

FIRST COMMUNITY
FINANCIAL CORPORATION

INTO FOCUS

2020
ANNUAL REPORT





INTO **FOCUS**

TABLE OF CONTENTS

2	Management's Letter to Shareholders
3	Helping Local Organizations
4-5	Giving Back
	Consolidated Financial Statements
6-7	Independent Auditor's Report
8	December 31, 2020 and 2019 <i>Consolidated Balance Sheets</i>
9-10	Years ended December 31, 2020 and 2019 <i>Consolidated Statements of Income and Comprehensive Income</i>
11	Years ended December 31, 2020 and 2019 <i>Consolidated Statements of Shareholders' Equity</i>
12	Years ended December 31, 2020 and 2019 <i>Consolidated Statements of Cash Flows</i>
13-51	Notes to Consolidated Financial Statements
52-53	Summary of Selected Financial Data
54	Board of Directors and Officers: First Community Financial Corporation
55-56	Officers: Pennian Bank
57	Directors Emeriti and Advisory Boards
58	Bank and Trust & Investment Services Offices <i>in Juniata, Perry, and Cumberland Counties</i>
59	Stock and Dividend Information

DEAR SHAREHOLDER



JOHN P. HENRY III
Chairman



SCOTT E. FRITZ
President & Chief
Executive Officer

We certainly are living in unprecedented times. This past year brought us new and pressing challenges, unlike anything our team has ever experienced. Like most banks, we implemented our Pandemic Plan in early March and quickly realized that COVID-19 was going to have a dramatic impact on our operations and our community.

We watched as people were confined to their homes, businesses were mandated to close their doors, and the Federal Reserve slashed rates to historic lows and released a historic amount of stimulus.

Due to the hard work of our Pennian team, we were able to transition approximately 80% of our workforce to a remote working environment within just a couple weeks. Our lobbies closed, while our drive-through operations remained open to help service our customers. Banking via online and mobile channels increased dramatically as our customers adapted to the changing times. We anticipate this change in behavior to be a permanent stance for much of our customer base.

We experienced a material increase in deposits over the course of the past year. This surge was due to the rollout of government stimulus programs, increased savings rates driven by economic anxiety, and the ongoing business development efforts of our team. This increase in deposits in conjunction with a dramatically lower interest rate environment allowed the Bank to significantly decrease our cost of funds.

Businesses of every type were hit hard with government-mandated closures. As soon as the CARES Act driven Paycheck Protection Program (PPP) was released in April, our team worked diligently to keep up with the almost daily program updates and work with our qualifying business customers to help them navigate and apply for the program. This initiative resulted in assisting many local businesses get back on their feet in a time of need.

Pennian Bank is well capitalized and can support our future growth initiatives. Credit quality remains strong through the disruptions of the past year and our liquidity metrics remain solid. We have streamlined retail operations through the closure of our West Perry and Shermans Dale offices. Though it was a difficult decision to close those offices, it was the right move for us to focus our investments on sustainable growth initiatives.

Though 2020 was full of challenges and changes at every turn, we are hopeful for a brighter 2021. Our team is working hard during this growth period, making sure we are serving our customers and adding value for our shareholders. We look forward to a productive year and remain focused on sustainable and profitable growth.

FOCUSING ON HELPING LOCAL ORGANIZATIONS

In August, we launched a new program aimed at benefitting community organizations. The Local First Program allows Pennian Bank customers to designate eligible checking and savings accounts to participating nonprofit organizations. Once a participating organization reaches 20 supporters, we make quarterly donations based on a percentage of the average balance in the supporters' accounts.

Local nonprofit organizations struggled in 2020. With demand for their services increasing and donations falling behind, we wanted to provide a way to give back. No money is ever taken out of the supporter's accounts and we help the organizations with marketing materials and promotions.

In January 2021, the first quarterly donation check was presented to Join Hands Ministry. Currently, there are 9 participating organizations and we look forward to helping more organizations and growing the program in 2021.



FOCUSING ON GIVING BACK

To say 2020 was a challenging year is an understatement. Our local community suffered from the mandated business shut downs, forcing people to turn to local organizations to help with everything from heating their homes to putting food on the table.

Part of our mission at Pennian Bank is giving back to the communities we serve. Recognizing this unprecedented need, we made emergency donations to several local organizations to assist with COVID-19 relief.



Community Comes First

“ Partnering with Juniata County BPW and Twilight Wish enabled us to provide for the most vulnerable in our community during these uncertain times when they may not be able to provide for themselves. ”

-Michele Fry, Branch Executive Officer



PennianBank



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Community Comes First D

"We were excited to be able to partner with Join Hands to provide children in our community with cold weather essentials that they may otherwise be unable to obtain during these difficult financial times."

-Genna Brownback,
Branch Executive Officer



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A Central Juniata EMS Donation

D Bloomfield Borough Community Outreach

G Medard's House EITC Donation

B West Shore Office Community Outreach

E Citizens Fire Company Donation

H Juniata County Food Pantry Donation

C Delaware Office Community Outreach

F The Center for Dairy Excellence Foundation EITC Donation



Guidance You
Can Count On.

INDEPENDENT AUDITOR'S REPORT

Board of Directors
First Community Financial Corporation
Mifflintown, Pennsylvania

REPORT ON THE FINANCIAL STATEMENTS

We have audited the accompanying consolidated financial statements of First Community Financial Corporation and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of income and comprehensive income, shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Community Financial Corporation and subsidiaries as of December 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

Smith Elliott Keorns + Company, LLC

Hagerstown, Maryland
February 26, 2021

CONSOLIDATED BALANCE SHEETS

	December 31,	
	2020	2019
ASSETS		
Cash and due from banks	\$ 25,166	\$ 16,427
Interest-bearing demand deposits	3,940	2,201
Federal funds sold	7	201
	<u>29,113</u>	<u>18,829</u>
Cash and Cash Equivalents		18,829
Time certificates of deposit	199	199
Securities available for sale	169,701	142,163
Loans	383,838	354,368
Less: Allowance for loan losses	(4,566)	(3,919)
Plus: Deferred loan costs, net	1,454	1,428
Net loans	<u>380,726</u>	<u>351,877</u>
Premises and equipment, net	6,278	6,793
Other real estate owned, net of allowance	-	1,761
Restricted investment in bank stocks	2,218	1,626
Investment in life insurance	12,663	12,127
Interest rate swap asset	302	-
Other assets	<u>7,091</u>	<u>7,039</u>
Total Assets	<u><u>\$ 608,291</u></u>	<u><u>\$ 542,414</u></u>

LIABILITIES AND SHAREHOLDERS' EQUITY

LIABILITIES

Deposits:		
Non-interest bearing	\$ 91,999	\$ 68,365
Interest-bearing	<u>402,264</u>	<u>383,990</u>
Total Deposits	494,263	452,355
Short-term borrowings	3,827	2,802
FHLB advances	44,000	27,000
Junior subordinated debt	5,155	5,155
Other liabilities	<u>5,251</u>	<u>4,743</u>
Total Liabilities	<u><u>552,496</u></u>	<u><u>492,055</u></u>

SHAREHOLDERS' EQUITY

Preferred stock, without par value; 10,000,000 shares authorized and unissued	-	-
Common stock, \$5 par value; 10,000,000 shares authorized;		
Shares issued, 2020 – 2,832,036; 2019 – 2,832,036		
Shares outstanding, 2020 – 2,823,567; 2019 – 2,823,567	14,160	14,160
Capital in excess of par value	720	720
Retained earnings	36,248	34,159
Treasury stock, at cost 2020 – 8,469 shares; 2019 – 8,469 shares	(200)	(200)
Accumulated other comprehensive income	<u>4,867</u>	<u>1,520</u>
Total Shareholders' Equity	<u><u>55,795</u></u>	<u><u>50,359</u></u>
Total Liabilities and Shareholders' Equity	<u><u>\$ 608,291</u></u>	<u><u>\$ 542,414</u></u>

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME

	Years Ended December, 31,	
	2020	2019
	(In Thousands, Except per Share Data)	
INTEREST INCOME		
Loans, including fees	\$ 16,365	\$ 16,321
Securities:		
Taxable	2,292	3,006
Tax exempt	1,267	742
Other	164	298
Total Interest Income	20,088	20,367
INTEREST EXPENSE		
Deposits	3,698	4,845
Short-term borrowings	53	113
Long-term debt	697	802
Total Interest Expense	4,448	5,760
Net Interest Income	15,640	14,607
PROVISION FOR LOAN LOSSES	600	450
Net Interest Income after Provision for Loan Losses	15,040	14,157
OTHER INCOME		
Service charges on deposits	578	647
Fiduciary activities	705	617
Earnings on investment in life insurance	292	297
ATM and debit card fees	826	822
Investment securities gains from sales	249	139
Unrealized gains on equity securities	38	119
Realized gains on sales of assets	36	19
Mutual fund commissions	248	206
Other	425	358
Total Other Income	3,397	3,224
OTHER EXPENSES		
Employee compensation and benefits	7,352	6,963
Net occupancy and equipment	1,700	1,692
Professional fees	453	564
Director and advisory boards compensation	370	431
ATM expenses	368	371
Supplies and postage	383	396
FDIC/OCC expense	229	113
Pennsylvania bank shares tax	320	314
Advertising	398	371
Internet banking	520	340
Information systems	513	349
Telecommunications	382	355
Other operating	871	1,105
Total Other Expenses	13,859	13,364
Income before Income Taxes	4,578	4,017
PROVISION FOR INCOME TAXES	513	460
Net Income	\$ 4,065	\$ 3,557

See notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF INCOME AND COMPREHENSIVE INCOME (CONTINUED)

	Years Ended December 31,	
	2020	2019
	(In Thousands, Except per Share Data)	
OTHER COMPREHENSIVE INCOME		
Unrealized gains on investment securities, net of tax	3,305	2,497
Unrealized gains on cash flow hedge, net of tax	239	-
Reclassification adjustment for realized gains on sales, net of tax	(197)	(110)
TOTAL OTHER COMPREHENSIVE INCOME	<u>3,347</u>	<u>2,387</u>
TOTAL COMPREHENSIVE INCOME	<u>7,412</u>	<u>5,944</u>
BASIC EARNINGS PER SHARE	<u>\$ 1.44</u>	<u>\$ 1.26</u>
DIVIDENDS PER SHARE	<u>\$ 0.70</u>	<u>\$ 0.69</u>

