
| **Net Interest Income after Provision for loan losses** | **6,681** | 5,858 |
| **Other Income** | | |
| Service fees | **174** | 196 |
| Fee income | **204** | 202 |
| Realized gain on sale of securities | **3** | 76 |
| Increase in cash surrender value of bank owned life insurance | **84** | 96 |
| Realized gain on sale of loans | **1,422** | 1,190 |
| Mortgage fee income | **538** | 579 |
| Other | **156** | 157 |
| **Total Other Income** | **2,581** | 2,496 |
| **Other Expense** | | |
| Salaries and employee benefits | **4,959** | 4,637 |
| Occupancy | **955** | 929 |
| Data processing costs | **129** | 123 |
| Advertising | **98** | 167 |
| Equipment | **614** | 650 |
| Electronic banking | **89** | 81 |
| Directors' fees | **173** | 145 |
| Mortgage fees and taxes | **364** | 343 |
| FDIC premium expense | **154** | 148 |
| Audit and tax services | **66** | 86 |
| Other | **698** | 684 |
| **Total Other Expense** | **8,299** | 7,993 |
| **Income before Income Taxes** | **963** | 361 |
| **Provision for Income Taxes** | **303** | 70 |
| **Net Income** | **$ 660** | $ 291 |
| **Basic earnings per common share** | **$ 0.38** | $ 0.17 |

See accompanying notes to consolidated financial statements

## Consolidated Statements of Comprehensive Income (Loss)

**Years Ended December 31, 2014 and 2013**

**(Dollars in thousands)**

| | 2014 | 2013 |
|---|---|---|
| **Net Income** | $ 660 | $ 291 |
| **Other Comprehensive Income (Loss) Net of Tax** | | |
| Change in unrealized holding gains (losses) on securities available for sale | 1,962 | (2,185) |
| Unrealized (losses) transferred to held to maturity | (372) | - |
| Accretion of net unrealized losses on securities transferred from available for sale | 17 | - |
| Reclassification adjustment for realized gains included in net income | (3) | (76) |
| **Other Comprehensive Income (Loss), Before Tax** | 1,604 | (2,261) |
| **Income Tax (Provision) Benefit Related to Other Comprehensive Income (Loss)** | (666) | 768 |
| **Other Comprehensive Income (Loss), Net of Tax** | 938 | (1,493) |
| **Comprehensive Income (Loss)** | $ 1,598 | $ (1,202) |

See accompanying notes to consolidated financial statements

## Consolidated Statements of Stockholders' Equity

### Years Ended December 31, 2014 and 2013

**(In Thousands)**

| | Common Stock | Paid-In Capital | Retained Earnings | Accumulated Other Comprehensive (Loss) Income | Treasury Stock | Unearned ESOP Shares | Total |
|---|---|---|---|---|---|---|---|
| **Balance - January 1, 2013** | $ 179 | $ 7,251 | $ 13,521 | $ 329 | $ (9) | $ (490) | $ 20,781 |
| Net income | - | - | 291 | - | - | - | 291 |
| Other comprehensive loss, net | - | - | - | (1,493) | - | - | (1,493) |
| Effect of employee stock option plan, net | - | - | - | - | (13) | - | (13) |
| ESOP shares committed to be released | - | (6) | - | - | - | 35 | 29 |
| **Balance - December 31, 2013** | 179 | 7,245 | 13,812 | (1,164) | (22) | (455) | 19,595 |
| Net income | - | - | 660 | - | - | - | 660 |
| Other comprehensive income, net | - | - | - | 938 | - | - | 938 |
| Effect of employee stock option plan, net | - | - | - | - | (18) | - | (18) |
| ESOP shares committed to be released | - | (6) | - | - | - | 35 | 29 |
| **Balance - December 31, 2014** | $ 179 | $ 7,239 | $ 14,472 | $ (226) | $ (40) | $ (420) | $ 21,204 |

See accompanying notes to consolidated financial statements

## Consolidated Statements of Cash Flows

### Years Ended December 31, 2014 and 2013

| | 2014 | 2013 |
|---|---|---|
| | (In Thousands) | |
| **Cash Flows from Operating Activities** | | |
| Net income | **$ 660** | $ 291 |
| Adjustments to reconcile net income to net cash (used by) provided by operating activities: | | |
| Net amortization of premiums and accretion of discounts on investments | **165** | 322 |
| Net gain on sales of securities | **(3)** | (76) |
| Gain on sale of loans | **(1,422)** | (1,190) |
| Proceeds from loans sold | **60,623** | 37,309 |
| Loans originated for sale | **(60,853)** | (34,907) |
| Amortization of net deferred loan origination costs | **133** | 129 |
| Amortization of deferred prepayment penalties on FHLB advances | **25** | 132 |
| Depreciation and amortization | **474** | 500 |
| Provision for loan losses | **127** | 90 |
| Expense related to ESOP | **29** | 29 |
| Deferred income tax (benefit) expense | **(48)** | 2 |
| Earnings on investment in bank owned life insurance | **(84)** | (96) |
| (Increase) decrease in accrued interest receivable | **(13)** | 30 |
| (Increase) decrease in prepaid FDIC premium and other assets | **(160)** | 260 |
| Increase in other liabilities | **165** | 287 |
| **Net Cash (Used by) Provided by Operating Activities** | **(182)** | 3,112 |
| **Cash Flows from Investing Activities** | | |
| Purchases of securities available for sale | **(3,078)** | (17,829) |
| Proceeds from maturities and calls of securities available for sale | **2,000** | 13,249 |
| Proceeds from sales of securities available for sale | **3,503** | 2,032 |
| Proceeds from principal paydowns on securities available for sale | **3,787** | 6,071 |
| Purchases of securities held to maturity | **(1,589)** | (214) |
| Proceeds from principal paydowns on securities held to maturity | **739** | 328 |
| Net increase in loans | **(12,089)** | (29,705) |
| Purchase of Federal Home Loan Bank stock | **(443)** | (310) |
| Purchase of premises and equipment | **(262)** | (230) |
| **Net Cash Used by Investing Activities** | **(7,432)** | (26,608) |
| **Cash Flows from Financing Activities** | | |
| Net (decrease) increase in deposits | **(4,706)** | 16,346 |
| Proceeds from borrowings | **21,000** | 24,694 |
| Repayments on borrowings | **(10,077)** | (18,139) |
| Purchase of treasury stock | **(18)** | (13) |
| Net (decrease) increase in official bank checks | **(148)** | 125 |
| **Net Cash Provided by Financing Activities** | **6,051** | 23,013 |
| **Net Decrease in Cash and Cash Equivalents** | **(1,563)** | (483) |
| **Cash and Cash Equivalents - Beginning** | **5,898** | 6,381 |
| **Cash and Cash Equivalents - Ending** | **$ 4,335** | $ 5,898 |
| **Supplementary Cash Flows Information** | | |
| Interest paid | **$ 1,834** | $ 1,894 |
| Taxes paid | **$ 437** | $ - |

See accompanying notes to consolidated financial statements

## Note 1 - Nature of Operations and Summary of Significant Accounting Policies

### Organization and Nature of Operations

On December 17, 2003, Fairport Savings Bank's (the "Bank") depositors approved a Plan of Reorganization (the "Plan") from a Federal Mutual Savings Bank to a Federal Mutual Holding Company. Under the Plan, effective January 14, 2005, FSB Community Bankshares, MHC (the "Mutual Holding Company") was incorporated under the laws of the United States as a mutual holding company. Also under the Plan, FSB Community Bankshares, Inc. (the "Company") was incorporated and became a wholly-owned subsidiary of the Mutual Holding Company. In addition, effective January 14, 2005, the Bank completed its reorganization whereby the Bank converted to a stock savings bank and became a wholly-owned subsidiary of the Company.

In August 2007, the Company completed its minority stock offering of 47% of the aggregate total voting stock of the Company. In connection with the minority stock offering, 1,785,000 shares of common stock were issued, of which 838,950 shares were sold, including 69,972 issued to the Company's Employee Stock Ownership Plan (ESOP), at $10 per share raising net proceeds of $7.4 million. The stock was offered to the Bank's eligible depositors, the Bank's ESOP, and the public. Additionally, the Company issued 946,050 shares, or 53% of its common stock, to the Mutual Holding Company.

The Company provides a variety of financial services to individuals and corporate customers through its wholly-owned subsidiary, Fairport Savings Bank. The Bank's operations are conducted in five branches located in Monroe County, New York. The Company and the Bank are subject to the regulations of certain regulatory authorities and undergo periodic examinations by those regulatory authorities.

The Company's principal business consists of originating one-to-four-family residential real estate mortgages, home equity loans and lines of credit and to a lesser extent, originations of commercial real estate, multi-family, construction and other consumer loans. The Company has four mortgage origination offices located in Pittsford, New York, Canandaigua, New York, Watertown, New York, and Greece, New York.

