# New heights


VICTORY BANCORP

THE VICTORY BANCORP INC | ANNUAL REPORT 2012

# THE VICTORY BANK
## STATEMENT OF PURPOSE

*We exist to optimize the financial lives of our clients.*

## VALUES

At The Victory Bank, we value:

**Extraordinary Personal Service –** The Victory Bank delivers fair value and professional advice in a convenient and highly responsive manner. Every contact is an opportunity to help our clients feel valued, important and satisfied.

**Respect –** We conduct ourselves with respect and tolerance for all, regardless of age, disability, gender, race, sexual preference, economic status, religion or political views.

**Ethical Behavior and Fairness –** In every action we strive to consider the long-term best interests of our clients, team members, communities and shareholders, and to always do what is ethically right. Business relationships must provide good value to our clients, and be fair and profitable to the Bank.

**Personal and Corporate Integrity –** Our values stand the challenges of business, and the tests of time. We do not compromise our values for personal or corporate gain.

**Candor –** Open, honest and direct communication is expected throughout the organization regardless of title or position. Pollution of our work environment with gossip and negativity is not acceptable.

**Credibility –** We do what we promise.

**Consistency and Excellence –** We do things right the first time, and are relentlessly committed to excellence.

**Planning, Efficiency and Systematic Thinking –** We establish well-defined strategic plans, set clear goals, and think systematically about the long-term implications of our decisions. We operate efficiently and without waste.

**A Learning Organization –** We are stewards of our team's collective talents and capabilities, committed to helping all team members reach their ultimate potential. We are committed to the never-ending improvement of our knowledge, processes, systems and technology.

**Adaptation and Innovation –** We know that we must always be in a state of growth and change, adapting to an evolving marketplace. We recognize those individuals who innovate and challenge the status quo. Mistakes are viewed as opportunities to learn and improve, and when things go wrong, we focus on solutions rather than blame.

**A Great Working Environment –** We believe that joy, satisfaction and happiness are an integral part of success. We strive to make The Victory Bank *the* employer of choice for an exclusive team of professionals who are, without exception, fully engaged in the pursuit of excellence, and committed to the safety, satisfaction and happiness of the group.

**Teamwork –** We recognize and celebrate the importance and power of teamwork, where individual recognition is secondary to working in a collaborative way in pursuit of common goals.

**Leadership –** Every Team Member proudly wears the mantle of leadership. We strive to model and teach our core values at all times, and gauge our effectiveness as leaders through the positive changes that we create.

***Ultimately, we measure our success through the outlook of our clients, whose total satisfaction assures financial success. Perfection is our inspiration.***

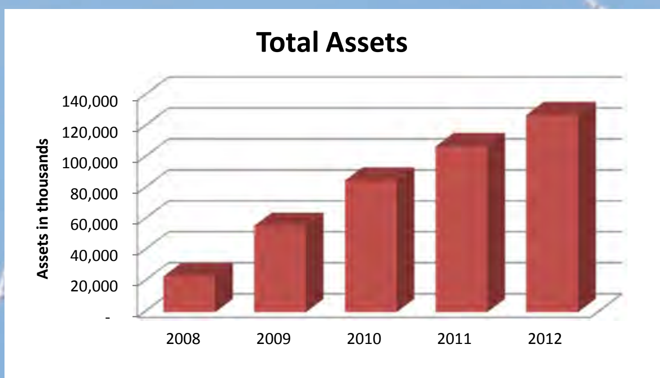
## TABLE OF CONTENTS



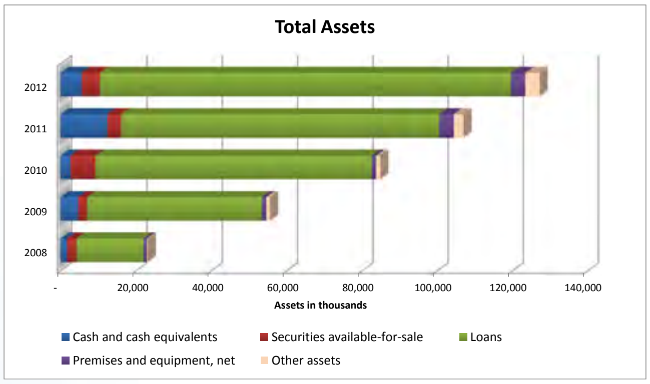
# *From the Chairman*

We are pleased to report that The Victory Bank and The Victory Bancorp achieved new levels of success in most significant areas during 2012, our fifth year of operations. Despite adverse economic conditions, the bank's core strategy from the beginning has focused on building valuable relationships with local businesses and professionals. We provide a broad array of business loans, deposit services, and cash management services to this target clientele, and have carefully invested in experienced people, systems, and technology, in order to provide these communities with a high level of personalized service, and to do so in an efficient manner. As you will see in the results detailed within this annual report, the bank has gained a degree of momentum and has reached new heights in many important areas.

In the world of banking today, achieving efficiency requires a certain amount of mass or size. Because of this, asset growth is a key element of success. The chart below depicts the consistent asset growth enjoyed by the bank since opening in 2008; most of it in loans:

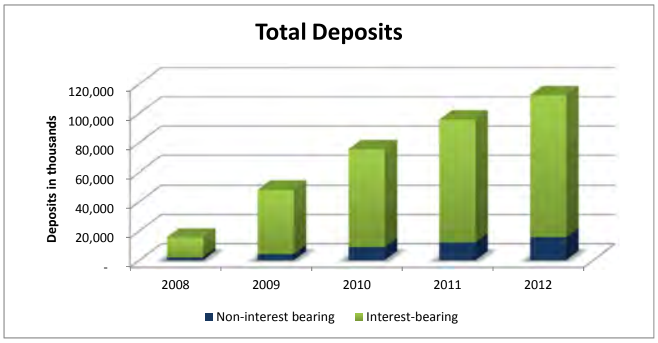


Unlike many other banks, approximately 87% of our assets are held in loans that we have underwritten and closed, and made mostly to local businesses and professionals. In fact, during 2012 we are pleased to report that the bank closed slightly over $50 million of loans and experienced net loan growth of approximately $25 million. The following chart shows more detail about the assets held by the bank from 2008 through 2012:



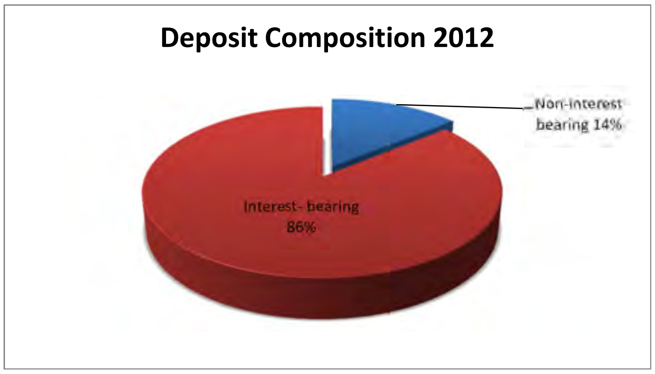

Note that premises and equipment grew significantly in 2011 when the bank acquired its headquarters building that was previously leased. We have also continued to invest in technology. This chart also shows the bank holding a modest investment portfolio of about $5 million. **Most importantly, the green bar shows the total loans held by the bank.** We believe that generating loans within the bank is important not only to the shareholders of the bank, but also to the communities that we serve. Our business strategy includes attracting quality core deposits from our local trade areas, and using those funds to make business loan back into the same communities. We have done this during a time when many other banks had been forced to pull back from community-based lending. These loans support local growth and employment, and help drive our local economy.

Funding the bank with deposits is a crucial part of the bank's core strategy. The following chart shows the deposit growth trends of the bank since opening:

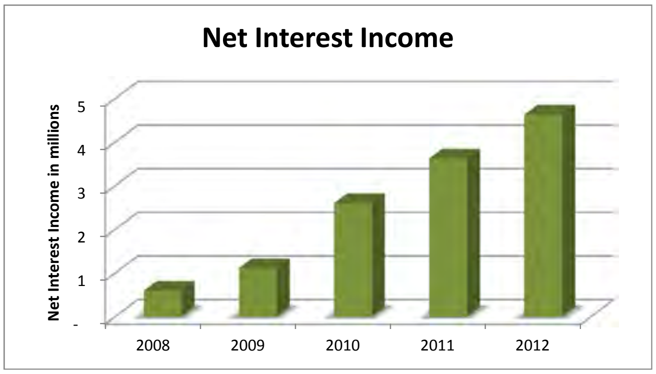



**Joseph W. Major**
*Bank Leader and*
*Chairman of the Board*

The bank is now servicing almost 3,000 deposit accounts, many offering interest rates that are competitive with the local market. The bank has also been able to generate a significant amount of non-interest bearing deposits, as presented below:




As a result of raising deposits locally and lending locally, the bank generated a net interest margin of above 4%, with total net interest income of $4,633,000 during 2012, more than $1 million higher than in 2011, and more than $2 million higher than in 2010:




Non-interest income from a variety of sources added another $369,000 of revenue during 2012. Non-interest expenses increased from $3.6 million in 2011 to $4.1 million in 2012, a figure that was slightly under budget and consistent with the business plan.

