



Lyons Bancorp, Inc.
It's all about people.

2016
ANNUAL REPORT

HOMETOWN VALUES

Helping Communities Thrive.



MISSION

The Lyons National Bank is an independent, hometown, community bank with an expanding geographic market. Our mission is to safely and profitably serve all of our customers and communities with the most professional service available. We will accomplish this by making a commitment to our most valuable assets—our employees—to treat them with integrity, compensate them appropriately and provide them with the necessary systems, technology, and appropriate training to enable them to become well-respected professionals. Our employees, in turn, will provide our growing customer base with superior service and respect and will be leaders in promoting the quality of life in the communities we serve.



VISION

The vision of The Lyons National Bank is to be the employer and financial institution of choice and to foster an environment of opportunity, growth, and prosperity for our employees, customers, shareholders, and local communities.

PROFILE

Lyons Bancorp, Inc. is a bank holding company headquartered in Lyons, New York, with assets of \$956 million at December 31, 2016. Lyons Bancorp, Inc. has one banking subsidiary, The Lyons National Bank. The Lyons National Bank is a community bank with offices in Clyde, Lyons, Macedon, Newark, Ontario, and Wolcott in Wayne County, Jordan in Onondaga County, Canandaigua and Geneva in Ontario County, Penn Yan in Yates County, Waterloo in Seneca County, and Fairport in Monroe County. The Lyons National Bank has one subsidiary, Lyons Realty Associates Corp.

OUR CULTURE—WOW!

WOW! is a personal conviction to consciously provide our customers and fellow employees with a level of service that exceeds their expectations during each and every encounter we have with them.

ANNUAL MEETING

The annual meeting of the stockholders will take place at 4:30 p.m. on May 17, 2017, at the historic Ohmann Theatre in Lyons, New York.



COMMITTED TO LOCAL BUSINESSES



ROOTSTOCK CIDERWORKS

When David DeFisher, a fourth-generation fruit farmer in Williamson, decided to pursue his dream of producing award-winning cider, he turned to LNB—a strong local bank with extensive commercial and lending solutions. LNB's experienced staff and local decision-making helped provide funding needed to launch Rootstock Ciderworks. *See their full story at BankwithLNB.com/Rootstock.*

Chairman's Message



Robert A. Schick

Chairman of the Board and CEO, Lyons Bancorp, Inc. & The Lyons National Bank



“...the daily commitment our employees make to provide superior service to our customers and potential customers is at the heart of our success.”

—Robert A. Schick

A year ago, in April, a Washington, D.C.-based think tank, Tax Foundation, reported that, for 2016, Americans were expected to pay \$3.3 trillion (that's a “t”) in federal taxes and \$1.6 trillion (that's another “t”) in state and local taxes for a total tax bill of almost \$5.0 trillion (yes, one more “t”) or almost one-third of the nation's income. This means that, collectively, America was expected to spend more on taxes than it would on food, clothing and housing combined. Hmm, maybe that helps explain the November surprise?

Whatever the case, there are no surprises when it comes to reporting the 2016 financial results of your company, Lyons Bancorp, Inc., and its main subsidiary, The Lyons National Bank. We posted another all-time high in earnings, extending our record run to the 20th consecutive year. But that's not a surprise because, as I've mentioned numerous times, our dedicated and professional employees put forth their usual outstanding effort and made it happen yet again. At the risk of being characterized as braggadocious as certain high-profile individuals, I am comfortable stating that the daily commitment our employees make to provide superior service to our customers and potential customers is at the heart of our success. This is what we call our WOW! culture, and it sets us apart from the competition. How else can one explain our performance? All banks offer similar products and services. Sure, each of us may have different catchy names for our loan, deposit, and technology-driven products, but their basic functionality differs little. Moreover, Upstate New York is hardly a growth area, so most of our gains come at the expense of our competitors. Even when we expand our footprint by opening new branches, our growth in these de novo markets comes from other banks and financial services companies. The fact that we are repeatedly successful in convincing individuals, families, and businesses to try our style of hometown banking tells me we are doing something very right, or our competitors are doing something seriously wrong. The answer is probably a little of both, but I prefer to think it is more of the former than the latter.

In 2016, we earned \$7.6 million or 3% more than the \$7.4 million we reported in 2015. On a diluted earnings per-share basis, we made \$2.39 in 2016 versus \$2.34 in 2015. We had approximately 28,000 more common shares outstanding on average in 2016 than we had in 2015. The increase in common shares was due to the conversion of the last of our Trust III junior subordinate debentures into common stock. Trust III is now officially history.

As has been the case the last few years, strong balance-sheet growth was the primary driver of our increased earnings. Total assets at the end of 2016 were \$956 million, up 10% or \$88 million from the end of 2015. Loans grew \$73 million last year and ended the year at \$679 million, up 12%. Our investment portfolio grew by \$11 million to \$206 million, more out of necessity than desire. Because a number of municipalities transferred their operating accounts to us from larger regional and money center banks and because New York State requires a municipality's deposits above the FDIC limit to be fully collateralized, we increased our investment portfolio to secure the extra deposits. We also grew our core retail, commercial, and agricultural customer deposits. In aggregate, our total deposits increased by \$88 million, ending the year at \$860 million.

All this growth requires a stronger capital base to support it. Plus, we expect to continue to take advantage of market opportunities. Consequently, late last year, we raised \$5 million in an equity offering. The offering, a private placement to accredited investors, was in the form of a non-cumulative, convertible preferred stock that pays an annual dividend of 5.00%. This series of preferred stock was originally approved by the common shareholders in 2012 and again in 2014.

In October, Diana Johnson, our longtime chief financial officer, retired. We thank Diana for the outstanding contribution she made to the Bank over her years of service and wish her and her family continued health and well-being. Our new chief financial officer, Chad Proper, details our financial performance in his report on subsequent pages.

We did not open a new branch office in 2016, but we did lay the foundation to open an office in Auburn, New York, later this year. Auburn is a \$725 million market; outside of Monroe County, it will be our largest market to date. Needless to say, we are thrilled about bringing our style of hometown banking to Auburn. A site has been chosen, and we have regulatory approval for our 14th branch. Currently, we are working with architects to design the facility and have targeted early fall for a Grand Opening. We'll keep you informed about the progress of this exciting project. In the meantime, we have hired an experienced banker of 16 years, Demetrius Murphy, to manage the office and another seasoned banker of 15 years, Greg Lattimore, to be our resident branch loan officer. As natives of Auburn, both Demetrius and Greg are well-known and connected in the area. We will put the balance of the staff in place as we get closer to opening.

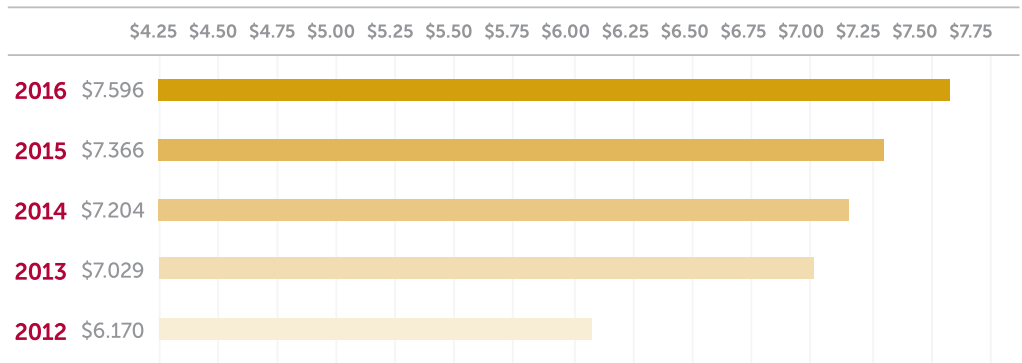
The banking environment in 2016 was very similar to the previous eight years. Continued historically low interest rates kept the pressure on our net-interest margin—the difference between what we earn on our loans and investments and what we pay our customers on their deposits. That made it imperative that we grow. Collectively, our growth of the past several years has us knocking on the door of the \$1 billion club, and all indications are that we will cross the threshold in 2017. While no one number is magical in itself, reaching this milestone puts us in a different league.



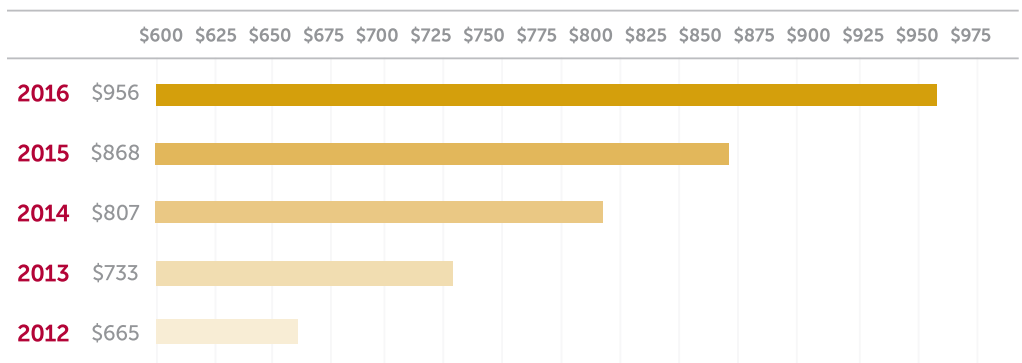
“...recording our 20th consecutive year of record earnings.”

At this level, the FDIC-defined peer group consists of 621 other commercial banks in the U.S. Our current peer group contains over 3,600 commercial banks. A larger balance sheet and a market capitalization in excess of \$120 million are desirable characteristics to institutional investors

NET INCOME (Year Ending, In Millions)



TOTAL ASSETS (Millions)



and potential market makers, which should add some trading liquidity to our common shares. Obviously, crossing thresholds only gets you a first look. To gain these financial professionals' favor (and their support of the stock), we must continue to perform at the top of our class.

The \$1 billion benchmark also results in additional regulatory scrutiny and greater board governance responsibilities. Recall that I wrote to you in the fall of 2016 to discuss just these points. As a consequence, my daily duties will focus more on working with the board in strengthening its structure and oversight. I will continue to lead our capital-raising initiatives and maintain a close relationship with you, our shareholders.

Tom Kime, our chief operating officer of these past 12 years, stepped into the role of president of the bank on January 1st. Much of the bank previously reported to Tom in his past role. Now, all department and branch executives will report to him. Tom will report to me. Together, we and the other senior executives of the bank will formulate and execute the strategic plan of the company.

In order to thrive in an ever-changing and competitive business environment, we need to grow, squeeze economies of scale out of that growth, and deliver a high-performing bottom line. Over the years, despite the many and varying headwinds we faced, we successfully met the challenges each presented. Now we have a different challenge: not getting caught up in our success. Rather, we need to constantly remind ourselves of the true reason for our accomplishments: our employees and their commitment to our WOW! culture—a culture of developing genuine relationships with our customers, of listening intently to their wants and needs, and of constantly striving to provide unmatched customer service. While the world in general and banking in particular is very dynamic, there is no reason for us to alter our style. And we won't!

Robert A. Schick



President's Message



Thomas L. Kime

President, The Lyons National Bank

Having had the opportunity of working for over a dozen years with our outstanding team of professionals, our valued customers and LNB's engaged Board of Directors and Advisory Board members, I can say, without question, that LNB has a winning team and a solid base that it has built on for over 150 years.

LNB's model of hometown banking is unique compared to most other banking models today. Although it may contradict current banking trends, it is also what differentiates us in the marketplace and has contributed significantly to our success. While bank branches in the U.S. as a whole have decreased from their peak of 99,550 seven years ago, to 91,861 as of September 2016, a 7.7% decline, along with large banks exiting some markets, LNB has done just the opposite and selectively opened new, full-service offices in targeted markets that we have assessed to be conducive and receptive to our model of banking.

While other bank branches are seeing a reduction in customer numbers and business volume, LNB's new offices have continued to generate strong growth in our customer base with increased utilization of in-branch services. At the same time, we have expanded usage of our technology-based services.

Our model of full-service branches has been successful in both our legacy offices, with LNB growing from 27% of the Wayne County deposit market share to 52% in the last 10 years, while our five most recent new market offices as of 12-31-16 represented 51% of our deposit base and 73% of our core deposit growth since 2012. On the loan side for the same periods, the results are 62% and 79% respectively of the Bank's loan portfolio generated by these new offices.

The next community that we are excited to be a part of is the Greater Auburn/Cayuga County market in which we have plans to open two offices during 2017. Longtime Auburn banking officers have already joined our team. Demetrius Murphy, our Auburn market manager, and Greg Lattimore, our commercial lender, jointly have over 30 years of banking experience in the Auburn market. We are also pleased to announce that local business and community leaders Joe Bartolotta, John Bouck, and Sal Franzone have joined us as three, of what will be six, founding advisory board members for our Auburn market. We look forward to their advice on how LNB can best serve this exceptional community—one with a strong vision and committed leaders who have made great strides to enhance the vitality of Auburn and the greater Cayuga County market.

As we have grown and are approaching the \$1 billion mark, we have also grown our local advisory boards to 36 members, who in conjunction with our 12 local board members and locally based officers and staff, all help to

keep LNB grounded in their respective communities and focused on addressing the needs of that office's customers and market.

LNB's approach and hometown banking philosophy is not the "least costly banking model"—one focused on cutting branch cost, staffing levels and in-market services to achieve an acceptable profit. It is one that focuses on providing in-market, full-service banking with professionals that provide a high level of service that enables us to grow our customer base and relationships in a manner that will enable us to do so profitably.

While emphasizing our personal one-on-one service profile and hometown banking model, we cannot ignore the reality of banking trends and customer needs for high-tech banking services. We offer best-in-class mobile banking, RDC and the security of personal CardValet transaction monitoring, to advanced online corporate and municipal cash management and lock box services. Today, customers want, need and deserve both personal service from a banker that knows them and understands their needs, to technology that lets them do banking how, when and where they wish to. At LNB, we believe in providing both high-touch and high-tech banking services.

For this model to continue to be successful, it will require us to be aggressive in growing each of our offices and to ensure that we expand our relationships with every customer. This means we must do our best every day and provide LNB's WOW! level of service that exceeds our customers' and our communities' expectations.

All of us at LNB are committed to doing so.

Thomas L. Kime

AUBURN ADVISORY BOARD MEMBERS



Joseph P. Bartolotta, Esq.
R&M Real Estate Group



John F. Bouck
Bouck Real Estate



Salvatore N. Franzone
Ciccino's Pizzeria and Restaurant



Celebrating WOW!

LNB's WOW! Employee Program ranks number one on our key initiatives each and every year. That's how important positive attitudes and customer service are to our culture. Our commitment to going the extra mile is celebrated quarterly through our WOW! recognition awards and annually at our employee event. Congratulations to all of our staff for their focus on customer service and to those who received special recognitions this year. It truly is "all about people."

PRESIDENT'S CHOICE AWARD



Jeffrey A. Friend was the 2016 recipient of the President's Employee of the Year Award. Robert Schick (disguised as Colonel Mustard for the event) noted Jeff's strong personal conviction to providing our customers and internal staff with outstanding customer service. Jeff, senior vice president, served as district manager for our Ontario and Seneca County offices and assumed the role of senior vice president and marketplace sales manager in 2017.

QUARTERLY WOW! AWARD WINNERS



(From left to right) **Meghan Creighton**, Assistant Branch Manager- Lyons Branch, Quarter 1 WOW! Winner, **Zachary Koczent**, Mortgage Originator Processor, Seneca County Office, Quarter 4 WOW! Winner, **James King**, Vice President, Commercial Loan Officer, Quarter 1 WOW! Winner, **Juliana McGhan**, Call Center Support Specialist, Quarter 2 WOW! Winner, **Jay Smith**, Lockbox Operations Specialist, Quarter 3 WOW! Winner



Victoria Cunningham, Assistant Branch Manager and **James Bilotta**, Branch Manager—Perinton Park Office, Quarter 1 WOW! Winners

Congratulations Team Members

In December, LNB's board of directors approved the promotions of eight exemplary employees. We are pleased to recognize their accomplishments and share their well-deserved recognition.



Susan K. Andersen
Marketplace Sales Manager

Promoted from Vice President to Senior Vice President



Trevor Thomas
Operations Manager

Promoted from Vice President to Senior Vice President



Melonie L. Tiffany
Senior Auditor

Promoted from Banking Officer to Assistant Vice President



Todd F. Juffs
Chief Information Officer

Promoted from Vice President to Senior Vice President



Kimberly A. Kelley
Director of Human Resources

Promoted from Assistant Vice President to Vice President



Shannon M. Romano
Executive Administrative Assistant

Promoted from Banking Officer to Assistant Vice President



Joshua N. Miller
Senior Retail Lender

Promoted from Vice President to Senior Vice President



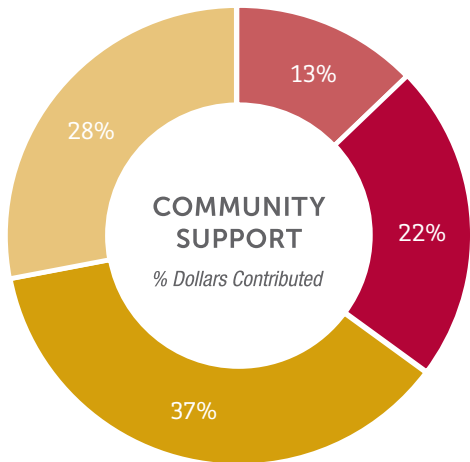
Michael J. Colacino
Facilities/Security Manager

Promoted from Assistant Vice President to Vice President



Community Leadership Is Personal To Us

As a corporate citizen, we believe we have a responsibility to be an active participant in the communities we serve. In 2016, the Bank donated over \$225,000 supporting over 320 important causes, organizations and events within our service footprint. As impressive as these numbers are, our support is enhanced through staff engagement. We encourage our employees to roll up their sleeves and get involved. Wherever you look within the communities we serve, you'll find LNB employees pitching in.



- Civic & Religious
- Community Health
- Youth Enrichment & Education
- Arts, Music & Entertainment



Employees embraced United Way's Day of Caring. LNB members from many offices helped with landscaping and other spring chores at the Humane Society in Wayne County. Shelter staff and it's furry residents were very appreciative.



Small Business Development Officer, **Michael Rusinko** (left), and Canandaigua Branch Manager, **Charles Parkhurst** (right), present Mercy Flight's president and CEO, **Jeffrey Bartkoski**, with a check for \$2,500. Mercy Flight is a non-profit dedicated to providing care for critically ill and injured patients requiring advanced treatment and rapid air transport to specialized medical centers across the northeast.

CONNECTED TO LOCAL COMMUNITIES



QWIKSOLAR POWER SYSTEMS

After relocating to Geneva in 2012, QwikSolar Power Systems discovered LNB—a bank that not only supported them financially but also provided a strong connection to the local community. With the help of LNB, QwikSolar continues to grow, bringing clean power to more homes and businesses throughout our region. See their full story at BankwithLNB.com/QwikSolar.