The Bank also provides non-deposit investment services to its customers through its wholly-owned subsidiary, Oakleaf Services Corporation ("Oakleaf"). The results of operations of Oakleaf are not material to the consolidated financial statements.

### Basis of Consolidation

The Mutual Holding Company, which engages in no significant business activity other than holding the stock of the Company, is not included in the accompanying consolidated financial statements. The consolidated financial statements include the accounts of the Company, the Bank and Oakleaf. All significant intercompany accounts and transactions have been eliminated in consolidation.

### Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant changes in the near term relate to the determination of the allowance for loan losses, the evaluation of other-than-temporary impairment of investment securities, and deferred tax assets.

**Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)**

**Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash, balances due from banks and interest-bearing demand deposits.

**Significant Group Concentrations of Credit Risk**

Most of the Company's activities are with customers located within Monroe, Livingston, Ontario, Orleans, and Wayne Counties, New York. Note 2 discusses the types of securities that the Company invests in. The concentration of credit by type of loan is set forth in Note 3. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is primarily dependent upon the real estate and general economic conditions in those areas.

**Securities**

The Company has classified as held to maturity, all U.S. Government and agency obligations, residential mortgage-backed securities and state and municipal securities which it has the positive intent and ability to hold until maturity. These securities are carried at amortized cost. All other debt securities, residential mortgage-backed securities, and Small Business Association (SBA) pools having readily determinable fair values are classified as available for sale and stated at fair value. Unrealized gains or losses related to securities available for sale are excluded from earnings and reported in other comprehensive income (loss) net of the related deferred income tax effect.

Amortization of premiums and accretion of discounts are calculated using the interest method and included in interest income. Realized gains or losses, determined on the basis of the cost of the specific securities sold, are included in other income.

When the fair value of a held to maturity or available for sale security is less than its amortized cost basis, an assessment is made at the balance sheet date as to whether other-than-temporary impairment ("OTTI") is present.

The Company considers numerous factors when determining whether potential OTTI exists and the period over which the debt security is expected to recover. The principal factors considered are (1) the length of time and the extent to which the fair value has been less than amortized cost basis, (2) the financial condition of the issuer (and guarantor, if any) and adverse conditions specifically related to the security industry or geographic area, (3) failure of the issuer of the security to make scheduled interest or principal payments, (4) any changes to the rating of a security by a rating agency, and (5) the presence of credit enhancements, if any, including the guarantee of the federal government or any of its agencies.

For debt securities, OTTI is considered to have occurred if (1) the Company intends to sell the security, (2) it is more likely than not the Company will be required to sell the security before recovery of its amortized cost basis, or (3) if the present value of expected cash flows is not sufficient to recover the entire amortized cost basis or carrying value.

For debt securities, credit-related OTTI is recognized in earnings while noncredit-related OTTI on securities not expected to be sold is recognized in other comprehensive income (loss). Credit-related OTTI is measured as the difference between the present value of an impaired security's expected cash flows and its amortized cost basis or carrying value. Noncredit-related OTTI is measured as the difference between the fair value of the security and its amortized cost, or carrying value, less any credit-related losses recognized. For securities classified as held to maturity, the amount of OTTI recognized in other comprehensive income (loss) is accreted to the credit-adjusted expected cash flow amounts of the securities over future periods.

Investment securities are exposed to various risks such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the accompanying financial statements.

**Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)**

**Federal Home Loan Bank of New York**

Federal law requires a member institution of the Federal Home Loan Bank System to hold stock of its district Federal Home Loan Bank ("FHLB") according to a predetermined formula. This restricted stock is carried at cost.

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

No impairment charges were recorded related to the FHLB stock during 2014 or 2013.

**Loans Held for Sale**

Mortgage loans held for sale in the secondary market are carried at the lower of cost or fair value. Separate determinations of fair value for residential and commercial loans are made on an aggregate basis. Fair value is determined based solely on the effect of changes in secondary market interest rates and yield requirements from the commitment date to the date of the consolidated financial statements. Realized gains and losses on sales are computed using the specific identification method.

**Loan Servicing Rights**

The Company retains the servicing on most fixed-rate mortgage loans sold and receives a fee based on the principal balance outstanding.

Loans serviced for others totaled $59,201,000 and $35,572,000 at December 31, 2014 and 2013, respectively.

The Company also sells correspondent FHA and VA mortgage loans, servicing released.

Loan servicing rights are recorded at fair value when loans are sold with servicing rights retained. The fair value of the mortgage servicing rights ("MSRs") is determined using a method which utilizes servicing income, discount rates, and prepayment speeds relative to the Bank's portfolio for MSRs and are amortized over the life of the loan. MSRs amounted to $366,000 and $188,000 at December 31, 2014 and 2013, respectively, and are included in other assets on the consolidated balance sheets.

**Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and net deferred origination fees and costs. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method over the estimated life of the loan.

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

**Allowance for Loan Losses**

The allowance for loan losses (the "Allowance") is established as losses are estimated to have occurred in the loan portfolio. The allowance for loan losses is recorded through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the loan is uncollectable. Subsequent recoveries, if any, are credited to the allowance.

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

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are deemed impaired and classified as either special mention, substandard, doubtful, or loss. For such loans that are also classified as impaired, an allowance is generally established when the collateral value of the impaired loan is lower than the carrying value of that loan. The general component covers non-classified loans and is based on historical loss experience adjusted for the following qualitative factors: effects of changes in lending policies; national and/or local economic trends and conditions; trends in volume and terms of loans; experience, ability, and depth of management; levels and trends of delinquencies, non-accruals and classified loans; quality of institutions loan review system; collateral value for collateral dependent loans; concentrations of credit; and competition, legal and regulatory requirements on level of estimated credit losses. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment disclosures unless subject to a troubled debt restructuring.

**Bank Owned Life Insurance**

The Company holds life insurance policies on a key executive. 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.

**Premises and Equipment**

Premises and equipment are stated at cost. Depreciation and amortization are computed on the straight-line basis over the shorter of the estimated useful lives or lease terms (in the case of leasehold improvements) of the related assets. Estimated useful lives are generally 20 to 30 years for premises and 3 to 10 years for furniture and equipment.

**Foreclosed Real Estate**

Real estate properties acquired through, or in lieu of, loan foreclosure are initially recorded at fair value less estimated selling costs at the date of foreclosure. Any write-downs based on the asset's fair value at date of acquisition are charged to the allowance for loan losses. After foreclosure, property held for sale is carried at the lower of the new basis or fair value less any costs to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to earnings, if necessary, to reduce the carrying value of the property to the lower of its cost or fair value less cost to sell. The Company had no foreclosed real estate at December 31, 2014 and 2013.

**Income Taxes**

Income taxes are provided for the tax effects of certain transactions reported in the consolidated financial statements. Income taxes consist of taxes currently due plus deferred taxes related primarily to temporary differences between the financial reporting and income tax basis of the allowance for loan losses, premises and equipment, certain state tax credits, and deferred loan origination costs. The deferred tax assets and liabilities represent the future tax return consequences of the temporary differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets are reduced by a valuation allowance when, in the opinion of management, it is more likely than not that some portion of the deferred tax assets will not be realized. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

**Advertising Costs**

The Company follows the policy of charging the costs of advertising to expense as incurred.

**Off-Balance Sheet Financial Instruments**

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

**Transfers 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 to be 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.

**Comprehensive Income (Loss)**

Accounting principles generally require that recognized revenue, expenses, gains, and losses be included in earnings. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the stockholders' equity section of the consolidated balance sheets, such items, along with net income, are components of comprehensive income (loss).

**Earnings Per Common Share**

Basic earnings per common share is calculated by dividing net income by the weighted-average number of common shares outstanding during the period. The Company has not granted any restricted stock awards or stock options and, during the years ended December 31, 2014 and 2013, had no potentially dilutive common stock equivalents. Unallocated common shares held by the ESOP are not included in the weighted-average number of common shares outstanding for purposes of calculating basic earnings per common share until they are committed to be released. The

**Note 1 - Nature of Operations and Summary of Significant Accounting Policies (Continued)**

average common shares outstanding were 1,737,784 and 1,736,388 for the years ended December 31, 2014 and December 31, 2013 respectively.

**Treasury Stock**

Treasury stock is recorded using the cost method and accordingly is presented as a reduction of stockholders' equity.

**Reclassifications**

Amounts in the prior year's consolidated financial statements have been reclassified whenever necessary to conform to the current year's presentation. Such reclassifications had no impact on stockholders' equity or net income.