Overall, loan quality remained quite good, and the bank increased the total loan loss reserve from $1,078,000 to $1,338,000 at year end, representing 1.22% of total loans. The bank charged off a modest .20% of its year-end loan portfolio during the course of the year. Loans on non-accrual status increased from .37% at the end of 2011 to 1.52% as of the end of 2012, primarily because of one large loan that went into default. However, the loan was well-collateralized and guaranteed by the principals of the borrowing entity, and I am pleased to report that as of the end of the first quarter of 2013, this credit has been completely resolved with the bank being paid in full, with the bank's non-accrual loans returning to .51%.

After the expected losses in years 2008, 2009 and 2010, net income increased from $730,000 in 2011, to $1,533,000 in 2012. A number of factors contributed to the growth in earnings in 2011 & 2012, including asset growth and growth in net interest income, the generation of significant loan fees and gains on the sale of SBA loans, and the recognition of certain tax benefits resulting from earlier operating losses.

Total consolidated capital was $12,600,000 at the end of 2012, with the bank meeting all of its regulatory capital requirements and positioned for consistent growth. The bank's three year business plan also calls for the opening of a residential mortgage lending operation, expected sometime in 2013.

Obviously, since opening in 2008 The Victory Bank has seen a very challenging operating environment. Lending has been difficult because many prospective borrowers have struggled with poor financial performance and losses. Generating net interest margin has been difficult because interest rates have been manipulated by the Federal Reserve to historically low levels for an unusually long period of time, and operations have been more challenging than ever as a result of technological changes and a significantly more difficult regulatory environment. Despite all of this, the bank has generated a profit in nine consecutive quarters through the end of 2012. In many ways, these results can be directly attributed to the efforts of the board of the bank and all of its team members who have worked hard and remained dedicated in the face of these challenges. In addition, the bank's shareholder base has proven to be an extremely positive resource and source of referrals for our company. Thank you!

Certainly the economic news of the past few months has been modestly encouraging. Compared to the "gloom and doom" we have heard over most of the past six years, this news feels a bit like the warmth of early spring sunshine after a long, cold winter. However, we believe that the dysfunction of the federal government in Washington regarding budgets, taxation, and deficits continues to hold the economy back, and we also expect that the banking industry will continue to operate under an extreme level of scrutiny and higher capital requirements into the foreseeable future. But, we approach these challenges with a sense of excitement. We don't think that complaining will do any good, and instead focus our energy on completing the day-to-day tasks that will help the bank grow, succeed, and generate an excellent rate of return for shareholders. We believe that this starts and ends with having a clearly stated set of values, published in this report as our Statement of Purpose, and by living by these values without compromise regardless of circumstances. We also believe that success is based on having a clear business plan, hiring the very best people and retaining them, investing in technology and systems, controlling costs and operating efficiently, and relishing the opportunity to sell the value of our bank to an ever-growing client base.

In closing, all of us at the bank wish to offer our most sincere appreciation to our board, shareholders and bank clients, who collectively helped us reach new heights in 2012.

Sincerely yours,

Joseph W. Major
Bank Leader
Chairman of the Board

ParenteBeard

# Independent Auditors' Report

Board of Directors
The Victory Bancorp, Inc.

**Report on the Consolidated Financial Statements**

We have audited the accompanying consolidated financial statements of The Victory Bancorp, Inc. and subsidiary (the "Company"), which comprise the consolidated balance sheet as of December 31, 2012 and 2011, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

**Management's Responsibility for the Financial Statements**

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

**Auditors' 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 auditors' 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 The Victory Bancorp, Inc. and subsidiary as of December 31, 2012 and 2011, 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.

ParenteBeard LLC

Harrisburg, Pennsylvania
March 22, 2013

Consolidated Balance Sheet
(Dollars in Thousands, except share data)
December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Assets** | | |
| Cash and due from banks | $ 3,171 | $ 4,626 |
| Federal funds sold | 2,406 | 7,745 |
| Cash and cash equivalents | 5,577 | 12,371 |
| Securities available-for-sale | 4,885 | 3,764 |
| Loans receivable, net of allowance for loan losses of $1,338 and $1,078 | 109,158 | 84,459 |
| Premises and equipment, net | 3,868 | 3,854 |
| Restricted investment in bank stocks | 508 | 387 |
| Accrued interest receivable | 394 | 287 |
| FDIC prepaid assessment | - | 66 |
| Bank owned life insurance | 1,259 | 1,207 |
| Other assets | 1,647 | 616 |
| Total assets | $ 127,296 | $ 107,011 |
| **Liabilities and Stockholders' Equity** | | |
| **Liabilities** | | |
| Deposits: | | |
| Non-interest bearing | $ 15,741 | $ 12,111 |
| Interest-bearing | 96,597 | 83,542 |
| Total deposits | 112,338 | 95,653 |
| Short term borrowings | 2,000 | - |
| Accrued interest payable and other liabilities | 406 | 283 |
| Total liabilities | 114,744 | 95,936 |
| **Stockholders' Equity** | | |
| Preferred stock, $1 par value; authorized 2,000,000: | | |
| Series E non-cumulative, convertible, $100 liquidation value 26,158 shares issued and outstanding; total liquidation value $2,616 | 2,616 | 2,616 |
| Series F cumulative, non-convertible, $1 liquidation 3,431 shares issued and outstanding; total liquidation value $3,431 | 3,431 | 3,431 |
| Common stock, $1 par value; authorized 10,000,000 shares; issued and outstanding 1,025,464 shares | 1,025 | 1,025 |
| Surplus | 9,221 | 9,221 |
| Accumulated deficit | (3,848) | (5,164) |
| Accumulated other comprehensive income (loss) | 107 | (54) |
| Total stockholders' equity | 12,552 | 11,075 |
| Total liabilities and stockholders' equity | $ 127,296 | $ 107,011 |

*See notes to consolidated financial statements.*

Consolidated Statement of Income
(In Thousands)
Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Interest Income** | | |
| Interest and fees on loans | $ 5,581 | $ 4,650 |
| Interest on investment securities | 114 | 61 |
| Other interest income | 12 | 8 |
| Total interest income | 5,707 | 4,719 |
| **Interest Expense** | | |
| Deposits | 1,070 | 1,089 |
| Short term borrowings | 4 | 2 |
| Total interest expense | 1,074 | 1,091 |
| Net interest income | 4,633 | 3,628 |
| **Provision for Loan Losses** | 472 | 279 |
| Net interest income after provision for loan losses | 4,161 | 3,349 |
| **Non-Interest Income** | | |
| Service charges and activity fees | 140 | 100 |
| Net gains on sales of loans | 123 | 579 |
| Other income | 106 | 53 |
| Total non-interest income | 369 | 732 |
| **Non-Interest Expenses** | | |
| Salaries and employee benefits | 2,307 | 1,896 |
| Occupancy and equipment | 368 | 438 |
| Legal and professional fees | 260 | 239 |
| Advertising and promotion | 98 | 70 |
| Loan expenses | 33 | 36 |
| Data processing costs | 461 | 434 |
| Supplies, printing and postage | 78 | 58 |
| Telephone | 22 | 19 |
| Entertainment | 77 | 66 |
| Mileage and tolls | 37 | 26 |
| Insurance | 36 | 34 |
| FDIC insurance premiums | 102 | 99 |
| Dues and subscriptions | 37 | 33 |
| Shares tax | 82 | 74 |
| Other | 59 | 29 |
| Total non-interest expenses | 4,057 | 3,551 |
| Income before income tax benefit | 473 | 530 |
| **Income Tax Benefit** | 1,060 | 200 |
| Net income | 1,533 | 730 |
| **Preferred Stock Dividends** | 217 | 233 |
| Net income available to common stockholders | $ 1,316 | $ 497 |



*See notes to consolidated financial statements*

Consolidated Statement of Comprehensive Income
(In Thousands)
Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Net Income** | $ 1,533 | $ 730 |
| **Other Comprehensive Income (Loss)** | | |
| Unrealized holding gain (loss) arising on securities available-for-sale | 216 | (64) |
| Tax effect | (55) | - |
| Other comprehensive income (loss) | 161 | (64) |
| Total comprehensive income | $ 1,694 | $ 666 |

See notes to consolidated financial statements

Consolidated Statement of Stockholders' Equity
(In Thousands)
December 31, 2012 and 2011

| | Preferred Stock | Common Stock | Surplus | Accumulated Deficit | Accumulated Other Comprehensive Income (Loss) | Total |
|---|---|---|---|---|---|---|
| **Balance, January 1, 2011** | $ 3,428 | $ 1,025 | $ 9,221 | $ (5,661) | $ 10 | $ 8,023 |
| Net income | - | - | - | 730 | - | 730 |
| Other comprehensive loss | - | - | - | - | (64) | (64) |
| Issuance of preferred stock | 4,726 | - | - | - | - | 4,726 |
| Redemption of preferred stock | (2,107) | | | | | (2,107) |
| Cash dividends on preferred stock | - | - | - | (233) | - | (233) |
| **Balance, December 31, 2011** | $ 6,047 | $ 1,025 | $ 9,221 | $ (5,164) | $ (54) | $ 11,075 |
| Net income | - | - | - | 1,533 | - | 1,533 |
| Other comprehensive income | - | - | - | - | 161 | 161 |
| Cash dividends on preferred stock | - | - | - | (217) | - | (217) |
| **Balance, December 31, 2012** | $ 6,047 | $ 1,025 | $ 9,221 | $ (3,848) | $ 107 | $ 12,552 |