2016 Financial Highlights



Chad J. Proper

Vice President & Chief Financial Officer,
The Lyons National Bank



**“During 2016,
we continued to
experience solid
loan and deposit
growth, supported
by a strong
capital base.”**

—Chad J. Proper

RESULTS OF OPERATIONS

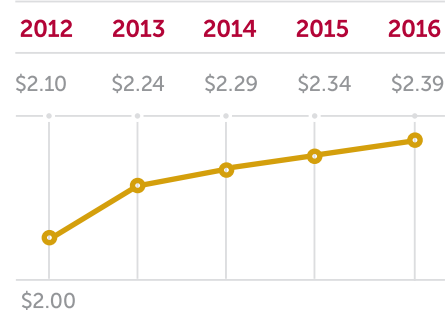
For the 20th consecutive year, Lyons Bancorp, Inc., experienced earnings growth, and it ended 2016 with record earnings of \$7.6 million, an increase of \$230,000 or 3% over 2015. This translates into earnings per diluted share of \$2.39 or a 2% increase year over year. Return on average assets was 0.85% and return on average shareholders' equity was 10.70%.

Our largest revenue source is net interest income, which is the difference between the interest income we earn on our interest-earning assets, primarily loans and investment securities, and the interest paid on our interest-bearing liabilities, primarily deposit accounts and borrowings. Net interest income for 2016 was \$28 million, an increase of \$2.2 million or 8.4% over 2015. This increase was due primarily to strong growth of our earning assets funded by steady deposit growth, as average earning assets increased \$79 million or 10% during 2016, and average interest-bearing deposits increased \$63.7 million or 11% year over year. Completing our story, average noninterest-bearing deposits increased \$19.4 million, providing additional funding for our strong balance sheet growth.

Our tax-equivalent margin decreased year over year, measuring 3.22% during 2016 compared to 3.35% in 2015, as we were able to hold asset yields essentially flat and reduce our overall funding costs.

Our provisions for loan losses are based upon our assessment of a variety of factors, including loan credit quality, the general economic environment, and growth in our loan portfolio. In 2016, we provided \$1.1 million for loan losses compared to \$1.3 million in 2015. At December 31, 2016 our nonperforming loans totaled 0.22% of total loans as compared to 0.68% at December 31, 2015, and compared favorably to our peers' ratio of 0.66%. Our net charge-offs to average loans during 2016

DILUTED EARNINGS PER SHARE



totaled 0.24%, up from the prior year, primarily due to one commercial relationship. The percentage of our commercial and agricultural loan portfolio with an aggregate “pass” rating within our internal risk rating system improved to 96.5%, compared to 94.6% in 2015.

Noninterest income is an important revenue source for us and consists primarily of income from service charges on deposit accounts, loan servicing, cardholder, financial services, gains and losses on the sale or impairment of securities, and gains on the sale of loans driven mostly by strong residential mortgage originations. In 2016, noninterest income represented 25% of all revenue sources and totaled \$9.3 million, an increase of \$980,000 or 12% over 2015 levels, and is reflected across most major categories of noninterest income.

Noninterest expense consists primarily of compensation and employee benefits, occupancy and equipment expenses, advertising, data processing, professional fees, FDIC insurance, and other operating expenses. In 2016, total noninterest expense was \$25.6 million, an increase of \$3.0 million or 13% over 2015. Increases in salaries and wages totaled \$1,176,000 and were primarily the result of annual wage increases and a full year of expenses relating to staffing at our newest branch location in Perinton. Pension and other benefits expense increased \$180,000 or 5.5% in 2016, due primarily to increases in pension-related costs and employer-paid health insurance.

	2016			2015		
	AVERAGE BALANCE (\$)	INTEREST INC/EXP (\$)	AVERAGE YIELD/COST (%)	AVERAGE BALANCE (\$)	INTEREST INC/EXP (\$)	AVERAGE YIELD/COST (%)
Interest-Earning Assets:						
Residential real estate	259,800	9,900	3.81%	228,497	8,748	3.83%
Commercial and agriculture real estate	197,795	9,358	4.73%	186,513	8,662	4.64%
Commercial and agriculture loans	147,090	6,509	4.43%	134,051	5,925	4.42%
Consumer installment loans	27,280	1,529	5.61%	26,207	1,514	5.78%
TOTAL LOANS	631,965	27,297	4.32%	575,268	24,849	4.32%
Investments	212,974	4,808	2.26%	202,850	5,225	2.58%
Federal funds sold & other interest-earning assets	26,738	134	0.50%	14,538	36	0.25%
TOTAL INTEREST-EARNING ASSETS	871,677	32,239	3.70%	792,656	30,110	3.80%
Noninterest-earning assets	51,416			48,518		
TOTAL ASSETS	923,093			841,174		

Interest-Bearing Liabilities:

Interest-bearing checking	105,137	288	0.27%	95,546	229	0.24%
Money market and savings accounts	384,374	1,867	0.49%	334,876	1,246	0.37%
Time deposits	165,008	1,544	0.94%	160,349	1,389	0.87%
Borrowings	7,280	82	1.13%	21,030	134	0.64%
Junior subordinated debentures	6,931	432	6.23%	9,100	534	5.87%
TOTAL INTEREST-BEARING LIABILITIES	668,730	4,213	0.63%	620,901	3,532	0.57%
Noninterest-bearing deposits	182,721			155,917		
Other noninterest-bearing liabilities	7,313			8,009		
TOTAL LIABILITIES	858,764			784,827		
Total equity	64,329			56,347		
TOTAL LIABILITIES AND EQUITY	923,093			841,174		
Net interest spread			3.07%			3.23%
Net interest income/margin on earning assets		28,026	3.22%		26,578	3.35%
Tax equivalent adjustment		(717)			(726)	
Net interest income per financial statements		27,309			25,852	

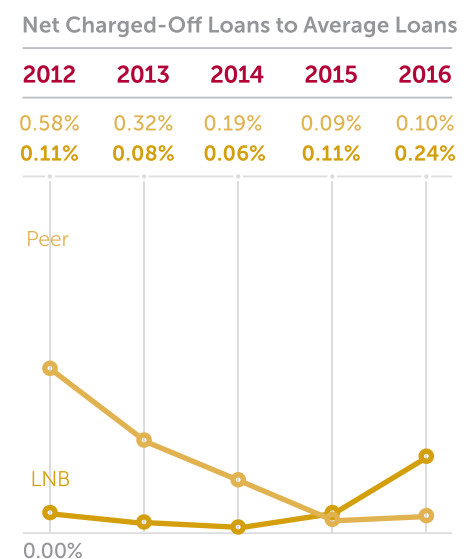
ANALYSIS OF FINANCIAL CONDITION

During 2016, we continued to experience solid loan and deposit growth, supported by a strong capital base. Total assets on December 31, 2016, were \$956.1 million, an increase of \$88.5 million or 10% over December 31, 2015. Total equity at December 31, 2016, was \$68.9 million, an increase of \$10.2 million or 17% over December 31, 2015.

Total loans were \$678.7 million at December 31, 2016, an increase of \$73.5 million or 12% from December 31, 2015. We continued to support our strategy of maintaining balance within the loan portfolio between consumer and commercial/ agricultural loans, ending the year with 46%



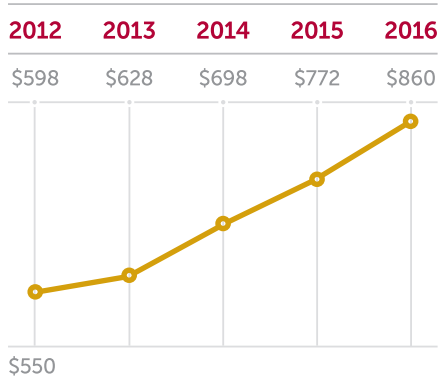
consumer-related loans versus 54% commercial-related loans, essentially unchanged from last year. We are well-positioned to continue prudent lending to the individuals, families, and businesses here in our Upstate New York marketplace and look forward to another year of solid loan growth.



2016 Financial Highlights CONT.

We maintain an investment portfolio to provide us with important liquidity considerations and earnings potential. Our investment portfolio consists primarily of United States Agency debt, mortgage-backed securities either guaranteed by the U.S. government or issued by the Federal Home Loan Bank, and state and local government debt. As of December 31, 2016, our investment portfolio totaled \$205.6 million, an increase of \$10.4 million over December 31, 2015, and had an average tax-equivalent yield of 2.92% during 2016. The majority of our portfolio is classified as available for sale and may be used for liquidity purposes as needed.

TOTAL DEPOSITS (Millions)



Deposits generated within our local markets are the major source of funds for our lending and investment activities. Total deposits at December 31, 2016, were \$860.0 million, an increase of \$88.0 million or 11% over December 31, 2015. We continued to experience strong growth in our core retail and commercial deposit base, with most of our branches increasing their presence in the communities they serve.

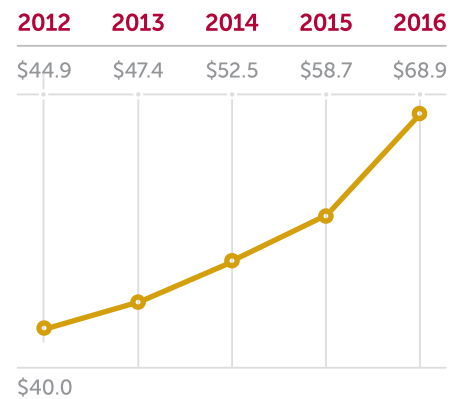
Total equity was \$68.9 million at December 31, 2016. Our board of directors is committed to providing a solid return to our shareholders and declared a total of \$0.95 per share in dividends during 2016. This represents a yield of 3.03% based on our yearend market price of \$31.36 per share.

On November 15, 2016, the company offered a private placement of 5,000 shares, par value of \$0.50 per share, Series A Non-Cumulative Convertible Preferred Stock at \$1,000 per share to accredited investors. The preferred stock is convertible, into shares of common stock, par value \$0.50 per share, at the option of the holder. Dividends will be paid quarterly, if declared by the board of directors, at a rate per annum equal to 5%. As of December 31, 2016, all 5,000 shares,

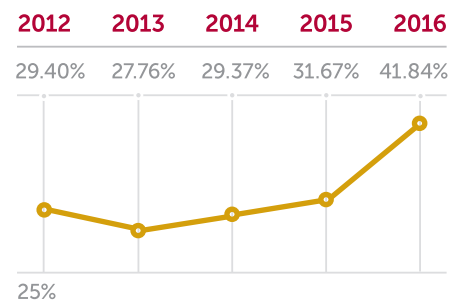
par value \$0.50 per share, of the authorized preferred stock have been issued.

Please refer to our Consolidated Financial Report as of December 31, 2016, for more information regarding our 2016 results.

TOTAL EQUITY (Millions)



Dividends Declared to Net Income



Board of Directors



FROM LEFT TO RIGHT: **Robert A. Schick**, Chairman of the Board, CEO of LNB and Lyons Bancorp., **Joseph A. Fragnoli**, Owner, Super Casuals, **Carol A. Snook**, Banking Officer & Corporate/Executive Secretary, **Case A. Marshall**, CFO & Vice President, Marshall Companies, **Clair J. Britt, Jr.**, EVP & Chief Commercial Loan Officer, LNB, **James A. Homburger**, Real Estate Broker/Investor, **Dale H. Hemminger**, President & General Manager, Hemdale Farms & Greenhouses, **James E. Santelli**, Retired Vice President & Co-owner, Santelli Lumber Co., **Brad A. Person**, President & General Manager, Nuttall Golf Cars Inc. and Nuttall Golf Car Leasing, LLC., **Kaye E. Stone-Ganz**, President & CEO, Stone Goose Enterprises, Inc., **Andrew F. Fredericksen** CPA, Consultant, Petrella Phillips, LLC, **David J. Breen, Jr.**, Owner, Herrema's Market Place, **Thomas L. Kime**, President, LNB.

Selected Financial Data

Year Ended December 31

(In thousands, except per share data ⁽¹⁾)

Financial Statement Highlights (\$)

	2016	2015	2014	2013	2012
Assets	956,132	867,633	806,844	732,830	665,472
Loans, gross	678,691	605,201	544,464	500,884	445,906
Deposits	860,073	772,111	698,202	627,919	598,305
Other borrowings	18,000	20,126	38,791	42,000	5,000
Junior subordinated debentures	6,190	8,867	9,217	9,217	9,217
Total equity	68,853	58,678	52,506	47,410	44,884
Interest and dividend income	32,239	29,384	27,062	24,963	23,147
Interest expense	4,213	3,532	3,795	2,952	3,556
Net interest income	28,026	25,852	23,267	22,011	19,591
Provision for loan losses	1,100	1,275	750	525	450
Net securities gains	470	167	139	429	215
Net income	7,596	7,366	7,204	7,029	6,170

Per Share Information (\$)

Basic earnings per share	2.42	2.47	2.42	2.36	2.22
Cash dividends declared	0.95	0.78	0.71	0.66	0.63
Book value per share	21.59	19.51	17.62	15.89	15.08

Selected Ratios

Return on average assets	0.85%	0.88%	0.94%	1.01%	0.99%
Return on average shareholders' equity	10.70%	13.09%	13.96%	15.22%	14.93%
Leverage ratio (Bank)	8.49%	8.14%	8.21%	8.38%	8.26%
Dividend payout ratio	41.84%	31.21%	28.97%	20.12%	34.98%

Other Selected Data (In Whole Numbers)

Employees (full-time equivalent)	197	185	175	163	155
Banking offices	13	13	12	12	11

(1) Per share data reflects a 2-for-1 stock split in the form of a stock dividend, effective October 30, 2015



READYING BANK FOR NEXT PHASE OF GROWTH

Expecting to reach the milestone of \$1 billion in assets in 2017 and to ready itself for its next phase of growth, the Board of Directors of Lyons Bancorp, Inc., the parent company of The Lyons National Bank announced the transition of Robert A. Schick to Chairperson of the Board of Directors effective January 1, 2017. In his new role, Schick will lead the Board in developing the proper framework to ensure the Bank meets its obligations to shareholders and depositors alike.

Thomas L. Kime was named President of The Lyons National Bank. Kime has 40 years in banking, 12 with LNB as Executive Vice President and Chief Operating Officer. In his new role, the LNB management team will report directly to Kime and he will be responsible for overseeing all sales and operations functions of the Bank. "Tom is a knowledgeable and experienced banker, having previously served as a bank president," said Schick. "I assure you, under his guidance, the Bank will not miss a beat in its march to ever-higher profitability and performance. Equally important, Tom shares my passion for protecting and enhancing our sterling reputation as an involved, customer and employee-centric, independent community bank."





New Faces & Changing Roles



Susan K. Andersen
Senior Vice President
& Marketplace Sales
Manager



Steven V. DeRaddo
Executive Vice
President & Chief
Development Officer



Jeffrey A. Friend
Senior Vice President
& Marketplace Sales
Manager



Todd F. Juffs
Senior Vice President
& Chief Information
Officer



Joshua N. Miller
Senior Vice President
& Senior Retail Lender



Kelly J. Mittiga
Executive Vice
President & Director
of Performance
Improvement



Chad J. Proper
Vice President &
Chief Financial
Officer

LNB is pleased to announce three new members of its Executive Management team. Kelly J. Mittiga joined LNB in January 2017 as executive vice president, director of performance improvement. In this newly created role, Mittiga will oversee operations and electronic data management departments, and help to implement initiatives that focus on the Bank's dedication to customer service.

Todd F. Juffs, senior vice president, chief information officer, has been with LNB since 1997. For the last 10 years, as head of the Information Technology Department, Juffs has played an instrumental role in implementing a new core operating system introducing convenience banking applications including, online banking, mobile banking, and corporate cash management technologies all while ensuring the highest level of network security. As a member of the Executive Management Team, he will lead the Bank's future technology strategies and management information systems.

Chad J. Proper rejoined LNB in December 2016 as vice president and chief financial officer. A graduate of SUNY Plattsburg with a bachelor's degree in Accounting, Proper went on to receive his master's degree in Taxation from the University of Albany and Nazareth College's post-baccalaureate certification program in

Business and Distributive Education. Previously at LNB, Proper was a financial analyst responsible for helping to develop the Bank's budgets and ALCO assessment. In his new role, he will be responsible for the Bank's Accounting Department functions as well as Holding Company and Bank reporting.

Stephen V. DeRaddo has been named chief development officer. A member of LNB's Executive Management team for nine years, DeRaddo brings over 30 years of banking experience to his new role. DeRaddo will oversee branch sales and financial and insurance services in addition to his previous oversight of the retail lending department.

Working with DeRaddo, Susan K. Andersen, former branch manager in Penn Yan, and Jeffrey A. Friend, former district executive overseeing Canandaigua, Geneva and Seneca County offices, have assumed marketplace sales manager titles. They will work in tandem to oversee all branch operations, including business development and sales. Joshua N. Miller has been named senior retail lender heading up LNB's retail and residential mortgage lending efforts. With nearly 40 combined years at LNB, they bring experience and management expertise to help the Bank perform at its best in the coming years.



Michael D. Linehan III

Heavy Hearts ...

On Wednesday, February 15, 2017, LNB lost a dear friend. Michael D. Linehan III, of Penn Yan, passed away unexpectedly. A member of our Penn Yan Advisory Board since its inception in 2005, Mike was an invaluable member of our team and a tireless advocate for the community he loved so much.

We will miss his energy and enthusiasm.

Advisory Boards

GENEVA



Stephen J. Blowers
Blowers Agri Service, Inc.



Peter J. D'Amico, Jr.
D'Amico Chrysler Dodge Jeep



Jason S. Feinberg, MD
Finger Lakes Health



Robert S. Flowers
Hobart and William Smith Colleges



Bernard G. Lynch
Lynch Furniture



Anne D. Nenneau
CCN International



Robert J. Tewksbury
Pearl Technologies, Inc.

PENN YAN



Bonnie B. Curbeau
Curbeau Realty



Jeffrey M. Kennedy
Morgan Marine



James H. Long
Long's Cards and Books



Paul W. Marble, Jr.
Marble's Automotive and Glass



Steven D. Perry
Knapp & Schlappi Lumber Co., Inc.



Neil J. Simmons
Simmons Vineyards

Not Pictured:
Henry H. Martin
Town of Benton Dairy Farmer

SENECA COUNTY



Salvatore N. Franzone
Ciccino's Pizzeria and Restaurant



Rodney D. Littlejohn, DDS, MS
Littlejohn Orthodontics



Kenneth W. Padgett, DO
Past President & Current Chancellor of NYCC



Eugene F. Pierce
Glenora Wine Cellars, Inc. and Knapp Winery



Robert L. Sessler
Retired, Sessler Companies



Raymond A. Tuuri, Jr.
Finger Lakes Equipment Rental



Stephen J. Wadhams
Wadhams Enterprises, Inc.