**Note 2 - Securities**

The amortized cost and estimated fair value of securities with gross unrealized gains and losses at December 31, 2014 and 2013 are as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | | (In Thousands) | | |
| **December 31, 2014:** | | | | |
| **Available for Sale:** | | | | |
| U.S. Government and agency obligations | **$ 5,000** | **$ 4** | **$ (45)** | **$ 4,959** |
| Mortgage-backed securities - residential | **15,616** | **219** | **(25)** | **15,810** |
| SBA pools | **1,170** | **43** | **-** | **1,213** |
| | **$ 21,786** | **$ 266** | **$ (70)** | **$ 21,982** |
| **Held to Maturity:** | | | | |
| Mortgage-backed securities - residential | **$ 2,898** | **$ 124** | **$ -** | **$ 3,022** |
| U.S. Government and agency obligations | **9,645** | **191** | **-** | **9,836** |
| State and municipal securities | **4,859** | **74** | **(8)** | **4,925** |
| | **$ 17,402** | **$ 389** | **$ (8)** | **$ 17,783** |
| **December 31, 2013:** | | | | |
| **Available for Sale:** | | | | |
| U.S. Government and agency obligations | $ 20,503 | $ 11 | $ (1,754) | $ 18,760 |
| Mortgage-backed securities - residential | 16,254 | 112 | (178) | 16,188 |
| SBA pools | 1,382 | 46 | - | 1,428 |
| | $ 38,139 | $ 169 | $ (1,932) | $ 36,376 |
| **Held to Maturity:** | | | | |
| Mortgage-backed securities - residential | $ 3,641 | $ 144 | $ - | $ 3,785 |
| U.S. Government and agency obligations | - | - | - | - |
| State and municipal securities | 3,287 | 77 | (3) | 3,361 |
| | $ 6,928 | $ 221 | $ (3) | $ 7,146 |

**Note 2 - Securities (Continued)**

Mortgage-backed securities consist of securities that are issued by Fannie Mae (“FNMA”), Freddie Mac (“FHLMC”), Ginnie Mae (“GNMA”), and are collateralized by residential mortgages. U.S. Government and agency obligations include notes and bonds with both fixed and variable rates. Tax exempt state and municipal securities consist of government obligation and revenue bonds.

During the second quarter of 2014, the Company transferred securities with an amortized cost of $10,000,000 from available for sale to held to maturity. The fair value of the securities transferred as of the date of the transfer was $9,628,490 with a net unrealized loss of $371,510. The unrealized loss amounts in accumulated other comprehensive loss are amortized simultaneously against interest income as the discount is accreted on the transferred securities. There is no effect on net income as the discount accretion offsets the accumulated other comprehensive loss amortization.

The amortized cost and estimated fair value by contractual maturity of debt securities at December 31, 2014 are shown below. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations.

| | **Available for Sale** | | **Held to Maturity** | |
|---|---|---|---|---|
| | **Amortized Cost** | **Estimated Fair Value** | **Amortized Cost** | **Estimated Fair Value** |
| | | **(In Thousands)** | | |
| Due in one year or less | **$ -** | **$ -** | **$ 1,435** | **$ 1,445** |
| Due after one year through five years | **-** | **-** | **1,841** | **1,888** |
| Due after five years through ten years | **2,000** | **1,962** | **4,389** | **4,430** |
| Due after ten years | **3,000** | **2,997** | **6,839** | **6,998** |
| Mortgage-backed securities - residential | **15,616** | **15,810** | **2,898** | **3,022** |
| SBA pools | **1,170** | **1,213** | **-** | **-** |
| | **$ 21,786** | **$ 21,982** | **$ 17,402** | **$ 17,783** |

There were $6,000 of gross realized gains and $3,000 of gross realized losses on sales of securities available for sale in 2014 resulting from proceeds of $3,503,000. There were $76,000 of gross realized gains and no losses on sales of securities available for sale in 2013 resulting from proceeds of $2,032,000.

No securities were pledged to secure public deposits or for any other purpose required or permitted by law at December 31, 2014 and 2013.

**Note 2 - Securities (Continued)**

The following table shows gross unrealized losses and fair value, aggregated by investment category and length of time the individual securities have been in a continuous unrealized loss position, at December 31, 2014 and 2013:

| | Less than 12 Months | | 12 Months or More | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| | | | (In Thousands) | | | |
| **2014:** | | | | | | |
| **Available for Sale** | | | | | | |
| U.S. Government and agency obligations | **$ -** | **$ -** | **$ 2,954** | **$ 45** | **$ 2,954** | **$ 45** |
| Mortgage-backed securities - residential | **4,960** | **7** | **2,224** | **18** | **7,184** | **25** |
| | **$ 4,960** | **$ 7** | **$ 5,178** | **$ 63** | **$ 10,138** | **$ 70** |
| **2014:** | | | | | | |
| **Held to Maturity** | | | | | | |
| State and municipal securities | **$ 1,112** | **$ 6** | **$ 126** | **$ 2** | **$ 1,238** | **$ 8** |
| Mortgage-backed securities - residential(1) | **386** | **-** | **-** | **-** | **386** | **-** |
| | **$ 1,498** | **$ 6** | **$ 126** | **$ 2** | **$ 1,624** | **$ 8** |
| **2013:** | | | | | | |
| **Available for Sale** | | | | | | |
| U.S. Government and agency obligations | $ 14,569 | $ 1,434 | $ 2,679 | $ 320 | $ 17,248 | $ 1,754 |
| Mortgage-backed securities - residential | 7,222 | 166 | 1,441 | 12 | 8,663 | 178 |
| | $ 21,791 | $ 1,600 | $ 4,120 | $ 332 | $ 25,911 | $ 1,932 |
| **2013:** | | | | | | |
| **Held to Maturity** | | | | | | |
| State and municipal securities | $ 107 | $ 1 | $ 126 | $ 2 | $ 233 | $ 3 |
| Mortgage-backed securities - residential | - | - | - | - | - | - |
| | $ 107 | $ 1 | $ 126 | $ 2 | $ 233 | $ 3 |

(1) Aggregate unrealized loss position of these securities is less than $500.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In 2014 and 2013, the Company did not record an other-than-temporary impairment charge.

At December 31, 2014, five residential mortgage-backed securities and two state and municipal securities were in a continuous unrealized loss position for less than twelve months. At December 31, 2014, four U.S. Government and agency obligations, two residential mortgage-backed securities, and three state and municipal securities were in a continuous unrealized loss position for more than twelve months. The debt securities and residential mortgage-backed securities were issued by U.S. Government sponsored agencies. All are paying in accordance with their terms with no deferrals of interest or defaults. Because the decline in fair value is attributable to changes in interest rates, not credit

quality, and because management does not intend to sell and will not be required to sell these securities prior to recovery or maturity, no declines are deemed to be other-than-temporary. The state and municipal securities are general obligation (G.O.) bonds backed by the full faith and credit of local municipalities. There has never been a default of a New York G.O. in the history of the state. Historical performance does not guarantee future performance, but it does indicate that the risk of loss on default of a G.O. municipal bond for the Company is relatively low. All are paying in accordance with their terms and with no deferrals of interest or defaults. Because the decline in fair value is attributable to changes in interest rates, not credit quality, and because management does not intend to sell and will not be required to sell these securities prior to recovery or maturity, no declines are deemed to be other-than-temporary. There were no SBA pools in a continuous loss position for less than or more than twelve months as of December 31, 2014.

**Note 3 – Loans and The Allowance for Loan Losses**

Net loans at December 31, 2014 and 2013 consist of the following:

| | **2014** | **2013** |
|---|---|---|
| | **(In Thousands)** | |
| Real estate loans: | | |
| Secured by one-to-four-family residences | **$169,323** | $158,189 |
| Secured by multi-family residences | **3,819** | 3,069 |
| Construction | **1,106** | 2,821 |
| Commercial | **1,427** | 2,015 |
| Home equity lines of credit | **13,378** | 11,045 |
| Commercial & industrial | **100** | - |
| Other loans | **65** | 71 |
| **Total Loans** | **189,218** | 177,210 |
| Net deferred loan origination costs | **265** | 317 |
| Allowance for loan losses | **(653)** | (526) |
| **Net Loans** | **$188,830** | $177,001 |

The loan portfolio is segmented into commercial and consumer loans. Commercial loans consist of commercial real estate and commercial and industrial classes. Commercial and industrial loans consist of the following classes: lines of credit, term, revolving, and overdraft protection. Consumer loans consist of the following classes: residential real estate secured by one-to-four-family residences, residential real estate secured by multi-family residences, construction, home equity lines of credit, and other loans.

The Company's primary lending activity is the origination of one-to-four-family residential real estate mortgage loans. At December 31, 2014, $169.3 million, or 89.5%, of the total loan portfolio consisted of one-to-four-family residential real estate mortgage loans compared to $158.2 million, or 89.3%, of the total loan portfolio at December 31, 2013. The Bank offers fixed-rate and adjustable rate residential real estate mortgage loans with maturities of up to 30 years and maximum loan amounts generally of up to $750,000.

The Company currently offers fixed-rate conventional mortgage loans with terms of up to 30 years that are fully amortizing with monthly loan payments, and adjustable-rate mortgage loans that provide an initial fixed interest rate for one, three, five, seven or ten years and that amortize over a period of up to 30 years. The Company originates fixed-rate mortgage loans with terms of less than 15 years, but at rates applicable to 15-year loans. The Company originates fixed-rate bi-weekly mortgage loans with terms of up to 30 years that are fully amortizing with bi-weekly loan payments, and "interest only" loans where the borrower pays interest for an initial period (ten years) after which the loan converts to a fully amortizing loan.