See notes to consolidated financial statements

Consolidated Statement of Cash Flows
(In Thousands)
Years Ended December 31, 2012 and 2011

| | 2012 | 2011 |
|---|---|---|
| **Cash Flows from Operating Activities** | | |
| Net income | $ 1,533 | $ 730 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Provision for loan losses | 472 | 279 |
| Depreciation and amortization | 252 | 222 |
| Deferred income tax benefit | (1,060) | (200) |
| Net accretion of investment securities | 31 | 14 |
| Realized gain on sale of non SBA loans | - | (105) |
| Earnings on bank owned life insurance | (52) | (7) |
| Net realized gains on sale of SBA loans | (123) | (474) |
| SBA loans originated for sale | (1,534) | (3,231) |
| Proceeds from sale of SBA loans | 1,657 | 4,729 |
| Increase in accrued interest receivable | (107) | (69) |
| Decrease in FDIC prepaid assessment | 66 | 93 |
| Increase in other assets | (26) | (74) |
| Decrease in accrued interest payable | (1) | (8) |
| Increase (decrease) in other liabilities | 124 | (32) |
| Net cash provided by operating activities | 1,232 | 1,867 |
| **Cash Flows from Investing Activities** | | |
| Activity in available-for-sale securities: | | |
| Purchases | (1,623) | (19,472) |
| Proceeds from maturities, calls and principal paydowns | 687 | 22,307 |
| Net increase in loans | (25,171) | (16,100) |
| Proceeds from sale of loans | - | 2,637 |
| Redemption of restricted investment in bank stocks | - | 75 |
| Purchase of restricted investment in bank stocks | (121) | - |
| Purchases of premises and equipment | (266) | (3,038) |
| Purchase of bank owned life insurance | - | (1,200) |
| Net cash used in investing activities | (26,494) | (14,791) |
| **Cash Flows from Financing Activities** | | |
| Net increase in deposits | 16,685 | 20,254 |
| Net increase in short term borrowings | 2,000 | - |
| Net proceeds from issuance of preferred stock | - | 4,726 |
| Redemption of preferred stock | - | (2,107) |
| Cash dividends on preferred stock | (217) | (233) |
| Net cash provided by financing activities | 18,468 | 22,640 |
| Net (decrease) increase in cash and cash equivalents | (6,794) | 9,716 |
| **Cash and Cash Equivalents, Beginning** | 12,371 | 2,655 |
| **Cash and Cash Equivalents, Ending** | $ 5,577 | $ 12,371 |
| **Supplementary Cash Flows Information** | | |
| Interest paid | $ 1,075 | $ 1,099 |
| Non-cash transfers of secured borrowings related to SBA loans sold within 90 days of year end in 2010 | $ - | $ 1,151 |

*See notes to consolidated financial statements*

## 1. Summary of Significant Accounting Policies

### Principles of Consolidation

The consolidated financial statements of The Victory Bancorp, Inc. (the “Corporation”) are prepared on the accrual basis and include the accounts of The Victory Bancorp, Inc. and its wholly-owned subsidiary, The Victory Bank (the “Bank”). All significant intercompany accounts and transactions have been eliminated from the accompanying consolidated financial statements.

### Organization and Nature of Operations

The Victory Bancorp, Inc. is a registered bank holding company, which owns 100% of the outstanding capital stock of The Victory Bank. The Corporation was incorporated under the laws of the State of Pennsylvania in 2009 for the purpose of serving as The Victory Bank’s holding company. The holding company structure provides flexibility for growth through expansion of core business activities and access to varied capital raising operations. The Corporation’s primary business activity consists of ownership of all of the outstanding stock of The Victory Bank. As of December 31, 2012, the Corporation had 312 stockholders of record.

The Bank is a Pennsylvania chartered commercial bank which was chartered in January 2008. The Bank operates a full-service commercial and consumer banking business in Montgomery County, Pennsylvania. The Bank’s focus is on small- and middle-market commercial and retail customers. The Bank originates secured and unsecured commercial loans, commercial mortgage loans, consumer loans and construction loans and does not make subprime loans. The Bank also offers revolving credit loans, small business loans and automobile loans. The Bank offers a variety of deposit products, including demand and savings deposits, regular savings accounts, investment certificates and fixed-rate certificates of deposit. As a state-chartered bank, the Bank is subject to regulation of the Pennsylvania Department of Banking and Federal Deposit Insurance Corporation.

### Subsequent Events

In preparing these consolidated financial statements, the Bank evaluated the events and transactions that occurred between December 31, 2012 through March 22, 2013, the date these financial statements were available for issuance.

**Estimates**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting year. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the fair value of financial instruments, the determination of other-than-temporary impairment of investment securities and the valuation of deferred tax assets.

**Significant Group Concentrations of Credit Risk**

Most of the Bank’s activities are with customers located within Montgomery County, Pennsylvania. Note 4 discusses the types of lending that the Bank engages in. Although the Bank has a diversified loan portfolio, its borrowers’ ability to honor their contracts is influenced by the economy of Montgomery County and the surrounding areas.

**Cash and Cash Equivalents**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks and federal funds sold, all of which mature within ninety days. Generally, federal funds are sold for one day periods.

**Securities**

Management determines the appropriate classification of debt investment securities at the time of purchase and re-evaluates such designation as of each balance sheet date. Securities that management has the positive intent and ability to hold until maturity are classified as held-to-maturity and are carried at their remaining unpaid principal balance, net of unamortized premiums, or unaccreted discounts. At December 31, 2012 and 2011, the Corporation had no investment securities classified as held-to-maturity.

Securities that will be held for indefinite periods of time, including securities that may be sold in response to changes in market interest or prepayment rates, needs for liquidity and changes in the availability of and the yield of alternative investments are classified as available-for-sale. These securities are carried at fair value, which is determined by obtaining quoted market prices or matrix pricing. Unrealized gains and losses are excluded from earnings and are reported in other comprehensive income (loss). Realized gains and losses are recorded on the trade date and are determined using the specific identification method. Premiums are amortized and discounts are accreted using the interest method over the estimated remaining term of the underlying security.

Management evaluates securities for other-than-temporary impairment on at least an annual basis, and more frequently when economic or market concerns warrant such evaluation. Declines in fair value of securities below their cost that are deemed to be other-than-temporary are separated into (a) the amount of the total other-than-temporary impairment related to a decrease in cash flows expected to be collected from the debt security (the credit loss) and (b) the amount of the total other-than-temporary impairment related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is recognized in earnings. The amount of the total other-than-temporary impairment related to all other factors is recognized in other comprehensive income (loss). In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) whether or not management intends to sell or expects that it is more likely than not that it will be required to sell the debt security prior to any anticipated recovery in fair value.

**U.S. Small Business Association (SBA) Lending Activities**

The Bank originates loans to customers in its primary market area under an SBA program that generally provides for SBA guarantees of up to 90 percent of each loan. The Bank generally sells the guaranteed portion of its SBA loans to a third party and retains the servicing, holding the nonguaranteed portion in its portfolio. When the guaranteed portion of an SBA loan is sold, the premium received on the sale and the present value of future cash flows of the servicing assets are recognized in income.

SBA servicing assets are recognized separately when rights are acquired through the sale of the SBA guaranteed portion. These servicing rights are initially measured at fair value at the date of sale and included in the gain on sale. To determine the fair value of Mortgage Servicing Rights (MSRs), the Bank uses market prices for comparable mortgage servicing contracts, when available, or alternatively, uses a valuation model that calculates the present value of estimated future net servicing income. In using this valuation method, the Bank incorporates assumptions that market participants would use in estimating future net servicing income, which includes estimates of the cost to service, the discount rate, custodial earnings rate, an inflation rate, ancillary income, prepayment speeds, default rates, late fees and losses.

These MSRs are amortized in proportion to, and over the period of, the estimated net servicing income or net servicing loss and measured for impairment based on fair value at each reporting date. The amortization of the MSRs is analyzed periodically and is adjusted to reflect changes in prepayment rates and other estimates.

Serviced loans sold to others are not included in the accompanying consolidated balance sheet. Income (losses) and fees collected for loan servicing are included in non-interest income.

**Loans Receivable**

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances, net of an allowance for loan losses and any deferred fees or 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 yield (interest income) of the related loans. The Corporation is generally amortizing these amounts over the contractual life of the loan. Premiums and discounts on purchased loans are amortized as adjustments to interest income using the effective yield method.

The loans receivable portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following classes: commercial term, commercial mortgage, commercial line, and construction. Consumer loans consist of the following classes: home equity and other consumer.

For all classes of loans receivable, the accrual of interest is 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 either guaranteed or well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans, including impaired 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 (generally six months) and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

**Allowance for Loan Losses**

The allowance for loan losses ("allowance") represents management's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectible are charged against the allowance, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. No portion of the allowance is restricted to any individual loan or groups of loans, and the entire allowance is available to absorb any and all loan losses.

The allowance is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Bank's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be 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 classified as impaired. For loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these categories of loans, adjusted for qualitative factors. These qualitative risk factors include:

1. Lending policies and procedures, including underwriting standards and collection, charge-off, and recovery practices.

2. National, regional, and local economic and business conditions as well as the condition of various market segments, including the value of underlying collateral for collateral dependent loans.