CANANDAIGUA



J. David Damaske
Parkview Fairways Golf Course



April E. Dawson
Constellation Brands



Gail D. Herman
The Medicine Shoppe Canandaigua



Eugene W. Hermetet
Retired, Curtice Burns Foods



Jack W. Moran
Roseland Bowl Family Fun Center



Charles W. Potter
Potter HVAC and Metal Fab, Inc.

PERINTON PARK



John A. Colaruotolo
ANCO Builders, LLC



Samual A. DiPrima
DiPrima Properties, LLC



Arthur S. Elting
Country Rode Motowerks



Donald R. Fox, Esq.
Partner, Evans & Fox, LLP



Howard I. Sharp
RV & E Bike and Skate



J. Lincoln Swedrock, P.E.
BME Associates

Executive Management



Robert A. Schick
*Chairman of the Board &
Chief Executive Officer*



Thomas L. Kime
President



Stephen V. DeRaddo
*Executive Vice President &
Chief Development Officer*



Clair J. Britt, Jr.
*Executive Vice President &
Chief Commercial Loan Officer*



Phillip M. McCann
*Executive Vice President &
Chief Risk Officer*



Kelly J. Mittiga
*Executive Vice President &
Director of Performance Improvement*



Todd F. Juffs
*Senior Vice President &
Chief Information Officer*



Chad J. Proper
*Vice President &
Chief Financial Officer*

Bank Officers and Supervisors

ADMINISTRATION

Carol A. Snook
Banking Officer & Corporate/Executive Secretary

Shannon M. Romano
Assistant Vice President & Executive Administrative Assistant

BRANCH DIVISION

Susan K. Andersen
Senior Vice President & Marketplace Sales Manager

Jeffrey A. Friend
Senior Vice President & Marketplace Sales Manager

Thomas D. Muller
Senior Vice President

Theodore J. Chamberlain
Vice President & Branch Manager—Macedon

Demetrius Murphy
Vice President & Branch Manager—Auburn

James S. Bilotta
Assistant Vice President & Branch Manager—Perinton Park

AUDIT & COMPLIANCE

Ruth M. Columbus
Vice President & Director of Internal Audit

Melonie L. Tiffany
Assistant Vice President & Senior Auditor

Jarrod M. Crawford
Assistant Vice President & Cash Management/E-Business Solutions Officer

Julieann B. Downey
Assistant Vice President & Branch Manager—Lyons

William L. Dungey
Assistant Vice President & Branch Manager—Clyde and Jordan

Steven J. Hasseler
Assistant Vice President & Branch Manager—Newark

Emily E. Hilimire
Assistant Vice President & Branch Manager—Seneca County

Charles K. Parkhurst
Assistant Vice President & Branch Manager—Canandaigua



INVESTED IN LOCAL ECONOMIES



MORGAN MARINE

When Jeff Kennedy of Morgan Marine in Penn Yan was looking to invest in ownership of the marina, he turned to LNB. When he was looking into expanding his operation, LNB's experienced staff and local decision-making helped make the financing the simplest part of the project. *See their full story at BankwithLNB.com/MorganMarine.*

Bank Officers and Supervisors CONT.

Tara R. Rago

Assistant Vice President & Branch Manager—Geneva

Jean E. Tsepas

Assistant Vice President & Branch Manager—Ontario

Sherri A. Viele

Assistant Vice President & Branch Manager—Wolcott

Kate E. Decker

Banking Officer & Customer Service Representative—Geneva

Cathy J. DeMay

Banking Officer & Assistant Branch Manager—Ontario

Heidi E. King

Banking Officer & Assistant Branch Manager—Canandaigua

Susan L. Snyder

Banking Officer & Assistant Branch Manager—Penn Yan

COMMERCIAL LENDING

Anna M. Bridger

Vice President & Commercial Loan Officer

Stephen V. D’Orazio

Vice President & Commercial Loan Officer

Mark J. DeBacco

Vice President & Commercial Loan Officer

Ryan M. Hallings

Vice President & Agricultural/Commercial Loan Officer

James H. King

Vice President & Commercial Loan Officer

Scott A. MacKenzie

Vice President & Agricultural/Commercial Loan Officer

Gregory G. Lattimore

Assistant Vice President & Commercial Loan Officer

Kraig M. vonHahmann

Assistant Vice President & Agricultural/Commercial Loan Officer

CREDIT ADMINISTRATION & COMPLIANCE

Pamela J. Lee

Vice President & Portfolio Monitoring Officer

Joyce A. Marble

Assistant Vice President & Compliance/BSA Officer

Amanda M. McDonald

Assistant Vice President & Senior Credit Underwriter

FINANCE

Shannon M. Davis

Assistant Vice President & Corporate Controller

IT

Karen D. Lombardozzi

Banking Officer & Systems Administrator

MARKETING

Barbara H. Taney

Banking Officer & Director of Marketing

HUMAN RESOURCES

Kimberly A. Kelley

Vice President & Director of Human Resources

SECURITY/FACILITIES

Michael J. Colacino

Vice President & Security/Facilities Manager

TRAINING

Deborah A. Odell

Vice President & Director of Training

RETAIL & RESIDENTIAL MORTGAGE LENDING

Joshua N. Miller

Senior Vice President & Senior Retail Lender

Robert T. MacDonnell

Vice President & Consumer Loan Officer/Underwriter

Joseph M. Arbogast

Assistant Vice President & Mortgage Specialist

Timothy H. Lead

Assistant Vice President & Mortgage Underwriter

Michael E. Rusinko

Assistant Vice President & Small Business Development Officer

James M. Allison

Banking Officer & Mortgage Specialist

Valorie A. Heinzman

Banking Officer & Mortgage Specialist

Angela M. Merola

Banking Officer & Senior Collector

Craig R. Mietz

Banking Officer & Mortgage Specialist

Craig A. Schojan

Banking Officer & Mortgage Underwriter

OPERATIONS

Trevor Thomas

Senior Vice President & Operations Manager

Hope A. Alexanian

Assistant Vice President & Retail Loan Operations Supervisor

Cheryl M. Graham

Assistant Vice President & Deposit Operations Supervisor

Lynnette M. Zelias

Assistant Vice President & Commercial Loan Operations Supervisor

FINANCIAL SERVICES

David J. DeRaddo, CFP®

Banking Officer & Financial Services Representative

Robert T. Koczent

Vice President & Director of Financial Services





Lyons Bancorp, Inc.
It's all about people.

**FINANCIAL
REPORT**
December 31, 2016

HOMETOWN VALUES

Helping Communities Thrive.

ANNUAL MEETING

The annual meeting of the stockholders will take place at 4:30 p.m. on May 17, 2017, at the historic Ohmann Theatre in Lyons, New York.



Lyons Bancorp, Inc.
It's all about people.

PROFILE

Lyons Bancorp, Inc. is a bank holding company headquartered in Lyons, New York, with assets of \$956 million at December 31, 2016. Lyons Bancorp, Inc. has one banking subsidiary, The Lyons National Bank.

The Lyons National Bank is a community bank with offices in Clyde, Lyons, Macedon, Newark, Ontario, and Wolcott in Wayne County, Jordan in Onondaga County, Canandaigua and Geneva in Ontario County, Penn Yan in Yates County, Waterloo in Seneca County, and Fairport in Monroe County. The Lyons National Bank has one subsidiary, Lyons Realty Associates Corp.

STOCK SYMBOL

LYBC

BOARD OF DIRECTORS

Robert A. Schick

Chairman of the Board & CEO

Lyons Bancorp, Inc. & The Lyons National Bank

Thomas L. Kime

President

The Lyons National Bank

Case A. Marshall

Vice President & Chief Operating Officer

Marshall Companies

David J. Breen, Jr.

Owner

Herrema's Market Place

Andrew F. Fredericksen, CPA

Consultant

Petrella Phillips, LLC

Brad A. Person

President & General Manager

Nuttall Golf Cars Inc. and Nuttall Golf Car Leasing, LLC

Clair J. Britt, Jr.

Executive Vice President &
Chief Commercial Loan Officer

The Lyons National Bank

Dale H. Hemminger

President & General Manager

Hemdale Farms & Greenhouses

James E. Santelli

Retired Vice President & Co-owner

Santelli Lumber Co.

Joseph A. Fragnoli

Owner

Super Casuals

James A. Homburger

Real Estate Broker/Investor

Kaye E. Stone-Gansz

President & Chief Executive Officer

Stone Goose Enterprises, Inc.

CANANDAIGUA ADVISORY BOARD

J. David Damaske
April E. Dawson
Gail D. Herman
Eugene W. Hermetet
Jack W. Moran
Charles W. Potter

GENEVA ADVISORY BOARD

Stephen J. Blowers
Peter J. D'Amico, Jr.
Jason S. Feinberg, MD
Robert S. Flowers
Bernard G. Lynch
Anne D. Nenneau
Robert J. Tewksbury

PENN YAN ADVISORY BOARD

Bonnie B. Curbeau
Jeffrey M. Kennedy
James H. Long
Paul W. Marble, Jr.
Henry H. Martin
Steven D. Perry
Neil J. Simmons

PERINTON PARK ADVISORY BOARD

John A. Colaruotolo
Samuel A. DiPrima
Arthur S. Elting
Donald R. Fox, Esq.
Howard I. Sharp
J. Lincoln Swedrock P.E.

SENECA COUNTY ADVISORY BOARD

Salvatore N. Franzone
Rodney D. Littlejohn, DDS, MS
Kenneth W. Padgett, DO
Eugene F. Pierce
Robert L. Sessler
Raymond A. Tuuri, Jr.
Stephen J. Wadhams

AUBURN ADVISORY BOARD

Joseph P. Bartolotta, Esq.
John F. Bouck
Salvatore N. Franzone

MAIN OFFICE

35 William Street
Lyons, NY 14489
(315) 946-4871
BankwithLNB.com

Lyons Bancorp, Inc.

Consolidated Financial Report

December 31, 2016

Bonadio & Co., LLP
Certified Public Accountants

Table of Contents December 31, 2016 and 2015

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REPORT OF INDEPENDENT AUDITORS' REPORT

February 28, 2017

To the Board of Directors and
Stockholders of Lyons Bancorp Inc.:

We have audited the accompanying consolidated balance sheets of Lyons Bancorp Inc. and subsidiary as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2016. These consolidated financial statements are the responsibility of Lyons Bancorp Inc. and subsidiary's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States) and 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 of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Lyons Bancorp Inc. and subsidiary as of December 31, 2016 and 2015, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2016, in conformity with accounting principles generally accepted in the United States of America.

Bonadio & Co., LLP
Syracuse, New York
February 28, 2017

432 North Franklin Street, Suite 60
Syracuse, New York 13204
p (315) 476-4004
f (315) 475-1513

www.bonadio.com

Lyons Bancorp, Inc.

Consolidated Balance Sheets December 31, 2016 and 2015

	2016	2015
Assets	(In thousands)	
Cash and due from banks	\$ 14,458	\$ 15,416
Interest-bearing deposits in banks	17,952	14,365
Cash and Cash Equivalents	32,410	29,781
Investment securities:		
Available for sale	142,983	138,387
Held to maturity	56,826	51,222
Restricted equity securities	5,792	5,576
Total Investment Securities	205,601	195,185
Loans	678,691	605,201
Less allowance for loan losses	(7,796)	(8,188)
Net Loans	670,895	597,013
Land, premises and equipment, net	20,097	20,880
Bank owned life insurance	15,610	14,895
Accrued interest receivable and other assets	11,519	9,879
Total Assets	\$ 956,132	\$ 867,633
Liabilities and Equity		
Liabilities		
Deposits:		
Interest-bearing	\$ 663,519	\$ 599,194
Non-interest-bearing	196,554	172,917
Total Deposits	860,073	772,111
Borrowings from Federal Home Loan Bank	18,000	20,126
Junior subordinated debentures	6,190	8,867
Accrued interest payable and other liabilities	3,016	7,851
Total Liabilities	887,279	808,955
Equity		
Lyons Bancorp, Inc. stockholders' equity:		
Preferred stock	3	-
Common stock	1,599	1,507
Paid-in capital	19,294	11,840
Retained earnings	52,449	48,032
Accumulated other comprehensive loss	(4,271)	(2,540)
Treasury stock, at cost	(277)	(217)
Total Lyons Bancorp, Inc. Stockholders' Equity	68,797	58,622
Noncontrolling interest	56	56
Total Equity	68,853	58,678
Total Liabilities and Equity	\$ 956,132	\$ 867,633

See notes to consolidated financial statements.

Lyons Bancorp, Inc.

Consolidated Statements of Income Years Ended December 31, 2016 and 2015

	2016	2015
	(In thousands, except per share data)	
Interest Income		
Loans	\$ 27,297	\$ 24,849
Investment securities:		
Taxable	3,486	3,062
Non-taxable	1,456	1,473
Total Interest Income	<u>32,239</u>	<u>29,384</u>
Interest Expense		
Deposits	3,699	2,864
Borrowings	514	668
Total Interest Expense	<u>4,213</u>	<u>3,532</u>
Net Interest Income	28,026	25,852
Provision for Loan Losses	<u>1,100</u>	<u>1,275</u>
Net Interest Income after Provision for Loan Losses	<u>26,926</u>	<u>24,577</u>
Noninterest Income		
Service charges on deposit accounts	2,888	2,800
Cardholder fees	1,973	1,751
Financial services fees	855	878
Loan servicing fees	955	865
Net realized gains from sales/calls of available for sale securities	470	167
Realized gains on loans sold	1,275	1,070
Earnings on investment in bank owned life insurance	416	388
Other	420	353
Total Noninterest Income	<u>9,252</u>	<u>8,272</u>
Noninterest Expense		
Salaries and wages	10,719	9,543
Pensions and benefits	3,481	3,301
Occupancy	2,828	2,336
Data processing	1,615	1,407
Professional fees	1,562	1,296
FDIC and OCC assessments	740	701
Advertising	952	693
Cardholder expense	845	670
Office supplies	277	434
Other	2,617	2,211
Total Noninterest Expense	<u>25,636</u>	<u>22,592</u>
Income before Income Taxes	10,542	10,257
Income Tax Expense	<u>2,941</u>	<u>2,886</u>
Net income attributable to noncontrolling interest and Lyons Bancorp, Inc.	7,601	7,371
Less: Net income attributable to noncontrolling interest	<u>5</u>	<u>5</u>
Net Income	<u>\$ 7,596</u>	<u>\$ 7,366</u>
Earnings Per Share – basic ⁽¹⁾	<u>\$ 2.42</u>	<u>\$ 2.47</u>
Earnings Per Share – diluted ⁽¹⁾	<u>\$ 2.39</u>	<u>\$ 2.34</u>

(1) Per share amounts have been adjusted to reflect a 2-for-1 stock split in the form of a stock dividend, effective October 30, 2015.

See notes to consolidated financial statements.

Lyons Bancorp, Inc.

Consolidated Statements of Comprehensive Income Years Ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Net income	\$ 7,596	\$ 7,366
Other comprehensive (loss) income :		
Securities available for sale:		
Net unrealized (losses) gains during the year	(3,042)	868
Reclassification adjustment for gains included in income	(470)	(167)
Securities held to maturity:		
Reclassification adjustment for amortization of unrealized losses included in income	262	84
Changes in unrealized gains during the year of restricted equity securities	51	22
Pension and postretirement benefits:		
Amortization of prior service credit	(3)	(3)
Amortization of net loss	199	224
Net actuarial (loss) gain	(28)	177
Cash flow hedge:		
Losses on the effective portion of cash flow hedge	(26)	(121)
Reclassification adjustment for losses included in income	177	196
	<u>(2,880)</u>	<u>1,280</u>
Tax benefit (expense)	<u>1,153</u>	<u>(512)</u>
Other comprehensive (loss) income	<u>(1,727)</u>	<u>768</u>
Comprehensive income	<u>\$ 5,869</u>	<u>\$ 8,134</u>

See notes to consolidated financial statements.

Lyons Bancorp, Inc.

Consolidated Statements of Stockholders' Equity Years Ended December 31, 2016 and 2015

(In thousands, except per share data)

	Preferred Stock	Common Stock	Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Treasury Stock	Noncontrolling Interest	Total
Balance - January 1, 2015	-	747	12,226	42,999	(3,308)	(214)	56	<u>\$ 52,506</u>
Net income attributable to noncontrolling interests and Lyons Bancorp, Inc.	-	-	-	7,366	-	-	5	7,371
Total other comprehensive income, net	-	-	-	-	768	-	-	768
Stock split in the form of a stock dividend	-	747	(747)	-	-	-	-	-
Conversion of trust preferred securities	-	13	337	-	-	-	-	350
Purchase of treasury stock	-	-	-	-	-	(155)	-	(155)
Deferred compensation shares awarded, net	-	-	24	-	-	152	-	176
Dividends to noncontrolling interests	-	-	-	-	-	-	(5)	(5)
Cash dividends declared, \$0.78 ⁽¹⁾ per share	-	-	-	(2,333)	-	-	-	(2,333)
Balance - December 31, 2015	-	1,507	11,840	48,032	(2,540)	(217)	56	<u>\$ 58,678</u>
Net income attributable to noncontrolling interests and Lyons Bancorp, Inc.	-	-	-	7,596	-	-	5	7,601
Total other comprehensive income, net	-	-	-	-	(1,731)	-	-	(1,731)
Conversion of trust preferred securities	-	92	2,489	-	-	-	-	2,581
Issuance of preferred stock	3	-	4,928	-	-	-	-	4,931
Purchase of treasury stock	-	-	-	-	-	(243)	-	(243)
Deferred compensation shares awarded, net	-	-	37	-	-	183	-	220
Dividends to noncontrolling interests	-	-	-	-	-	-	(5)	(5)
Cash dividends declared, \$1.01 per share	-	-	-	(3,179)	-	-	-	(3,179)
Balance - December 31, 2016	<u>\$ 3</u>	<u>\$ 1,599</u>	<u>\$ 19,294</u>	<u>\$ 52,449</u>	<u>\$ (4,271)</u>	<u>\$ (277)</u>	<u>\$ 56</u>	<u>\$ 68,853</u>

(1) Per share amounts have been adjusted to reflect a 2-for-1 stock split in the form of a stock dividend, effective October 30, 2015.

See notes to consolidated financial statements.

Lyons Bancorp, Inc.