Management actively monitors the interest rate risk position to determine the desired level of investment in fixed-rate mortgages. Depending on market interest rates and the Bank's capital and liquidity position, all newly originated longer term fixed-rate residential mortgage loans may be retained, or, all or a portion of such loans may be sold in the secondary mortgage market to government sponsored entities such as Freddie Mac or other purchasers.

The Company originates residential, first mortgage loans with the assistance of computer-based underwriting engines licensed from Fannie Mae and/or Freddie Mac. Appraisals of real estate collateral are contracted directly with independent appraisers and not through appraisal management companies. The Bank's appraisal management policy and procedure is in accordance with all rules and best practice guidance from the Bank's primary regulator. Credit scoring, using FICO is employed in the ultimate, judgmental credit decision by the Bank's underwriting staff. The Company does not use third party contract underwriting services. Residential mortgage loans include fixed and variable interest rate loans secured by one-to-four-family homes generally located in Monroe, Ontario, and Wayne Counties of New York State. The Bank's ability to be repaid on such loans is closely linked to the economic and real estate market conditions in this region. Underwriting policies generally adhere to Fannie Mae and Freddie Mac guidelines for loan requests of conforming and non-conforming amounts. In deciding whether to originate each residential mortgage, the Bank considers the qualifications of the borrower as well as the value of the underlying property. During 2014 and 2013, the Bank elected to sell many of its fixed-rate loan originations due to the low level of market interest rates and the Bank's desire to manage the credit and interest rate risk inherent in the balance sheet by minimizing the additions of such long-term, low-fixed-rate instruments.

Adjustable-rate mortgage loans generally present different credit risks than fixed-rate mortgage loans primarily because the underlying debt service payments of the borrowers increase as interest rates increase, thereby increasing the potential for default. Interest-only loans present different credit risks than fully amortizing loans, as the principal balance of the loan does not decrease during the interest-only period. As a result, the Bank's exposure to loss of principal in the event of default does not decrease during this period.

The Company offers home equity lines of credit, which are primarily secured by a second mortgage on one-to-four-family residences. At December 31, 2014, home equity lines of credit totaled $13.4 million, or 7.0%, of total loans receivable compared to $11.0 million, or 6.2%, of total loans receivable at December 31, 2013.

The underwriting standards for home equity lines of credit include a determination of the applicant's credit history, an assessment of the applicant's ability to meet existing obligations and payments on the proposed loan and the value of the collateral securing the loan. The combined loan-to-value ratio (first and second mortgage liens) for home equity lines of credit is generally limited to 90%. The Company originates home equity lines of credit without application fees or borrower-paid closing costs. Home equity lines of credit are offered with adjustable-rates of interest indexed to the prime rate, as reported in *The Wall Street Journal*.

Multi-family residential loans generally are secured by rental properties. Multi-family real estate loans are offered with fixed and adjustable interest rates. Loans secured by multi-family real estate totaled $3.8 million, or 2.0%, of the total loan portfolio at December 31, 2014 compared to $3.1 million, or 1.7%, of the total loan portfolio at December 31, 2013. Multi-family real estate loans are originated for terms of up to 20 years. Adjustable-rate multi-family real estate loans are tied to the average yield on U.S. Treasury securities, subject to periodic and lifetime limitations on interest rate changes.

Loans secured by multi-family real estate generally involve a greater degree of credit risk than one-to four-family residential mortgage loans and carry larger loan balances. This increased credit risk is a result of several factors, including the concentration of principal in a limited number of loans and borrowers, the effects of general economic conditions on income producing properties, and the increased difficulty of evaluating and monitoring these types of loans. Furthermore, the repayment of loans secured by multi-family real estate typically depends upon the successful operation of the real estate property securing the loans. If the cash flow from the project is reduced, the borrower's ability to repay the loan may be impaired.

**Note 3 – Loans and The Allowance for Loan Losses (Continued)**

The Company originates construction loans for the purchase of developed lots and for the construction of single-family residences. At December 31, 2014, construction loans totaled $1.1 million, or 0.6%, of total loans receivable compared to $2.8 million, or 1.6%, at December 31, 2013. At December 31, 2014, the additional unadvanced portion of these construction loans totaled $1.1 million compared to $2.6 million at December 31, 2013. Construction loans are offered to individuals for the construction of their personal residences by a qualified builder (construction/permanent loans).

Before making a commitment to fund a construction loan, the Company requires an appraisal of the property by an independent licensed appraiser. The Company generally also reviews and inspects each property before disbursement of funds during the term of the construction loan.

Construction financing generally involves greater credit risk than long-term financing on improved, owner-occupied real estate. Risk of loss on a construction loan depends largely upon the accuracy of the initial estimate of the value of the property at completion of construction compared to the estimated cost (including interest) of construction and other assumptions. If the estimate of construction cost proves to be inaccurate, the Company may be required to advance additional funds beyond the amount originally committed in order to protect the value of the property. Moreover, if the estimated value of the completed project proves to be inaccurate, the borrower may hold a property with a value that is insufficient to assure full repayment of the loan.

Commercial real estate loans are secured by office buildings, mixed use properties, places of worship and other commercial properties. Loans secured by commercial real estate totaled $1.4 million, or 0.7%, of the Company's total loan portfolio at December 31, 2014 compared to $2.0 million, or 1.1%, of our total loan portfolio at December 31, 2013.

The Company generally originates adjustable-rate commercial real estate loans with maximum terms of up to 15 years. The maximum loan-to-value ratio of commercial real estate loans is 70%.

Loans secured by commercial real estate generally are larger than one-to-four-family residential loans and involve greater credit risk. Commercial real estate loans often involve large loan balances to single borrowers or groups of related borrowers. Repayment of these loans depends to a large degree on the results of operations and management of the properties securing the loans or the businesses conducted on such property, and may be affected to a greater extent by adverse conditions in the real estate market or the economy in general. Accordingly, the nature of these loans makes them more difficult for management to monitor and evaluate.

In 2014, the Company hired a seasoned commercial lending officer and began offering a variety of commercial & industrial loan products. This product set includes loans to individuals or businesses on an installment basis secured by vehicles, equipment or other durable goods for which the loans were made, loans for and secured by machinery and/or equipment for which a legitimate resale market exists, lines of credit to businesses and individuals, and unsecured loans to businesses and individuals on a short-term basis. At December 31, 2014, these loans totaled $100,000, or 0.1%, of the total loan portfolio.

These loans carry a higher risk than commercial real estate loans by the nature of the underlying collateral, which can be business assets such as equipment and accounts receivable. To reduce the risk, management also attempts to secure secondary collateral, such as real estate, and obtain personal guarantees of the borrowers. To further reduce risk and enhance liquidity, these loans generally carry variable rates of interest, repricing in five year periods, and have a maturity of ten years or less.

In 2014, the Company applied and was approved as an SBA lender. SBA acts as a loan guarantor and these loans are generally for commercial business purposes versus real estate. The Company follows the Small Business Administration lending guidelines regarding eligibility, underwriting etc. as stated in SBA's most current version of SOP 50 10 SBA's Lender and Development Company Loan Program.

The Company offers a variety of other loans secured by property other than real estate. At December 31, 2014, these other loans totaled $65,000, or 0.1%, of the total loan portfolio compared to other loans totaling $71,000, or 0.1%, of the total loan portfolio at December 31, 2013. These loans include automobile, passbook, overdraft protection and unsecured loans. Due to the relative immateriality of other loans, the Company's risk associated with these loans is not considered significant.

The following table sets forth the allowance for loan losses allocated by loan class and the activity in the allowance for loan losses for the years ending December 31, 2014 and 2013. The allowance for loan losses allocated to each class is not necessarily indicative of future losses in any particular class and does not restrict the use of the allowance to absorb losses in other classes.

| | Secured by 1-4 family residential | Secured by multi-family residential | Construction | Commercial | Home Equity Lines of Credit | Commercial & Industrial | Other/ Unallocated | Total |
|---|---|---|---|---|---|---|---|---|
| | | | (In Thousands) | | | | | |
| At December 31, 2014 | | | | | | | | |
| Beginning Balance | $404 | $23 | $14 | $20 | $55 | $ - | $10 | $526 |
| Charge Offs | - | - | - | - | - | - | - | - |
| Recoveries | - | - | - | - | - | - | - | - |
| Provisions | 44 | 6 | (8) | (6) | 32 | 1 | 58 | 127 |
| Ending Balance (1) | $448 | $29 | $6 | $14 | $87 | $1 | $68 | $653 |
| At December 31, 2013 | | | | | | | | |
| Beginning Balance | $348 | $4 | $4 | $21 | $51 | $ - | $8 | $436 |
| Charge Offs | - | - | - | - | - | - | - | - |
| Recoveries | - | - | - | - | - | - | - | - |
| Provisions | 56 | 19 | 10 | (1) | 4 | - | 2 | 90 |
| Ending Balance (1) | $404 | $23 | $14 | $20 | $55 | $ - | $10 | $526 |

(1)All Loans are collectively evaluated for impairment.