CONSOLIDATED STATEMENTS OF SHAREHOLDER'S EQUITY

	Common Stock	Capital In Excess of Par Value	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Income (Loss)	Total
	(In Thousands, Except per Share Data)					
Balance - January 1, 2019	\$ 14,160	\$ 720	\$ 32,550	\$ (97)	\$ (867)	\$ 46,466
Comprehensive income:						
Net income			3,557			3,557
Change in net unrealized gains on securities available for sale, net of deferred income taxes					2,387	2,387
Total comprehensive income						5,944
Treasury Stock purchase (4,538 shares)				(103)		(103)
Cash dividends, \$0.69 per share			(1,948)			(1,948)
Balance, December 31, 2019	\$ 14,160	\$ 720	\$ 34,159	\$ (200)	\$ 1,520	\$ 50,359
Comprehensive income:						
Net income			4,065			4,065
Change in net unrealized gains on securities available for sale, and cash flow hedge, net of deferred income taxes					3,347	3,347
Total comprehensive income						7,412
Cash dividends, \$0.70 per share			(1,976)			(1,976)
Balance, December 31, 2020	\$ 14,160	\$ 720	\$ 36,248	\$ (200)	\$ 4,867	\$ 55,795

See notes to consolidated financial statements

CONSOLIDATED STATEMENTS OF CASH FLOWS

	Years Ended December 31, 2020	
	(In Thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 4,065	\$ 3,557
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation of premises and equipment	604	588
Net amortization of debt investment securities	628	696
Earnings on investment in life insurance	(292)	(297)
Realized gains on securities	(249)	(139)
Realized (gains) losses on sales of assets	(29)	1
Realized (gains) on sale of premises and equipment	(7)	(20)
Unrealized (gains) on equity securities	(38)	(119)
Provision for loan losses	600	450
Deferred income taxes	(205)	31
Increase in accrued interest receivable and other assets	(303)	(866)
Decrease in accrued interest payable and other liabilities	267	735
Net Cash Provided by Operating Activities	5,041	4,617
CASH FLOWS FROM INVESTING ACTIVITIES		
Securities available for sale:		
Proceeds from maturities, calls and principal repayments	29,518	26,013
Proceeds from sales	14,164	4,766
Purchases	(67,627)	(38,928)
Net (increase) in loans	(29,449)	(12,658)
Purchases of premises and equipment	(278)	(856)
Proceeds from sale of assets	1,846	479
Purchase of annuities	(295)	-
Proceeds from life insurance death benefit	-	216
Net (purchases) disposition of restricted investment in bank stocks	(593)	240
Net Cash Used in Investing Activities	(52,714)	(20,728)
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	41,908	29,732
Net increase (decrease) in short-term borrowings	1,025	(3,868)
Net increase in FHLB advances	17,000	-
Purchases of treasury stock	-	(103)
Cash dividends paid	(1,976)	(1,948)
Net Cash Provided by Financing Activities	57,957	23,813
Net Increase in Cash and Cash Equivalents	10,284	7,702
CASH AND CASH EQUIVALENTS - BEGINNING	18,829	11,127
CASH AND CASH EQUIVALENTS - ENDING	\$ 29,113	\$ 18,829
SUPPLEMENTARY CASH FLOWS INFORMATION		
Interest paid	\$ 4,556	\$ 5,731
Income taxes paid	\$ 761	\$ 442
Non-cash investing activities		
Transfers from loans to foreclosed real estate	\$ -	\$ 1,823
Unrealized gain on debt securities available for sale – net of tax	\$ 3,108	\$ 2,387
Unrealized gain on interest rate swap – net of tax	\$ 239	\$ -

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES

First Community Financial Corporation (the Corporation) through its wholly-owned subsidiary, Pennian Bank (the Bank), provides loan, deposit, trust and other related financial services through ten full service banking offices in Cumberland, Juniata and Perry Counties of Pennsylvania. The Corporation's other subsidiary, First Community Financial Capital Trust I (the Trust), was established during December 2003 for the purpose of issuing \$5,000,000 of trust preferred securities. On June 29, 2017, the bank changed from a National-Chartered bank to a Pennsylvania State-chartered bank. The Bank's name was changed from The First National Bank of Mifflintown to Pennian Bank on July 1, 2017. In February 2019 the Bank formed a subsidiary insurance agency. The Corporation is subject to regulation and supervision by the Federal Reserve Board and the Bank is subject to regulation and supervision by the Pennsylvania Department of Banking and the FDIC.

Principles of Consolidation

The consolidated financial statements include the accounts of the Corporation, and its wholly-owned subsidiaries, the Bank and the Trust. In consolidation, significant intercompany accounts and transactions between the Bank and the Corporation have been eliminated. The Trust qualifies as a variable interest entity and is accounted for under the provisions of GAAP. The subordinated debt of the Trust is reflected as a liability of the Corporation.

Subsequent Events

The Corporation has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2020, for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through February 26, 2021 the date these consolidated financial statements were available to be issued.

Basis of Accounting

The Corporation uses the accrual basis of accounting.

Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the balance sheet dates, and the reported amounts of income and expenses for the years then ended. Actual results could differ from those estimates. The material estimates that are particularly susceptible to significant change in the near term are the determination of the allowance for loan losses, the evaluation of other-than-temporary impairment of securities, the valuation of foreclosed real estate and deferred tax assets.

While management uses available information to recognize losses on loans, future additions to the allowance may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for losses on loans. Such agencies may require the Bank to recognize additions to the allowance based on their judgments about information available to them at the time of their examination. Because of these factors, management's estimate of credit losses inherent in the loan portfolio and the related allowance may change in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Trust Department Assets

Assets held by the Trust Department in an agency or fiduciary capacity for its customers are excluded from the consolidated financial statements since they do not constitute assets of the Corporation. The market value of assets held by the Trust Department amounted to \$90,319,000 and \$87,076,000 at December 31, 2020 and 2019, respectively. Income from fiduciary activities is recognized on the accrual method.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Significant Group Concentrations of Credit Risk

Most of the Corporation's activities are with customers located within the Central Pennsylvania region. Note 3 discusses the types of securities in which the Corporation invests. Note 4 discusses the types of lending that the Corporation engages in. The Corporation does not have any significant concentrations in any one customer or industry, except for agricultural loans as disclosed in Note 4.

Cash and Cash Equivalents

Cash and cash equivalents includes cash and due from banks, interest bearing demand deposits, federal funds sold and investments with an original maturity of 90 days or less. Federal funds are typically purchased and sold for one day periods. At times, the Corporation may have due from bank balances with its correspondent banks that exceed the federally insured limits, which management considers to be normal and acceptable business risk.

Securities

Management determines the appropriate classification of debt securities at the time of purchase and re-evaluates such designation as of each balance sheet date. Securities available for sale are those debt securities that the Corporation intends to hold for an indefinite period of time, but not necessarily to maturity. Any decision to sell an available for sale debt security would be based on various factors. These securities are stated at fair value. Unrealized gains (losses) are reported as changes in other comprehensive income, a component of shareholders' equity, net of the related deferred tax effect. Premiums and discounts are recognized as interest income over the estimated lives of the securities, using the interest method. Securities held to maturity are those debt securities that the Corporation has the intent and ability to hold to maturity. These debt securities are stated at cost adjusted for amortization of premiums and accretion of discounts, which is recognized as interest income over their estimated lives, using the interest method. Equity securities unrealized gains and losses are recognized in the consolidated statements of income and comprehensive income. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) for equity securities, the intent and ability of the Corporation to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. Other than temporary impairment (OTTI) loss is recognized in earnings through the consolidated statements of income and comprehensive income in the period in which OTTI loss is incurred, except for the non-credit component of OTTI losses on debt securities, which are recognized in other comprehensive income.

Time Certificates of Deposit

Time certificates of deposit are carried at cost, which approximates fair value.

Loans

The Bank grants commercial, residential and consumer loans to customers primarily within Juniata, Perry, Cumberland, and Dauphin Counties of Pennsylvania and the surrounding area. A large portion of the loan portfolio is secured by real estate. Although the Bank has a diversified loan portfolio, its debtors' ability to honor their contracts is influenced by the region's economy.

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 related costs, are deferred and recognized as an adjustment of the yield (interest income) of the related loans. The Corporation is generally amortizing these amounts over the contractual life of the loan.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Loans (Continued)

The accrual of interest is generally discontinued when the contractual payment of principal or interest has become 90 to 120 days past due, or management has significant doubts about further collectability of principal or interest even though the loan is currently performing. A loan may remain on accrual status if it is in the process of collection and is either guaranteed or well secured. When a loan is placed on non-accrual status, unpaid interest credited to income is reversed. Interest received on non-accrual loans generally is either applied against principal or reported as interest income, according to management's judgment as to the collectability of principal. Generally, loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time and the ultimate collectability of the total contractual principal and interest is no longer in doubt. When management determines that the Bank will not be able to collect the entire outstanding principal from either primary or secondary repayment sources, management recommends for charge-off the amount of principal that exceeds the liquidation value (orderly or forced) of the collateral or the entire principal balance if unsecured.

The bank participated in the Paycheck Protection Program (PPP) in 2020. These loans were part of the federal government's response to the economic impact of COVID-19 by providing businesses with funding to cover payroll and other operating costs. The loans associated with this program will either be forgiven, if the business meets the requirements for forgiveness, or will remain loans that have maturities of two or five years. The loans are guaranteed by the Small Business Administration (SBA) and have an interest rate of 1%. The bank originated \$13,300,000 of these loans and as of December 31, 2020 \$7,600,000 was outstanding. There was \$396,000 of PPP fee income recognized in 2020. Due to the guarantees associated with these loans, they represent minimal risk to the bank.

Loan Risk Assessment:

The Bank has a diverse loan portfolio with varying degrees of risk within each segment of the portfolios as discussed below.

Commercial –

- a. Commercial and industrial loans include loans to businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit, demand, or term loans. Some commercial and industrial loans may be unsecured to higher-rated customers, but the majority of these loans are secured by the borrower's accounts receivable, inventory and machinery and equipment and in many loans, the collateral also includes the business real estate or the business owner's personal real estate or assets. Commercial and industrial loans have credit exposure since they are more susceptible to risk of loss during a downturn in the economy as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline.
- b. Obligations of state and political subdivisions in the U.S. These loans are generally pledged by the full faith, credit and taxing power of the governmental entity.
- c. Commercial construction and land development loans are also included in this segment. The risk of loss on these loans is contingent on the assessment of the property's value at the completion of the project, which should exceed the property's construction costs. A number of factors can negatively affect the project during the construction phase such as cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. If the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance,

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Loan Risk Assessment (Continued)

repayment of the loan would potentially need to rely on other repayment sources, including the guarantors of the project or other collateral securing the loan.