3. Nature and volume of the portfolio and terms of loans.

4. Volume and severity of past due, classified and nonaccrual loans as well as and other loan modifications.

5. Existence and effect of any concentrations of credit and changes in the level of such concentrations.

6. Effect of external factors, such as competition and legal and regulatory requirements.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management's best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

The Bank's credit policies determine advance rates against the different forms of collateral that can be pledged against commercial term, line and mortgage loans. Typically, the majority of loans will be limited to a percentage of their underlying collateral values such as real estate values, equipment, eligible accounts receivable and inventory. Individual loan advance rates may be higher or lower depending upon the financial strength of the borrower and/or term of the loan. The assets financed through commercial loans are used within the business for its ongoing operation. Repayment of these kinds of loans generally comes from the cash flow of the business or the ongoing conversions of assets. Commercial mortgage loans include long-term loans financing commercial properties. Repayment of this kind of loan is dependent upon either the ongoing cash flow of the borrowing entity or the resale of or lease of the subject property. Commercial mortgage loans typically require a loan to value ratio of not greater than 80% and vary in terms.

Construction lending is generally considered to involve high risk due to the concentration of principal in a limited number of loans and borrowers and the effects of general economic conditions on developers and builders. Moreover, a construction loan can involve additional risks because of the inherent difficulty in estimating both a property's value at completion of the project and the estimated cost (including interest) of the project. The nature of these loans is such that they are generally difficult to evaluate and monitor.

Home equity loans are secured by the borrower's residential real estate in either a first or second lien position. Residential mortgages and home equity loans have varying loan rates depending on the financial condition of the borrower and the loan to value ratio. Risks associated with home equity loans in second lien positions are greater than those in first position due to subordinate nature of the loans.

Other consumer loans include installment loans, car loans, and overdraft lines of credit. The majority of these loans are unsecured. Risks associated with other consumer loans tend to be greater due to the rapidly depreciating nature of the underlying assets.

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 for commercial term, commercial mortgage, commercial line and commercial construction loans 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.

An allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of substantially all of the Corporation's impaired loans are measured based on the estimated fair value of the loan's collateral.

For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the original appraisal and the condition of the property. Appraised values are discounted to arrive at the estimated selling price of the collateral, which is considered to be the estimated fair value. The discounts also include estimated costs to sell the property.

For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable agings or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual, home equity loans and other consumer loans for impairment disclosures, unless such loans are the subject of a troubled debt restructuring agreement.

Loans whose terms are modified are classified as troubled debt restructurings if the Bank grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date at a below market interest rate based on the credit risk associated with the loan. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into risk rating categories. The borrower's overall financial condition, repayment sources, guarantors and value of collateral, if appropriate, are evaluated quarterly for commercial loans or when credit deficiencies arise, such as delinquent loan payments, for commercial and consumer loans. Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful and loss. Loans criticized special mention have potential weaknesses that deserve management's close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

Banking regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management's comprehensive analysis of the loan portfolio, management believes the current level of the allowance for loan losses is adequate.

**Transfers of Financial Assets**

Transfers of financial assets, including loan and loan participation sales, 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 Corporation, put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership; (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 Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**Bank Premises and Equipment**

Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the related assets. Amortization of leasehold improvements is recorded over the shorter of the estimated useful life or lease term.

**Restricted Investment in Bank Stocks**

Restricted investment in bank stocks, which represents required investments in the common stock of correspondent banks, is carried at cost, and consists of common stock of the Atlantic Central Bankers Bank (ACBB) and Federal Home Loan Bank of Pittsburgh (FHLB) stocks totaling $508,000 and $387,000 at December 31, 2012 and 2011, respectively. In December 2008, the FHLB notified member banks that it was suspending dividend payments and the repurchase of capital stock. In October 2010, partial repurchases of capital stock resumed, and in February 2012, the FHLB began making dividend payments.

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

**Advertising Costs**

The Corporation follows the policy of charging the costs of advertising to expense as incurred. Advertising expense incurred for the years ended December 31, 2012 and 2011 totaled approximately $10,000 and $6,000, respectively.

**Income Taxes**

Current income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the current period taxable income. The Corporation determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax basis of assets and liabilities, net operating loss carryforwards, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of the evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

The Corporation accounts for uncertain tax positions if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appears or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment.

The Corporation recognizes interest and penalties on income taxes, if any, as a component of the provision for income taxes. There were no interest and penalties recognized in 2012 or 2011.

Federal and state tax returns for the years 2009 through 2011 are open for examination as of December 31, 2012.

**Comprehensive Income (Loss)**

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. 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 stockholders' equity section of the consolidated balance sheet, such items along with net income are components of comprehensive income (loss).

**Fair Value of Financial Instruments**

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 15. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

**Off-Balance Sheet Financial Instruments**

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

**Employee Benefit Plan**

The Bank has established a 401(k) plan (“the Plan”). Under the Plan, all employees are eligible to contribute the maximum allowed by the Internal Revenue Code of 1986, as amended. The Bank may make discretionary matching contributions. For the years ended December 31, 2012 and 2011, expense attributable to the Plan amounted to approximately $50,000 and $37,000, respectively.

**Share-Based Compensation**

The Bank follows the provisions of ASC 718-10, *Compensation – Stock Compensation*. This standard requires the Bank to recognize the cost of employee and organizer services received in share-based payment transactions and measure the cost based on the grant-date fair value of the award. The cost will be recognized over the period during which the employee or organizer is required to provide service in exchange for the award.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employee’s service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Sholes model is used to estimate the fair value of stock options, while the fair value of the Corporation’s common stock at the date of grant is used for restricted stock awards.

**2. Restrictions on Cash and Due from Banks**

In return for services obtained through correspondent banks, the Bank is required to maintain non-interest bearing cash balances in those correspondent banks. At December 31, 2012 and 2011, compensating balances approximated $150,000.

## 3. Securities Available-for-Sale

The amortized cost and fair value of securities as of December 31, 2012 and 2011 is summarized as follows:

| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| | **2012** | | | |
| | (In Thousands) | | | |
| Residential mortgage-backed securities | $ 2,614 | $ 92 | $ (11) | $ 2,695 |
| Corporate financial institution bonds | 2,109 | 83 | (2) | 2,190 |
| | $ 4,723 | $ 175 | $ (13) | $ 4,885 |
| | **2011** | | | |
| Residential mortgage-backed securities | $ 3,318 | $ 20 | $ (11) | $ 3,327 |
| Corporate financial institution bonds | 500 | - | (63) | 437 |
| | $ 3,818 | $ 20 | $ (74) | $ 3,764 |

Residential mortgage backed securities include FHLMC and GNMA pass through certificates at December 31, 2012 and 2011.

The unrealized losses and related fair value of investment securities available for sale with unrealized losses less than 12 months and those with unrealized losses 12 months or longer as of December 31, 2012 and 2011 are as follows (in thousands):

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| | **December 31, 2012** | | | | | |
| Residential mortgage-backed securities | $ 244 | $ 11 | $ - | $ - | $ 244 | $ 11 |
| Corporate financial institution bonds | - | - | 498 | 2 | 498 | 2 |
| Total | $ 244 | $ 11 | $ 498 | $ 2 | $ 742 | $ 13 |
| | **December 31, 2011** | | | | | |
| Residential mortgage-backed securities | $ 3,327 | $ 11 | $ - | $ - | $ 3,327 | $ 11 |
| Corporate financial institution bonds | 437 | 63 | - | - | 437 | 63 |
| Total | $ 3,764 | $ 74 | $ - | $ - | $ 3,764 | $ 74 |

There were 2 individual securities in an unrealized loss position as of December 31, 2012 and 3 individual securities in an unrealized loss position as of December 31, 2011. The unrealized loss positions at December 31, 2012 and 2011 are the result of interest rate changes and do not represent other than temporary impairment of investment securities.

The amortized cost and fair value of securities as of December 31, 2012 and 2011, by contractual maturity, are shown below. Mortgage backed securities are included in the table below based on final maturity. Expected maturities may differ from contractual maturities because the securities may be called without any penalties.

| | 2012 | | 2011 | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| | (In Thousands) | | | |
| Due in one year or under | $ - | $ - | $ - | $ - |
| Due after one year through five years | 2,109 | 2,190 | 500 | 437 |
| Due after five years through ten years | - | - | - | - |
| Due after ten years | 2,614 | 2,695 | 3,318 | 3,327 |
| | $ 4,723 | $ 4,885 | $ 3,818 | $ 3,764 |

No securities at December 31, 2012 and 2011 have been pledged to collateralize municipal deposits.