The Company's policies, consistent with regulatory guidelines, provide for the classification of loans that are considered to be of lesser quality as substandard, doubtful, or loss assets. An asset is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard assets include those assets characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets classified as doubtful have all of the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable. Assets (or portions of assets) classified as loss are those considered uncollectible and of such little value that their continuance as assets is not warranted. Assets that do not expose the Company to risk sufficient to warrant classification in one of the aforementioned categories, but which possess potential weaknesses that deserve close attention, are required to be designated as special mention.

When the Company classifies assets as pass a portion of the related general loss allowances is allocated to such assets as deemed prudent. The allowance for loan losses is the amount estimated by management as necessary to absorb credit losses incurred in the loan portfolio that are both probable and reasonably estimable at the balance sheet date. The Company's determination as to the classification of its assets and the amount of its loss allowances are subject to review by its principal state regulator, the New York State Department of Financial Services, which can require that the Company establish additional loss allowances. The Company regularly reviews its asset portfolio to determine whether any assets require classification in accordance with applicable regulations.

At December 31, 2014 and 2013, there were no loans considered to be impaired and no troubled debt restructuring.

**Note 3 – Loans and The Allowance for Loan Losses (Continued)**

The following table presents the risk category of loans by class at December 31, 2014 and 2013:

| | Pass | Special Mention | Substandard | Doubtful | Total |
|---|---|---|---|---|---|
| **2014** | | | (In Thousands) | | |
| **One-to-four-family residential** | $ 168,644 | $ 423 | $ 256 | $ - | $169,323 |
| **Multi-family residential** | 3,819 | - | - | - | 3,819 |
| **Construction** | 1,106 | - | - | - | 1,106 |
| **Commercial real estate** | 1,427 | - | - | - | 1,427 |
| **Home equity lines of credit** | 13,063 | 200 | 115 | - | 13,378 |
| **Commercial & industrial** | 100 | - | - | - | 100 |
| **Other loans** | 65 | - | - | - | 65 |
| **Total** | $ 188,224 | $ 623 | $ 371 | $ - | $189,218 |
| **2013** | | | | | |
| **One-to-four-family residential** | $ 157,706 | $ 427 | $ 56 | $ - | $158,189 |
| **Multi-family residential** | 3,069 | - | - | - | 3,069 |
| **Construction** | 2,821 | - | - | - | 2,821 |
| **Commercial real estate** | 2,015 | - | - | - | 2,015 |
| **Home equity lines of credit** | 11,045 | - | - | - | 11,045 |
| **Commercial & industrial** | - | - | - | - | - |
| **Other loans** | 71 | - | - | - | 71 |
| **Total** | $ 176,727 | $ 427 | $ 56 | $ - | $177,210 |

At December 31, 2014, the Company had one nonaccrual residential mortgage loan for $56,000 and one nonaccrual home equity line of credit for $18,000, and at December 31, 2013 the Company had the same nonaccrual residential mortgage loan for $56,000. There were no loans that were past due 90 days or more and still accruing interest at December 31, 2014 and 2013. Interest on non-accrual loans that would have been earned if loans were accruing interest was immaterial for both 2014 and 2013.

***Delinquent Loans***. The following table sets forth the Company's analysis of the age of the loan delinquencies by type and by amount past due as of December 31, 2014 and 2013.

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater than 90 Days | Total Past Due | Current | Total Loans Receivable |
|---|---|---|---|---|---|---|
| | | | (In thousands) | | | |
| **2014** | | | | | | |
| **Real estate loans:** | | | | | | |
| **One-to-four-family residential** | $ 162 | $ 93 | $ 56 | $ 311 | $ 169,012 | $ 169,323 |
| **Multi-family residential** | - | - | - | - | 3,819 | 3,819 |
| **Construction** | - | - | - | - | 1,106 | 1,106 |
| **Commercial** | - | - | - | - | 1,427 | 1,427 |
| **Home equity lines of credit** | - | - | 18 | 18 | 13,360 | 13,378 |
| **Commercial & industrial** | - | - | - | - | 100 | 100 |
| **Other loans** | - | - | - | - | 65 | 65 |
| **Total** | $ 162 | $ 93 | $ 74 | $ 329 | $ 188,889 | $ 189,218 |
| **2013** | | | | | | |
| Real estate loans: | | | | | | |
| One-to-four-family residential | $ 394 | $ - | $ 56 | $ 450 | $ 157,739 | $ 158,189 |
| Multi-family residential | - | - | - | - | 3,069 | 3,069 |
| Construction | - | - | - | - | 2,821 | 2,821 |
| Commercial | - | - | - | - | 2,015 | 2,015 |
| Home equity lines of credit | - | - | - | - | 11,045 | 11,045 |
| Commercial & industrial | - | - | - | - | - | - |
| Other loans | - | - | - | - | 71 | 71 |
| Total | $ 394 | $ - | $ 56 | $ 450 | $ 176,760 | $ 177,210 |

**Note 4 - Premises and Equipment**

Premises and equipment at December 31, 2014 and 2013 are summarized as follows:

| | 2014 | 2013 |
|---|---|---|
| | (In Thousands) | |
| Premises | **$4,122** | $4,101 |
| Furniture and equipment | **2,632** | 2,904 |
| | **6,754** | 7,005 |
| Accumulated depreciation and amortization | **(3,918)** | (3,957) |
| | **$2,836** | $3,048 |

At December 31, 2014, the Company was obligated under non-cancelable operating leases for existing branches in Penfield, Irondequoit, Webster, and Perinton, New York and for four mortgage origination offices in Canandaigua, Watertown, Pittsford, and Greece, New York. Rent expense under leases totaled $407,000 during 2014. Rent expense under the same non-cancelable operating leases totaled $384,000 during 2013. Future minimum rental payments under these leases for the next five years and thereafter are as follows (in thousands):

| Years ending December 31, | | |
|---|---|---|
| 2015 | $ | 402 |
| 2016 | | 387 |
| 2017 | | 368 |
| 2018 | | 352 |
| 2019 | | 307 |
| Thereafter | | 2,654 |
| Total | $ | 4,470 |

**Note 5 - Deposits**

The components of deposits at December 31, 2014 and 2013 consist of the following:

| | 2014 | 2013 |
|---|---|---|
| | (In Thousands) | |
| Non-interest bearing | **$ 5,710** | $ 5,675 |
| NOW accounts | **26,551** | 21,849 |
| Regular savings, tax escrow and demand clubs | **29,316** | 29,637 |
| Money market | **22,621** | 22,450 |
| Individual retirement accounts | **11,262** | 14,451 |
| Certificates of deposit | **79,847** | 85,951 |
| | **$175,307** | $180,013 |

**Note 5 – Deposits (Continued)**

As of December 31, 2014, individual retirement accounts and certificates of deposit have scheduled maturities as follows (in thousands):

| | |
|---|---|
| 2015 | **$ 63,977** |
| 2016 | **20,459** |
| 2017 | **3,111** |
| 2018 | **1,606** |
| 2019 | **1,956** |
| | **$ 91,109** |

The aggregate amount of time deposits, each with a minimum denomination of $250,000 was $7,987,000 and $7,805,000 at December 31, 2014 and 2013, respectively. Under the Dodd-Frank Act, deposit insurance per account owner is $250,000.

Interest expense on deposits for the years ended December 31, 2014 and 2013 is as follows:

| | **2014** | **2013** |
|---|---|---|
| | **(In Thousands)** | |
| NOW accounts | **$ 38** | $ 37 |
| Regular savings and demand clubs | **114** | 130 |
| Money market | **76** | 81 |
| Individual retirement accounts | **165** | 212 |
| Certificates of deposit | **831** | 748 |
| | **$ 1,224** | $ 1,208 |

**Note 6 - Borrowings**

Borrowings consist of advances from the Federal Home Loan Bank of New York (FHLB).