Commercial Real Estate –

- a. Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrower's business, with the cash flows generated from the business being the primary source of repayment of these loans. If the business suffers a downturn in sales or profitability, the borrower's ability to repay the loan could be in jeopardy, which could increase the risk of loss.
- b. Non-owner occupied and multi-family commercial real estate loans are dependent on the borrower's ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirements and operating expenses. Lower occupancy or lease rates may result in a reduction in cash flows, which may affect the ability of the borrower to meet debt service requirements, and may result in lower collateral values, which represents a higher inherent risk than owner-occupied commercial loans.

Agricultural –

Farm and agricultural loans consist of commercial loans to local, family-owned farms for operation of farm activities including raising and selling cattle or milk produced, raising and selling poultry, and raising and selling crops. The risks to repayment of farm loans include unfavorable weather conditions that can affect the production of crops for sale or feed, milk production and mortality rates of cattle and poultry that can be affected if cattle or poultry become ill, and milk prices paid which can vary depending on market prices and government subsidies. Collateral for these types of loans typically consists of farm real estate, but can also include equipment, livestock and crops.

Residential –

- a. 1-4 family owner-occupied real estate loans include fixed and adjustable-rate first and junior-lien mortgage loans with the underlying 1-4 family owner-occupied residential property securing the loan. Risk exposure is mitigated somewhat through the evaluation of the credit worthiness of the borrower, including credit scores and debt-to-income ratios, and limits on the loan-to-value ratios.
- b. Home equity term loans and lines of credit represent a slightly higher risk than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but there are loan-to-value limits on the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios.
- c. Non-owner occupied 1-4 family residential loans are dependent on the borrower's ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirements and operating expenses. Lower occupancy or lease rates may result in a reduction in cash flows, which may affect the ability of the borrower to meet debt service requirements, and may result in lower collateral values, which represents a higher inherent risk than owner-occupied 1-4 family residential loans.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Loan Risk Assessment (Continued)

Consumer –

Installment and other consumer loan credit risk is mitigated through evaluation of the credit worthiness of the borrower through credit scores and debt-to-income ratios and, if secured, the collateral value of the assets. However, these loans can be unsecured or secured by assets that may depreciate quickly or may fluctuate and represent a greater risk than 1-4 family residential loans.

Allowance for Loan Losses

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level considered adequate to provide for losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

Loans are risk rated by a universal bank grading system (1-9) endorsed by federal agencies. Level 1 is a loan with minimal risk; 2 – moderate risk; 3 – average risk; 4 – acceptable risk; 5 – marginally acceptable risk (grades 1 - 5 are considered pass loans); 6 – Other Assets Especially Mentioned (OAEM) (potential weaknesses identified); 7 – Substandard (well defined weaknesses); 8 – Doubtful (unlikely to be paid in full); 9 – Loss (will not be paid in full).

A loan review of a sample of the loan portfolio by an independent third-party is conducted semi-annually. All criticized and classified loans graded 6 and higher are reviewed by management quarterly.

The allowance consists of specific and general components. There have been no significant changes in management's methodology for evaluating the allowance for loan losses from prior periods. The specific component relates to loans that are classified as impaired. For such loans, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value for that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. Individual portfolio segments are evaluated on a quarterly basis that values internal and external qualitative factors including: trends in loan volume and mix, past due loans, watch and criticized loans, economic factors; and changes in lending personnel, underwriting processes, underlying collateral and loan policies. Historical losses are evaluated on a rolling 16 quarter basis.

Commercial loans classified OAEM and below are reviewed for possible impairment. A commercial loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Allowance for Loan Losses (Continued)

the length of the delay, the reasons for the delay, the borrower’s prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial, financial and agricultural loans by either the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price or the fair value of the collateral if the loan is collateral dependent.

A Troubled Debt Restructuring (TDR) identification process has been established to determine whether a debtor is experiencing financial difficulty and, if so, whether the Bank has granted a concession to the borrower by modifying or renewing their loan. Then, mitigating factors are evaluated to determine a final conclusion as to whether the loan should be considered a troubled debt restructuring.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual installment and residential loans for impairment consideration unless such loans are the subject of a restructuring agreement.

On March 27, 2020, the federal government enacted the CARES act into law which provides relief from certain requirements under U.S. GAAP, including temporary relief from the accounting and disclosure requirements for troubled debt restructurings (TDRs) in certain situations. On April 7, 2020, a group of banking agencies issued an interagency statement that offers practical expedients for evaluating whether loan modifications that occur in response to the corona virus pandemic are TDRs. For a loan modification to be a TDR in accordance with ASC 310-40, both of the following conditions must be met: 1) the borrower must be experiencing financial difficulty, and 2) the creditor has granted a concession (except for an insignificant delay in payment). While the CARES Act permits the suspension of ASC 310-40, the interagency statement interprets ASC 310-40 by indicating that a lender can conclude that a borrower is not experiencing financial difficulty if short-term modifications (i.e. six months) are made in response to COVID-19, such as payment deferrals, fee waivers, extensions of repayment terms, or other delays that are insignificant related to loans in which the borrower is less than 30 days past due on its contractual payments at the time a modification program is implemented. Therefore, all short-term loan modifications (loan deferrals for six months or less) that meet the above criteria are not considered to be TDRs.

Restricted Investment in Bank Stocks

Restricted investment in bank stocks represents required investments in the common stock of correspondent banks, including Atlantic Community Bankers Bank in the amount of \$20,000, and the Federal Home Loan Bank (FHLB) of Pittsburgh in the amount of \$2,198,000 for the year ended December 31, 2020. At December 31, 2019, the required investment in Atlantic Community Bankers Bank was \$20,000 and the Federal Home Loan Bank (FHLB) of Pittsburgh was \$1,606,000. No readily available market exists for these stocks. These restricted investments are carried at cost, which is considered to be fair value.

Management evaluates the restricted stock for impairment in accordance with FASB ASC Topic 942, *Financial Services – Depository and Lending*. Management’s determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of their cost is influenced by criteria such as (1) the significance of the decline in net assets of the entity as compared to the capital stock amount and the length of time this situation has persisted, (2) commitments by the entity to make payments required by law or regulation and the level of such payments in relation to the operating performance of the entity, and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the entity.

Management believes no impairment charge is necessary related to its restricted stock as of December 31, 2020.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets. Leasehold improvements are depreciated over the shorter of the estimated useful lives or the lease terms. Maintenance and repairs are expensed when incurred and expenditures for significant improvements are capitalized.

Foreclosed Real Estate

Foreclosed real estate includes assets acquired through foreclosure and loans identified as in-substance foreclosures. A loan is classified as an in-substance foreclosure when the Corporation has taken possession of the collateral regardless of whether formal foreclosure proceedings have been commenced. Foreclosed real estate is initially valued at its estimated fair market value, net of anticipated selling costs, at the time of foreclosure, establishing the property's new basis. Subsequent to foreclosure, valuations are periodically performed by management and the foreclosed assets are carried at the lower of carrying amount or fair value less cost to sell. Gains and losses on the sale of foreclosed real estate and writedowns from periodic revaluations on foreclosed real estate are included in other income, while incurred expenses on foreclosed real estate are included in other expenses. Foreclosed real estate amounted to \$0 at December 31, 2020 and \$1,761,000 at December 31, 2019.

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 Corporation, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Corporation does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Derivative Financial Instruments

The Corporation's ALM and risk management activities include the use of a derivative to mitigate risk to the Corporation. The Corporation's goal in using an interest rate derivative is to manage interest rate sensitivity and volatility so that movements in interest rates do not significantly adversely affect earnings or capital.

The Corporation records all derivatives on the consolidated balance sheets at fair value. Fair value is based on dealer quotes, pricing models, discounted cash flow methodologies or similar techniques for which the determination of fair value may require significant judgment or estimation.

At inception, the Corporation formally documents all relationships between the hedging instrument and hedged items, as well as the risk management objectives and strategies for undertaking the hedge. The Corporation assesses the hedge, both at inception and on an ongoing basis, to determine whether the derivative used in a hedging transaction is effective in offsetting changes in the fair value or cash flows of the hedged item and whether the derivative is expected to remain effective during subsequent periods. The Corporation discontinues hedge accounting when (1) it determines that a derivative is no longer effective in offsetting changes in fair value or cash flows of a hedged item; (2) the derivative expires or is sold, terminated or exercised; (3) probability exists that the forecasted transaction will no longer occur; or (4) management determines that designating the derivative as a hedging instrument is no longer appropriate. When hedge accounting is discontinued and a derivative remains outstanding, the Corporation recognizes the derivative in the consolidated balance sheets at its fair value and changes in the fair value are recognized in the consolidated statements of income and comprehensive income.

At inception, the Corporation designates a derivative as (1) a hedge of the exposure to changes in the fair value of recognized assets or liabilities or of unrecognized firm commitments attributable to a particular risk, such as interest rate risk (fair value hedge) or (2) a hedge of the exposure to variability in expected cash flows or other

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Derivative Financial Instruments (Continued)

types of forecasted transactions (cash flow hedge). For a derivative treated as a fair value hedge, a change in fair value is recorded as an adjustment to the hedged item and recognized in earnings. For a derivative treated as a cash flow hedge, the effective portion of the derivative's change in fair value is recorded as an adjustment to the hedged item and recognized as a component of accumulated other comprehensive income (loss) within shareholder's equity while the ineffective portion of a change in fair value is recorded as an adjustment to the hedged item and recognized in earnings. For more information on derivative financial instruments see Note 14.

Advertising Costs

The Corporation charges the costs of advertising to expense as incurred. Advertising expense was \$398,000 and \$371,000 for the years ended December 31, 2020 and 2019, respectively.

Income Taxes

Deferred income taxes are provided on the liability method whereby deferred tax assets are recognized for deductible temporary differences and deferred tax liabilities are recognized for taxable temporary differences. Temporary differences are the differences between the reported amounts of assets and liabilities and their tax basis. Deferred tax assets are reduced by a valuation allowance, when in the opinion of management, it is more likely than not that some portion or all of the deferred tax assets will not be realized. Deferred tax assets and liabilities are adjusted through the provision for income taxes for the effects of changes in tax laws and rates on the date of enactment.