Consolidated Statements of Cash Flows

Years Ended December 31, 2016 and 2015

	2016	2015
	(In thousands)	
Cash Flows from Operating Activities		
Net income	\$ 7,596	\$ 7,366
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,100	1,275
Earnings on investment in bank owned life insurance	(415)	(388)
Net realized gain from sales/calls of available for sale securities	(470)	(167)
Realized gains on loans sold	(1,275)	(1,070)
Gain on sale of real estate owned and other repossessed assets	(11)	-
Deferred compensation expense	291	234
Net amortization on securities	511	186
Depreciation and amortization	1,146	978
Deferred income tax benefit	(7)	(125)
Contribution to defined benefit pension plan	(1,000)	(1,000)
Increase in accrued interest receivable and other assets	(84)	(855)
Increase in accrued interest payable and other liabilities	(4,276)	1,295
Loans originated for sale	(61,663)	(47,210)
Proceeds from sales of loans	62,558	51,855
Net Cash Provided by Operating Activities	4,001	12,374
Cash Flows from Investing Activities		
Purchases of securities available for sale	(98,694)	(50,288)
Proceeds from sales of securities available for sale	54,215	20,559
Proceeds from maturities and calls of securities available for sale	36,207	32,945
Purchases of held to maturity securities	(20,580)	(6,955)
Proceeds from maturities of securities held to maturity	15,099	13,247
Net increase in restricted equity securities	(164)	589
Proceeds from sales of commercial loans	1,266	2,691
Net increase in portfolio loans	(75,736)	(67,764)
Proceeds from sale of real estate owned, net and other repossessed assets	137	-
Purchase of bank owned life insurance	(300)	(823)
Premises and equipment purchases, net	(363)	(5,417)
Net Cash Used in Investing Activities	(88,913)	(61,216)
Cash Flows from Financing Activities		
Net increase in demand and savings deposits	92,491	75,959
Net decrease in time deposits	(4,529)	(2,050)
Net (decrease) increase in overnight borrowings from Federal Home Loan Bank	6,000	(22,600)
Proceeds from term borrowings from Federal Home Loan Bank	-	5,000
Repayment of term borrowings from Federal Home Loan Bank	(8,126)	(1,065)
Net proceeds from sale of stock	4,931	-
Purchase of treasury stock	(243)	(155)
Dividends paid	(2,983)	(2,299)
Net Cash Provided by Financing Activities	87,541	52,790
	2,629	3,948
Cash and Cash Equivalents – Beginning	29,781	25,833
Cash and Cash Equivalents – Ending	\$ 32,410	\$ 29,781
Supplementary Cash Flow Information		
Interest paid	\$ 4,226	\$ 3,534
Income taxes paid, net of refund received	\$ 3,104	\$ 3,306
Non-cash Disclosure		
Transfer of loans to foreclosed real estate and other repossessed assets	\$ 271	\$ 126
Conversion of Trust III debentures to common stock	\$ 2,582	\$ 350

See notes to consolidated financial statements.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1 - Summary of Significant Accounting Policies

Nature of Operations

Lyons Bancorp, Inc. (the Company) provides a full range of commercial and retail banking services to individual and small business customers through its wholly-owned subsidiary, The Lyons National Bank (the Bank). The Bank's operations are conducted in thirteen branches located in Wayne, Onondaga, Yates, Ontario, Monroe and Seneca Counties, New York. The Company and the Bank are subject to the regulations of certain federal agencies and undergo periodic examinations by those regulatory authorities.

The Company owns all of the voting common shares of Lyons Capital Statutory Trust I (Trust I), Lyons Capital Statutory Trust II (Trust II), Lyons Statutory Trust III (Trust III) and Lyons Statutory Trust IV (Trust IV). Trust I was formed in 2003, Trust II was formed in 2004, Trust III was formed in 2009. The Trusts were each formed for the purpose of securitizing trust preferred securities, the proceeds of which were advanced to the Company and contributed to the Bank as additional capital.

The Bank owns all of the voting stock of Lyons Realty Associates Corp. (LRAC). LRAC is a real estate investment trust which holds a portfolio of real estate mortgages. In order to maintain its status as a real estate investment trust, LRAC holds the real estate mortgages until they are paid. The real estate mortgages held by LRAC are included in loans on the consolidated balance sheet.

Basis of Presentation

The consolidated financial information included herein combines the results of operations, the assets, liabilities, and shareholders' equity (including comprehensive income or loss) of the Company and all entities in which the Company has a controlling financial interest. All significant intercompany balances and transactions are eliminated in consolidation.

Variable interest entities (VIEs) are required to be consolidated if it is determined the company is the primary beneficiary of a VIE. The primary beneficiary of a VIE is the enterprise that has both the power and ability to direct the activities of the VIE that most significantly impact the VIE's economic performance and an obligation to absorb losses or the right to receive benefits that could potentially be significant to the VIE. The Company's wholly owned subsidiaries, Trust I, Trust II, and Trust III are VIE's for which the Company is not the primary beneficiary. Accordingly, the accounts of these entities are not included in the Company's consolidated financial statements, as discussed in Note 8.

Reclassification

Amounts in the prior years' consolidated financial statements are reclassified when necessary to conform to the current year's presentation.

Note 1 - Summary of Significant Accounting Policies (Continued)

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America (GAAP) requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near future relate to the determination of the allowance and provision for loan losses, actuarial assumptions associated with the Company's benefit plans and deferred tax assets and liabilities.

Recently Issued Accounting Pronouncements

There are no recently issued accounting pronouncements that materially affect the Company's consolidated financial statements this year.

Investment Securities

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them until maturity. Securities to be held for indefinite periods of time are classified as available for sale and carried at fair value, with the unrealized holding gains and losses reported as a component of other comprehensive income, net of tax. Securities held for resale for liquidity purposes are classified as trading and are carried at fair value, with changes in unrealized holding gains and losses included in income. Management determines the appropriate classification of securities at the time of purchase. Restricted equity securities consist primarily of Federal Reserve Bank and the Federal Home Loan Bank stock.

Purchase premiums and discounts are recognized in interest income using the interest method or methods that approximate the interest method over the terms of the securities. Interest and dividends on securities are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are determined using the specific identification method.

On a quarterly basis, the Company performs an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment. A security is considered impaired if the fair value is less than its amortized cost basis at the reporting date. If impaired, the Company then assesses whether the unrealized loss is other-than-temporary. The assessment considers (i) whether the Company intends to

Note 1 - Summary of Significant Accounting Policies (Continued)

Investment Securities - continued

sell the security prior to recovery and/or maturity, (ii) whether it is more likely than not that the Company will have to sell the security prior to recovery and/or maturity and (iii) if the present value of the expected cash flows is not sufficient to recover the entire amortized cost basis. If a debt security is deemed to be other-than-temporarily impaired, the credit loss component of an other-than-temporary impairment write-down is recorded in earnings while the remaining portion of the impairment loss is recognized, net of tax, in other comprehensive income provided that the Company does not intend to sell the underlying security and it is more-likely-than not that the Company would not have to sell the security prior to recovery.

The Company considers the following factors in determining whether a credit loss exists and the period over which the security is expected to recover:

- The length of time and the extent to which the fair value has been less than the amortized cost basis;
- The level of credit enhancement provided by the structure which includes, but is not limited to, credit subordination positions, excess spreads, overcollateralization, protective triggers;
- Changes in the near term prospects of the issuer or underlying collateral of a security, such as changes in default rates, loss severities given default and significant changes in prepayment assumptions;
- The level of excess cash flow generated from the underlying collateral supporting the principal and interest payments of the debt securities; and
- Any adverse change to the credit conditions of the issuer of the security such as credit downgrades by the rating agencies.

Loans

The Bank grants real estate, commercial and consumer loans to its customers. A substantial portion of the loan portfolio is represented by real estate loans in Wayne, Ontario, Yates, Onondaga, and Seneca Counties. The Company's loan portfolio includes residential real estate, commercial real estate, agricultural real estate, commercial and agricultural loans, and consumer installment classes. Residential real estate loans include classes for 1-4 family and home equity loans. Consumer installment loans include classes for direct and indirect loans.

Loans 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 Bank 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.

Note 1 - Summary of Significant Accounting Policies (Continued)

Loans - continued

Interest income is accrued on the unpaid principal balance. The accrual of interest on loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income or the allowance for loan losses if the interest income was earned in a prior period. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Management, considering current information and events regarding the borrowers' ability to repay their obligations, considers a loan to be impaired when it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. When a loan is considered to be impaired, the amount of the impairment is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate, or at the loan's observable fair value or the fair value of underlying collateral if the loan is collateral-dependent. Impairment losses are included in the allowance for loan losses through a charge to the provision for loan losses. Cash receipts on impaired loans are generally applied to reduce the principal balance outstanding. In considering loans for evaluation of impairment, management generally excludes smaller balance, homogeneous loans: residential mortgage loans, home equity loans, and all consumer loans, unless subject to a troubled debt restructuring. These loans are collectively evaluated for risk of loss.

Loans Held for Sale

Generally, loans held for sale consist of residential mortgage loans that are originated and are intended to be sold through agreements the Bank has with the Federal Home Loan Bank (FHLB) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Realized gains and losses on sales are computed using the specific identification method. These loans are carried on the consolidated balance sheet at the lower of cost or estimated fair value determined in the aggregate. Residential loans held for sale totaled \$1.2 million and \$1 million at December 31, 2016 and 2015, respectively, and are included in loans on the consolidated balance sheets.

During 2016 and 2015, the Company sold residential mortgage loans totaling \$ 62.6 million and \$51.9 million, respectively, and realized gains on these sales were \$ 1.2 million and \$906,000, respectively. These residential real estate loans are generally sold without recourse in accordance with standard secondary market loan sale agreements. When residential mortgage loans are sold, the Company typically retains all servicing rights, which provides the Company with a source of fee income. In connection with the sales in 2016 and 2015, the Company recorded mortgage-servicing assets of \$589,000 and \$448,000, respectively. Amortization of mortgage-servicing assets amounted to \$247,000 in 2016 and \$235,000 in 2015. Net mortgage-servicing assets included in the consolidated balance sheets totaled \$1.3 million and \$943,000 net of amortization, as of December 31, 2016 and 2015, respectively.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1 - Summary of Significant Accounting Policies (Continued)

Loans Held for Sale - continued

Government-guaranteed loans which may be sold after origination are not classified as held for sale in as much as sale of such loans is largely dependent upon the extent to which gains may be realized. During 2016 and 2015, the Company sold commercial loans backed by Small Business Administration guarantees totaling \$1.1 million and \$2.7 million, respectively, and realized gains on these sales were \$72,000 and \$164,000, respectively. There were no commercial loans held for sale at December 31, 2016.

Total loans serviced for others amounted to \$269.3 million and \$235.5 million at December 31, 2016 and 2015, respectively.

Allowance for Loan Losses

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

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

The allowance consists of general, specific and unallocated components as further described below.

General Component

The general component of the allowance is based on historical loss experience adjusted for qualitative factors stratified by the following loan classes: residential real estate, commercial real estate, agricultural real estate, commercial and agricultural loans, and consumer installment segments. Management uses a rolling average of historical losses based on a time frame appropriate to capture relevant loss data for each loan class. The historical loss factor is adjusted for the following qualitative factors: levels and trends in delinquencies; trends in volume and terms of loans; effects of changes in risk selection and underwriting standards and other changes in lending policies, procedures and practices; experience/ability/depth of lending management and staff; and national and local economic trends and conditions. There were no changes in the Company's policies or its methodology pertaining to the general component of the allowance during 2016 or 2015.

The qualitative factors are determined based on the various risk characteristics of each loan type. Risk characteristics relevant to each loan type are as follows:

Note 1 - Summary of Significant Accounting Policies (Continued)

Allowance for Loan Losses - continued

Residential real estate - The Company generally does not originate loans with a loan-to-value ratio greater than 80 percent and does not grant subprime loans. The majority of loans in this segment are collateralized by owner-occupied residential real estate and repayment is dependent on the credit quality of the individual borrower. The overall health of the economy, including unemployment rates and housing prices, will have an effect on the credit quality in this class.

Commercial real estate - Loans in this class represent both extensions of credit for owner-occupied real estate and income-producing properties throughout the local region. The underlying cash flows of the operating commercial businesses (owner-occupied) and income properties (non-owner occupied) can be adversely impacted by a downturn in the economy as evidenced by increased vacancy rates, which in turn, will have an effect on the credit quality in this class. In a majority of cases, the Company obtains rent rolls annually and continually monitors the cash flows of non-owner occupied loans commensurate with sound lending practices.

Agricultural real estate – Loans in this class represent extensions of credit for owner-occupied agricultural real estate throughout the local region. The underlying cash flows generated by the agribusinesses can be adversely impacted by adverse climate and a weakened economy, which in turn, will have an effect on the credit quality in this class. Management obtains annual tax returns and continually monitors the cash flows of these loans commensurate with sound lending practices.

Commercial and Agricultural loans – Loans in these classes are made to businesses and generally secured by the assets of the business. Repayment is expected from the cash flows of the business. A weakened economy, and resultant decreased consumer spending, will have an effect on the credit quality in this class.

Consumer installment loans – Loans in this segment may be secured or unsecured and repayment is dependent on the credit quality of the individual borrower. Unemployment rates will have an effect on the credit quality in this class.

Specific Component

The specific component relates to loans that are classified as impaired. Impairment is measured on a loan by loan basis for commercial and agricultural loans, commercial real estate and agricultural real estate 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, less costs to sell, if determined to be more appropriate. An allowance is established when the discounted cash flow or collateral value of the impaired loan is lower than the carrying value of that loan. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Company does not separately identify individual consumer or residential real estate loans for impairment disclosures, unless such loans are subject to a troubled debt restructuring agreement.

Note 1 - Summary of Significant Accounting Policies (Continued)

Allowance for Loan Losses - continued

A loan is considered impaired when, based on current information and events, it is probable that the Company 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.

All impaired loans require appraisals and/or chattel evaluations within 180 days of impairment, unless existing evaluation is less than 24 months old and no market or physical deterioration is noted. Re-appraisals and/or re-evaluations are conducted whenever deemed appropriate, but typically performed on a 24 month cycle if repayment is predicated upon liquidation of collateral and evidence suggests collateral values may have deteriorated.

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 reason for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Unallocated Component

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 allocated and general reserves in the portfolio.

Troubled Debt Restructurings

A modification of a loan constitutes a troubled debt restructuring ("TDR") when a borrower is experiencing financial difficulty and the modification constitutes a concession. Loans modified in a TDR often involve temporary interest-only payments, term extensions, reducing the interest rate for the remaining term of the loan, extending the maturity date at an interest rate lower than the current market rate for new debt with similar risk, requesting additional collateral, releasing collateral for consideration, or substituting or adding a new borrower or guarantor.

Nonaccrual loans that are restructured remain on nonaccrual status, but may move to accrual status after they have performed according to the restructured terms for a period of time of at least six months.

Land, Premises and Equipment

Land is stated at cost. Premises and equipment are recorded at cost and are generally depreciated by the straight-line method over the estimated useful lives of the assets. Buildings are generally depreciated over a useful life of thirty nine and one half years, furniture and equipment over a useful life of three to seven years, and leasehold improvements over the lesser of the asset's useful life or the term of the lease.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1 - Summary of Significant Accounting Policies (Continued)

Bank Owned Life Insurance

Bank owned life insurance (BOLI) was purchased by the Bank as a financing tool for employee benefits and to fund discriminatory retirement benefits for the Board of Directors and executive management. The value of life insurance financing is the tax preferred status of increases in life insurance cash values and death benefits and the cash flow generated at the death of the insured. The proceeds or increases in cash surrender value of the life insurance policy results in tax-exempt income to the Company. The largest risk to the BOLI program is credit risk of the insurance carriers. To mitigate this risk, annual financial condition reviews are completed on all carriers. BOLI is stated on the Company's consolidated balance sheets at its current cash surrender value. Increases in BOLI's cash surrender value are reported as noninterest income in the Company's consolidated statements of income.

Foreclosed Real Estate

Included in other assets are real estate properties acquired through, or in lieu of, loan foreclosure. These properties are initially recorded at fair value less estimated selling costs at the date of foreclosure. Any write-downs based on the asset's fair value at date of foreclosure are charged to the allowance for loan losses. After foreclosure, property held for sale is carried at the lower of the new basis or fair value less any costs to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Valuations are periodically performed by management, and any subsequent write-downs are recorded as a charge to operations, if necessary, to reduce the carrying value of the property to the lower of its cost or fair value less cost to sell. Foreclosed real estate at December 31, 2015 was approximately \$126,000. The recorded investment in real estate in process of foreclosure at December 31, 2016 and 2015 was approximately \$271,000 and \$27,000, respectively. There was no foreclosed real estate at December 31, 2016.

Treasury Stock

Treasury stock is recorded at cost. Shares are reissued on the average cost method on a first in, first out basis, except for issuance of deferred compensation shares, which are discussed in Note 11.

Interest Rate Swap Agreement

The Company utilizes an interest rate swap agreement as part of its management of interest rate risk to modify the repricing characteristics of its floating-rate junior subordinate debentures. For this swap agreement, amounts receivable or payable are recognized as accrued under the terms of the agreement, and the net differential is recorded as an adjustment to interest expense of the related debentures. The interest rate swap agreement is designated as a cash flow hedge. Therefore, the effective portion of the swap's unrealized gain or loss was initially recorded as a component of other comprehensive income, net of tax. The ineffective portion of the unrealized gain or loss, if any, is immediately reported in other operating income. The Company considers its interest rate swap agreement to be fully effective and accordingly it has not recorded any gains or losses in earnings during 2016 or 2015.

Advertising Costs

Advertising costs are expensed as incurred.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1 - Summary of Significant Accounting Policies (Continued)

Noncontrolling Interest

Noncontrolling interest represents the portion of ownership and interest expense that is attributable to the minority owners of LRAC. The minority ownership is in the form of 8.50% cumulative preferred stock, and the dividends paid are included in noncontrolling interest as a charge against income.

Income Taxes

Income taxes are provided for the tax effects of certain transactions reported in the consolidated financial statements. Income taxes consist of taxes currently due plus deferred taxes related primarily to temporary differences between the financial reporting and income tax basis of available for sale securities, the allowance for loan losses, premises and equipment, and prepaid and accrued employee benefits. The deferred tax assets and liabilities represent the future tax return consequences of the temporary differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled. Deferred tax assets and liabilities are reflected at income tax rates applicable to the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. The Company recognizes interest and penalties accrued on any unrecognized tax benefits as a component of income tax expense.

Transfers of Financial Assets

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

Earnings Per Share

Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as adjustments to net income for interest expense relating to convertible securities, net of tax, that would result from the assumed issuance. Treasury shares are not deemed outstanding for earnings per share calculations. See Note 12 for earnings per share calculations.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 1 - Summary of Significant Accounting Policies (Continued)

Statements of Cash Flows

For the purpose of presentation in the consolidated statements of cash flows, cash and cash equivalents are defined as the sum of cash and due from banks, federal funds sold, and interest-bearing deposits in banks with an original maturity of less than three months.

Off-Balance-Sheet Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance-sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the consolidated financial statements when they are funded or related fees are incurred or received.

Segment Reporting

The Company has evaluated the activities relating to its strategic business units, and determined that these strategic business units are similar in nature, and managed accordingly. The strategic business units are not reviewed separately to make operating decisions or assess performance. Therefore, the Company has determined it has no reportable segments.