The following table sets forth the contractual maturities of borrowings with the FHLB as of December 31:

| Advance Date | Maturity Date | Current Rate | 2014 | 2013 |
|---|---|---|---|---|
| | | | (In Thousands) | |
| 09/14/05 | 09/14/15 | 4.75 % | **$ 475** | $ 544 |
| 06/05/06 | 06/06/16 | 5.63 % | **1,000** | 1,000 |
| 08/17/06 | 08/17/15 | 5.50 % | **1,000** | 1,000 |
| 11/03/09 | 11/03/14 | 2.37 % | **-** | 209 |
| 07/21/10 | 01/21/14 | 1.66 % | **-** | 1,000 |
| 07/21/10 | 01/21/14 | 1.66 % | **-** | 500 |
| 07/21/10 | 01/21/14 | 1.66 % | **-** | 1,494 |
| 07/21/10 | 01/21/14 | 1.66 % | **-** | 1,061 |
| 07/21/10 | 07/21/14 | 1.89 % | **-** | 1,000 |
| 07/21/10 | 07/21/14 | 1.89 % | **-** | 1,252 |
| 07/21/10 | 01/21/15 | 2.07 % | **510** | 510 |
| 04/25/12 | 04/25/17 | 1.03 % | **735** | 1,033 |
| 08/16/12 | 08/16/17 | 1.00 % | **1,112** | 1,509 |
| 09/05/12 | 09/05/19 | 1.13 % | **1,398** | 1,678 |
| 11/06/12 | 11/06/17 | 0.86 % | **1,210** | 1,607 |
| 11/27/12 | 11/27/17 | 1.12 % | **1,000** | 1,000 |
| 12/19/12 | 12/19/19 | 1.20 % | **1,469** | 1,748 |
| 12/27/12 | 12/27/16 | 0.97 % | **1,000** | 1,000 |
| 12/27/12 | 12/27/17 | 0.89 % | **622** | 820 |
| 01/04/13 | 01/04/19 | 1.52 % | **1,000** | 1,000 |
| 01/15/13 | 01/16/18 | 1.18 % | **1,000** | 1,000 |
| 01/22/13 | 01/23/17 | 0.96 % | **1,000** | 1,000 |
| 01/22/13 | 01/22/18 | 1.20 % | **1,000** | 1,000 |
| 01/22/13 | 01/22/19 | 1.44 % | **1,000** | 1,000 |
| 02/12/13 | 02/12/16 | 0.79 % | **1,500** | 1,500 |
| 02/20/13 | 02/21/20 | 1.28 % | **758** | 897 |
| 02/20/13 | 02/21/23 | 1.77 % | **838** | 931 |
| 06/25/13 | 06/25/15 | 0.82 % | **2,000** | 2,000 |
| 07/02/13 | 07/02/18 | 1.35 % | **1,480** | 1,871 |
| 07/22/13 | 07/23/18 | 1.27 % | **1,479** | 1,870 |
| 09/19/13 | 09/19/18 | 1.37 % | **773** | 968 |
| 09/19/13 | 09/16/16 | 1.14 % | **2,000** | 2,000 |
| 01/21/14 | 01/22/18 | 1.72 % | **1,000** | - |
| 01/21/14 | 01/22/19 | 1.45 % | **838** | - |
| 03/20/14 | 03/20/19 | 1.50 % | **1,306** | - |
| 03/24/14 | 03/24/17 | 1.32 % | **1,500** | - |
| 07/21/14 | 07/21/21 | 1.94 % | **955** | - |
| 07/21/14 | 07/22/19 | 2.08 % | **500** | - |
| 07/21/14 | 07/23/18 | 1.79 % | **1,000** | - |
| 08/06/14 | 08/06/15 | 0.50 % | **1,000** | - |
| 08/06/14 | 08/06/18 | 1.80 % | **1,000** | - |
| 08/21/14 | 08/21/15 | 0.50 % | **1,000** | - |
| 08/21/14 | 08/22/16 | 0.92 % | **1,000** | - |
| 08/21/14 | 08/21/19 | 2.12 % | **1,000** | - |
| 10/02/14 | 10/04/21 | 2.00 % | **1,978** | - |

**Note 6 – Borrowings (Continued)**

| Advance Date | Maturity Date | Current Rate | 2014 | 2013 |
|---|---|---|---|---|
| | | | (In Thousands) | |
| 10/09/14 | 01/09/15 | 0.34 % | **1,500** | - |
| 10/15/14 | 10/15/21 | 1.69 % | **989** | - |
| 11/28/14 | 11/29/21 | 1.90 % | **2,000** | - |
| 12/31/14 | 12/31/19 | 1.63 % | **1,000** | - |
| 12/31/14 | 01/02/18 | 1.52 % | **1,000** | - |
| | | | **47,925** | 37,002 |
| Deferred prepayment penalties | | | **-** | 25 |
| | | | **$47,925** | $36,977 |

Prepayment penalties that qualified for deferral when paid in prior years have been recognized in interest expense as an adjustment to the cost of the Company's new borrowings over the repayment period of these new borrowings.

Borrowings are secured by residential mortgages with a carrying amount of $159,648,000 at December 31, 2014 and the Company's investment in FHLB stock. As of December 31, 2014, $91,257,000 was available for borrowings. At December 31, 2013, the carrying amount of borrowings secured by residential mortgages was $148,406,000 and $87,506,000 was available for new borrowings.

The following table sets forth the contractual maturities of all FHLB borrowings at December 31, 2014 (dollars in thousands):

| | Contractual Maturity | Weighted Average Rate |
|---|---|---|
| 2015 | **$ 7,485** | **1.60%** |
| 2016 | **6,500** | **1.69** |
| 2017 | **7,179** | **1.05** |
| 2018 | **9,732** | **1.45** |
| 2019 | **9,511** | **1.50** |
| Thereafter | **7,518** | **1.83** |
| | **$ 47,925** | **1.52%** |

The Company also has a repurchase agreement with Raymond James providing an additional $10 million in liquidity collateralized by the Company's U.S. Government and agency obligations. There were no advances outstanding under the repurchase agreement at December 31, 2014 and 2013. Securities are not pledged until the borrowing is initiated.

**Note 7 - Income Taxes**

The provision for income taxes for 2014 and 2013 consists of the following:

| | **2014** | **2013** |
|---|---|---|
| | **(In Thousands)** | |
| Current | | |
| Federal | **$ 345** | $ 65 |
| State | **6** | 3 |
| Deferred | **(48)** | 2 |
| | **$ 303** | $ 70 |

The Company's effective tax rate was 31% and 19% in 2014 and 2013, respectively. The effective tax rate primarily reflects the impact of non-tax interest and dividends from tax exempt securities.

Items that give rise to differences between income tax expense included in the consolidated statements of income and taxes computed by applying the statutory federal tax at a rate of 34% in 2014 or 2013 included the following (dollars in thousands):

| | **2014** | | **2013** | |
|---|---|---|---|---|
| | **Amount** | **% of Pre-tax Income** | **Amount** | **% of Pre-tax Income** |
| Federal Tax at a Statutory rate | **$ 328** | **34%** | $ 123 | 34% |
| State taxes, net of Federal provision | **4** | **-** | 3 | 1 |
| Change in valuation allowance | **179** | **19** | 219 | 90 |
| Nontaxable interest and dividend income | **(42)** | **(4)** | (45) | (12) |
| Allowance for loan loss tax benefit subject to valuation allowance | **(179)** | **(19)** | (219) | (90) |
| Other items | **13** | **1** | (11) | (4) |
| Income tax provision | **$ 303** | **31%** | $ 70 | 19% |

**Note 7 - Income Taxes (Continued)**

Deferred income tax assets and liabilities resulting from temporary differences are summarized as follows and are included in other liabilities at December 31, 2014 and at December 31, 2013 in the accompanying consolidated balance sheets:

| | 2014 | 2013 |
|---|---|---|
| | (In Thousands) | |
| Deferred tax assets: | | |
| Deferred loan origination fees | **$ 48** | $ 52 |
| Allowance for loan losses - Federal | **253** | 203 |
| Charitable contributions carry forward | **-** | 3 |
| State tax credits | **1,165** | 993 |
| Depreciation | **28** | - |
| Supplemental Executive Retirement Plan | **177** | 141 |
| Other-than-temporary impairment loss on securities | **22** | 22 |
| Unrealized loss on securities available for sale | **-** | 600 |
| Other | **2** | 1 |
| | **1,695** | 2,015 |
| Valuation allowance | **(1,319)** | (1,140) |
| Total deferred tax assets, net of valuation allowance | **376** | 875 |
| Deferred tax liabilities: | | |
| Depreciation | **-** | (19) |
| Unrealized gain on securities available for sale and transferred to held to maturity | **(67)** | - |
| Mortgage servicing rights | **(142)** | (73) |
| Total deferred tax liabilities | **(209)** | (92) |
| Net deferred tax asset | **$ 167** | $ 783 |

The Company has recorded a valuation allowance for state tax deductions and mortgage recording tax credits since anticipated levels of future state taxable income makes it more likely than not that all of these tax benefits will not be used. In addition, a deferred tax asset associated with a portion of the allowance for loan loss established before 2004 had not been recognized in the past as there was no expectation of achieving any tax benefit of this portion of the allowance. In 2010, that deferred tax asset was recorded, but because the future realization of the tax benefit remains unlikely to be realized, the valuation allowance was further increased to include this deferred tax asset.

As a thrift institution, the Bank is subject to special provisions in the income tax laws regarding its allowable income tax bad debt deduction and related tax basis bad debt reserves. Deferred income tax liabilities are to be recognized with respect to any base-year reserves which are to become taxable (or "recaptured") in the foreseeable future.

Under current income tax laws, the base-year reserves would be subject to recapture if the Company pays a cash dividend in excess of earnings and profits or liquidates. The Bank does not expect to take any actions in the foreseeable future that would require the recapture of any Federal reserves.