Earnings per Share

Basic earnings per share represents net income divided by the weighted average number of common shares outstanding during the period. The weighted average number of common shares outstanding was 2,823,567 for the year ended 2020 and 2,823,741 for the year ended 2019.

Segment Reporting

Management does not separately allocate expenses, including the cost of funding loan demand, between the commercial, retail, trust and other operations of the Corporation. As such, discrete financial information is not available and segment reporting would not be meaningful.

Comprehensive Income

Accounting principles generally accepted in the United States of America generally require that recognized revenue, expenses, gains and losses be included in net income. Changes in certain assets and liabilities, such as unrealized gains (losses) on debt securities available for sale, and derivatives used in cash flow hedges, are reported as a separate component of the equity section of the consolidated balance sheets. Such items, along with net income, are components of comprehensive income. Changes in equity securities are recorded in the consolidated statements of income and comprehensive income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

The components of other comprehensive income and the related tax effects are as follows:

	<u>Years Ended December 31,</u>	
	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Unrealized holding gains on available for sale securities	\$ 4,184	\$ 3,161
Unrealized holding gains on cash flow hedge	302	-
Reclassification adjustment for gains realized in net income	<u>(249)</u>	<u>(139)</u>
Net Unrealized Gains	4,237	3,022
Tax effect	<u>(890)</u>	<u>(635)</u>
Net of Tax Amount	<u><u>\$ 3,347</u></u>	<u><u>\$ 2,387</u></u>

Reclassifications out of accumulated other comprehensive income

Years ended December 31,

Details about accumulated other comprehensive income components	Amount reclassified from accumulated other comprehensive income		Affected line item in the statement where net income is presented
	2020	2019	
Realized gains and losses on available-for-sale securities	\$ 249	\$ 139	Investment securities gains from sales
Tax effect	52	29	Provision for income taxes
	<u>\$ 197</u>	<u>\$ 110</u>	Net of Tax

Loans Serviced

Currently, the Bank originates some single-family residential loans for immediate sale in the secondary market and Quicken Loans services the loans. At December 31, 2020 and 2019, the balance of loans serviced for others was \$30,042,000 and \$38,231,000 respectively. The estimated fair value of mortgage servicing rights (MSRs) related to loans sold and serviced by the Corporation is recorded as an asset upon sale of such loans. MSRs are amortized as a reduction to servicing income over the estimated lives of the underlying loans. MSRs are evaluated periodically for impairment, by comparing the carrying amount to the estimated fair value. Mortgage servicing income was \$91,000 and \$56,000 for 2020 and 2019, respectively, which is reflected in other income on the consolidated statements of income and comprehensive income. Fair value of MSRs was \$28,000 and \$58,000 at December 31, 2020 and 2019 respectively.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Off Balance Sheet Financial Instruments

In the ordinary course of business, the Corporation has entered into off balance sheet financial instruments consisting of commitments to extend credit and standby letters of credit. Such financial instruments are recorded in the consolidated financial statements when they become payable.

Fair Value Measurements

Fair values of financial instruments are estimated using relevant information and assumptions, as more fully disclosed in Note 13. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions would significantly affect the estimates.

Risks and Uncertainties

Recent economic and government reactions to the COVID-19 pandemic have caused decreased sales for many businesses, resulting in temporary reductions or ceasing of operations for some businesses and created many economic uncertainties. These uncertainties may impact the ability of businesses and individuals to make their loan payments and could result in increased delinquencies and possible increases in the bank's allowance for loan losses. However, the financial impact and durations of these events cannot be reasonably estimated at this time.

Revenue Recognition

All of the Corporation's revenue from contracts with customers within the scope of FASB ASC 606, Revenue from Contracts with Customers, is recognized within noninterest income in the statements of income and comprehensive income. Consistent with ASC 606, noninterest income covered by this guidance is recognized as services are transferred to our customers in an amount that reflects the consideration we expect to be entitled to in exchange for those services.

Following is further detail of the various types of revenue the Corporation earns and when it is recognized.

Interest income: Interest income is generated from various sources, including loans outstanding and investments, and is recognized on an accrual basis according to loan agreements, securities contracts or other such written contracts. These revenues are outside the scope of ASC 606.

Service charges on deposit accounts: Service charges are generated from customer deposit accounts for overdraft and account maintenance services. Overdraft fees are recognized when the overdraft occurs. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Corporation satisfies the performance obligation. The Corporation also earns fees from its customers for other transaction-based services. Such services include safe deposit, box, ATM, stop payment, wire transfer fees, foreign currency order fees and merchant service fees. In each case, these service charges and fees are recognized in income at the time or within the same period that the Corporation's performance obligation is satisfied.

Fiduciary activities: Revenue is primarily comprised of fees earned from the management and administration of trusts, estates and other customer assets and by providing investment brokerage services. Fees that are transaction-based (e.g., execution of trades) are recognized at the time of the transaction. Other fees, such as general management of assets, are earned over time as the contracted monthly or quarterly services, such as account availability, reporting and general administration, are provided. These fees are assessed based on either account activity or the market value of assets under management at month end.

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Revenue Recognition (Continued)

Earnings on investment in life insurance: Revenues are generated from life insurance policies by increases in cash surrender values as premiums are paid, and by the redemption and payout of the policies. These revenues are recognized at the time of carriers reporting cash surrender values to the Corporation and at the time proceeds are received. These revenues are outside the scope of ASC 606.

ATM and debit card fees: ATM fees are generated from non-customer ATM transactions initiated with the Corporation's ATM's. These fees are transaction-based and are recognized at the time the Corporation processes the transaction. Other debit card fees are primarily comprised of interchange fees from debit cardholder transactions conducted through various payment networks. Interchange fees from cardholder transactions are substantially driven by the underlying transaction value and are recognized daily, concurrently with the transaction processing services.

Investment securities gains from sales and unrealized gains on equities: Gains presented in other income represent amounts realized on the sale of all types of investment securities. Unrealized gains on equity securities are also included in this grouping representing changes in market value of equity investment securities that are available for sale. These gains are recognized upon being realized or at the time the investments are marked to market (generally daily), as applicable. These revenues are outside the scope of ASC 606.

Realized gains on sales of assets: Realized gains on the sale of assets represent proceeds in excess of carrying value for property and equipment used in the operations of the Corporation, repossessed assets, or real estate acquired through foreclosure. These gains are recognized at a point in time once control of the assets have transferred to the buyers and collectability of the transaction price is reasonably assured.

Other income: Other income is comprised primarily of secondary market loan fees, other fees and commissions, and mutual fund commissions, all of which are transaction-based fees that are recognized in income at the time or within the same period that the Corporation's performance obligation is satisfied. Also included within other income is a minimal amount of income from an insignificant investment in a limited liability company. The income recognized from this investment is recognized when earned and is outside the scope of ASC 606.

Lease Accounting

In February 2016, the Financial Accounting Standards Board (FASB) released Accounting Standard Update (ASU) 2016-02, *Leases (Topic 842)*. The update is intended to increase transparency and comparability among organizations by recognizing right-of-use (ROU) assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. The core principle of the Update is that a lessee recognizes the assets and liabilities that arise from leases, which is a change from previous GAAP that did not require lease assets and lease liabilities to be recognized on the balance sheet for operating leases. The Corporation implemented ASU 2016-02 and all subsequent ASUs that modified Topic 842 on January 1, 2019 using the modified retrospective approach.

The standard provides for several practical expedients in transition, which among other things, allowed it to carryforward the prior conclusions on lease identification, lease classification, initial direct costs and determination of the lease term. Financial results and disclosures for reporting periods beginning on or after January 1, 2019 are presented under the Topic 842 requirements. The Corporation also elected certain practical expedients within the standards and consistent with such elections did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)

Lease Accounting (Continued)

The implementation of the new standard resulted in recognition of a right-of-use asset and lease liability of \$443,621 at the date of adoption, which is related to the Bank's lease of premises used in operations. Since the calculated right of use asset and lease liability were materially the same, a cumulative effect adjustment to retained earnings as of the implementation date was not recorded.

NOTE 2 - RESTRICTIONS ON CASH AND DUE FROM BANKS

In return for services obtained through correspondent banks, the Corporation is required to maintain non-interest bearing cash balances in those correspondent banks. At December 31, 2020 and 2019, compensating balances approximated \$200,000 and \$1,179,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - SECURITIES

Amortized cost and fair value at December 31, 2020 and December 31, 2019 were as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(In Thousands)			
SECURITIES AVAILABLE FOR SALE:				
December 31, 2020:				
U.S. agency securities	\$ 37,460	\$ 1,309	\$ (261)	\$ 38,508
Mortgage-backed securities	49,976	2,079	(61)	51,994
State and municipal securities	75,100	2,870	(77)	77,893
Equity securities	635	671	-	1,306
	<u>\$ 163,171</u>	<u>\$ 6,929</u>	<u>\$ (399)</u>	<u>\$ 169,701</u>
December 31, 2019:				
U.S. agency securities	\$ 58,332	\$ 784	\$ (372)	\$ 58,744
Mortgage-backed securities	53,252	752	(135)	53,869
Corporate securities	500	-	-	500
State and municipal securities	26,886	937	(41)	27,782
Equity securities	635	633	-	1,268
	<u>\$ 139,605</u>	<u>\$ 3,106</u>	<u>\$ (548)</u>	<u>\$ 142,163</u>

The following table shows the Corporation's investments' gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at December 31, 2020 and December 31, 2019:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2020	(In Thousands)					
SECURITIES AVAILABLE FOR SALE:						
U.S. agency securities	\$ 1,837	\$ 15	\$ 15,585	\$ 246	\$ 17,422	\$ 261
Mortgage-backed securities	6,268	55	440	6	6,708	61
State and municipal securities	11,192	77	-	-	11,192	77
	<u>\$ 19,297</u>	<u>\$ 147</u>	<u>\$ 16,025</u>	<u>\$ 252</u>	<u>\$ 35,322</u>	<u>\$ 399</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - SECURITIES (CONTINUED)

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2019	(In Thousands)					
SECURITIES AVAILABLE FOR SALE:						
U.S. agency securities	\$ 5,019	\$ 48	\$ 20,317	\$ 324	\$ 25,336	\$ 372
Mortgage-backed securities	14,896	62	6,314	73	21,210	135
State and municipal securities	3,304	41	-	-	3,304	41
	<u>\$ 23,219</u>	<u>\$ 151</u>	<u>\$ 26,631</u>	<u>\$ 397</u>	<u>\$ 49,850</u>	<u>\$ 548</u>

At December 31, 2020, fourteen mortgage-backed securities have unrealized losses. The aggregate depreciation from the Corporation's amortized cost basis on these securities is 0.1%. At December 31, 2019, thirty mortgage-backed securities had unrealized losses. The aggregate depreciation from the Corporation's amortized cost basis on these securities was 0.3%. In management's opinion, these unrealized losses relate to changes in interest rates. The Corporation's mortgage backed security portfolio consists of only government sponsored agencies, and contains no private label securities.