Note 2 - Restrictions on Cash and Due from Banks

The Bank is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The required reserve at December 31, 2016 and 2015 was \$16.4 million and \$13.3 million, respectively.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3 - Investments

The amortized cost and fair value of investment securities, with gross unrealized gains and losses, are as follows at December 31, 2016 and 2015:

(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2016:				
Available for Sale:				
United States agencies	\$ 39,496	\$ -	\$ (1,118)	\$ 38,378
State and local governments	70,076	241	(731)	69,586
Mortgage-backed securities	36,395	-	(1,376)	35,019
Total Available for Sale	<u>\$ 145,967</u>	<u>\$ 241</u>	<u>\$ (3,225)</u>	<u>\$ 142,983</u>
Held to Maturity:				
State and local governments	\$ 7,212	\$ 29	\$ -	\$ 7,241
Mortgage-backed securities	47,614	359	(650)	47,323
Corporate	2,000	-	-	2,000
Total Held to Maturity	<u>\$ 56,826</u>	<u>\$ 388</u>	<u>\$ (650)</u>	<u>\$ 56,564</u>
Restricted Equity Securities	<u>\$ 5,717</u>	<u>\$ 75</u>	<u>\$ -</u>	<u>\$ 5,792</u>
(In thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
December 31, 2015:				
Available for Sale:				
United States agencies	\$ 41,432	\$ 107	\$ (336)	\$ 41,203
State and local governments	67,514	1,235	(11)	68,738
Mortgage-backed securities	28,913	26	(493)	28,446
Total Available for Sale	<u>\$ 137,859</u>	<u>\$ 1,368</u>	<u>\$ (840)</u>	<u>\$ 138,387</u>
Held to Maturity:				
United States agencies	\$ 2,784	\$ 169	\$ -	\$ 2,953
State and local governments	5,231	48	-	5,279
Mortgage-backed securities	41,207	598	(98)	41,707
Corporate	2,000	-	-	2,000
Total Held to Maturity	<u>\$ 51,222</u>	<u>\$ 815</u>	<u>\$ (98)</u>	<u>\$ 51,939</u>
Restricted Equity Securities	<u>\$ 5,552</u>	<u>\$ 24</u>	<u>\$ -</u>	<u>\$ 5,576</u>

Note 3 – Investments (Continued)

All of the above mortgage-backed securities are residential direct pass through securities or collateralized mortgage obligations issued or backed by U.S. government sponsored enterprises (GSEs). Restricted equity securities primarily include non-marketable Federal Home Loan Bank New York (FHLB NY) stock and non-marketable Federal Reserve Bank (FRB) stock, both of which are required to be held for regulatory purposes and for borrowing availability. The required investment in FHLB NY stock is tied to both the Company's borrowing levels with the FHLB and commitments to sell residential mortgage loans to the FHLB. Holdings of FHLB NY stock and FRB stock totaled \$4.8 million and \$500,000 at December 31, 2016, respectively, and \$4.6 million and \$500,000 at December 31, 2015, respectively. These securities are carried at par, which is also cost. The Company has an investment in Federal Agricultural Mortgage Corp (Farmer Mac) class A stock totaling \$116,000 and \$65,000 at December 31, 2016 and 2015, respectively, in order to participate in certain lending activities with Farmer Mac. The stock is actively traded on the NYSE, pays a dividend, and is reflective of current market value. Restricted equity securities also include miscellaneous investments carried at par, which is also cost.

Restricted equity securities are held as a long-term investment and value is determined based on the ultimate recoverability of the par value. Impairment of these investments is evaluated quarterly and is a matter of judgment that reflects management's view of the issuer's long-term performance, which includes factors such as the following: its operating performance; the severity and duration of declines in the fair value of its net assets related to its capital stock amount; its commitment to make payments required by law or regulation and the level of such payments in relation to its operating performance; and its liquidity and funding position. After evaluating these considerations, the Company concluded that the par value of these investments will be recovered and, as such, has not recognized any impairment on its holdings of restricted equity securities during the current year.

The Company elected to transfer six available for sale (AFS) securities with an aggregate fair value of \$25.2 million to a classification of held to maturity (HTM) on December 31, 2013. The transfer from AFS to HTM was recorded at the fair value of the AFS securities at the time of transfer. The net unrealized holding loss of \$330,000, net of tax, at the date of transfer was retained in accumulated other comprehensive loss, with the associated pretax amount of the unrealized losses retained in the carrying amount of the HTM securities. Such amounts are being amortized to interest income over the remaining life of the securities. The fair value of the transferred AFS securities became the carrying amount of the HTM securities at December 31, 2013, with no unrealized gain or loss at this date. During 2016, \$262,000 of net amortized holding loss was amortized into income with a remaining net unamortized loss of \$82,000, net of tax.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3 – Investments (Continued)

The following table sets forth the Company's investment in securities with unrealized losses of less than twelve months and unrealized losses of twelve months or more at December 31:

(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, 2016:						
United States agencies	\$ 42,278	\$ (1,118)	\$ -	\$ -	\$ 42,278	\$ (1,118)
State and local governments	41,774	(731)	-	-	41,774	(731)
Mortgage-backed securities	60,357	(2,026)	-	-	60,357	(2,026)
	<u>\$ 144,409</u>	<u>\$ (3,875)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 144,409</u>	<u>\$ (3,875)</u>

(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, 2015:						
United States agencies	\$ 21,183	\$ (180)	\$ 9,837	\$ (156)	\$ 31,020	\$ (336)
State and local governments	4,517	(9)	321	(2)	4,838	(11)
Mortgage-backed securities	19,492	(272)	8,746	(319)	28,238	(591)
	<u>\$ 45,192</u>	<u>\$ (461)</u>	<u>\$ 18,904</u>	<u>\$ (477)</u>	<u>\$ 64,096</u>	<u>\$ (938)</u>

On a quarterly basis, the Company performs an assessment to determine whether there have been any events or economic circumstances indicating that a security with an unrealized loss has suffered other-than-temporary impairment. Consideration is given to (1) the length of time and the extent to which the fair value has been less than the amortized cost basis, (2) the financial condition of the issuer (and guarantor, if any) and adverse conditions specifically related to the security, industry or geographic area, (3) failure of the issuer of the security to make scheduled interest or principal payments, (4) any changes to the rating of a security by a rating agency, (5) the presence of credit enhancements, if any, including the guarantee of the federal government or any of its agencies, (6) whether the Company intends to sell or more likely than not be required to sell the debt security, and (7) if the present value of the expected cash flow is not sufficient to recover the entire amortized cost.

There were one hundred seventy three securities with unrealized losses at December 31, 2016, while at December 31, 2015 there were thirty securities with unrealized losses. Substantially all of the unrealized losses on the Company's securities were caused by market interest rate changes from those in effect when the securities were purchased by the Company. The contractual terms of these securities do not permit the issuer to settle the securities at a price less than par value. Except for certain state and local government

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 3 – Investments (Continued)

obligations, all securities rated by an independent rating agency carry an investment grade rating. Financial information relating to unrated state and government obligations is reviewed for indications of adverse conditions that may indicate other-than-temporary impairment. Because the Company does not intend to sell the securities with unrealized losses and it believes it is not likely to be required to sell the securities before recovery of their amortized cost basis, which may be, and is likely to be, maturity, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2016. In addition, there were no other-than-temporary impairment charges in 2016 and 2015.

The amortized cost and fair value of debt securities at December 31, 2016, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations without call or prepayment penalties.

(In thousands)

	Available for Sale		Held to Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Due in one year or less	\$ 2,752	\$ 2,768	\$ 3,251	\$ 3,252
Due after one year through five years	60,317	60,110	1,356	1,365
Due after five years through ten years	39,584	38,475	6,842	6,739
Due after ten years	6,918	6,611	1,785	1,785
Securities not due at a single maturity date	36,395	35,019	43,592	43,423
	<u>\$ 145,967</u>	<u>\$ 142,983</u>	<u>\$ 56,826</u>	<u>\$ 56,564</u>

During 2016, the Company sold \$54.2 million of available for sale securities, while in 2015 the Company sold \$20.6 million of available for sale securities. Net gains on the sales of investments in 2016 were \$470,000. Gross gains on the sales of investment securities in 2015 were \$167,000. Investment securities with carrying amounts of \$153.4 million and \$125.7 million at December 31, 2016 and 2015, respectively, were pledged to secure deposits as required or permitted by law.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans

Loans consist of the following at December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Real estate:		
Residential:		
1-4 family	\$ 183,123	\$ 162,855
Home equity	102,436	84,158
Commercial	153,724	149,894
Agriculture	48,688	42,105
Total mortgage loans on real estate	<u>487,971</u>	<u>439,012</u>
Commercial loans	122,214	102,671
Agriculture loans	40,870	37,458
Consumer installment loans:		
Direct	17,612	15,698
Indirect	10,024	10,362
Total consumer installment loans	<u>27,636</u>	<u>26,060</u>
Total loans	<u>\$ 678,691</u>	<u>\$ 605,201</u>

Net unamortized loan origination costs totaled \$1.6 million and \$1.2 million at December 31, 2016 and 2015, respectively and are included with their related loan class.

The Company has transferred a portion of its originated commercial, commercial real estate, agriculture and agriculture real estate loans to participating lenders. The amounts transferred have been accounted for as sales and are therefore not included in the Company's accompanying consolidated balance sheets. The Company and participating lenders share ratably in cash flows and any gains or losses that may result from a borrower's lack of compliance with contractual terms of the loan. The Company continues to service the loans on behalf of the participating lenders and, as such, collects cash payments from the borrowers, remits payments (net of servicing fees) to participating lenders and disburses required escrow funds to relevant parties. At December 31, 2016 and 2015 the Company was servicing loans for participants aggregating \$18.8 million and \$18.7 million, respectively.

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments are due. Generally loans are placed on nonaccrual status if principal or interest payments become 90 days or more past due and/or management deems the collectability of the principal and/or interest to be in question, as well as when required by regulatory requirements.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

The following table presents past due loans by classes of the loan portfolio at December 31, 2016 and 2015:

(In thousands)	<u>Current</u>	<u>30-89 Days Past Due</u>	<u>90 Days and Greater</u>	<u>Total Loans</u>	<u>Loans on Nonaccrual</u>
December 31, 2016:					
Residential real estate:					
1-4 family	\$ 182,460	\$ 663	\$ -	\$ 183,123	\$ -
Home equity	102,228	149	59	102,436	167
Commercial real estate	153,369	355	-	153,724	-
Agriculture real estate	48,688	-	-	48,688	-
Commercial loans	120,127	905	1,182	122,214	1,297
Agriculture loans	40,870	-	-	40,870	-
Consumer installment loans:					
Direct	17,569	43	-	17,612	-
Indirect	9,989	35	-	10,024	-
Total	\$ 675,300	\$ 2,150	\$ 1,241	\$ 678,691	\$ 1,464

(In thousands)	<u>Current</u>	<u>30-89 Days Past Due</u>	<u>90 Days and Greater</u>	<u>Total Loans</u>	<u>Loans on Nonaccrual</u>
December 31, 2015:					
Residential real estate:					
1-4 family	\$ 162,651	\$ 159	\$ 45	\$ 162,855	\$ 45
Home equity	84,026	105	27	84,158	220
Commercial real estate	146,143	3,561	190	149,894	2,838
Agriculture real estate	42,105	-	-	42,105	-
Commercial loans	101,208	646	817	102,671	1,015
Agriculture loans	37,458	-	-	37,458	-
Consumer installment loans:					
Direct	15,642	56	-	15,698	-
Indirect	10,268	94	-	10,362	-
Total	\$ 599,501	\$ 4,621	\$ 1,079	\$ 605,201	\$ 4,118

At December 31, 2016 and 2015, there were no loans that were over 90 days delinquent and still accruing interest. During 2016, the Company resolved a large problem loan which had been recorded as a non-performing asset since 2010 and subject to litigation. The Company's settlement resulted in a \$1.1 million charge-off. As a result, non-performing assets decreased by approximately \$2.5 million at the time of the resolution.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

Activity in the allowance for loan losses for the Years Ended December 31, 2016 and 2015 follows:

(In thousands)

	Commercial	Commercial Real Estate	Agriculture	Agriculture Real Estate	Residential Real Estate	Consumer	Unallocated	Total
2016								
Beginning balance	\$ 2,007	\$ 2,911	\$ 453	\$ 442	\$ 1,729	\$ 376	\$ 270	\$ 8,188
Provisions for loan losses	394	(99)	12	22	83	165	523	1,100
Recoveries of loans previously charged off	11	34	-	-	18	81	-	144
Loans charged off	(245)	(1,084)	-	-	(48)	(259)	-	(1,636)
Ending balance	<u>\$ 2,167</u>	<u>\$ 1,762</u>	<u>\$ 465</u>	<u>\$ 464</u>	<u>\$ 1,782</u>	<u>\$ 363</u>	<u>\$ 793</u>	<u>\$ 7,796</u>
2015								
Beginning balance	\$ 1,336	\$ 2,620	\$ 380	\$ 361	\$ 1,987	\$ 385	\$ 480	\$ 7,549
Provisions for loan losses	700	745	73	81	(221)	107	(210)	1,275
Recoveries of loans previously charged off	9	-	-	-	3	49	-	61
Loans charged off	(38)	(454)	-	-	(40)	(165)	-	(697)
Ending balance	<u>\$ 2,007</u>	<u>\$ 2,911</u>	<u>\$ 453</u>	<u>\$ 442</u>	<u>\$ 1,729</u>	<u>\$ 376</u>	<u>\$ 270</u>	<u>\$ 8,188</u>

The allocation of the allowance for loan losses by loan class is as follows at December 31, 2016 and 2015:

(In thousands)

	Commercial	Commercial Real Estate	Agriculture	Agriculture Real Estate	Residential Real Estate	Consumer	Unallocated	Total
December 31, 2016								
Amount of allowance for loan losses on loans individually evaluated for impairment	\$ 900	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 900
Amount of allowance for loan losses on loans collectively evaluated for impairment	<u>1,267</u>	<u>1,762</u>	<u>465</u>	<u>464</u>	<u>1,782</u>	<u>363</u>	<u>793</u>	<u>6,896</u>
Total allowance for loan losses	<u>\$ 2,167</u>	<u>\$ 1,762</u>	<u>\$ 465</u>	<u>\$ 464</u>	<u>\$ 1,782</u>	<u>\$ 363</u>	<u>\$ 793</u>	<u>\$ 7,796</u>
Loans individually evaluated for impairment	\$ 1,297	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,297
Loans collectively evaluated for impairment	<u>120,917</u>	<u>153,724</u>	<u>40,870</u>	<u>48,688</u>	<u>285,559</u>	<u>27,636</u>	<u>-</u>	<u>677,791</u>
Total Loans	<u>\$ 122,214</u>	<u>\$ 153,724</u>	<u>\$ 40,870</u>	<u>\$ 48,688</u>	<u>\$ 285,559</u>	<u>\$ 27,636</u>	<u>\$ -</u>	<u>\$ 678,691</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

December 31, 2015	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Agriculture</u>	<u>Agriculture Real Estate</u>	<u>Residential Real Estate</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
Amount of allowance for loan losses on loans individually evaluated for impairment	\$ 674	\$ 907	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 1,581
Amount of allowance for loan losses on loans collectively evaluated for impairment	<u>1,333</u>	<u>2,004</u>	<u>453</u>	<u>442</u>	<u>1,729</u>	<u>376</u>	<u>270</u>	<u>6,607</u>
Total allowance for loan losses	<u>\$ 2,007</u>	<u>\$ 2,911</u>	<u>\$ 453</u>	<u>\$ 442</u>	<u>\$ 1,729</u>	<u>\$ 376</u>	<u>\$ 270</u>	<u>\$ 8,188</u>
Loans individually evaluated for impairment	\$ 890	\$ 2,920	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 3,810
Loans collectively evaluated for impairment	<u>101,781</u>	<u>146,974</u>	<u>37,458</u>	<u>42,105</u>	<u>247,013</u>	<u>26,060</u>	<u>-</u>	<u>601,391</u>
Total Loans	<u>\$ 102,671</u>	<u>\$ 149,894</u>	<u>\$ 37,458</u>	<u>\$ 42,105</u>	<u>\$247,013</u>	<u>\$ 26,060</u>	<u>\$ -</u>	<u>\$605,201</u>

Management is committed to early recognition of loan problems and to maintaining an adequate allowance. At least quarterly, management reviews all commercial and commercial real estate loans and leases and agriculturally related loans with an outstanding principal balance of over \$100,000 that are internally risk rated substandard or worse, giving consideration to payment history, debt service payment capacity, collateral support, strength of guarantors, local market trends, industry trends, and other factors relevant to the particular borrowing relationship. Through this process, management identifies impaired loans. For loans considered impaired, estimated exposure amounts are based upon collateral values or present value of expected future cash flows discounted at the original effective interest rate of each loan. For commercial loans, commercial mortgage loans, agricultural mortgages and agricultural loans not specifically reviewed, and for homogenous loan portfolios such as residential mortgage loans and consumer loans, estimated exposure amounts are assigned based upon historical net loss experience and current charge-off trends, past due status, and management's judgment of the effects of current economic conditions on portfolio performance. In determining and assigning historical loss factors to the various homogeneous portfolios, the Company calculates average net losses over a period of time and compares this average to current levels and trends to ensure that the calculated average loss factor is reasonable.

Significant factors that could give rise to changes in these estimates may include, but are not limited to, changes in economic conditions in the local area, concentration of risk, changes in interest rates, and declines in local property values. While management uses available information to recognize losses on loans, future additions to the allowance may be necessary. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize additions to the allowance based on their judgments about information available to them at the time of their examination.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

The above allocation is neither indicative of the specific amounts or the loan categories in which future charge-offs may occur, nor is it an indicator of future loss trends. The allocation of the allowance to each category does not restrict the use of the allowance to absorb losses in any category.

The following table summarizes information regarding impaired loans by loan portfolio class as of December 31, 2016 and 2015:

(In thousands)	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
December 31, 2016					
With no related allowance recorded:					
Commercial loans	\$ 241	\$ 246	\$ -	\$ 232	\$ -
Commercial real estate	-	-	-	42	-
With an allowance recorded:					
Commercial loans	1,056	1,731	900	1,006	-
Commercial real estate	-	-	-	2,093	-
Total	<u>\$ 1,297</u>	<u>\$ 1,977</u>	<u>\$ 900</u>	<u>\$ 3,373</u>	<u>\$ -</u>
Summary:					
Commercial	\$ 1,297	\$ 1,977	\$ 900	\$ 3,373	\$ -
Agriculture	-	-	-	-	-
Total	<u>\$ 1,297</u>	<u>\$ 1,977</u>	<u>\$ 900</u>	<u>\$ 3,373</u>	<u>\$ -</u>
(In thousands)	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
December 31, 2015					
With no related allowance recorded:					
Commercial loans	\$ 125	\$ 125	\$ -	\$ 50	\$ 2
Commercial real estate	190	229	-	201	-
With an allowance recorded:					
Commercial loans	890	897	674	516	-
Commercial real estate	2,648	3,295	907	2,803	-
Total	<u>\$ 3,853</u>	<u>\$ 4,546</u>	<u>\$ 1,581</u>	<u>\$ 3,570</u>	<u>\$ 2</u>
Summary:					
Commercial	\$ 3,853	\$ 4,546	\$ 1,581	\$ 3,570	\$ 2
Agriculture	-	-	-	-	-
Total	<u>\$ 3,853</u>	<u>\$ 4,546</u>	<u>\$ 1,581</u>	<u>\$ 3,570</u>	<u>\$ 2</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

There were no troubled debt restructurings for the years ended December 31, 2016 or 2015.