A deferred tax liability has not been recognized with respect to the Federal base-year reserve of $1,518,000 at December 31, 2014 and 2013, because the Bank does not expect that this amount will become taxable in the foreseeable future. The unrecognized deferred tax liability with respect to the Federal base-year reserve was $516,000 at December 31, 2014 and 2013. It is more likely than not that this liability will never be incurred because, as noted above, the Bank does not expect to take any action in the future that would result in this liability being incurred.

**Note 7 - Income Taxes (Continued)**

Accounting for uncertainty in income taxes guidance requires an entity to analyze each income tax position taken in its tax returns and determine the likelihood that the position will be realized. Only tax positions that are "more-likely-than-not" to be realized can be recognized in an entity's financial statements. For tax positions that do not meet this recognition threshold, an entity will have an unrecognized tax benefit for the difference between the position taken on the tax return and the amount recognized on the financial statements. The Company does not have any unrecognized tax benefits at December 31, 2014 or 2013. The Company's policy is to recognize interest and penalties in income tax expense in the consolidated statement of income. The Company's Federal and New York State tax returns, constituting the returns of the major taxing jurisdictions, are subject to examination by the taxing authorities for 2011, 2012, and 2013 as prescribed by applicable statute. No waivers have been executed that would extend the period subject to examination beyond the period prescribed by statute.

No unrecognized tax benefits from uncertain tax positions are expected to arise within the next twelve months.

**Note 8 – Comprehensive Income (Loss)**

The following table presents the tax effects allocated to each component of other comprehensive income (loss) for the years ended December 31, 2014 and 2013. Components of other comprehensive income (loss) include changes in net unrealized gains (losses) and reclassification adjustments for securities available for sale and held to maturity.

The balances and changes in the components of accumulated other comprehensive income (loss), net of taxes, are as follows (in thousands):

| | Unrealized Gains (Losses) on Available for Sale Securities | Unrealized Gains (Losses) on Held to Maturity Securities | Total |
|---|---|---|---|
| Accumulated other comprehensive income as of January 1, 2013 | $ 329 | $ - | $ 329 |
| Other comprehensive income before reclassifications | (1,443) | - | (1,443) |
| Amounts reclassified from accumulated other comprehensive income | (50) | - | (50) |
| Accumulated other comprehensive loss as of December 31, 2013 | (1,164) | - | (1,164) |
| Other comprehensive gain (loss) before reclassifications | 1,147 | - | 1,147 |
| Reclassification adjustment for realized gains included in net income | (2) | - | (2) |
| Net unrealized losses transferred to held to maturity | - | (217) | (217) |
| Accretion of net unrealized losses on securities transferred to held to maturity | - | 10 | 10 |
| Accumulated other comprehensive loss as of December 31, 2014 | $ (19) | $ (207) | $ (226) |

**Note 8 – Comprehensive Income (Loss) (Continued)**

Reclassifications out of accumulated other comprehensive (loss) income for the years ended December 31, 2014 and 2013 are as follows:

| | 2014 | 2013 | |
|---|---|---|---|
| | (In Thousands) | | |
| Unrealized gains and losses on available-for-sale securities (before tax) | $ 3 | $ 76 | Realized gain on sale of securties |
| Tax expense | (1) | (26) | Provision for Income Taxes |
| Net of tax | $ 2 | $ 50 | |

**Note 9 - Employee Benefit Plans**

The Bank has a 401(k) plan for all eligible employees. Employees are eligible for participation in the 401(k) Plan after one year of service and attaining age 21. The 401(k) Plan allows employees to contribute 1% to 100% of their annual salary subject to statutory limitations. Matching contributions made by the Bank are 100% of the first 6% of compensation that an employee contributes to the 401(k) Plan. In addition, the Bank may make a discretionary contribution as a percentage of each eligible employee's annual base compensation including the value of ESOP shares allocated. Matching contributions to the 401(k) Plan amounted to $156,000 and $150,000 for the years ended December 31, 2014 and 2013, respectively. Discretionary contributions to the 401(k) Plan were $70,000 and $62,000 for the years ended December 31, 2014 and 2013, respectively.

The Bank sponsors an Employee Stock Ownership Plan (ESOP) for eligible employees who have attained age 21 and completed one year of employment. The cost of shares not committed to be released is presented in the accompanying consolidated balance sheets as a reduction of stockholders' equity. Allocations to individual accounts are based on participant compensation and years of service. As shares are committed to be released to participants, the Company reports compensation expense equal to the current market price of the shares and the shares become outstanding for earnings per share computations. The difference between the market price and the cost of shares committed to be released is recorded as an adjustment to additional paid-in-capital. Any dividends on allocated shares reduce retained earnings. Any dividends on unallocated ESOP shares reduce debt and accrued interest. In connection with establishing the ESOP in 2007, the ESOP borrowed $700,000 from the Company to purchase 69,972 common shares of the Company's stock. The loan is being repaid in twenty equal annual installments through 2026. The loan bears interest at the prime rate plus 300 basis points.

Shares are released to participants on a straight line basis as the loan is repaid and totaled 3,498 shares for each of the years ended December 31, 2014 and December 31, 2013. Total expense for the ESOP was $29,000 for both 2014 and 2013. At December 31, 2014, the Company had 41,983 unearned ESOP shares having an aggregate market value of $405,136.

The Bank has a supplemental executive retirement plan (SERP) for two of its executives. All benefits provided under the SERP are unfunded and, as these executives retire, the Company will make payments to participants. The Company has recorded $495,000 and $400,000 at December 31, 2014 and 2013 respectively, for the SERP in other liabilities. In 2014 and 2013, the expense under the SERP totaled $95,000 and $91,000, respectively.

**Note 10 - Related Party Transactions**

Certain employees, executive officers and directors are engaged in transactions with the Bank in the ordinary course of business. It is the Bank's policy that all related party transactions are conducted at "arms length" and all loans and commitments included in such transactions are made in the ordinary course of business, on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with persons not related to the Bank and do not involve more than the normal risk of collectability or present other unfavorable terms.

As of December 31, 2014 and 2013, loans outstanding with related parties were $423,000 and $371,000, respectively. During 2014, there were new loans of $92,000 and repayments totaled $40,000.

**Note 11 - Commitments**

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments summarized as follows at December 31, 2014 and 2013:

| | 2014 | 2013 |
|---|---|---|
| | (In Thousands) | |
| Commitments to extend credit: | | |
| Commitments to grant loans | **$ 5,176** | $ 7,563 |
| Unfunded commitments under lines of credit | **12,221** | 11,330 |
| | **$17,397** | $18,893 |

Commitments to grant loans at fixed-rates at December 31, 2014 totaled $4,117,000 and had interest rates that ranged from 2.625% to 4.625%.

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 many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount and type of collateral obtained, if deemed necessary by the Bank upon extension of credit, varies and is based on management's credit evaluation of the counterparty.

**Note 12 - Regulatory Matters**

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

**Note 12 - Regulatory Matters (Continued)**

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 and tangible capital (as defined) to adjusted total assets (as defined). Management believes that, as of December 31, 2014 and 2013, the Bank met all capital adequacy requirements to which it was subject. As of December 31, 2014, the most recent notification categorized the Bank as well capitalized 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, and Tier 1 leverage ratios as set forth in the following table.

There are no conditions or events since that notification that management believes have changed the Bank's status as well capitalized.

The Bank's actual capital amounts and ratios are presented in the table below.

| | Actual | | For Capital Adequacy Purposes | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | | | (Dollars in Thousands) | | | |
| **December 31, 2014:** | | | | | | |
| Total risk-based capital (to risk-weighted assets) | **$18,220** | **15.19** % | **≥$9,594** | **≥8.0** % | **≥$11,993** | **≥10.0** % |
| Tier 1 capital (to risk-weighted assets) | **17,567** | **14.65** | **≥4,797** | **≥4.0** | **≥7,196** | **≥ 6.0** |
| Tier 1 capital (leveraged - to adjusted total assets) | **17,567** | **7.24** | **≥9,710** | **≥4.0** | **≥12,137** | **≥ 5.0** |
| Tangible capital (to adjusted total assets) | **17,567** | **7.24** | **≥3,641** | **≥1.5** | **N/A** | **N/A** |
| **December 31, 2013:** | | | | | | |
| Total risk-based capital (to risk-weighted assets) | $17,462 | 15.28 % | ≥$9,142 | ≥8.0 % | ≥$11,428 | ≥10.0 % |
| Tier 1 capital (to risk-weighted assets) | 16,936 | 14.82 | ≥4,571 | ≥4.0 | ≥6,857 | ≥ 6.0 |
| Tier 1 capital (leveraged - to adjusted total assets) | 16,936 | 7.23 | ≥9,364 | ≥4.0 | ≥11,705 | ≥ 5.0 |
| Tangible capital (to adjusted total assets) | 16,936 | 7.23 | ≥3,511 | ≥1.5 | N/A | N/A |

At December 31, 2014 the Company's consolidated equity totaled $21,204,000 compared to the Bank's equity capital of $17,607,000. See Note 14 for details concerning the Company's consolidated equity.