At December 31, 2020, twenty state and municipal securities have unrealized losses with aggregate depreciation of 0.1% from the Corporation's amortized cost basis. At December 31, 2019, eight state and municipal securities had unrealized losses with aggregate depreciation of 0.2% from the Corporation's amortized cost basis. In management's opinion, these unrealized losses relate primarily to changes in interest rates. In analyzing the issuer's financial condition, management considers the issuer's bond rating as well as the financial performance of the respective municipality.

At December 31, 2020, twenty U.S. agency securities have unrealized losses with aggregate depreciation of 0.7% from the Corporation's amortized cost basis. At December 31, 2019, twenty-seven U.S. agency securities had unrealized losses with aggregate depreciation of 0.6% from the Corporation's amortized cost basis. In management's opinion, these unrealized losses relate primarily to changes in interest rates.

In management's opinion none of the debt securities have declines in value that are deemed to be other than temporary.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - SECURITIES (CONTINUED)

Gross realized gains and losses for the years ending December 31, 2020 and December 31, 2019 were as follows (in thousands):

	<u>Gross Realized Gains</u>	<u>Gross Realized Losses</u>	<u>Net Gains (Losses)</u>
December 31, 2020:			
Mortgage-backed securities	\$ 59	\$ (24)	\$ 35
U.S. agency securities	<u>242</u>	<u>(28)</u>	<u>214</u>
	<u>\$ 301</u>	<u>\$ (52)</u>	<u>\$ 249</u>
December 31, 2019:			
State and municipal securities	\$ 3	\$ -	\$ 3
Mortgage-backed securities	-	(3)	(3)
U.S. agency securities	<u>139</u>	<u>-</u>	<u>139</u>
	<u>\$ 142</u>	<u>\$ (3)</u>	<u>\$ 139</u>

Amortized cost and fair value at December 31, 2020 by contractual maturity are shown below. Municipal securities with prerefunded issues are included in the category in which payment is expected to occur. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay with or without penalties.

	<u>Available for Sale</u>	
	<u>Amortized Cost</u>	<u>Fair Value</u>
1 year or less	\$ 445	\$ 446
Over 1 year through 5 years	5,168	5,509
Over 5 years through 10 years	14,205	14,512
Over 10 years	92,742	95,934
Mortgage-backed securities	49,976	51,994
Equity securities	<u>635</u>	<u>1,306</u>
	<u>\$ 163,171</u>	<u>\$ 169,701</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 - SECURITIES (CONTINUED)

At December 31, 2020 and 2019, securities with a carrying value of \$78,490,000 and \$72,804,000, respectively, were pledged as collateral as required by law on public deposits and for other purposes.

NOTE 4 - LOANS

Allowance for loan losses at December 31, 2020 and December 31, 2019 and loans receivable at December 31, 2020 and December 31, 2019 are as follows:

Allowance for Loan Losses:

	Commercial	Commercial Real Estate	Agricultural	Consumer	Residential Real Estate	Un - allocated	Total
(in Thousands)							
December 31, 2019 Total Allowance for loan losses	\$ 679	\$ 673	\$ 1,256	\$ 19	\$ 1,206	\$ 86	\$ 3,919
Provision	250	339	(312)	(2)	206	119	600
Charge-offs	-	-	-	(3)	-	-	(3)
Recoveries	9	-	29	2	10	-	50
December 31, 2020 Total Allowance for loan losses	\$ 938	\$ 1,012	\$ 973	\$ 16	\$ 1,422	\$ 205	\$ 4,566
Ending balance for loans individually evaluated for impairment	\$ -	\$ -	\$ 9	\$ -	\$ -	\$ -	\$ 9
Ending balance for loans collectively evaluated for impairment	\$ 938	\$ 1,012	\$ 964	\$ 16	\$ 1,422	\$ 205	\$ 4,557

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - LOANS (CONTINUED)

Allowance for Loan Losses:

	Commercial	Commercial Real Estate	Agricultural	Consumer	Residential Real Estate	Un - allocated	Total
(in Thousands)							
December 31, 2018 Total Allowance for loan losses	\$ 634	\$ 572	\$ 1,209	\$ 14	\$ 1,287	\$ 70	\$ 3,786
Provision	168	101	171	5	(11)	(16)	450
Charge-offs	(138)	-	(125)	-	(70)	-	(333)
Recoveries	15	-	1	-	-	-	16
December 31, 2019 Total Allowance for loan losses	\$ 679	\$ 673	\$ 1,256	\$ 19	\$ 1,206	\$ 86	\$ 3,919
Ending balance for loans individually evaluated for impairment	\$ -	\$ -	\$ 1	\$ -	\$ -	\$ -	\$ 1
Ending balance for loans collectively evaluated for impairment	\$ 679	\$ 673	\$ 1,255	\$ 19	\$ 1,206	\$ 86	\$ 3,918

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - LOANS (CONTINUED)

Loans Receivable:

December 31, 2020	Commercial					Total
	Commercial	Real Estate	Agricultural	Consumer	Residential	
	(in Thousands)					
Individually evaluated for impairment	\$ 133	\$ 1,667	\$ 1,833	\$ -	\$ 987	\$ 4,620
Collectively evaluated for impairment	91,397	93,152	52,580	1,568	140,521	379,218
Total loans	\$ 91,530	\$ 94,819	\$ 54,413	\$ 1,568	\$ 141,508	\$ 383,838

December 31, 2019	Commercial					Total
	Commercial	Real Estate	Agricultural	Consumer	Residential	
	(in Thousands)					
Individually evaluated for impairment	\$ 6	\$ -	\$ 1,435	\$ -	\$ 358	\$ 1,799
Collectively evaluated for impairment	81,056	73,441	\$ 63,572	1,560	132,940	352,569
Total loans	\$ 81,062	\$ 73,441	\$ 65,007	\$ 1,560	\$ 133,298	\$ 354,368

Analysis of credit quality indicators is as follows:

December 31, 2020	Commercial					Total
	Commercial	Real Estate	Agricultural	Consumer	Residential	
	(in Thousands)					
Pass	\$ 91,322	\$ 93,125	\$ 48,430	\$ 1,539	\$ 139,188	\$ 373,604
Special Mention	17	6	365	-	324	712
Substandard	191	1,688	5,618	29	1,996	9,522
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	\$ 91,530	\$ 94,819	\$ 54,413	\$ 1,568	\$ 141,508	\$ 383,838

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - LOANS (CONTINUED)

December 31, 2019	Commercial					Total
	Commercial	Real Estate	Agricultural	Consumer	Residential	
	(in Thousands)					
Pass	\$ 80,781	\$ 71,153	\$ 54,535	\$ 1,524	\$ 130,596	\$ 338,589
Special Mention	19	8	2,087	-	334	2,448
Substandard	262	2,280	8,385	36	2,368	13,331
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total loans	\$ 81,062	\$ 73,441	\$ 65,007	\$ 1,560	\$ 133,298	\$ 354,368

The following is a summary of impaired loans:

December 31, 2020	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no specific allowance needed					
Commercial	\$ 133	\$ 207	\$ -	\$ 113	\$ -
Commercial Real Estate	1,667	1,760	-	1,410	-
Agricultural	1,337	1,382	-	1,351	57
Residential	987	1,234	-	894	-
With an allowance recorded					
Commercial	-	-	-	-	-
Commercial Real Estate	-	-	-	-	-
Agricultural	496	496	9	496	25
Residential	-	-	-	-	-
Total					
Commercial	133	207	-	113	-
Commercial Real Estate	1,667	1,760	-	1,410	-
Agricultural	1,833	1,878	9	1,847	82
Residential	987	1,234	-	894	-
Total	\$ 4,620	\$ 5,079	\$ 9	\$ 4,264	\$ 82

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - LOANS (CONTINUED)

December 31, 2019	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
			(In Thousands)		
With no specific allowance needed					
Commercial	\$ 6	\$ 79	\$ -	\$ 12	\$ -
Agricultural	1,354	1,384	-	1,479	57
Residential	358	394	-	233	-
With an allowance recorded					
Commercial	-	-	-	-	-
Agricultural	81	81	1	82	4
Residential	-	-	-	-	-
Total					
Commercial	6	79	-	12	-
Agricultural	1,435	1,465	1	1,561	61
Residential	358	394	-	233	-
Total	\$ 1,799	\$ 1,938	\$ 1	\$ 1,805	\$ 61

Age analysis of past-due loans is as follows:

December 31, 2020	30 - 59	60 - 89	> 90	Total	Current	Total Loans	>90 Days And Still Accruing	Nonaccruals
	Days	Days	Days					
	Past Due	Past Due	Past Due					
(In Thousands)								
Commercial	\$ -	\$ -	\$ -	\$ -	\$ 91,530	\$ 91,530	\$ -	\$ 290
Commercial Real Estate	21	-	-	21	94,798	94,819	-	1,688
Agricultural	-	-	1,337	1,337	53,076	54,413	1,127	210
Consumer	-	2	-	2	1,566	1,568	-	-
Residential	182	-	-	182	141,326	141,508	-	1,297
Total	\$ 203	\$ 2	\$ 1,337	\$ 1,542	\$ 382,296	\$ 383,838	\$ 1,127	\$ 3,485

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - LOANS (CONTINUED)