There were no troubled debt restructurings that defaulted in the first twelve months after restructuring was granted.

Credit Quality

The Company utilizes a ten grade internal loan rating system for commercial, commercial real estate, agriculture and agriculture real estate loans. Loans that are rated “1” through “6” are considered “pass” rated loans with low to average risk.

Loans rated a “7” are considered “special mention”. These loans have potential weaknesses that deserve management’s close attention. These weaknesses may, if not checked or corrected, weaken the asset or inadequately protect the Company’s position at some future date. Borrowers may be experiencing adverse operating trends, or an ill-proportioned balance sheet. Adverse economic or market conditions may also support a special mention rating. These assets pose elevated risks, but their weakness does not yet justify a substandard classification.

Loans rated an “8” are considered “substandard”. Generally a loan is considered substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. Substandard loans have a high probability of payment default or they have other well-defined weaknesses. They require more intensive supervision by Company management. Substandard loans are generally characterized by current or unexpected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization.

Loans rated a “9” are considered “doubtful”. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable. There were no doubtful loans at December 31, 2016 or 2015.

Loans rated a “10” are considered uncollectible (“loss”) and of such little value that their continuance as loans is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless loan even though partial recovery may be affected in the future. There were no loss loans at December 31, 2016 or 2015.

On an annual basis, or more often if needed, the Company formally reviews the ratings on all commercial, commercial real estate, agriculture and agriculture real estate loans. The Company also annually engages an independent third party to review a significant portion of loans within these classes. Management uses the results of these reviews as part of its annual review process.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

Credit Quality – continued

The following table presents the classes of the commercial and agriculture loan portfolios summarized by the aggregate pass rating and the criticized and classified ratings of special mention and substandard within the Company's internal risk rating system as of December 31, 2016 and 2015:

(In thousands)

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Agriculture</u>	<u>Agriculture Real Estate</u>	<u>Total</u>
December 31, 2016					
Grade:					
Pass	\$ 116,568	\$ 148,577	\$ 40,277	\$ 47,454	\$ 352,876
Special Mention	3,702	4,293	179	1,075	9,249
Substandard	1,944	854	414	159	3,371
Total	<u>\$ 122,214</u>	<u>\$ 153,724</u>	<u>\$ 40,870</u>	<u>\$ 48,688</u>	<u>\$ 365,496</u>
December 31, 2015					
Grade:					
Pass	\$ 95,597	\$ 142,258	\$ 36,407	\$ 40,028	\$ 314,290
Special Mention	1,624	285	40	39	1,988
Substandard	5,450	7,351	1,011	2,038	15,850
Total	<u>\$ 102,671</u>	<u>\$ 149,894</u>	<u>\$ 37,458</u>	<u>\$ 42,105</u>	<u>\$ 332,128</u>

Loans within the residential real estate and consumer portfolios do not have an internal loan rating system. Instead, they are monitored for past due status. If a residential real estate or consumer loan becomes 90 days past due, it is placed into nonaccrual status and the accrual of interest is discontinued.

Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual if collection of principal or interest is considered doubtful.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 4 – Loans (Continued)

Credit Quality – continued

The following table presents the classes of the residential real estate and consumer loan portfolios summarized by performing or nonaccrual as of December 31, 2016 and 2015:

(In thousands)

	<u>1-4 Family</u>	<u>Home Equity</u>	<u>Consumer - Direct</u>	<u>Consumer - Indirect</u>	<u>Total</u>
December 31, 2016					
Performing	\$ 183,123	\$ 102,269	\$ 17,612	\$ 10,024	\$ 313,028
Nonaccrual	<u>-</u>	<u>167</u>	<u>-</u>	<u>-</u>	<u>167</u>
Total	<u>\$ 183,123</u>	<u>\$ 102,436</u>	<u>\$ 17,612</u>	<u>\$ 10,024</u>	<u>\$ 313,195</u>
December 31, 2015					
Performing	\$ 162,810	\$ 83,938	\$ 15,698	\$ 10,362	\$ 272,808
Nonaccrual	<u>45</u>	<u>220</u>	<u>-</u>	<u>-</u>	<u>265</u>
Total	<u>\$ 162,855</u>	<u>\$ 84,158</u>	<u>\$ 15,698</u>	<u>\$ 10,362</u>	<u>\$ 273,073</u>

Note 5 - Land, Premises and Equipment

Land, premises and equipment, net consist of the following at December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Land	\$ 4,330	\$ 4,239
Buildings	15,099	15,145
Furniture and equipment	6,380	7,019
Leasehold improvements	2,858	2,846
Construction in progress	<u>35</u>	<u>-</u>
	<u>28,702</u>	<u>29,249</u>
Less: Accumulated depreciation	<u>(8,605)</u>	<u>(8,369)</u>
	<u>\$ 20,097</u>	<u>\$ 20,880</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 5 - Land, Premises and Equipment (Continued)

Depreciation and amortization expense in 2016 and 2015 are included in noninterest expense as follows:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Buildings	389	332
Furniture and equipment	622	550
Leasehold improvements	135	96
	<u>\$ 1,146</u>	<u>\$ 978</u>

At December 31, 2016, the Bank leased four of its branch facilities, as well as two operations facilities under non-cancelable operating leases. Future minimum rental payments under these leases are as follows:

Years Ending December 31,	(In thousands)
2017	\$ 308
2018	313
2019	327
2020	256
2021	182
Thereafter	1,346
	<u>\$ 2,732</u>

Rent expense under the operating leases totaled \$311,000 and \$298,000 in 2016 and 2015, respectively.

At December 31, 2016, the Bank leased out space under non-cancelable operating leases. Future minimum rental payments to be received by the Company under these leases are as follows:

Years Ending December 31,	(In thousands)
2017	\$ 74
2018	75
2019	77
2020	79
2021	81
Thereafter	14
	<u>\$ 400</u>

Rent income under the operating leases totaled \$87,000 and \$126,000 in 2016 and 2015, respectively.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 6 - Deposits

Certificates of deposit in denominations of \$250,000 and over were \$50.8 million and \$52.7 million at December 31, 2016 and 2015, respectively.

At December 31, 2016, scheduled maturities of time deposits are as follows:

Years Ending December 31,	(In thousands)
2017	\$ 121,432
2018	29,539
2019	2,910
2020	1,727
2021	2,381
	<u>\$ 157,989</u>

Note 7 - Borrowings

Borrowings consist of overnight advances and amortizing borrowings. At December 31, 2016 and 2015, there were \$18 million and \$12 million in overnight advances outstanding, respectively. The table below details additional information related to overnight advances for the years ended December 31,

	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)	
Average outstanding balance	\$ 2,595	\$ 16,308
Interest expense	\$ 18	\$ 68
Weighted average interest rate during the year	0.69%	0.42%
Weighted average interest rate at end of year	0.74%	0.52%

In 2016, both long-term amortizing advances were prepaid. Gains from the sale of investments were used to offset the FHLB prepayment penalty of \$52,000. Long term debt at December 31, 2016 and 2015 consists of the following FHLB advances:

	<u>Amount</u>		<u>Weighted Average Rate</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
	(Dollars in thousands)			
Amortizing advances, due January 2019	\$ -	\$ 3,207	-	1.39%
Amortizing advances, due October 2020	-	<u>4,919</u>	=	<u>1.38%</u>
Total	\$ -	\$ 8,126	-	1.38%

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 7 – Borrowings (Continued)

As a member of the FHLB, the Bank can use certain unencumbered mortgage-related assets to secure borrowings from the FHLB. At December 31, 2016, total unencumbered mortgage-related loans were \$57.4 million. Additional assets may also qualify as collateral for FHLB advances.

The Company, through the Bank, can use certain unencumbered collateral to secure borrowings at the Federal Reserve Bank. At December 31, 2016, total unencumbered collateral in the form of home equity loans and other consumer loans was \$57.0 million.

The Company, through the Bank, had available unsecured line of credit agreements with correspondent banks permitting borrowings to a maximum of \$17.0 million and \$15.0 million at December 31, 2016 and 2015, respectively. There were no outstanding advances against those lines at December 31, 2016 or 2015.

Note 8 - Junior Subordinated Debentures

On June 27, 2003, the Company issued \$1.035 million in junior subordinated debentures due June 27, 2033, to Trust I. The Company owns all of the \$35,000 in common equity of Trust I and the debentures are the sole asset of Trust I. Trust I issued \$1.0 million of floating-rate trust capital securities in a non-public offering. The floating-rate capital securities provide for quarterly distributions at a variable annual coupon rate, reset quarterly, based on three-month LIBOR plus 2.75%. The coupon rate was 3.75% at December 31, 2016 and 3.35% at December 31, 2015. The securities are callable by the Company, subject to any required regulatory approval, at par, after June 2008.

The Company unconditionally guarantees the Trust I capital securities. The terms of the junior subordinated debentures and the common equity of Trust I mirror the terms of the trust capital securities issued by Trust I. The Company used the net proceeds from this offering to fund an additional \$1.0 million capital investment in the Bank to fund its operations and future growth.

On August 23, 2004, the Company issued \$5.155 million in junior subordinated debentures due August 23, 2034, to Trust II. The Company owns all of the \$155,000 in common equity of Trust II and the debentures are the sole asset of Trust II. Trust II issued \$5.0 million of floating-rate trust capital securities in a non-public offering. The floating-rate capital securities provide for quarterly distributions at a variable annual coupon rate, reset quarterly, based on three-month LIBOR plus 2.65%. The coupon rate was 3.57% at December 31, 2016 and 3.03% at December 31, 2015. The securities are callable by the Company subject to any required regulatory approval, at par, after August 2009.

The Company unconditionally guarantees the Trust II capital securities. The terms of the junior subordinated debentures and the common equity of Trust II mirror the terms of the trust capital securities issued by Trust II. The Company used the net proceeds from this offering to fund an additional \$5.0 million capital investment in the Bank to fund its operations and future growth.

In December 2009, the Company entered into an interest rate swap agreement (swap) with an effective date of February 23, 2011. The Company designated the swap as a cash flow hedge and it is intended to protect against the variability of cash flows associated with Trust II. The swap modifies the pricing characteristic of Trust II, wherein the Company receives interest at three-month LIBOR plus 2.65% from

Note 8 - Junior Subordinated Debentures (Continued)

a counterparty and pays a fixed rate of interest of 6.80% to the same counterparty calculated on a notional amount of \$5.0 million. This agreement will expire on November 23, 2019. The swap agreement was entered into with a counterparty that met the Company's credit standards, and the agreement contains collateral provisions protecting the at-risk party. The Company believes that the credit risk inherent in this contract is not significant. At December 31, 2016, the company pledged \$520,000 cash collateral to the counterparty.

At December 31, 2016 and 2015, the fair value of the swap agreement was a loss of \$377,000 and \$528,000, respectively, and was the amount the Company would have expected to pay to terminate the agreement. The fair value of the swap is included in other liabilities in the accompanying consolidated balance sheets. The net effect of the swap increased interest expense by \$177,000 and \$196,000 in 2016 and 2015, respectively.

On February 12, 2010, the Company issued \$3.027 million in junior subordinated debentures due February 12, 2040, to Trust III. The Company owned all of the \$95,000 in common equity of Trust III and the debentures were the sole asset of Trust III. Trust III issued \$2.932 million of fixed rate convertible trust capital securities in a non-public offering. These capital securities provided for quarterly distributions at a fixed annual coupon rate of 6.00%. The securities were callable by the Company, subject to any required regulatory approval, at par, after February 2015. Holders of the trust securities were able to convert the securities, at any time, into shares of the Company's common stock at a conversion price of \$13.89 per share, subject to adjustments for splits, stock dividends, recapitalization and the like and issuances on a pro rata basis below the current market value, in-kind dividends and tender offers above market value.

The Company unconditionally guaranteed the Trust III capital securities. The terms of the junior subordinated debentures and the common equity of Trust III mirror the terms of the convertible trust capital securities issued by Trust III. The Company used the net proceeds from this offering to fund an additional \$2.9 million capital investment in the Bank for its operations and future growth. In 2016 the shareholders of Trust III elected to convert all remaining shares into shares of LYBC common stock and Trust III was fully dissolved. The conversion of the Trust III capital securities resulted in 186,000 shares converted to common stock increasing additional paid in capital by \$2.5 million.

The accounts of Trust I, Trust II and Trust III are not included in the consolidated financial statements of the Company. However, for regulatory purposes, the trust capital securities qualify as Tier I capital of the Company subject to a 25% of capital limitation under risk-based capital guidelines. The portion that exceeds the 25% of capital limitation qualifies as Tier II capital. At December 31, 2016 and 2015, \$6.0 million and \$8.6 million in trust capital securities qualified as Tier I capital, respectively.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 9 - Income Taxes

The provision for income taxes consists of the following for the years ended December 31:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Current tax provision:		
Federal	\$ 2,617	\$ 2,775
State	331	236
Total current tax provision	<u>2,948</u>	<u>3,011</u>
Deferred tax (benefit)/expense:		
Federal	(42)	(197)
State	35	72
Total deferred tax benefit	<u>(7)</u>	<u>(125)</u>
	<u>\$ 2,941</u>	<u>\$ 2,886</u>

Income tax expense differed from the statutory federal income tax rate for the years ended December 31 as follows:

	<u>2016</u>	<u>2015</u>
Statutory federal tax rate	34.0%	34.0%
Increase (decrease) resulting from:		
Tax-exempt interest income	(5.2)	(5.3)
Non-taxable earnings on bank-owned life insurance	(1.3)	(1.3)
Nondeductible expenses	0.1	0.1
Disallowed interest expense	0.2	0.2
Other, net	0.1	0.4
Effective tax rate	<u>27.9%</u>	<u>28.1%</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 9 - Income Taxes (Continued)

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for tax purposes. Components of the Company's net deferred tax assets at December 31, included in other assets in the accompanying consolidated balance sheets, are as follows:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 2,933	\$ 3,095
Compensation and benefits	3,458	3,358
Net unrealized loss on available for sale securities	1,164	-
Net unrealized loss on held to maturity securities transferred from available for sale	54	159
Other	706	741
Total deferred tax assets	<u>\$ 8,315</u>	<u>\$ 7,353</u>
Deferred tax liabilities:		
Prepaid pension	\$ 851	\$ 924
Depreciation	647	717
Net unrealized gain on available for sale securities	-	221
Other	1,053	889
Total deferred tax liabilities	<u>\$ 2,551</u>	<u>\$ 2,751</u>
Net deferred tax assets	<u>\$ 5,764</u>	<u>\$ 4,602</u>

Management believes it is more likely than not that all of the deferred tax assets will be realized. The amount of the deferred tax asset considered realizable, however, could be reduced in the near term if estimates of future taxable income are reduced.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 10 - Stockholders' Equity

Preferred Stock – The Company is authorized to issue 5,000 shares of preferred stock having a par value of \$0.50 per share and a stated value of \$1,000 per share. The board of directors is authorized to issue these shares of preferred stock without stockholder approval in different classes and series and, with respect to each class or series, to determine the dividend rate, the redemption provisions, conversion provisions, liquidation preference, and other rights, privileges, and restrictions.

On November 15, 2016, the company offered a private placement of 5,000 shares, par value of \$0.50 per share, Series A Non-Cumulative Convertible Preferred Stock at \$1,000 per share. The preferred stock is convertible, at any time, into shares of common stock, par value \$0.50 per share, at the option of the holder. Upon a deemed liquidation event of Lyons Bancorp, the holders of the preferred shares are entitled to receive a liquidation distribution of \$1,000 per share plus any declared and unpaid dividends, before any distribution of assets to holders of common stock. Dividends will be paid quarterly, if declared by the board of directors, at a rate per annum equal to 5%. As of December 31, 2016, all 5,000 shares, par value \$0.50 per share, of the authorized preferred stock have been issued.

Common Stock – The holders of the Company's common stock are entitled to receive dividends, if any, the board of directors may declare from time to time from funds legally available therefore, subject to the preferential rights of the holders of any shares of preferred stock that the Company may issue in the future. The holders of the Company's common stock are entitled to one vote per share on any matter to be voted upon by stockholders.