The FRB has issued a policy guidance regarding the payment of dividends by bank holding companies that it has made applicable to savings and loan holding companies as well. In general, the FRB's policies provide that dividends should be paid only out of current earnings and only if the prospective rate of earnings retention by the holding company appears consistent with the organization's capital needs, asset quality and overall financial condition. FRB guidance provides for prior regulatory review of capital distributions in certain circumstances such as where the company's net income for the past four quarters, net of dividends previously paid over that period, is insufficient to fully fund the dividend or the company's overall rate of earnings retention is inconsistent with the company's capital needs and overall financial condition. The ability of a holding company to pay dividends may be restricted if a subsidiary bank becomes undercapitalized. These regulatory policies could affect the ability of FSB Community Bankshares to pay dividends or otherwise engage in capital distributions.

**Note 13 - Fair Value Measurement and Fair Values of Financial Instruments**

Management uses its best judgment in estimating the fair value of the Company's assets and liabilities; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all assets and liabilities, the fair value estimates herein are not necessarily indicative of the amounts the Company could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective year-ends and have not been re-evaluated or updated for purposes of these consolidated financial statements subsequent to those respective dates. As such, the estimated fair values of assets and liabilities subsequent to the respective reporting dates may be different than the amounts reported at each year-end.

Accounting guidance establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy are as follows:

Level 1: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical unrestricted assets or liabilities.

Level 2: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability.

Level 3: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e. supported with little or no market activity).

An asset or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

For financial assets measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used are as follows at December 31:

| **2014** | **(In Thousands) Total** | **Level 1** | **Level 2** | **Level 3** |
|---|---|---|---|---|
| U.S. Government and agency obligations | **$4,959** | **$ -** | **$4,959** | **$ -** |
| Mortgage-backed securities - residential | **15,810** | **-** | **15,810** | **-** |
| SBA Pools | **1,213** | **-** | **1,213** | **-** |
| Total Available for Sale Securities | **$21,982** | **$ -** | **$21,982** | **$ -** |

| 2013 | Total | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| U.S. Government and agency obligations | $18,760 | $ - | $18,760 | $ - |
| Mortgage-backed securities - residential | 16,188 | - | 16,188 | - |
| SBA Pools | 1,428 | - | 1,428 | - |
| Total Available for Sale Securities | $36,376 | $ - | $36,376 | $ - |

There were no securities transferred out of level 2 securities available for sale during the twelve months ended December 31, 2014. No assets or liabilities have been measured on a non-recurring basis at December 31, 2014 or 2013.

Required disclosures include fair value information about financial instruments, whether or not recognized in the consolidated balance sheets, for which it is practicable to estimate that value. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instrument. Certain financial instruments and all non-financial instruments are excluded from the disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of certain of the Company's assets and liabilities at December 31, 2014 and 2013.

**Cash, Due from Banks, and Interest Bearing Demand Deposits**

The carrying amounts of these assets approximate their fair values.

**Investment Securities**

The fair value of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique used widely in the banking industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted prices. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are based on observable market based assumptions (Level 3). In the absence of such evidence, management's best estimate is used. Management's best estimate consists of both internal and external support on certain Level 3 investments. Internal cash flow models using a present value formula that includes assumptions market participants would use along with indicative exit pricing obtained from broker/dealers (where available) are used to support fair values of certain Level 3 investments. The Company had no Level 1 or Level 3 investment securities at December 31, 2014 or 2013.

**Investment in FHLB Stock**

The carrying value of FHLB stock approximates its fair value based on the redemption provisions of the FHLB stock, resulting in a Level 2 classification.

**Loans**

The fair values of loans held to maturity are estimated using discounted cash flow analyses, using market rates at the balance sheet date that reflect the credit and interest rate-risk inherent in the loans, resulting in a Level 3 classification. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal. Generally, for variable rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values.

Mortgage loans held for sale in the secondary market are carried at the lower of cost or fair value, resulting in a Level 2 classification. Separate determinations of fair value for residential and commercial loans are made on an aggregate basis. Fair value is determined based solely on the effect of changes in secondary market interest rates and yield requirements from the commitment date to the date of the financial statements.

**Note 13 - Fair Value Measurement and Fair Values of Financial Instruments (Continued)**

**Accrued Interest Receivable and Payable**

The carrying amount of accrued interest receivable and payable approximates fair value.

**Deposits**

The fair values disclosed for demand deposits (e.g., NOW accounts, non-interest checking, regular 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 amounts), resulting in a Level 1 classification. The carrying amounts for variable-rate certificates of deposit approximate their fair values at the reporting date, resulting in a Level 1 classification. Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits, resulting in a Level 2 classification.

**Borrowings**

The fair values of FHLB long-term borrowings are estimated using discounted cash flow analyses, based on the quoted rates for new FHLB advances with similar credit risk characteristics, terms and remaining maturity, resulting in a Level 2 classification.

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2014 and 2013 are as follows:

| | Fair Value Hierarchy | 2014 Carrying Amount | 2014 Fair Value | 2013 Carrying Amount | 2013 Fair Value |
|---|---|---|---|---|---|
| | | (In Thousands) | | | |
| Financial assets: | | | | | |
| Cash and due from banks | 1 | **$ 1,191** | **$ 1,191** | $ 1,215 | $ 1,215 |
| Interest bearing demand deposits | 1 | **3,144** | **3,144** | 4,683 | 4,683 |
| Securities available for sale | 2 | **21,982** | **21,982** | 36,376 | 36,376 |
| Securities held to maturity | 2 | **17,402** | **17,783** | 6,928 | 7,146 |
| Investment in FHLB stock | 2 | **2,449** | **2,449** | 2,006 | 2,006 |
| Loans held for sale | 2 | **2,961** | **2,961** | 1,309 | 1,309 |
| Loans, net | 3 | **188,830** | **187,562** | 177,001 | 175,751 |
| Accrued interest receivable | 1 | **655** | **655** | 642 | 642 |
| Financial liabilities: | | | | | |
| Deposits | 1/2 | **175,307** | **175,204** | 180,013 | 179,581 |
| Borrowings | 2 | **47,925** | **47,803** | 36,977 | 37,018 |
| Accrued interest payable | 1 | **59** | **59** | 48 | 48 |

**Note 14 - FSB Community Bankshares, Inc. (Parent Company Only) Financial Information**

## Balance Sheets

| | December 31 | |
|---|---|---|
| | **2014** | **2013** |
| | (In Thousands) | |
| Assets | | |
| Cash and cash equivalents | **$ 217** | $ 159 |
| Securities available for sale | **2,938** | 3,000 |
| Investment in banking subsidiary | **17,607** | 15,975 |
| ESOP loan receivable | **463** | 494 |
| Accrued interest receivable | **25** | 21 |
| Total Assets | **$ 21,250** | $ 19,649 |
| Liabilities and Stockholders' Equity | | |
| Total Liabilities | **$ 46** | $ 54 |
| Stockholders' equity | **21,204** | 19,595 |
| Total Liabilities and Stockholders' Equity | **$ 21,250** | $ 19,649 |

## Statements of Income

| | Year Ended December 31 | |
|---|---|---|
| | **2014** | **2013** |
| | (In Thousands) | |
| Interest Income | **$ 95** | $ 80 |
| Other Expense | **(55)** | (70) |
| Equity in undistributed earnings of banking subsidiary | **620** | 281 |
| Net Income | **$ 660** | $ 291 |

**Note 14 - FSB Community Bankshares, Inc. (Parent Company Only) Financial Information (Continued)**

## Statements of Cash Flows

| | Year Ended December 31 | |
|---|---|---|
| | **2014** | **2013** |
| | **(In Thousands)** | |
| Cash flows from operating activities | | |
| Net income | **$ 660** | $ 291 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Equity in undistributed earnings of banking subsidiary | **(620)** | (281) |
| Amortization of premiums on securities available for sale | **-** | 8 |
| Decrease in accrued interest receivable | **3** | - |
| Net (decrease) increase in other liabilities | **(8)** | 33 |
| Net cash provided by operating activities | **35** | 51 |
| Cash flows from investing activities | | |
| Purchases of securities available for sale | **(1,438)** | (500) |
| Proceeds from maturities and calls of securities available for sale | **1,500** | 500 |
| Payments received on ESOP loan | **31** | 30 |
| Net cash provided by investing activities | **93** | 30 |
| Net increase in cash and cash equivalents | **58** | 81 |
| Cash and cash equivalents - beginning | **159** | 78 |
| Cash and cash equivalents - ending | **$ 217** | $ 159 |

**Note 15 - Subsequent Events**

The Company has evaluated events and transactions through March 25, 2015, which is the date the consolidated financial statements were available for issuance, for items that should potentially be recognized or disclosed in the consolidated financial statements.