## 4. Loans Receivable

The composition of loans receivable at December 31, 2012 and 2011 is as follows:

| | 2012 | 2011 |
|---|---|---|
| | (In Thousands) | |
| Commercial term | $ 21,999 | $ 17,614 |
| Commercial mortgage | 46,820 | 34,415 |
| Commercial line | 13,398 | 12,628 |
| Construction | 8,030 | 4,567 |
| Home equity | 10,523 | 8,937 |
| Consumer | 9,661 | 7,380 |
| Total loans | 110,431 | 85,541 |
| Deferred fees, net | 65 | (4) |
| Allowance for loan losses | (1,338) | (1,078) |
| Net loans | $ 109,158 | $ 84,459 |

### Allowance for Loan Losses and Recorded Investment in Financial Receivables

The following table summarizes the activity in the allowance for loan losses by loan class for the year ended December 31, 2012 and information in regards to the allowance for loan losses and the recorded investment in loans receivable by loan class as of December 31, 2012 (in thousands):

| | Allowance for Loan Losses | | | | | | |
|---|---|---|---|---|---|---|---|
| | Beginning Balance | Charge-offs | Recoveries | Provisions | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
| Commercial term | $ 132 | $ (14) | $ - | $ 130 | $ 248 | $ 77 | $ 171 |
| Commercial mortgage | 228 | - | - | 69 | 297 | 25 | 272 |
| Commercial line | 164 | - | 6 | (39) | 131 | - | 131 |
| Construction | 35 | - | - | 27 | 62 | - | 62 |
| Home equity | 57 | - | - | 8 | 65 | - | 65 |
| Consumer | 93 | (204) | - | 171 | 60 | - | 60 |
| Unallocated | 369 | - | - | 106 | 475 | - | 475 |
| | $ 1,078 | $ (218) | $ 6 | $ 472 | $ 1,338 | $ 102 | $ 1,236 |

| | Loans Receivable | | |
|---|---|---|---|
| | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
| Commercial term | $ 21,999 | $ 279 | $ 21,720 |
| Commercial mortgage | 46,820 | 1,350 | 45,470 |
| Commercial line | 13,398 | - | 13,398 |
| Construction | 8,030 | - | 8,030 |
| Home equity | 10,523 | - | 10,523 |
| Consumer | 9,661 | 50 | 9,611 |
| | $ 110,431 | $ 1,679 | $ 108,752 |

The following table summarizes the activity in the allowance for loan losses by loan class for the year ended December 31, 2011 and information in regards to the allowance for loan losses and the recorded investment in loans receivable by loan class as of December 31, 2011 (in thousands):

| | Allowance for Loan Losses | | | | | | |
|---|---|---|---|---|---|---|---|
| | Beginning Balance | Charge-offs | Recoveries | Provisions | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
| Commercial term | $ 152 | $ (59) | $ - | $ 39 | $ 132 | $ - | $ 132 |
| Commercial mortgage | 176 | - | - | 52 | 228 | - | 228 |
| Commercial line | 156 | (75) | - | 83 | 164 | 77 | 87 |
| Construction | 10 | - | - | 25 | 35 | - | 35 |
| Home equity | 60 | - | - | (3) | 57 | - | 57 |
| Consumer | 21 | - | - | 72 | 93 | 49 | 44 |
| Unallocated | 358 | - | - | 11 | 369 | - | 369 |
| | $ 933 | $ (134) | $ - | $ 279 | $ 1,078 | $ 126 | $ 952 |

| | Loans Receivable | | |
|---|---|---|---|
| | Ending Balance | Ending Balance: Individually Evaluated for Impairment | Ending Balance: Collectively Evaluated for Impairment |
| Commercial term | $ 17,614 | $ 171 | $ 17,443 |
| Commercial mortgage | 34,415 | - | 34,415 |
| Commercial line | 12,628 | 144 | 12,484 |
| Construction | 4,567 | - | 4,567 |
| Home equity | 8,937 | - | 8,937 |
| Consumer | 7,380 | 49 | 7,331 |
| | $ 85,541 | $ 364 | $ 85,177 |

### Impaired Loans

The following table summarizes information in regards to impaired loans by loan portfolio class as of December 31, 2012 and for the year then ended (in thousands):

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial term | $ 161 | $ 302 | $ - | $ 165 | $ - |
| Commercial mortgage | 1,089 | 1,089 | - | 218 | 48 |
| Commercial line | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | 50 | 205 | - | 10 | 4 |
| With an allowance recorded: | | | | | |
| Commercial term | $ 118 | $ 119 | $ 77 | $ 125 | $ - |
| Commercial mortgage | 261 | 261 | 25 | 249 | 13 |
| Commercial line | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Total: | | | | | |
| Commercial term | $ 279 | $ 421 | $ 77 | $ 290 | $ - |
| Commercial mortgage | 1,350 | 1,350 | 25 | 467 | 61 |
| Commercial line | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | 50 | 205 | - | 10 | 4 |

The following table summarizes information in regards to impaired loans by loan portfolio class as of December 31, 2011 and for the year then ended (in thousands):

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial term | $ 171 | $ 306 | $ - | $ 172 | $ - |
| Commercial mortgage | - | - | - | - | - |
| Commercial line | - | - | - | - | - |
| Construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| With an allowance recorded: | | | | | |
| Commercial term | $ - | $ - | $ - | $ - | $ - |
| Commercial mortgage | - | - | - | - | - |
| Commercial line | 144 | 144 | 77 | 168 | - |
| Construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | 49 | 49 | 49 | 49 | 3 |
| Total: | | | | | |
| Commercial term | $ 171 | $ 306 | $ - | $ 172 | $ - |
| Commercial mortgage | - | - | - | - | - |
| Commercial line | 144 | 144 | 77 | 168 | - |
| Construction | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | 49 | 49 | 49 | 49 | 3 |

### Loan Receivables on Nonaccrual Status

The following table presents nonaccrual loans by classes of the loan portfolio as of December 31, 2012 and 2011 (in thousands):

| | 2012 | 2011 |
|---|---|---|
| Commercial term | $ 279 | $ 171 |
| Commercial mortgage | 1,350 | - |
| Commercial line | - | 144 |
| Construction | - | - |
| Home equity | - | - |
| Consumer | 50 | - |
| | $ 1,679 | $ 315 |

Interest income recognized during the year on loans on non-accrual status at December 31, 2012 and 2011 was $65,000 and $-0-, respectively. Additional interest income that would have been recognized on non-accrual loans, had the loans been performing in accordance with the original terms of their contracts totaled approximately $27,000 and $16,000 for the years ended December 31, 2012 and 2011, respectively.

### Credit Quality Indicators

The following tables present the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard and doubtful within the Bank's internal risk rating system as of December 31, 2012 and 2011 (in thousands):

| | 2012 | | | | |
|---|---|---|---|---|---|
| | Pass | Special Mention | Substandard | Doubtful | Total |
| Commercial term | $ 21,720 | $ - | $ 279 | $ - | $ 21,999 |
| Commercial mortgage | 45,470 | 1,207 | 143 | - | 46,820 |
| Commercial line | 13,398 | - | - | - | 13,398 |
| Construction | 8,030 | - | - | - | 8,030 |
| Home equity | 10,523 | - | - | - | 10,523 |
| Consumer | 9,661 | - | - | - | 9,661 |
| | $ 108,802 | $ 1,207 | $ 422 | $ - | $ 110,431 |

| | 2011 | | | | |
|---|---|---|---|---|---|
| Commercial term | $ 17,443 | $ - | $ 171 | $ - | $ 17,614 |
| Commercial mortgage | 34,415 | - | - | - | 34,415 |
| Commercial line | 12,484 | - | 144 | - | 12,628 |
| Construction | 4,567 | - | - | - | 4,567 |
| Home equity | 8,937 | - | - | - | 8,937 |
| Consumer | 7,331 | - | - | 49 | 7,380 |
| | $ 85,177 | $ - | $ 315 | $ 49 | $ 85,541 |

### Age Analysis of Past Due Loans Receivables

The performance and credit quality of the loan portfolio is also monitored by analyzing the age of the loans receivable as determined by the length of time a recorded payment is past due. The following table presents the classes of the loan portfolio summarized by the past due status as of December 31, 2012 and 2011 (in thousands):

| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans Receivables | Loans Receivable >90 Days and Accruing |
|---|---|---|---|---|---|---|---|
| **2012** | | | | | | | |
| Commercial term | $ - | $ - | $ 279 | $ 279 | $ 21,720 | $ 21,999 | $ - |
| Commercial mortgage | - | 12 | 1,338 | 1,350 | 45,470 | 46,820 | - |
| Commercial line | - | 212 | - | 212 | 13,186 | 13,398 | - |
| Construction | - | - | - | - | 8,030 | 8,030 | - |
| Home equity | - | - | - | - | 10,523 | 10,523 | - |
| Consumer | - | - | 50 | 50 | 9,611 | 9,661 | - |
| | $ - | $ 224 | $ 1,667 | $ 1,891 | $ 108,540 | $ 110,431 | $ - |
| **2011** | | | | | | | |
| Commercial term | $ 47 | $ - | $ 171 | $ 218 | $ 17,396 | $ 17,614 | $ - |
| Commercial mortgage | - | - | - | - | 34,415 | 34,415 | - |
| Commercial line | - | - | - | - | 12,628 | 12,628 | - |
| Construction | - | - | - | - | 4,567 | 4,567 | - |
| Home equity | 60 | - | - | 60 | 8,877 | 8,937 | - |
| Consumer | - | 49 | - | 49 | 7,331 | 7,380 | - |
| | $ 107 | $ 49 | $ 171 | $ 327 | $ 85,214 | $ 85,541 | $ - |

### Modifications

The Corporation may grant a concession or modification for economic or legal reasons related to a borrower's financial condition that it would not otherwise consider resulting in a modified loan which is then identified as a troubled debt restructuring (TDR). The Corporation may modify loans through rate reductions, below market rates, extensions of maturity, interest only payments, or payment modifications to better match the timing of cash flows due under the modified terms with the cash flows from the borrowers' operations. Loan modifications are intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. TDRs are considered impaired loans for purposes of calculating the Corporation's allowance for loan losses.

The Corporation identifies loans for potential restructure primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future.

There were no troubled debt restructurings for the years ended December 31, 2012 and 2011.

**Loan Sales**

The Corporation originates and sells loans secured by the SBA. The Bank retains the unguaranteed portion of the loan and the servicing on the loans sold and receives a fee based upon the principal balance outstanding. During the years ended December 31, 2012 and 2011, the Bank sold loans held for sale for total proceeds of approximately $1,657,000 and $4,729,000 respectively. The loan sales resulted in realized gains of approximately $123,000 and $474,000 for the years ended December 31, 2012 and 2011, respectively. SBA loans held for sale at December 31, 2012 and 2011 amounted to $-0-.