December 31, 2019

	30 – 59 Days	60 - 89 Days	> 90 Days	Total		Total	>90 Days And Still	
	Past Due	Past Due	Past Due	Past Due	Current	Loans	Accruing	Nonaccruals
(In Thousands)								
Commercial	\$ 5	\$ -	\$ -	\$ 5	\$ 81,057	\$ 81,062	\$ -	14
Commercial Real Estate	104	-	-	104	73,337	73,441	-	30
Agricultural	-	-	1,487	1,487	63,520	65,007	1,261	226
Consumer	-	-	-	-	1,560	1,560	-	-
Residential	324	88	297	709	132,589	133,298	-	659
Total	\$ 433	\$ 88	\$ 1,784	\$ 2,305	\$352,063	\$354,368	\$ 1,261	\$ 929

The following is a summary of Troubled Debt Restructurings (in thousands):

Twelve Months Ended December 31, 2020

Twelve Months Ended December 31, 2019

Number of contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment	Number of contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
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Troubled Debt Restructurings

Commercial Real Estate	2	\$ 1,760	\$ 1,760	-	\$ -	\$ -
Residential Real Estate	-	-	-	1	154	154
Consumer	-	-	-	-	-	-
Commercial	2	138	138	-	-	-
Agriculture	1	496	496	-	-	-

The following is a summary of Troubled Debt Restructurings that subsequently defaulted (in thousands):

Twelve Months Ended December 31, 2020

Twelve Months Ended December 31, 2019

Number of contracts	Outstanding Recorded Investment	Number of contracts	Outstanding Recorded Investment
---------------------	---------------------------------	---------------------	---------------------------------

Troubled Debt Restructurings Defaulted

Commercial Real Estate	-	\$ -	-	\$ -
Residential Real Estate	-	-	-	-
Consumer	-	-	-	-
Commercial	-	-	1	141
Agriculture	-	-	3	1,743

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 - LOANS (CONTINUED)

During 2020 there was 1 modification to agriculture troubled restructurings, 2 modifications to commercial troubled debt restructurings, and 2 modifications to commercial real estate troubled debt restructurings. These loans were in financial distress prior to the pandemic and required modifications in terms or rates.

During 2019 modifications to one residential real estate troubled debt restructuring was a term extension.

No additional funds are committed to be advanced in connection with any loans whose terms have been modified in troubled debt restructurings.

As of December 31, 2020 and 2019 no consumer mortgage loans were in process of foreclosure.

The Corporation, in the ordinary course of business, has loan, deposit and other routine transactions with its officers, directors and principal shareholders and entities in which they have principal ownership. Changes during 2020 and 2019 in these related party loans were as follows (in thousands):

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Balance, beginning	\$ 2,374	\$ 1,737
Advances	472	1,473
Repayments	<u>(1,188)</u>	<u>(836)</u>
Balance, ending	<u>\$ 1,658</u>	<u>\$ 2,374</u>

NOTE 5 - PREMISES AND EQUIPMENT

Premises and equipment at December 31 were as follows:

	Range of Useful Lives (in years)	<u>2020</u>	<u>2019</u>
		(In Thousands)	
Land	-	\$ 920	\$ 920
Buildings and improvements	7 - 39	9,302	9,335
Furniture, equipment and software	3 - 20	8,188	8,064
Construction in process		0	124
Right of use assets		<u>390</u>	<u>529</u>
		18,800	18,972
Accumulated depreciation		<u>(12,522)</u>	<u>(12,179)</u>
Premises and equipment, net		<u>\$ 6,278</u>	<u>\$ 6,793</u>

NOTE 6 - LEASES

Lease liabilities represent the Corporation's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted based on our best estimate of the rate implicit in the lease. Right-of-use assets represent the Corporation's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

The Corporation's long-term lease agreements are classified as operating leases. Certain of these leases offer the option to extend the lease term and the Bank has included such extensions in its calculation of the lease liabilities

NOTE 6 – LEASES (CONTINUED)

to the extent the options are reasonably assured of being exercised. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations. There are no variable short-term lease costs for the years ended December 31, 2020 and 2019.

The Corporation leases its Delaware office (Juniata County), West Shore office (Cumberland County), the Trust & Financial Services office in Mifflintown and the land on which its East Waterford office was constructed. The Corporation has an option through June 30, 2024 to purchase the leased land, for a predetermined price of \$125,000. The East Waterford land lease is for five years and expires on June 30, 2024 with a five year renewal option. The West Shore office lease is for five years and expires December 31, 2023, and there are two renewal options each for five years. The Trust and Financial Services office lease is for five years and expires February 28, 2024, and there is a renewal option that allows the lease to be renewed at a year-to-year discretion. The Delaware office lease is for five years and expires March 31, 2024, and there is no renewal option. The Corporation also received rental income for leasing of available space at its West Perry and Loysville offices. The Corporation also leases copy machines.

As of December 31, 2020 and 2019, the weighted average remaining lease term for all operating leases is 3.1 and 4.0 years, respectively. The discount rates used are based on our best estimate of the rate implicit in the leases. The weighted average discount rate associated with operating leases as of December 31, 2020 and 2019, is 5.81% and 6%, respectively.

During the years ended December 31, 2020 and 2019, rent expense associated with leases is as follows:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Operating lease cost:		
Fixed rent expense	\$ 184	\$ 167
Sublease income	(46)	(46)
Net lease cost	138	121
Lease cost included in net occupancy and equipment	138	121

Amounts recognized as right-of-use assets related to operating leases are included in premises and equipment, net and related liabilities are included in other liabilities on the consolidated balance sheets. At December 31, 2020 and 2019, right-of-use assets and lease liabilities in operating leases were as follows:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	(In Thousands)
Operating lease right-of-use assets	\$ 390	\$ 529
Operating lease liabilities	390	529

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – LEASES (CONTINUED)

During the years ended December 31, 2020 and 2019, the corporation had the following cash and non-cash activities associated with leases:

	<u>2020</u> (In Thousands)	<u>2019</u> (In Thousands)
Cash paid for amounts related in the measurement of lease liabilities:		
Operating cash flows from operating leases	\$ 184	\$ 167
Non-cash investing and financing activities:		
Additions to ROU assets obtained from:		
New operating leases	17	414

The future payments due under operating leases as of December 31, 2020 are as follows:

	<u>2020</u> (In Thousands)
Due in 2021	\$ 158
2022	158
2023	158
2024	13
2025 and thereafter	0
Total	487
Less effects of discounting	(97)
Lease liabilities recognized	<u>390</u>

NOTE 7 – DEPOSITS

Deposits were comprised of the following as of December 31:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Non-interest bearing demand	\$ 91,999	\$ 68,365
Interest bearing demand	101,021	66,622
Savings	183,662	149,989
Time deposits less than \$100,000	71,939	89,603
Time deposits greater than \$100,000	45,642	77,776
Total	<u>\$ 494,263</u>	<u>\$ 452,355</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7 – DEPOSITS (CONTINUED)

Time deposits greater than \$250,000 were \$11,492,000 and \$25,295,000 at year end 2020 and 2019, respectively.

Scheduled maturities of time deposits at December 31, 2020 were as follows (in thousands):

2021	\$ 64,716
2022	18,379
2023	16,629
2024	6,317
2025	11,540
	<hr/>
Total	\$ 117,581

The aggregate amount of deposit account overdrafts reclassified as loan balances were \$39,000 and \$44,000 at December 31, 2020 and 2019, respectively.

Total aggregate deposits of employees, officers, directors and related interests were \$6,192,000 and \$5,633,000 at December 31, 2020 and 2019, respectively.

NOTE 8 - BORROWINGS

Short-term borrowings at December 31 were as follows:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Amount outstanding at end of year:		
Securities sold under agreements to repurchase	\$ 3,827	\$ 2,802
Weighted average interest rate at end of year	0.31 %	1.17 %
Maximum amount outstanding at any end of month	\$ 7,324	\$ 17,933
Daily average amount outstanding	4,165	5,268
Approximate weighted average interest rate for the year	0.44 %	2.15 %

Securities sold under agreements to repurchase generally mature within one day from the transaction date. At December 31, 2020, securities with a fair value of \$6,805,000 were pledged as collateral for these agreements. At December 31, 2019, securities with a fair value of \$3,868,000 were pledged as collateral for these agreements. As of December 31, 2020, and 2019, the interest rate on securities sold under agreements to repurchase was 0.31% and 1.17%, respectively. The securities underlying the agreements were under the Corporation's control.

FHLB borrowings at December 31 were as follows:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Fixed Rate:		
Maturing in 2020 with a weighted average rate of 1.72%	\$ -	\$ 13,000
Maturing in 2021 with a weighted average rate of 0.75%	30,000	6,000
Maturing in 2022 with a weighted average rate of 2.37%	5,000	4,000
Maturing in 2023 with a weighted average rate of 1.71%	2,000	-
Maturing in 2024 with a weighted average rate of 1.69%	5,000	4,000
Maturing in 2025 with a weighted average rate of 1.01%	2,000	-
	<hr/>	<hr/>
Total	\$ 44,000	\$ 27,000

NOTE 8 – BORROWINGS (CONTINUED)

The Corporation has a maximum borrowing capacity through the Federal Home Loan Bank of approximately \$214,674,000, of which \$170,262,000 was available at December 31, 2020. The borrowing capacity is collateralized by security agreements in certain residential real estate backed assets of the Corporation, including loans and investments. At December 31, 2020, the carrying amount of the qualifying loan collateral was \$302 million.

The Corporation has a \$5,000,000 unsecured fed fund borrowing line at Atlantic Community Bankers Bank. At December 31, 2020, and 2019, there were no outstanding balances on this borrowing line.

The Corporation has issued \$5,155,000 of floating rate junior subordinated deferrable interest debentures to a non-consolidated subsidiary trust, First Community Financial Capital Trust I (the Trust). The Corporation owns all of the common equity of the Trust. The debentures held by the Trust are the sole assets of the Trust.

The Trust issued \$5,000,000 of mandatorily redeemable preferred securities to third-party investors. The Corporation’s obligations under the debentures and related documents, taken together, constitute a full and unconditional guarantee by the Corporation of the Trust’s obligations under the preferred securities. The junior subordinated debt securities pay interest quarterly at 3-month LIBOR plus 3.00% (3.24% and 4.99% at December 31, 2020 and 2019, respectively). Pursuant to the debenture agreement, the Corporation can elect to defer payments of interest for up to 20 consecutive quarterly periods, provided there is no event of default as defined in the indenture. The Corporation has not deferred any quarterly interest payments through December 31, 2020. The preferred securities are redeemable quarterly by the Corporation at 100% of principal plus accrued interest on or after January 7, 2009. The preferred securities must be redeemed upon maturity of the debentures on January 7, 2034. The terms of the junior subordinated deferrable interest debentures match those of the preferred securities.