The common stock and treasury stock of the Company at December 31, 2016 and 2015 are as follows:

	<u>2016</u>	<u>2015</u>
Common stock, authorized shares, \$0.50 par value	<u>5,000,000</u>	<u>5,000,000</u>
Issued shares	3,198,660	3,012,756
Less: treasury stock shares	<u>(8,954)</u>	<u>(8,370)</u>
Outstanding shares	<u>3,189,706</u>	<u>3,004,386</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 10 - Stockholders' Equity (Continued)

The amounts of income tax expense (benefit) allocated to each component of other comprehensive income are as follows for the Years Ended December 31, 2016 and 2015:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Securities available for sale:		
Net unrealized (losses) gains during the year	\$ (1,219)	\$ 347
Reclassification adjustment for gains included in income	(188)	(67)
Securities held to maturity:		
Reclassification adjustment for amortization of unrealized losses included in income	105	33
Changes in unrealized gains during the year of restricted equity securities	20	9
Pension and postretirement benefits:		
Amortization of prior service credit	(1)	(1)
Amortization of net loss	80	90
Net actuarial (loss) gain	(11)	71
Cash flow hedge		
Losses on the effective portion of cash flow hedge	(10)	(48)
Reclassification adjustment for losses included in income	71	78
Tax (benefit) expense	<u>\$ (1,153)</u>	<u>\$ 512</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 10 - Stockholders' Equity (Continued)

Reclassifications out of accumulated other comprehensive (loss) income for the Years Ended December 31, 2016 and 2015 are as follows:

Details About Accumulated Other Comprehensive (Loss) Income Components	Amount Reclassified from Accumulated Other Comprehensive (Loss) Income		Affected Line Item In The Statement Where Net Income is Presented
	<u>2016</u>	<u>2015</u>	
	(In Thousands)		
Unrealized gains and losses on available for sale securities (before tax)	\$ 470	\$ 167	Net realized gains from sales/calls of available for sale securities
Tax expense	<u>(188)</u>	<u>(67)</u>	Income tax expense
Net of tax	<u>282</u>	<u>100</u>	
Amortization of unrealized losses on securities transferred to held to maturity (before tax):	(262)	(84)	Interest Income – investment securities, taxable
Tax benefit	<u>105</u>	<u>33</u>	Income tax expense
Net of tax	<u>(157)</u>	<u>(51)</u>	
Amortization of pension and postretirement benefit plan items (before tax):			
Prior service credit	3	3	
Net losses	<u>(199)</u>	<u>(224)</u>	
Tax benefit	<u>79</u>	<u>89</u>	Pensions and benefits expense
Net of tax	<u>(117)</u>	<u>(132)</u>	Income tax expense
Gains and losses on cash flow hedge (before tax)	(177)	(196)	Interest expense - borrowings
Tax benefit	<u>71</u>	<u>78</u>	Income tax expense
Net of tax	<u>(106)</u>	<u>(118)</u>	
Total reclassification for the year, net of tax	<u>\$ (98)</u>	<u>\$ (201)</u>	

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 10 - Stockholders' Equity (Continued)

The balances and changes in the components of accumulated other comprehensive loss, net of tax, are as follows:

(In thousands)	Unrealized gains (losses) on securities available for sale	Unrealized losses on securities transferred to held to maturity	Unrealized gains on restricted equity securities	Pension and postretirement benefits	Unrealized losses on cash flow hedge	Total
Balance – January 1, 2015	(103)	(289)	1	(2,556)	(361)	(3,308)
Other comprehensive income (loss) before reclassifications	521	-	13	106	(73)	567
Amounts reclassified from accumulated other comprehensive income	(100)	51	-	132	118	201
Other comprehensive income (loss) for 2015	421	51	13	238	45	768
Balance – December 31, 2015	<u>\$ 318</u>	<u>\$ (238)</u>	<u>\$ 14</u>	<u>\$ (2,318)</u>	<u>\$ (316)</u>	<u>\$ (2,540)</u>
Other comprehensive income (loss) before reclassifications	(1,825)	-	31	(17)	(16)	(1,827)
Amounts reclassified from accumulated other comprehensive income	(282)	157	-	118	106	99
Other comprehensive income for 2016	(2,107)	157	31	101	90	(1,728)
Balance – December 31, 2016	<u>\$ (1,789)</u>	<u>\$ (81)</u>	<u>\$ 45</u>	<u>\$ (2,219)</u>	<u>\$ (226)</u>	<u>\$ (4,268)</u>

Note 11 - Pension and Postretirement Benefit Plans

The Company participates in the New York State Bankers Retirement System (the “System”), a non-contributory defined benefit pension plan (the “Pension Plan”) covering substantially all employees. The benefits are based on years of service and the employee’s highest average compensation during five consecutive years of employment.

The Company also maintains an unfunded postretirement health insurance plan (the “Healthcare Plan”) for certain employees meeting eligibility requirements.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

The Company engages independent, external actuaries to compute the amounts of liabilities and expense relating to these plans, subject to the assumptions that the Company selects. The benefit obligation for these plans represents the liability of the Company for current and retired employees, and is affected primarily by the following: service cost (benefits attributed to employee service during the period); interest cost (interest on the liability due to the passage of time); actuarial gains/losses (experience during the year different from that assumed and changes in plan assumptions); and benefits paid to participants.

The following table provides a reconciliation of the changes in the Pension Plan's benefit obligations and fair value of assets and the accumulated benefit obligation for the Healthcare Plan for the years ending December 31, 2016 and 2015:

	Pension Plan		Healthcare Plan	
	2016	2015	2016	2015
	(In thousands)			
Change in benefit obligation:				
Benefit obligation at beginning of year	\$ 12,744	\$ 12,626	\$ 652	\$ 545
Service cost	1,082	1,135	6	6
Interest cost	540	489	25	24
Actuarial (gain) loss	220	(1,082)	(49)	109
Expected expenses	(104)	(98)	-	-
Benefits paid	(429)	(326)	(35)	(32)
Benefit obligation at end of year	14,053	12,744	599	652
Change in plan assets:				
Fair value of plan assets at beginning of year	11,639	11,150	-	-
Actual return on plan assets	893	(84)	-	-
Employer contribution	1,000	1,000	32	32
Actual expenses paid	(119)	(101)	-	-
Benefits paid	(429)	(326)	(32)	(32)
Fair value of plan assets at end of year	12,984	11,639	-	-
Funded status recognized	\$ (1,069)	\$ (1,105)	\$ (599)	\$ (652)
Accumulated benefit obligation	\$ 11,700	\$ 10,571	\$ 599	\$ 652

The underfunded status of the Pension and Healthcare Plans as of December 31, 2016 and 2015 has been recognized in other liabilities in the consolidated balance sheets.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

The components of net periodic benefit cost and other comprehensive income are as follows:

	Pension Plan		Healthcare Plan	
	2016	2015	2016	2015
Components of net periodic benefit cost:	(In thousands)			
Service cost	\$ 1,082	\$ 1,135	\$ 6	\$ 6
Interest cost	540	489	25	24
Expected return on plan assets	(740)	(710)	-	-
Amortization of prior service cost (credit)	1	1	(4)	(4)
Amortization of net loss	175	209	24	15
Net periodic benefit cost	<u>\$ 1,058</u>	<u>\$ 1,124</u>	<u>\$ 51</u>	<u>\$ 41</u>
Other changes in plan assets and benefit obligations recognized in other comprehensive income:				
Net (gain) loss	\$ 82	\$ (286)	\$ (54)	\$ 109
Recognized actuarial loss	(175)	(209)	(24)	(15)
Recognized prior service (cost) credit	(1)	(1)	4	4
Recognized in other comprehensive income	<u>\$ (94)</u>	<u>\$ (496)</u>	<u>\$ (74)</u>	<u>\$ 98</u>
Total recognized in net periodic benefit cost and other comprehensive income	<u>\$ 964</u>	<u>\$ 628</u>	<u>\$ (23)</u>	<u>\$ 139</u>

The following table presents the components of accumulated other comprehensive loss, net of taxes, as of December 31:

	Pension Plan		Healthcare Plan	
	2016	2015	2016	2015
	(In thousands)			
Prior service cost (credit)	\$ 1	\$ 2	\$ (10)	\$ (12)
Net actuarial loss	2,073	2,129	153	199
	<u>\$ 2,074</u>	<u>\$ 2,131</u>	<u>\$ 143</u>	<u>\$ 187</u>

The estimated costs that will be amortized from accumulated other comprehensive loss into net periodic cost during 2017 are as follows:

	Pension Plan	Healthcare Plan	Total
	(In thousands)		
Prior service cost (credit)	\$ 1	\$ (4)	\$ (3)
Net actuarial loss	214	20	234
Total	<u>\$ 215</u>	<u>\$ 16</u>	<u>\$ 231</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

Weighted-average assumptions used in accounting for the plans were as follows:

	<u>Pension Plan</u>		<u>Healthcare Plan</u>	
	<u>2016</u>	<u>2015</u>	<u>2016</u>	<u>2015</u>
Discount rates:				
Benefit cost for Plan Year	4.32%	3.95%	4.16%	3.81%
Benefit obligation at end of Plan Year	4.12%	4.32%	4.00%	4.16%
Expected long-term return on plan assets	6.50%	6.50%	N/A	N/A
Rate of compensation increase:				
Benefit cost for Plan Year	3.00%	3.00%	N/A	N/A
Benefit obligation at end of Plan Year	3.00%	3.00%	N/A	N/A

The assumed health care cost trend rate used in the postretirement benefit plan at December 31, 2016 was 4.00%. Assumed health care trend rates may have a significant effect on the amounts reported for this plan. A 1% increase in the trend rate would increase the periodic benefit cost by \$5,000 and increase the accumulated postretirement benefit obligation by \$83,000.

The discount rate used for each period was based upon the rates of return on high-quality fixed income investments. The objective of using this approach is to measure the single amount that, if invested at the measurement date in a portfolio of high-quality debt instruments, would provide the necessary future cash flows to pay benefits when they became due. The discount rates are evaluated at each measurement date to give effect to changes in the general level of interest rates.

The Company utilizes the Healthy Annuitant/Employee Mortality Table (RP-2015) to measure its pension plan obligation. In 2015, the Company used RP-2014 adjusted to reflect the Mortality Improvement Scale of 2015 (MP-2015), while in 2016, the Company utilized RP-2016 adjusted to reflect the Mortality Improvement Scale of 2016 (MP-2016). The change in mortality improvement scales decreased the projected benefit obligation by approximately \$206,000.

The Company's funding policy is to contribute, at a minimum, an actuarially determined amount that will satisfy the minimum funding requirements determined under the appropriate sections of the Internal Revenue Code. While the Company has satisfied the minimum funding requirement for 2015, it expects to contribute to the Pension Plan during 2016. However, the amount of the contribution is not known at this time.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

Years Ending December 31,	<u>Pension Plan</u>	<u>Healthcare Plan</u>
	(In thousands)	
2017	\$ 295	\$ 37
2018	340	37
2019	424	37
2020	461	37
2021	509	37
2022 - 2026	3,515	192
	<u>\$ 5,544</u>	<u>\$ 377</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

The fair value of the Company's pension plan assets at December 31, 2016 and 2015 by asset category are as follows:

	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
	(In thousands)			
December 31, 2016:				
Cash equivalents:				
Foreign currencies	\$ 17	\$ 17	\$ -	\$ -
Short term investment funds	54	-	54	-
Total cash equivalents	71	17	54	-
Equity securities:				
Common stock	2,299	2,299	-	-
Depository receipts	68	68	-	-
Commingled pension trust funds	2,702	-	2,702	-
Exchange traded funds	-	-	-	-
Total equity securities	5,069	2,367	2,702	-
Fixed income securities:				
Collateralized mortgage obligations	109	-	109	-
Commingled pension trust funds	2,785	-	2,785	-
Corporate bonds	494	-	494	-
Federal Home Loan Mortgage Corporation	100	-	100	-
Government issues	1,688	-	1,688	-
Other securities	6	-	6	-
Total fixed income securities	5,182	-	5,182	-
Other financial instruments				
Commingled pension trust funds	455	-	-	455
Total other financial instruments	455	-	-	455
Investments valued using Net Asset Value	2,207	-	-	2,207
Total	<u>\$ 12,984</u>	<u>\$ 2,384</u>	<u>\$ 7,938</u>	<u>\$ 2,662</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

	Total	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
	(In thousands)			
December 31, 2015:				
Cash equivalents:				
Foreign currencies	\$ 6	\$ 6	\$ -	\$ -
Total cash equivalents	<u>6</u>	<u>6</u>	<u>-</u>	<u>-</u>
Equity securities:				
Common stock	2,104	2,104	-	-
Depository receipts	54	54	-	-
Commingled pension trust funds	1,698	-	1,698	-
Exchange traded funds	1,639	1,639	-	-
Total equity securities	<u>5,495</u>	<u>3,797</u>	<u>1,698</u>	<u>-</u>
Fixed income securities:				
Collateralized mortgage obligations	98	-	98	-
Commingled pension trust funds	2,878	-	2,878	-
Corporate bonds	553	-	553	-
Federal Home Loan Mortgage Corporation	44	-	44	-
Federal National Mortgage Association	316	-	316	-
Government National Mortgage Association II	62	-	62	-
Government issues	1,155	-	1,155	-
Total fixed income securities	<u>5,106</u>	<u>-</u>	<u>5,106</u>	<u>-</u>
Other financial instruments				
Commingled pension trust funds	430	-	-	430
Total other financial instruments	<u>430</u>	<u>-</u>	<u>-</u>	<u>430</u>
Investments valued using Net Asset Value	<u>602</u>	<u>-</u>	<u>602</u>	<u>-</u>
Total	<u>\$ 11,639</u>	<u>\$ 3,803</u>	<u>\$ 7,406</u>	<u>\$ 430</u>

At December 31, 2016 and 2015, the portfolio was managed by two investment firms. In addition, as of December 31, 2016 and 2015, approximately \$605,000 and \$482,000, respectively, of Pension Plan monies had not yet been allocated to either investment manager. At December 31, 2016 and 2015, control was split at approximately 58%, 38% and 4%.

Note 11 - Pension and Postretirement Benefit Plans (Continued)

At December 31, 2016 and 2015, there were the following investment concentrations:

- Two commingled pension trust funds, which were 7% and 11% of the total portfolio,
- An exchange traded fund, which was 7% of the total portfolio, and
- The short term investment fund, which was 5% of the total portfolio.

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date.

Valuation techniques used to measure fair value must maximize the use of observable inputs and minimize the use of unobservable inputs. The standard describes a fair value hierarchy based on three levels of inputs, of which the first two are considered observable and the last unobservable, that may be used to measure fair value which are the following:

- Level 1—Quoted prices in active markets for identical assets or liabilities.
- Level 2—Inputs other than Level 1 that are observable, either directly or indirectly, such as 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 assets or liabilities.
- Level 3—Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities.

In instances in which the inputs used to measure fair value fall into different levels of the fair value hierarchy, the fair value measurement has been determined based on the lowest level input that is significant to the fair value measurement in its entirety. Investments valued using the Net Asset Value (NAV) are classified as Level 2 if the Pension Plan can redeem its investment with the investee at the NAV at the measurement date. If the Pension Plan can never redeem the investment with the investee at the NAV, it is considered a Level 3. If the Pension Plan can redeem the investment at the NAV at a future date, the Pension Plan's assessment of the significance of a particular item to the fair value measurement in its entirety requires judgment, including the consideration of inputs specific to the asset.

The Pension Plan uses the Thomson Reuters Pricing Service to determine the fair value of equities excluding commingled pension trust funds, the pricing service of IDC Corporate USA to determine the fair value of fixed income securities excluding commingled pension trust funds and JP Morgan Chase Bank, N.A. and Northern Trust to determine the fair value of equity and fixed income commingled pension trust funds.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

The following is a table of the pricing methodology and unobservable inputs used by JPMorgan in pricing commingled pension trust funds:

Commingled Pension Trust Funds (CPTF) – Fixed Income	Principal Valuation Technique(s) Used	Unobservable Inputs
CPTF (Corporate High Yield) of JPMorgan Chase Bank, N.A.	Market	None
CPTF (High Yield) of JPMorgan Chase Bank, N.A.	Market Comparables Companies	EBITDA multiple and discounts for lack of marketability
CPTF (Long Duration Investment Grade) of JPMorgan Chase Bank, N.A.	Market	None
CPTF (Emerging Markets Currency Debt) of JPMorgan Chase Bank, N.A.	Market	None
CPTF (Emerging Markets – Fixed Income Debt) of JPMorgan Chase Bank, N.A.	Market	None
NY Collective Aggregate Bond Index Fund – Lending	NAV	None
Commingled Pension Trust Funds (CPTF) –Other	Principal Valuation Technique(s) Used	Unobservable Inputs
CPTF (Strategic Property) of JPMorgan Chase Bank, N.A.	Market, income, debt service and sales comparison	Credit spreads, discount rate, loan to value ratio, terminal capitalization rate and value per square foot

When valuing Commingled Pension Trust Funds (Equity), JPMorgan uses a market methodology and does not rely on unobservable inputs in those valuations.

The following table sets forth a summary of the changes in Level 3 assets for the year ended December 31, 2016:

January 1, 2015	\$ -
Purchase	375
Gains	55
Balance, December 31, 2015	<u>\$ 430</u>
Sales	(66)
Realized gains	9
Unrealized gains	82
Balances, December 31, 2016	<u><u>\$ 455</u></u>

There were no transfers in or out of Level 3 in the Years Ended December 31, 2016 and 2015.

The Pension Plan was established in 1938 to provide for the payment of benefits to employees of participating banks. The Pension Plan is overseen by a Board of Trustees who meet quarterly and set the investment policy guidelines.

Note 11 - Pension and Postretirement Benefit Plans (Continued)

The overall investment strategy is to achieve a mix of approximately 97% of investments for long-term growth and 3% for near-term benefit payments with a wide diversification of asset types, fund strategies, and fund managers. The target allocations are shown in the table below. Cash equivalents consist primarily of government issues (maturing in less than three months) and short term investment funds. Equity securities primarily include investments in common stock, depository receipts, preferred stock, commingled pension trust funds, exchange traded funds and real estate investment trusts. Fixed income securities include commingled pension trust funds, corporate bonds, credit card receivables, municipals, government issues, mortgage backed securities, and other asset backed securities. Other investment are real estate interests and related investments held within a commingled pension trust fund.

The weighted average expected long-term rate of return is estimated based on current trends as well as projected future rates of return on those assets and reasonable actuarial assumptions based on the guidance provided by Actuarial Standard Of Practice No. 27 "Selection of Economic Assumptions for Measuring Pension Obligations" for long term inflation, and the real and nominal rate of investment return for a specific mix of asset classes. The following assumptions were used in determining the long-term rate of return:

Equity securities: Dividend discount model, the smoothed earnings yield model, and the equity risk premium model

Fixed income securities: Current yield-to-maturity and forecasts of future yields

Other financial instruments: Comparison of the specific investment's risk to that of fixed income and equity instruments and using judgment.

The long term rate of return considers historical returns. Adjustments were made to historical returns in order to reflect expectations of future returns. These adjustments were due to factor forecasts by economists and long-term U.S. Treasury yields to forecast long-term inflation. In addition, forecasts by economists and others for long-term gross domestic product growth were factored into the development of assumptions for earnings growth and per capita income.

Investment managers are prohibited from purchasing any security greater than 5% of the portfolio at the time of purchase or greater than 8% at market value in any one issuer. The issuer of any security purchased must be located in a country in the Morgan Stanley Capital International World Index. In addition, the following investments are prohibited:

Equity securities:

- Short sales,
- Unregistered securities, and
- Margin purchases.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 11 - Pension and Postretirement Benefit Plans (Continued)

Fixed income securities:

- Mortgage backed derivatives that have an inverse floating rate coupon or that are interest only securities,
- Any asset backed security that is not issued by the U.S. government or its agencies or instrumentalities,
- In general, securities of less than Baa2/BBB quality,
- Securities of less than A-quality may not in the aggregate exceed 13% of the investment manager's portfolio, and
- An investment manager's portfolio of commercial mortgage-backed securities and asset-backed securities may not exceed 10% of the portfolio at the time of purchase.

Other financial instruments:

- Unhedged currency exposure in countries not defined as "high income economies" by the World Bank

All other investments not prohibited by policy are permitted. At December 31, 2016 and 2015 the Pension Plan held certain investments which are no longer deemed acceptable to acquire. These positions will be liquidated when the investment managers deem that such liquidation is in the best interest of the Pension Plan.

The target allocation for 2016 and actual allocation of plan assets as of December 31, 2016 and 2015 are as follows:

Asset Category	Target Allocation 2016	% of Plan Assets at December 31,	
		2016	2015
Cash equivalents	0-20%	6.1%	5.2%
Equity securities	40-60%	47.9%	47.2%
Fixed income securities	40-60%	42.6%	43.9%
Other financial instruments	0-5%	3.4%	3.7%

Defined Contribution Plan

The Bank has a contributory 401(k) Plan for substantially all employees. Employees are eligible to contribute a percentage of their salary up to the maximum as determined by the Internal Revenue Service. The Bank is required to match 75% of the employees' contributions up to a maximum of 6% of the employees' salaries. The Bank contributed \$385,000 and \$316,000 under these provisions during 2016 and 2015, respectively.