Loans serviced for others are not included in the accompanying consolidated balance sheets. The risks inherent in the servicing assets relate primarily to changes in prepayments that result from shifts in interest rates. The unpaid principal balances of loans serviced for others were approximately $6,922,000 and $7,071,000 at December 31, 2012 and 2011, respectively. The following summarizes the activity pertaining to servicing rights using the amortization method for the years ended December 31, 2012 and 2011:

| | 2012 | 2011 |
|---|---|---|
| | (In Thousands) | |
| Balance, beginning | $ 139 | $ 79 |
| Additions | 20 | 68 |
| Disposals | - | - |
| Amortization | (16) | (8) |
| Balance, ending | $ 143 | $ 139 |

The Corporation completed a sale of approximately $2,532,000 of non-SBA loans during 2011. The sale had net proceeds of $2,637,000, resulting in a gain of $105,000. No non-SBA sales took place during the year ended December 31, 2012.

## 5. Bank Premises and Equipment

The components of premises and equipment at December 31, 2012 and 2011 are as follows:

| | Estimated Useful Lives | 2012 | 2011 |
|---|---|---|---|
| | | (In Thousands) | |
| Leasehold improvements | 10 - 20 years | $ 734 | $ 710 |
| Computer equipment and software | 3 - 5 years | 650 | 474 |
| Automobiles | 3 years | 146 | 124 |
| Bank equipment | 5 years | 164 | 161 |
| Furniture, fixtures and equipment | 3 - 10 years | 205 | 184 |
| Building | 40 years | 1,687 | 1,687 |
| Land | | 1,200 | 1,200 |
| | | 4,786 | 4,540 |
| Accumulated depreciation | | (918) | (686) |
| | | $ 3,868 | $ 3,854 |

Depreciation and amortization expense charged to operations amounted to approximately $252,000 and $222,000 for the years ended December 31, 2012 and 2011, respectively.

On October 31, 2011, the Corporation purchased the building and land at 548 North Lewis Road, Limerick, Pennsylvania, where the Corporation's branch and executive offices reside. The purchase price of $2,850,000 is comprised of the land valued at $1,200,000 and the 6,500 square foot Bank branch and executive offices.

## 6. Deposits

The components of deposits at December 31, 2012 and 2011 are as follows:

| | 2012 | 2011 |
|---|---|---|
| | (In Thousands) | |
| Demand, non-interest bearing | $ 15,741 | $ 12,111 |
| Demand interest-bearing | 9,296 | 5,173 |
| Money market accounts | 10,891 | 11,524 |
| Savings accounts | 53,424 | 45,531 |
| Time, $100,000 and over | 13,222 | 12,761 |
| Time, other | 9,764 | 8,553 |
| | $ 112,338 | $ 95,653 |

Included in money market deposits are brokered deposits of approximately $1,771,000 and $-0- for the years ended December 31, 2012 and 2011, respectively.

At December 31, 2012, the scheduled maturities of time deposits are as follows (in thousands):

| | | |
|---|---|---|
| 2013 | $ | 9,954 |
| 2014 | | 9,375 |
| 2015 | | 1,759 |
| 2016 | | 1,123 |
| 2017 and thereafter | | 775 |
| | $ | 22,986 |

Included in time deposits are brokered deposits of approximately $1,646,000 and $2,572,000 for the years ended December 31, 2012 and 2011, respectively.

## 7. Line of Credit

The Bank has a $1,500,000 unsecured federal funds overnight line of credit with a correspondent bank. There were no borrowings on the line of credit at December 31, 2012 and 2011.

The Bank is a member of the FHLB and has $48.2 million of borrowing capacity at December 31, 2012. There were borrowings of $2,000,000 and $-0- under this capacity at December 31, 2012 and 2011, respectively.

## 8. Lease Commitments and Total Rental Expense

The Corporation has an operating lease agreement for its administrative office maturing in 2013. Future minimum lease payments for 2013 under the non-cancellable lease agreement total $2,500.

The Corporation has an operating lease agreement for its Wyomissing Loan Production office that commenced on April 12, 2012 and matures in 2015. Future minimum lease payments under the non-cancellable lease agreement are as follows:

| | | |
|---|---|---|
| 2013 | $ | 12,000 |
| 2014 | | 12,000 |
| 2015 | | 4,000 |

The Corporation has entered into an operating lease agreement for its administrative office commencing April 1, 2013 and maturing in 2018. Future minimum lease payments under the non-cancellable lease agreement are as follows:

| | | |
|---|---|---|
| 2013 | $ | 14,000 |
| 2014 | | 19,000 |
| 2015 | | 50,000 |
| 2016 | | 60,000 |
| 2017 | | 60,000 |
| 2018 | | 15,000 |

Rent expense for leases for the years ended December 31, 2012 and 2011 was approximately $21,000 and $150,000, respectively. The prior year included rent expense through October 31, 2011 for the main banking office building. The Corporation purchased this building in November of 2011 and the lease was terminated.

## 9. Stockholders' Equity

The Corporation is authorized to issue 50,000 shares of Series E Preferred Stock, par value of $1 per share. Holders of the shares are entitled to receive a quarterly non-cumulative dividend at an annual rate of 7.0% if and when declared by the Company's Board of Directors. Non-cumulative dividends are payable quarterly on the Series E Preferred Stock, beginning January 1, 2011. During 2012 and 2011, the Corporation issued 0 and 12,950 shares of Series E Preferred Stock. Proceeds in 2012 and 2011 were $-0- and $1,295,000, respectively, net of offering costs.

On September 22, 2011, the Corporation entered into a Purchase Agreement with the Treasury, pursuant to which the Corporation issued and sold to the Treasury 3,431 shares of its Preferred Stock, Series F, having a liquidation preference of $1,000 per share (the "Liquidation Amount"), for proceeds of $3,431,000. The Purchase Agreement was entered into, and the Preferred Stock, Series F was issued, pursuant to the Treasury's Small Business Lending Fund program, a $30 billion fund established under the Small Business Jobs Act of 2010 that encourages lending to small businesses by providing capital to qualified community banks with assets of less than $10 billion. A portion of the proceeds were used to redeem the Preferred Stock, Series A through Series D previously issued to the United States Department of the Treasury under the CPP. The remaining proceeds were contributed to the Bank as additional capital for future growth.

The Series F Preferred Stock, qualifies as Tier 1 capital for the Corporation. The dividend rate is calculated as a percentage of the aggregate Liquidation Amount of the outstanding Preferred Stock, Series F and is based on changes in the level of Qualifying Small Business Lending ("QSBL") (as defined in the Purchase Agreement) by the Corporation. Based upon the increase in the Corporation's level of QSBL over the baseline level calculated under the terms of the Purchase Agreement, the dividend rate for the initial dividend period, which is from the date of issuance through December 31, 2011, has been set at approximately 1.0%. For the 2nd through 10th calendar quarters, the annual dividend rate may be adjusted to between 1% and 5%, to reflect the amount of change in the Corporation's level of QSBL. For the 11th calendar quarter through 4.5 years after issuance, the dividend rate will be fixed at between 1% and 7% based upon the increase in QSBL as compared to the baseline. After 4.5 years from issuance, the dividend rate will increase to 9%. The dividend rate was 1.00% at December 31, 2012.

The Series F Preferred shares are non-voting, other than class voting rights on matters that could adversely affect the shares. The preferred shares are redeemable at any time, with Treasury, Federal Reserve and FDIC approval.

## 10. Federal Income Taxes

The components of income tax benefit for the years ended December 31, 2012 and 2011 are as follows:

| | 2012 | 2011 |
|---|---|---|
| | (In Thousands) | |
| Current | $ - | $ - |
| Deferred | 1,060 | 200 |
| | $ 1,060 | $ 200 |

The deferred tax benefit in 2012 is attributable to reductions in the deferred tax asset valuation allowance.

The components of the net deferred tax asset at December 31, 2012 and 2011 are as follows:

| | 2012 | 2011 |
|---|---|---|
| | (In Thousands) | |
| Deferred tax assets: | | |
| Allowance for loan losses | $ 372 | $ 352 |
| Organization and start-up costs | 177 | 195 |
| Nonqualified stock options | 21 | 26 |
| Net operating loss carryforwards | 1,145 | 1,047 |
| Premises and equipment | - | 272 |
| Other | 1 | - |
| Deferred tax asset | 1,716 | 1,892 |
| Valuation allowance | - | (1,381) |
| Total deferred tax assets, net of valuation allowance | 1,716 | 511 |
| Deferred tax liabilities: | | |
| Cash basis conversion | (87) | (56) |
| Deferred loan costs | (136) | (52) |
| Servicing asset | (49) | (20) |
| Unrealized gain on available-for-sale securities | (55) | - |
| Premises and equipment | (44) | - |
| Other | - | (43) |
| Deferred tax liabilities | (371) | (171) |
| Net deferred tax asset, included in other assets | $ 1,345 | $ 340 |

The income tax provision for financial reporting purposes differs from the amount computed by applying the statutory income tax rate of 34% to income before income taxes. The difference relates primarily to the impact of non-taxable income offset by the decrease in deferred tax asset valuation allowance.

The Bank has net operating loss carryforwards available for federal income tax purposes of approximately $3,370,000 which expire through 2030. The decrease in valuation allowance during 2012 is the result of management's estimate of net operating loss carryforwards more likely than not to be utilized over the next 24 to 36 months.