NOTE 9 - INCOME TAXES

The components of income tax expense for the years ended December 31, 2020 and 2019 are as follows:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Federal:		
Current	\$ 718	\$ 429
Deferred	<u>(205)</u>	<u>31</u>
Total	<u>\$ 513</u>	<u>\$ 460</u>
	Percentage of Income before Income Taxes	
	<u>2020</u>	<u>2019</u>
Federal income tax at statutory rate	21.0 %	21.0 %
Other Adjustments	0.1	0.1
Tax-exempt income	(8.8)	(8.4)
Earnings on investment in life insurance	<u>(1.1)</u>	<u>(1.3)</u>
Total	<u>11.2 %</u>	<u>11.4 %</u>

NOTE 9 – INCOME TAXES (CONTINUED)

Components of deferred tax assets and liabilities at December 31 were as follows:

	2020	2019
	(In Thousands)	
Deferred tax assets:		
Allowance for loan losses	\$ 995	\$ 798
Nonaccrual loans interest	28	28
Retirement liabilities	575	566
Deferred loan fees	194	130
State net operating loss carryforward	384	367
Gross deferred tax asset	<u>2,176</u>	<u>1,889</u>
Valuation allowance	<u>(384)</u>	<u>(367)</u>
	<u>1,792</u>	<u>1,522</u>
Deferred tax liabilities:		
Accumulated depreciation	234	239
Available for sale debt securities	1,230	404
Unrealized gain on cash flow hedge	63	-
Deferred loan costs	499	430
Unrealized gain on equity securities	141	133
Mortgage servicing rights	<u>6</u>	<u>12</u>
	<u>2,173</u>	<u>1,218</u>
Net Deferred Tax Assets (Liabilities)	<u><u>\$ (381)</u></u>	<u><u>\$ 304</u></u>

The Corporation accounts for income taxes in accordance with income tax accounting guidance (FASB ASC 740, *Income Taxes*). The Corporation follows accounting guidance related to accounting for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

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

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

As of December 31, 2020, the Corporation has state net operating loss carryforwards of \$3,848,000 that expire through the year 2040. Management does not believe that these net operating loss carryforwards will be utilized prior to their expiration, as they were incurred by the holding company with little revenue opportunities to offset the losses, and as such, a valuation allowance has been provided for them.

Uncertain tax positions are recognized if it is more likely than not, based on the technical merits, that the tax position will be sustained upon examination. The term “more likely than not” means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals of litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and

NOTE 9 – INCOME TAXES (CONTINUED)

subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being sustained upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management’s judgment.

The Corporation recognizes interest and penalties on income taxes as a component of income tax expense.

NOTE 10 - RETIREMENT PLANS

The Corporation maintains a 401(k) plan for the benefit of eligible employees. Employer contributions include matching a portion of employee contributions. Corporation contributions to the Plan were \$137,000 and \$127,000 for the years ended December 31, 2020 and 2019, respectively.

The Corporation maintains non-qualified compensation plans for selected employees (supplemental retirement) and directors (deferred fees). The estimated present value of future benefits is accrued over the period from the effective date of the agreements until the expected retirement dates of the individuals. Expenses include the following amounts for these non-qualified plans:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Employee compensation	\$ 107	\$ 128
Director compensation	94	118

The balance accrued for these plans included in other liabilities as of December 31, 2020 and 2019 totaled \$2,740,000 and \$2,686,000, respectively.

The Corporation is the owner of single premium life insurance policies on participants as part of a strategy to fund the benefits in the non-qualified retirement plans. At December 31, 2020 and 2019, the cash value of these policies was \$12,663,000 and \$12,127,000, respectively. The Corporation also uses annuities to fund the benefits of these plans. The value of these annuities was \$3,643,000 at December 31, 2020 and \$3,383,000 at December 31, 2019, and they are included in other assets.

The Corporation has an Employee Stock Ownership Plan (ESOP). Contributions to the ESOP are made by the Corporation, and the ESOP uses funds contributed to purchase Corporation stock for the accounts of ESOP participants. All employees who meet the eligibility requirements are participants in the Plan and receive an allocation of cash and stock contributions based on eligible compensation. Stock purchases can be made on the market or from the Corporation. Dividends paid on shares held by the ESOP are included in the calculation of weighted-average shares outstanding for purposes of calculating earnings per share. The Corporation’s contributions to the ESOP totaled \$172,000 in 2020 and \$156,000 in 2019 and are reflected as compensation expense. The ESOP purchased 30,100 shares in 2020 and purchased no shares in 2019. The ESOP held 38,688 shares and 8,588 shares of the Corporation at December 31, 2020 and 2019, respectively, all of which were allocated to participants as of those dates.

Under Federal income tax regulations, the employer stock that is held by the Plan and its participants and is not readily tradable on an established market, or is subject to trading limitations, includes a put option. The put option is a right to demand that the Corporation buy any shares of its stock distributed to participants for which there is no market. The put price is representative of the current value of the stock. The Corporation can pay for the purchase with interest over a period of five years. The purpose of the put option is to ensure that the participant has the ability to ultimately obtain cash. The Corporation may assign the put option to the Plan.

NOTE 10 - RETIREMENT PLANS (CONTINUED)

The estimated fair value of the shares subject to a put or repurchase obligation at December 31, 2020 is approximately \$841,000 based on the most recent valuation performed for ESOP purposes as of December 31, 2020.

NOTE 11 - REGULATORY MATTERS AND SHAREHOLDERS' EQUITY

The Corporation and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Corporation's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation 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 Corporation and the Bank to maintain minimum amounts and ratios (set forth below) of Tier 1 capital to average assets and of Tier 1 and total capital (as defined in the regulations) to risk weighted assets. Management believes, as of December 31, 2020, that the Corporation and the Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2020, the most recent notification from the regulators categorized the Bank as "well capitalized" under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

The actual and required capital amounts and ratios were as follows:

	Actual		For Capital Adequacy Purposes		To be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in Thousands)						
BANK:						
As of December 31, 2020:						
Tier 1 leverage ratio (to average assets)	\$54,443	9.1 %	\$≥24,038	≥4.0 %	\$≥30,048	≥ 5.0 %
Common Equity tier 1 capital ratio (to risk-weighted assets)	54,443	15.4	≥15,872	≥4.5	≥22,926	≥6.5
Tier 1 risk-based capital ratio (to risk-weighted assets)	54,443	15.4	≥21,163	≥6.0	≥28,217	≥ 8.0
Total risk-based capital ratio (to risk-weighted assets)	58,857	16.7	≥28,217	≥8.0	≥35,271	≥10.0
As of December 31, 2019:						
Tier 1 leverage ratio (to average assets)	\$52,457	9.7 %	\$≥21,549	≥4.0 %	\$≥26,937	≥ 5.0 %
Common Equity tier 1 capital ratio (to risk-weighted assets)	52,457	16.6	≥14,236	≥4.5	≥20,564	≥6.5
Tier 1 risk-based capital ratio (to risk-weighted assets)	52,457	16.6	≥18,982	≥6.0	≥25,309	≥ 8.0
Total risk-based capital ratio (to risk-weighted assets)	56,414	17.9	≥25,309	≥8.0	≥31,636	≥10.0

Under the provisions of the Pennsylvania Banking Code, cash dividends may be paid from accumulated net earnings (retained earnings) so long as minimum capital requirements are met. The minimum capital requirements stipulate that the Bank's surplus or additional paid-in capital be equal to the amount of capital. Pennian Bank is well above these requirements and the balance of \$45,828,000 in its retained earnings at December 31, 2020 is

NOTE 11 – REGULATORY MATTERS AND SHAREHOLDERS’ EQUITY (CONTINUED)

available for cash dividends to the Corporation. First Community Financial Corporation’s balance of retained earnings at December 31, 2020 is \$36,248,000 and would be available for dividends, although payment of dividends to such extent would not be prudent or likely.

The Board of Directors of the Corporation have authorized and approved the repurchase of shares of outstanding Corporation common stock in an aggregate amount not to exceed \$1,000,000 (based on gross consideration paid). Share repurchases will be made from time to time and may be affected through open market purchases, block trades, or in privately negotiated transactions. The Corporation did not purchase shares under this plan in 2020 and purchased 4,538 shares in 2019.

NOTE 12 - FINANCIAL INSTRUMENTS WITH OFF BALANCE SHEET RISK

The Corporation is a party to financial instruments with off balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments consist primarily of commitments to extend credit (typically mortgages and commercial loans) and, to a lesser extent, standby letters of credit. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized on the balance sheet. The Corporation’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on balance sheet instruments. The Corporation does not anticipate any material losses from these commitments.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since some of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Corporation evaluates each customer’s creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Corporation upon extensions of credit, is based on management’s credit evaluation of the customer. Collateral held varies but may include accounts receivable, inventory, property and equipment and income-producing commercial properties. On loans secured by real estate, the Corporation generally requires loan to value ratios of no greater than 80%.

Standby letters of credit are conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements and similar transactions. The terms of the letters of credit vary and may have renewal features. The credit risk involved in using letters of credit is essentially the same as that involved in extending loans to customers. The Corporation holds collateral supporting those commitments for which collateral is deemed necessary. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. The current amount of the liability as of December 31, 2020 and 2019 for guarantees under standby letters of credit issued is not material.

The Corporation has not been required to perform on any financial guarantees, and has not incurred any losses on its commitments, during the past two years.

A summary of the Corporation’s commitments, both fixed and variable rates, at December 31 were as follows:

	<u>2020</u>	<u>2019</u>
	(In Thousands)	
Commitments to extend credit	\$ 105,404	\$ 93,688
Standby letters of credit	\$ 3,504	\$ 421

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS

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

ASC Topic 820, *Fair Value Measurements and Disclosure*, which defines fair value, establishes a framework for measuring fair value under GAAP, expands disclosures about fair value measurements, and applies to other accounting pronouncements that require or permit fair value measurements.

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. Additional guidance is provided on determining when the volume and level of activity for the asset or liability has significantly decreased.

Fair value measurement and disclosure provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with fair value measurement and disclosure guidance.

ASC Topic 820 clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the evidence to determine whether the transaction is orderly. This Topic provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

The following information regarding the fair value of the Corporation's financial instruments should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful.