Note 11 - Pension and Postretirement Benefit Plans (Continued)

Supplemental Employee Retirement Plans

The Company maintains supplemental employee retirement plans (the “SERP”) for certain executives. All benefits provided under the SERP are unfunded and, as these executives retire, the Company will make payments to plan participants. The unfunded status of the SERP at December 31, 2016 and 2015 was \$3.5 million and \$3.2 million, respectively, and is recorded in other liabilities in the consolidated balance sheets. Compensation expense related to the SERP was \$300,000 and \$265,000 for the years ended December 31, 2016 and 2015.

Deferred Compensation Plans

Prior to 2007, the Company had entered into employment agreements with key executives. These employment agreements established deferred compensation plans whereby Company stock was awarded and vested each year. In 2007, the Company terminated the employment agreements and related deferred compensation plans and established new deferred compensation plans for key executives. The new plans require a vesting period of three years from the original date the executive entered the plan. Awarded shares from both the prior plan and the current plan are restricted from being sold until employment is terminated.

The Company obtains shares for the new deferred compensation plan either through open market purchases or from treasury shares. The amount of awarded shares is based on the amount earned by each executive under the deferred compensation plan. The executives are awarded a number of shares based on the amount of deferred compensation earned divided by the value of the shares. The value of the shares purchased on the open market is the price paid. The value of the shares from treasury is the average daily closing price of the stock for each day within the past quarter. Total deferred compensation shares were 141,266 and 133,978 at December 31, 2016 and 2015 respectively. Total shares awarded were 7,288 and 7,606 for 2016 and 2015, respectively. There were no unvested shares at December 31, 2016. Compensation expense is recognized over the vesting period, and is based upon the total amount of the value of the shares awarded to each executive. Compensation expense related to the plan was approximately \$161,000 and \$134,000 for the Years Ended December 31, 2016 and 2015, respectively.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 12 - Earnings Per Share

The following table presents a reconciliation of the earnings and shares used in calculating basic and diluted EPS for each of the years ended December 31:

	<u>2016</u>	<u>2015</u>
	(in thousands, except per share data)	
Net income available to common shareholders	\$ 7,596	\$ 7,371
Adjustment for dilutive potential common shares	<u>23</u>	<u>101</u>
Net income available for diluted common shares	<u>\$ 7,619</u>	<u>\$ 7,472</u>
Weighted average common shares used to calculate basic EPS ⁽¹⁾	3,140,523	2,988,981
Add: effect of common stock equivalents ⁽¹⁾	46,734	202,656
Weighted average common shares used to calculate diluted EPS ⁽¹⁾	<u>3,187,257</u>	<u>3,191,637</u>
Earnings per common share ⁽¹⁾ :		
Basic	<u>\$ 2.42</u>	<u>\$ 2.47</u>
Diluted	<u>\$ 2.39</u>	<u>\$ 2.34</u>

(1) Per share amounts have been adjusted to reflect a 2-for-1 stock split in the form of a stock dividend, effective October 30, 2015.

Note 13 - Related Party Transactions

In the ordinary course of business, the Bank has and expects to continue to have transactions, including loans and deposit accounts, with the Company's and the Bank's executive officers and directors and their affiliates. In the opinion of management, such transactions were on substantially the same terms, including interest rates and collateral, as those prevailing at the time of comparable transactions with other unrelated persons and did not involve more than a normal risk of collectability or present any other unfavorable features.

The rollforward of loans to related parties for the years ended December 31, 2016 and December 31, 2015 is as follows:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Beginning balance, January 1	\$ 10,517	\$ 12,021
New loans	2,005	745
New (Former) Directors	(30)	-
Sold Loans	(250)	-
Repayments	(1,686)	(2,249)
Ending balance, December 31	<u>\$ 10,556</u>	<u>\$ 10,517</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 14 - Commitments and Contingent Liabilities

The Bank is a party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amounts recognized in the consolidated balance sheets. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments summarized as follows at December 31:

	<u>2016</u>	<u>2015</u>
	(In thousands)	
Commitments to extend credit:		
Commitments to grant loans	\$ 68,235	\$ 47,171
Unfunded commitments under commercial lines of credit	76,862	68,836
Unfunded commitments under consumer lines of credit	70,143	54,254
Standby letters of credit	<u>9,697</u>	<u>10,924</u>
	<u>\$ 224,937</u>	<u>\$ 181,185</u>

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

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

Standby letters of credit are conditional lending commitments issued by the Bank to guarantee the performance of a customer to a third party. These letters of credit are primarily issued to support public and private borrowing arrangements. Generally, letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank's policy for obtaining collateral, and the nature of such collateral, is essentially the same as that involved in making commitments to extend credit. The Bank generally holds collateral supporting those commitments. Such collateral amounted to \$7.7 million and \$7.6 million at December 31, 2016 and 2015, respectively. The amount of the liability related to guarantees under standby letters of credit was not material at December 31, 2016 and 2015.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 14 - Commitments and Contingent Liabilities (Continued)

In addition to other investors, the Bank sells residential mortgage loans to the FHLB. The agreement with the FHLB includes a maximum credit enhancement liability of \$9.4 million and \$7.9 million at December 31, 2016 and 2015 respectively, which the Bank may be required to pay if realized losses on any of the sold mortgages exceed the amount held in the FHLB's spread account. The FHLB is funding the spread account annually based on the outstanding balance of loans sold. The Bank's historical losses on residential mortgages have been lower than the amount being funded to the spread account. As such, the Bank does not anticipate recognizing any losses and, accordingly, has not recorded a liability for the credit enhancement.

In addition to pledging investment securities to secure deposits, the Bank has entered into an agreement with the FHLB whereby the FHLB agrees to issue letters of credit for the benefit of securing deposits. In the event the FHLB makes a payment under this agreement, such payment will constitute an advance to the Bank and shall be immediately due and payable. The Bank has pledged unencumbered mortgage-related assets to secure letters of credit from the FHLB. As of December 31, 2016 and 2015, the Bank had letters of credit outstanding with the FHLB of \$33.1 million.

Note 15 - Concentrations of Credit

The Company's loan customers are located primarily in the New York communities served by the Bank. Investments in state and local government securities also involve governmental entities within the Company's market area. Although operating in numerous communities in New York State, the Company is still dependent on the general economic conditions of New York. The largest concentration of credit by industry is Lessor's of Nonresidential Buildings, with loans outstanding of \$36 million or 5.29% of total loans as of December 31, 2016. Risk related to this concentration is controlled through adherence to loan policy guidelines, including appropriate debt service coverage, adequate property values substantiated by current appraisals, and obtaining guarantors where appropriate. The Company, as a matter of policy, does not extend credit to any single borrower, or group of related borrowers, in excess of its legal lending limit. Further information on the Company's lending activities is provided in "Note 4 Loans" in Notes to Consolidated Financial Statements.

Note 16 - Regulatory Matters

The supervision and regulation of financial and bank holding companies and their subsidiaries is intended primarily for the protection of depositors, the deposit insurance funds regulated by the Federal Deposit Insurance Corporation ("FDIC") and the banking system as a whole, and not for the protection of shareholders or creditors of bank holding companies. The various bank regulatory agencies have broad enforcement power over financial holding companies and banks, including the power to impose substantial fines, operational restrictions and other penalties for violations of laws and regulations and for safety and soundness considerations.

Note 16 - Regulatory Matters (Continued)

Capital

The Company (on a consolidated basis) and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary, actions by regulators that, if undertaken, could have a direct material effect on the Company's and the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The 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 Company and the Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined by regulation) and of Tier I capital (as defined) to average assets (as defined). The Company's and the Bank's capital amounts and ratios are also presented in the table below.

In July 2013, the Federal Reserve approved and published the final Basel III Capital Rules establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. The Basel III Capital Rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, including the Company and the Bank, compared to the current U.S risk-based capital rules. The Basel III Capital Rules define the components of capital, and address risk weights and other issues affecting the denominator in the banking institutions' regulatory capital ratios. It also replaces the existing risk-weighting approach, with a more risk-sensitive approach based, in part, on the standardized approach in the Basel Committee's 2004 "Basel II" capital accords and implements the requirements of Section 939A of the Dodd-Frank Act to remove references to credit ratings utilized in the federal banking agencies' rules. The Basel III Capital Rules were effective for the Company and the Bank on January 1, 2015 (subject to a phase-in period).

As required under Dodd-Frank, a new capital ratio, "common equity tier 1 capital ratio" (CET1) was established. This ratio allows only common equity to qualify as tier 1 capital. The new CET1 ratio also will include most elements of accumulated other comprehensive income, including unrealized securities gains and losses, as part of both total regulatory capital (numerator) and total assets (denominator). Community banks, however, were given the opportunity to make a one-time irrevocable election to include or not to include certain elements of other comprehensive income, most notably unrealized securities gains or losses. The Company and the Bank elected to not include the certain items of other comprehensive income in their capital calculations.

In addition to setting higher minimum capital ratios, the new rules, introduce a capital conservation buffer, which must be added to each of the minimum capital ratios and is designed to absorb losses during periods of economic stress. The capital conservation buffer will be phased-in over five years beginning on January 1, 2016 and will be set at 2.5% when fully phased-in. If a banking organization fails to hold capital above minimum capital ratios, including the capital conservation buffer, it will be subject to certain restrictions on capital distribution and discretionary bonus payments.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 16 - Regulatory Matters (Continued)

The final rules eliminated the proposed phase-out over 10 years of Trust Preferred Securities, or “TRUPs” as tier 1 capital for bank holding companies and bank, such as the Company and the Bank, that have less than \$15 billion in total assets. Under the final rule, grandfathered TRUPs would continue to qualify as tier 1 capital until they mature or are redeemed, up to a limit of 25% of tier 1 capital (for grandfathered TRUPs and other grandfathered tier 1 capital components).

(Dollars in thousands)

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To be Well Capitalized under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
December 31, 2016:						
Total risk-based capital						
Consolidated	\$81,785	11.6 %	\$≥56,434	≥8.0 %	\$≥70,543	≥10.0 %
Bank	\$87,350	12.3 %	\$≥56,631	≥8.0 %	\$≥70,789	≥10.0 %
Tier 1 capital						
Consolidated	\$78,967	11.2 %	\$≥42,326	≥6.0 %	\$≥56,434	≥8.0 %
Bank	\$79,498	11.2 %	\$≥42,474	≥6.0 %	\$≥56,631	≥8.0 %
Tier 1 leverage						
Consolidated	\$78,967	8.4 %	\$≥37,630	≥4.0 %	\$≥47,038	≥ 5.0 %
Bank	\$79,498	8.5 %	\$≥37,555	≥4.0 %	\$≥46,944	≥ 5.0 %
Common Equity Tier 1						
Consolidated	\$72,967	10.3 %	\$≥31,744	≥4.5 %	\$≥45,853	≥ 6.5 %
Bank	\$74,570	10.5 %	\$≥31,855	≥4.5 %	\$≥46,013	≥ 6.5 %
December 31, 2015:						
Total risk-based capital						
Consolidated	\$77,527	12.0 %	\$≥51,478	≥8.0 %	\$≥64,348	≥10.0 %
Bank	\$78,254	12.2 %	\$≥51,467	≥8.0 %	\$≥64,334	≥10.0 %
Tier 1 capital						
Consolidated	\$69,426	10.8 %	\$≥38,609	≥6.0 %	\$≥51,478	≥8.0 %
Bank	\$70,155	10.9 %	\$≥36,600	≥6.0 %	\$≥51,467	≥8.0 %
Tier 1 leverage						
Consolidated	\$69,426	8.0 %	\$≥34,548	≥4.0 %	\$≥43,185	≥ 5.0 %
Bank	\$70,155	8.1 %	\$≥34,463	≥4.0 %	\$≥43,078	≥ 5.0 %
Common Equity Tier 1						
Consolidated	\$60,844	9.5 %	\$≥28,957	≥4.5 %	\$≥41,826	≥ 6.5 %
Bank	\$70,155	10.9 %	\$≥28,950	≥4.5 %	\$≥41,817	≥ 6.5 %

Note 16 - Regulatory Matters (Continued)

Management believes, as of December 31, 2016, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

As of the most recent notification from the Office of the Comptroller of the Currency, the Bank was categorized as well capitalized. There are no conditions or events since the notification that management believes have changed the institution's category

Dividend Restrictions

In the ordinary course of business, the Company is dependent upon dividends from the Bank to provide funds for the payment of interest expense on the junior subordinated debentures, dividends to shareholders and to provide for other cash requirements. Banking regulations may limit the amount of dividends that may be paid. Approval by regulatory authorities is required if the effect of dividends declared would cause the regulatory capital of the Bank to fall below specified minimum levels. Approval is also required if dividends declared exceed the net profits for that year combined with the retained net profits for the preceding two years.

At December 31, 2016, the Bank's retained earnings available for the payment of dividends was approximately \$14.3 million.

Note 17 - Fair Value Measurements and Fair Values of Financial Instruments

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. The 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 Company's various assets and liabilities. 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 instrument.

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.

Note 17 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Fair Value Hierarchy

The Company 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 are accessible at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market.

Level 2: Valuation is based upon inputs other than quoted prices included within level 1 that are observable 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 measurement. 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.

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

The following information should not be interpreted as an estimate of the fair value of the entire Company since a fair value calculation is only provided for a limited portion of the Company'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 Company's disclosures and those of other companies may not be meaningful. The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at December 31, 2016 and 2015:

Cash, Due From Banks, and Interest-bearing Deposits in Banks

The carrying amounts reported in the consolidated balance sheets for these assets approximate fair values based on the short-term nature of the assets.

Investment Securities

The fair value of securities available for sale and held to maturity are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or pricing models (Level 2), which consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, credit spreads and new issue data. For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or non-transferability, and such adjustments are generally based on available market evidence (Level 3). In the absence of such evidence, management's best estimate is used.

Note 17 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Management's best estimate consists of external support on certain Level 3 investments. Management has determined that the fair value of local government securities in the held to maturity portfolio approximate their carrying value. Restricted equity securities have restrictions on their sale and are primarily carried at cost due to their limited marketability. The fair value of the Company's investment in Farmer Mac is determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1).

Loans Held for Sale

The fair value of loans held for sale is determined 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, resulting in a Level 2 classification.

Loans

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, resulting in a Level 3 classification. Projected future cash flows are calculated based upon contractual maturity or call dates, projected repayments and prepayments of principal.

Impaired Loans

The fair value of loans considered impaired is generally determined based upon independent third party appraisals of the properties (market approach), 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 fair value consists of the loan balances of \$1.3 million and \$3.8 million, net of valuation allowances of \$0.9 million and \$1.6 million as of December 31, 2016 and 2015, respectively.

Accrued Interest Receivable and Payable

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

Mortgage Servicing Rights

The carrying amount of mortgage servicing rights approximates their fair value.

Deposits

The fair values disclosed for demand and savings deposits are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits, resulting in a Level 2 classification.

Borrowings from the Federal Home Loan Bank

Fair values of borrowings from the FHLB are estimated using discounted cash flow analysis, based on quoted prices for new borrowings from the FHLB with similar credit risk characteristics, terms

Note 17 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

and remaining maturity, resulting in a Level 2 classification. These prices obtained from this active market represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party.

Junior Subordinated Debentures

The fair values of junior subordinated debentures are estimated using discounted cash flow analysis, based on market rates currently offered on such debt with similar credit risk characteristics, terms and remaining maturity, resulting in a Level 2 classification.

Interest Rate Swap Agreements

The fair value of the interest rate swap derivative is calculated based on a discounted cash flow model. All future floating cash flows are projected and both floating and fixed cash flows are discounted to the valuation date. The curve utilized for discounting and projecting is built by obtaining publicly available third party market quotes for various swap maturity terms, resulting in a Level 2 classification.

Off-Balance Sheet Financial Instruments

Fair values for off-balance sheet financial instruments (lending commitments and letters 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.

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 17 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Assets and Liabilities Measured at Fair Value on a Recurring Basis

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, 2016 and 2015 are as follows:

	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
Carrying Value			
(In thousands)			
December 31, 2016:			
Securities available for sale:			
United States agencies	\$ 38,378	\$ -	\$ 38,378
State and local governments	69,586	-	69,586
Mortgage-backed securities	35,019	-	35,019
Total securities available for sale	<u>\$ 142,983</u>	<u>\$ -</u>	<u>\$ 142,983</u>
Restricted equity security	<u>\$ 116</u>	<u>\$ 116</u>	<u>\$ -</u>
Interest rate swap agreements	<u>\$ (377)</u>	<u>\$ -</u>	<u>\$ (377)</u>
December 31, 2015:			
Securities available for sale:			
United States agencies	\$ 41,203	\$ -	\$ 41,203
State and local governments	68,738	-	67,738
Mortgage-backed securities	28,446	-	28,446
Total securities available for sale	<u>\$ 138,387</u>	<u>\$ -</u>	<u>\$ 138,387</u>
Restricted equity security	<u>\$ 65</u>	<u>\$ 65</u>	<u>\$ -</u>
Interest rate swap agreements	<u>\$ (528)</u>	<u>\$ -</u>	<u>\$ (528)</u>

Lyons Bancorp, Inc.

Notes to Consolidated Financial Statements

December 31, 2016 and 2015

Note 17 - Fair Value Measurements and Fair Values of Financial Instruments (Continued)

Assets Measured at Fair Value on a Nonrecurring Basis

There were no assets measured at fair value on a nonrecurring basis at December 31, 2016 and 2015.

The carrying amounts and estimated fair values of the Company's financial instruments at December 31, 2016 and 2015 are as follows:

	Fair Value Hierarchy	2016		2015	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
(In thousands)					
Financial assets:					
Cash and due from banks	1	\$ 14,458	\$ 14,458	\$ 15,416	\$ 15,416
Interest-bearing deposits in banks	1	17,952	17,952	14,365	14,365
Investment securities	1 and 2	205,601	205,339	195,185	195,902
Loans, net of allowance	2 and 3	670,895	677,205	597,013	600,183
Accrued interest receivable	1	3,052	3,052	2,616	2,616
Mortgage servicing rights	2	1,286	1,286	943	943
Financial liabilities:					
Demand and savings deposits	1	\$ 703,626	\$ 703,626	\$ 611,135	\$ 611,135
Certificates of deposit	2	156,447	157,761	160,976	160,898
Borrowings from FHLB	2	18,000	18,000	20,126	20,072
Junior subordinated debentures	2	6,190	6,177	8,867	8,879
Interest rate swap agreements	2	377	377	528	528
Accrued interest payable	1	145	145	158	158

Amounts in the preceding table are included in the consolidated balance sheets under the applicable captions. The fair values of off-balance sheet financial instruments are not significant.