## 11. Transactions with Executive Officers, Directors and Principal Stockholders

The Corporation has had, and may be expected to have in the future, banking transactions in the ordinary course of business with its executive officers, directors, principal stockholders, their immediate families and affiliated companies (commonly referred to as related parties), on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others. There were loans receivable from related parties totaling approximately $2,246,000 and $1,893,000 at December 31, 2012 and 2011, respectively. Loans originated for related parties totaled $791,000 and payments received were approximately $438,000 for the year ended December 31, 2012. Deposits of related parties totaled approximately $3,140,000 and $2,663,000 as of December 31, 2012 and 2011, respectively.

## 12. Share-Based Compensation

Organizers of the Bank were issued a total of 100,000 "organizer warrants" for their efforts during the organization and start-up of the Bank. These warrants were immediately exercisable, expire in 10 years and will enable the warrant holder to purchase one share of common stock at $10.00 per share for each warrant exercised. At December 31, 2012, there were 100,000 warrants outstanding, which expire in 2018.

In 2008, the Board of Directors adopted the 2008 Stock Option Plan ("2008 Plan"), which was approved by the Board of Directors on March 18, 2008, and was approved by the shareholders on May 28, 2008.

The 2008 Plan enables the Board of Directors to grant stock options to employees, directors, consultants, and other individuals who provide services to the Bank. The shares subject to or related to options under the 2008 Plan are authorized and unissued shares of the Corporation. The maximum number of shares that may be subject to options under the 2008 Plan is 205,092, all of which may be issued as incentive stock options and as non-qualified stock options. Incentive stock options are subject to limitations under Section 422 of the Internal Revenue Code. The Corporation has reserved, for the purposes of the 2008 Plan, out of its authorized and unissued shares, such number of shares. The 2008 Plan will terminate ten years from stockholder approval. Options may not be granted with an exercise price that is less than 100% of the fair market value of the Corporation's common stock on the date of grant. Options may not be granted with a term longer than 10 years. However, any incentive stock option granted to any employee who, at the time such option is granted, owns more than 10% of the voting power of all classes of shares of the Corporation, its parent or of a subsidiary may not have a term of more than five years. Options will vest and be exercisable at such time or times and subject to such terms and conditions as determined by the Board of Directors. Generally, options will vest over a vesting period of approximately equal percentages each year over an initial term no shorter than three years. In 2009, 4,000 incentive stock options were issued under the 2008 Plan and no non-qualified stock options were issued under the 2008 Plan. No options were granted in 2012 or 2011. At December 31, 2012 and 2011, there are 30,679 shares available for grant under the 2008 Plan.

The following is a summary of the Corporation's share-based compensation activity and related information for the years ended December 31, 2012 and 2011 (in thousands):

| | Warrants and Options | Weighted Average Exercise Price | Weighted Average Remaining Contractual Term | Aggregate Intrinsic Value |
|---|---|---|---|---|
| Outstanding at January 1, 2011 | 169 | $ 10.00 | | |
| Stock options granted in 2011 | - | - | | |
| Stock options forfeited in 2011 | (1) | 10.00 | | |
| Outstanding at December 31, 2011 | 168 | 10.00 | 7 years | $ - |
| Stock options granted in 2012 | - | - | | |
| Stock options forfeited in 2012 | - | - | | |
| Outstanding at December 31, 2012 | 168 | $ 10.00 | 6 years | $ - |
| Exercisable at December 31, 2012 | 168 | $ 10.00 | 6 years | $ - |

There were no organizer warrants granted in 2012 or 2011. The fair value of the warrants granted in 2008 was $2.96, which were expensed upon issuance as no future services were required by the recipients.

The fair value of each option granted during 2009 was estimated at $3.91 on the date of grant using the Black-Scholes option-pricing model.

During 2010, the directors, senior management and employees of the Corporation forfeited all non-vested options as of July 1, 2010. As a result, no additional compensation expense will be recognized in connection with the options.

Total share-based compensation cost related to stock options totaled approximately $-0- for the years ended December 31, 2012, and 2011.

## 13. Financial Instruments with Off-Balance Sheet Risk

The Corporation 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. Such commitments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the balance sheet.

The Corporation'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. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The Corporation had the following off-balance sheet financial instruments whose contract amounts represent credit risk at December 31, 2012 and 2011:

| | 2012 | 2011 |
|---|---|---|
| | (In Thousands) | |
| Unfunded commitments under lines of credit | $ 19,442 | $ 19,340 |

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. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The Bank evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation. Collateral held varies but may include personal or commercial real estate, accounts receivable, inventory and equipment. The liability associated with these commitments is not material at December 31, 2012.

## 14. Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the 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 Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth below) of total and Tier 1 capital (as defined in the regulations) to risk-weighted assets, and of Tier 1 capital to average assets. Management believes, as of December 31, 2012, that the Bank meets all capital adequacy requirements to which it is subject.

The Federal Deposit Insurance Corporation requires that the Bank maintain a ratio of Tier 1 leverage capital to total assets of at least 8% during the first seven years of operation. Under these guidelines, the Bank is considered "well capitalized" as of December 31, 2012 and 2011.

The Bank's actual capital amounts and ratios at December 31, 2012 and 2011 are presented below:

| | 2012 | | | | | |
|---|---|---|---|---|---|---|
| | Actual | | For Capital Adequacy Purposes | | To be Well Capitalized under Prompt Corrective Action Provisions | |
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| | (Dollar Amounts in Thousands) | | | | | |
| Total capital (to risk-weighted assets) | $ 11,721 | 10.32 % | $ ≥9,090 | ≥8.00 % | $ ≥11,362 | ≥10.00 % |
| Tier 1 capital (to risk-weighted assets) | 10,383 | 9.14 | ≥4,545 | ≥4.00 | ≥6,817 | ≥ 6.00 |
| Tier 1 capital (to average assets) | 10,383 | 8.50 | ≥4,889 | ≥4.00 | ≥6,111 | ≥ 5.00 |
| | 2011 | | | | | |
| Total capital (to risk-weighted assets) | $ 10,782 | 11.72 % | $ ≥7,358 | ≥8.00 % | $ ≥9,198 | ≥10.00 % |
| Tier 1 capital (to risk-weighted assets) | 9,704 | 10.55 | ≥3,679 | ≥4.00 | ≥5,519 | ≥ 6.00 |
| Tier 1 capital (to average assets) | 9,704 | 9.39 | ≥4,135 | ≥4.00 | ≥5,169 | ≥ 5.00 |

The Bank is subject to certain restrictions on the amount of dividends that it may declare due to regulatory considerations.

## 15. Fair Value Measurements

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation 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 financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year end.

**Determination of Fair Value**

The Corporation uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the Topic 820 *Fair Value Measurements and Disclosures* fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Corporation's various financial instruments. 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. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instruments.

Current fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

**Fair Value Hierarchy**

The Corporation groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

*Level 1* - Valuation is based on unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

*Level 2* - Valuation is based on inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

*Level 3* - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon 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 at December 31, 2012 and 2011 are as follows (in thousands):

| | 2012 | | | |
|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Residential mortgage-backed securities | $ 2,695 | $ - | $ 2,695 | $ - |
| Corporate financial institution bonds | 2,190 | - | 2,190 | - |
| | $ 4,885 | $ - | $ 4,885 | $ - |
| | **2011** | | | |
| Residential mortgage-backed securities | $ 3,327 | $ - | $ 3,327 | $ - |
| Corporate financial institution bonds | 437 | - | 437 | - |
| | $ 3,764 | $ - | $ 3,764 | $ - |

Residential mortgage backed securities include FHLMC and GNMA pass through certificates at December 31, 2012 and 2011.

The Corporation's available-for-sale investment securities, which include corporate financial institution bonds and mortgage-backed securities, are reported at fair value. These securities are valued by an independent third party ("Preparer"). The Preparer's evaluations are based on market data. They utilize evaluated pricing models that vary by asset and incorporate available trade, bid and other market information. For securities that do not trade on a daily basis, their evaluated pricing applications apply available information such as benchmarking and matrix pricing. The market inputs normally sought in the evaluation of securities include benchmark yields, reported trades, broker/dealer quotes (only obtained from market makers or broker/dealers recognized as market participants), issuer spreads, two-sided markets, benchmark securities, bid, offers and reference data. For certain securities additional inputs may be used or some market inputs may not be applicable. Inputs are prioritized differently on any given day based on market conditions.

Assets and liabilities measured at fair value on a non-recurring basis are summarized below (in thousands):

| | 2012 | | | |
|---|---|---|---|---|
| | Total | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Impaired loans | $ 489 | $ - | $ - | $ 489 |
| | 2011 | | | |
| Impaired loans | $ 238 | $ - | $ - | $ 238 |

Impaired loans are those that the Corporation has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values, based upon the lowest level of input that is significant to the fair value measurements.

The following table presents additional quantitative information about assets measured at fair value on a non-recurring basis and for which the Corporation has utilized Level 3 inputs to measure fair value at December 31, 2012:

| | 2012 | | | |
|---|---|---|---|---|
| Description | Total | Valuation Technique | Unobservable Input | Range (Weighted Average) |
| | | (In Thousands) | | |
| Impaired loans | $ 448 | Appraisal of collateral | Appraisal adjustments | 0-10% |
| | | | Liquidation expenses | 0-10% |
| Impaired loans | 41 | Sales prices | Liquidation expenses | 0% |
| | 489 | | | |

The following information should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful. In addition to the fair value methods for available for sale securities and impaired loans, previously disclosed, the following methods and assumptions were used to estimate the fair values of the Corporation's financial instruments at December 31, 2012:

**Cash and Cash Equivalents (Carried at Cost)**

The carrying amounts reported in the balance sheet for cash and short-term instruments approximate those assets' fair values.

**Servicing Asset (Carried Lower of Cost or Fair Value)**

The fair value of the servicing asset is based on a valuation model that calculates the present value of estimated net servicing income. The valuation incorporates assumptions that market participants would use in estimating future net servicing income. The Corporation is able to compare the valuation model inputs and results to widely available published industry data for reasonableness.

**Loans (Carried at Cost)**

The fair values of loans 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. 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.

**Loans Held for Sale (Carried at Lower of Cost or Fair Value)**

The fair value of loans held for sale is determined, when possible, using quoted secondary-market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan.

**Restricted Investments in Bank Stock (Carried at Cost)**

The carrying amount of restricted investments in bank stock approximates fair value, and considers the limited marketability of such securities.

**Accrued Interest Receivable and Payable (Carried at Cost)**

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

**Deposits (Carried at Cost)**

The fair values disclosed for demand deposits (e.g., interest and noninterest checking, passbook savings and money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market on certificates to a schedule of aggregated expected monthly maturities on time deposits.

**Short Term Borrowings (Carried at Cost)**

The carrying amount of short term borrowings approximates fair value.

**Off-Balance Sheet Financial Instruments (Disclosed at Cost)**

Fair values for the Corporation's off-balance sheet financial instruments (lending commitments and lines of credit) are based on fees currently charged in the market to enter into similar agreements, taking into account, the remaining terms of the agreements and the counterparties' credit standing.

The fair values, and related carrying amounts, of the Corporation's financial instruments were as follows at December 31, 2012 and 2011:

| | 2012 | | 2011 | |
|---|---|---|---|---|
| | Carrying Amount | Estimated Fair Value | Carrying Amount | Estimated Fair Value |
| Assets: | | | | |
| Cash and cash equivalents | $ 5,577 | 5,577 | 12,371 | 12,371 |
| Securities available-for-sale | 4,885 | 4,885 | 3,764 | 3,764 |
| Restricted investments in bank stocks | 508 | 508 | 387 | 387 |
| Loans, net | 109,158 | 109,845 | 84,459 | 85,561 |
| Servicing asset | 143 | 144 | 139 | 139 |
| Accrued interest receivable | 394 | 394 | 287 | 287 |
| Liabilities: | | | | |
| Deposits | 112,338 | 113,387 | 95,653 | 95,957 |
| Short term borrowings | 2,000 | 2,000 | - | - |
| Accrued interest payable | 17 | 17 | 18 | 18 |
| Off balance sheet asset (liability): | | | | |
| Commitments to extend credit | - | - | - | - |
| Standby letters of credit | - | - | - | - |

**COMMERCIAL TEAM** Front (L-R): **Matthew Melcher,** Credit Analyst; **Leslie Unger,** Administrative Assistant; **Joseph Bergquist,** Vice President, Commercial Relationship Manager; **Noel Billingsley,** Vice President, Commercial Relationship Manager; Back (L-R): **Benjamin Major,** Credit Analyst; **Deborah Lee,** Vice President, Credit Department Manager; **Alexander Kroll,** Senior Vice President, Commercial Relationship Manager; **Richard Graver,** President – The Victory Bancorp and Chief Banking Officer – The Victory Bank; **Eric Offner,** Executive Vice President, Chief Credit Officer; **James Phillips,** Business Development Officer; **Vincent Raffeo,** Business Development

**RETAIL TEAM** (L-R): **Mary Locricchio,** Banking Center Representative; **Thomas Moore,** Courier; **Sarah Benson,** Banking Center Representative; **Saul Rivkin,** Vice President, Chief Retail Officer; **Roxanne Raymond,** Banking Center Branch Manager; **Jennifer Gilbert,** Banking Center Assistant Branch Manager; **Diana Stephens,** Banking Center Representative

**OPERATIONS AND ADMINISTRATIVE TEAM** Front (L-R): **Pam Havrilla,** Loan Administration Manager; **Kelly Taylor,** Executive Assistant; Back (L-R): **Noreen Cobourn,** Assistant Vice President, Loan Operations Manager; **Danae Soley,** Loan Operations Clerk; **Dennis Zielinski,** Bank Secrecy Act and Security Officer; **Donna Colella,** Assistant Vice President, Operations Manager; **Christine Gray,** Staff Accountant; **Robert Schultz,** Chief Financial Officer and Chief Operating Officer

**WYOMISSING LOAN OFFICE TEAM** (L-R): **Jodi Moore,** Administrative Assistant; **Laurie Kercher,** Vice President, Commercial Relationship Manager; **Tony D'Antonio,** Senior Vice President, Commercial Relationship Manager

# BOARD OF DIRECTORS

**Alan S. Apt**
*President and CEO*
Aptcor Commercial Realtors

**Matthew "Bo" Bates**
*Chief Executive Officer*
West Motor Freight

**Robert L. Brant, Esquire**
*Principal*
Robert L. Brant & Associates LLC

**Beryl B. Byles**
*Executive Coach*
Beryl B. Byles Consulting

**Michael A. Eddinger**
*Principal and Co Owner*
Surburban Water Technology

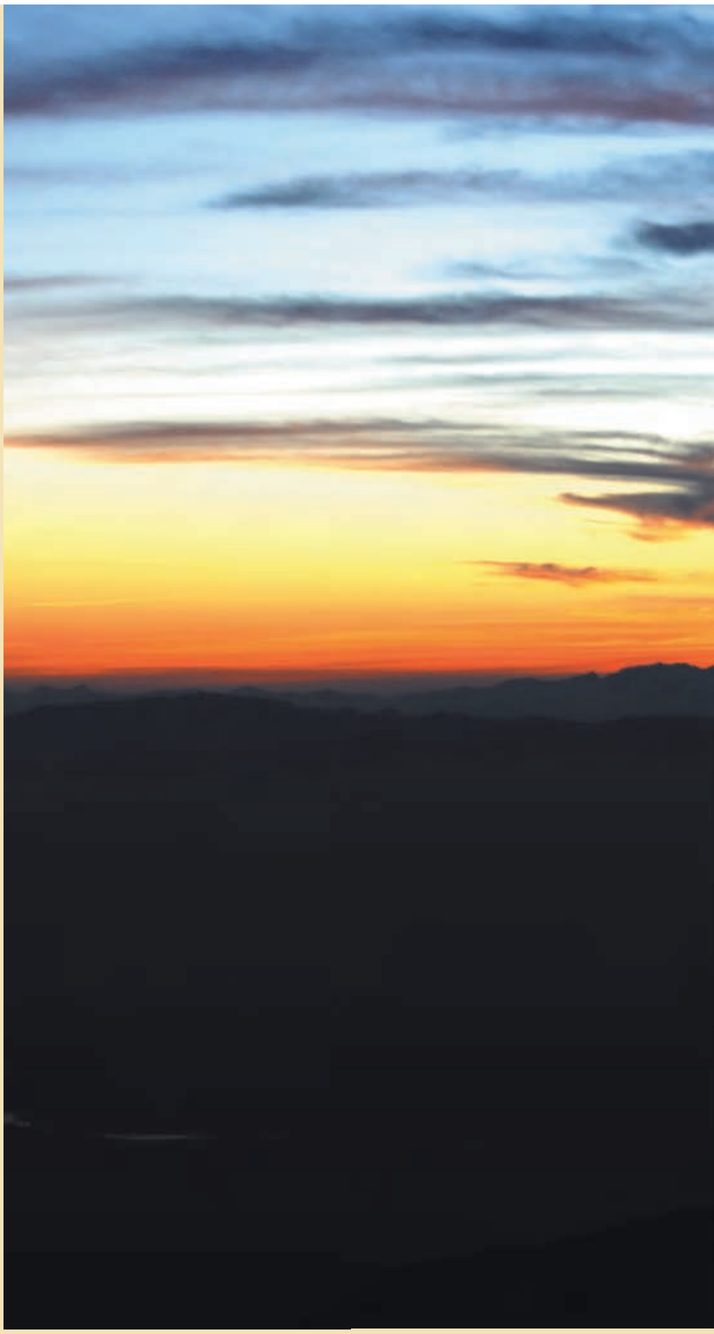
**Karl Glocker**
*President*
Glocker and Co.

**Kevin L. Johnson**
*President*
Traffic Planning and Design, Inc.

**Joseph W. Major**
*Chairman of the Board*
*Bank Leader*
The Victory Bank

**Dennis R. Urffer, CPA**
*Chairman and Shareholder*
Reshnick Amsterdam Leshner, PC

**SENIOR MANAGEMENT TEAM** Front (L R): **Richard Graver,** President The Victory Bancorp and Chief Banking Officer The Victory Bank; **Joseph Major,** Chairman The Victory Bancorp and Bank Leader The Victory Bank; Back (L R): **Saul Rivkin,** Vice President, Chief Retail Officer; **Eric Offner,** Executive Vice President, Chief Credit Officer; **Shelly Stockmal,** Leader of Human Resource Development; **Robert Schultz,** Chief Financial Officer and Chief Operating Officer



VICTORY
BANCORP

548 North Lewis Road

Limerick PA 19468

610.948.9000

www.thevictorybank.com