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

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

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

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

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 describes the valuation techniques used by the Corporation to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

Securities available for sale: Securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using pricing models that consider observable market data (Level 2). For certain securities which are not traded in active markets or are subject to transfer restrictions, valuations are adjusted to reflect illiquidity and/or transferability, and such adjustments are generally based on available unobservable market evidence (Level 3).

Cash flow hedge: The Corporation recognizes cash flow hedges at fair value. The Corporation has contracted with a third party to provide valuations for cash flow hedges using valuation techniques such as dealer quotes, pricing models, discounted cash flow methodologies or similar techniques (Level 2).

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, 2020 and 2019 are as follows (in thousands):

Description	December 31, 2020			
	Fair Value	(Level 1) Quoted Prices in Active Markets for Identical Assets	(Level 2) Significant Other Observable Inputs	(Level 3) Significant Unobservable Inputs
U. S. agency securities	\$ 38,508	\$ -	\$ 38,508	\$ -
Mortgage-backed securities	51,994	-	51,994	-
State and municipal securities	77,893	-	77,893	-
Equity securities	1,306	501	-	805
Total securities available for sale	\$ 169,701	\$ 501	\$ 168,395	\$ 805
Cash flow hedge	\$ 302	-	\$ 302	-
Total financial assets	\$ 170,003	\$ 501	\$ 168,697	\$ 805

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

December 31, 2019

Description	Fair Value	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
U. S. agency securities	\$ 58,744	\$ -	\$ 58,744	\$ -
Mortgage-backed securities	53,869	-	53,869	-
Corporate securities	500	-	500	-
State and Municipal securities	27,782	-	27,782	-
Equity securities	1,268	550	-	718
Total securities available for sale	\$ 142,163	\$ 550	\$ 140,895	\$ 718

The table below presents a reconciliation of activity for available for sale securities measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the periods ending December 31, 2020 and December 31, 2019.

	<u>2020</u>	<u>2019</u>
Fair Value, beginning of year	\$ 718	\$ 560
Total gains (losses) included in earnings	87	158
Total gains (losses) included in other comprehensive income	-	-
Transfers in/out	-	-
Fair Value, end of year	<u>\$ 805</u>	<u>\$ 718</u>

The following describes the valuation techniques used by the Corporation to measure certain financial assets recorded at fair value on a nonrecurring basis in the consolidated financial statements:

Impaired Loans: Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Corporation using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports (Level 3). Impaired loans allocated to the Allowance for Loan Losses are measured at fair value on a non-recurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

Foreclosed Real Estate: Certain assets such as real estate owned are measured at fair value less the estimated cost to sell.

Assets measured at fair value on a non-recurring basis at December 31, 2020 and 2019 are summarized below:

Description	December 31, 2020	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Impaired loans	\$ 487	\$ -	\$ -	\$ 487

Description	December 31, 2019	(Level 1)	(Level 2)	(Level 3)
		Quoted Prices in Active Markets for Identical Assets	Significant Other Observable Inputs	Significant Unobservable Inputs
Impaired loans	\$ 80	\$ -	\$ -	\$ 80
Foreclosed Real Estate	1,761	-	-	1,761

Total impaired loans with an allowance, which are measured for impairment using the fair value of the collateral for collateral-dependent loans, had a carrying amount of \$496,000 and \$81,000, net of the valuation allowances of \$9,000 and \$1,000 as of December 31, 2020 and December 31, 2019, respectively. This resulted in an additional provision for loan losses for the period ending December 31, 2020 of \$9,000 and an additional provision of \$1,000 for the period ending December 31, 2019.

The following table displays quantitative information about Level 3 Fair Value Measurements for December 31, 2020 and December 31, 2019.

Quantitative information about Level 3 fair value measurements for December 31, 2020				
	Fair Value	Valuation Techniques	Weighted Average	Unobservable Input
Securities available for sale	\$ 805	Last sale price	-	-
Impaired loans	\$ 487	Discounted appraised value	10 – 20%	Constant prepayment rate, selling cost and discount for lack of marketability

Quantitative information about Level 3 fair value measurements for December 31, 2019				
	Fair Value	Valuation Techniques	Weighted Average	Unobservable Input
Securities available for sale	\$ 718	Last sale price	-	-
Impaired loans	\$ 80	Discounted cash flow	7.76%	Constant prepayment rate, selling cost and discount for lack of marketability
		Discounted appraised value	10 – 20%	
Other real estate owned	\$ 1,761	Discounted appraised value	10 – 20%	Selling cost and discount for lack of marketability

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

The estimated fair values of the Corporation's financial instruments were as follows at December 31, 2020 and 2019.

	December 31, 2020				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
(In Thousands)					
Financial assets:					
Cash and cash equivalents	\$ 29,113	\$ 29,113	\$ 29,113	\$ -	\$ -
Time certificates of deposit	199	199	199	-	-
Investment securities:					
Available for sale	169,701	169,701	501	168,395	805
Loans, net	380,726	381,234	-	380,747	487
Accrued interest receivable	1,864	1,864	-	1,864	-
Investment in life insurance	12,663	12,663	-	12,663	-
Investment in annuities	3,643	3,643	-	3,643	-
Restricted investment in bank stocks	2,218	2,218	-	2,218	-
Cash flow hedge	302	302	-	302	-
Mortgage servicing rights	28	28	-	28	-
Total financial assets	\$ 600,457	\$ 600,965	\$ 29,813	\$ 569,860	\$ 1,292
Financial liabilities:					
Deposits	\$ 494,263	\$ 495,976	\$ -	\$ 495,976	\$ -
Short-term borrowings	3,827	3,827	-	3,827	-
FHLB advances	44,000	44,307	-	44,307	-
Junior subordinated debt	5,155	5,155	-	5,155	-
Accrued interest payable	180	180	-	180	-
Total financial liabilities	\$ 547,425	\$ 549,445	\$ -	\$ 549,445	\$ -
Off-balance sheet financial instruments	\$ -	\$ -	\$ -	\$ -	\$ -

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13 - FAIR VALUE OF FINANCIAL INSTRUMENTS (CONTINUED)

	December 31, 2019				
	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
(In Thousands)					
Financial assets:					
Cash and cash equivalents	\$ 18,829	\$ 18,829	\$ 18,829	\$ -	\$ -
Time certificates of deposit	199	199	199	-	-
Investment securities:					
Available for sale	142,163	142,163	550	140,895	718
Loans, net	351,877	352,538	-	352,458	80
Accrued interest receivable	1,758	1,758	-	1,758	-
Investment in life insurance	12,127	12,127	-	12,127	-
Investment in annuities	3,383	3,383	-	3,383	-
Foreclosed real estate	1,761	1,761	-	-	1,761
Restricted investment in bank stocks	1,626	1,626	-	1,626	-
Mortgage servicing rights	58	58	-	58	-
Total financial assets	\$ 533,781	\$ 534,442	\$ 19,579	\$ 512,304	\$ 2,559
Financial liabilities:					
Deposits	\$ 452,355	\$ 452,908	\$ -	\$ 452,908	\$ -
Short-term borrowings	2,802	2,802	-	2,802	-
FHLB advances	27,000	27,023	-	27,023	-
Junior subordinated debt	5,155	5,155	-	5,155	-
Accrued interest payable	288	288	-	288	-
Total financial liabilities	\$ 487,600	\$ 488,176	\$ -	\$ 488,176	\$ -
Off-balance sheet financial instruments	\$ -	\$ -	\$ -	\$ -	\$ -

NOTE 14 – DERIVATIVE INSTRUMENTS & HEDGING ACTIVITIES

The Corporation's derivative instrument is used as a risk management tool to manage differences in the amount, timing, and duration of the Corporation's exposure to variability in expected cash flows. The Corporation's objectives in using interest rate derivatives are to add stability to net interest income and to manage its exposure to interest rate movements. To accomplish this objective, the Corporation primarily uses interest rate swaps as part of its interest rate risk management strategy. Interest rate swaps designated as cash flow hedges involve the receipt of variable amounts from a counterparty in exchange for the Corporation making fixed-rate payments over the life of the agreements without exchange of the underlying notional amount.

At December 31, 2020, the Corporation had one interest rate swap which it designated as a cash flow hedging instrument. The Corporation entered into the interest rate swap agreement on September 24, 2020 to manage the interest rate exposure on \$24,000,000 of its FHLB borrowing. This portion of its FHLB borrowings have a current maturity of March 2021, though the Corporation will renew these borrowings throughout the ten year term of the swap agreement. Generally accepted accounting principles require that unrealized gains and losses from swap agreements be recognized in current earnings unless they meet certain conditions from the time of their inception and throughout their term. If these conditions are met and ongoing assessments of the hedge effectiveness occur at least quarterly, these principles allow for the unrealized gains and losses to instead be presented as a component of other comprehensive income. The Corporation performed all steps necessary upon inception of the swap to classify the unrealized gains and losses as a component of other comprehensive income and will take actions necessary to continue meeting this criteria prospectively. The most significant aspect of this commitment is that

NOTE 14 – DERIVATIVE INSTRUMENTS & HEDGING ACTIVITIES (CONTINUED)

the Corporation will renew its \$24,000,000 FHLB borrowing through the duration of the swap. If these criteria cease to be met, all accumulated unrealized gains and losses associated with the swap agreement will be reclassified to earnings at that time.

By entering into the swap agreement and designating it as a cash flow hedge, the Corporation expects to effectively convert the variable rates associated with the ongoing FHLB borrowings to a fixed rate. The Corporation pays a fixed interest rate of 0.76% to the counterparty, Vining Sparks, on the notional amount of the swap and it receives a floating rate of interest on the same notional amount that is based on the 3 month LIBOR. A comparable rate based on SOFR will commence when LIBOR no longer exists. Interest payments are calculated and paid quarterly on a net basis, and the related impact of this net transaction is presented as an adjustment to the interest expense of the associated FHLB borrowing within current earnings.

The notional amount of the swap is not exchanged and does not represent exposure to credit loss. In the event of a default by the counterparty, the risk in this transaction is the cost of replacing the agreement at current market rates.

The following table summarizes the Corporation’s derivative financial instrument as of December 31, 2020: (In thousands)

<u>Derivative designated as hedging instrument</u>	<u>Notional Contract Amount</u>	<u>Fair Value</u>	<u>Balance Sheet Location</u>
Cash flow hedge	\$ 24,000	\$ 302	Interest rate swap asset

The maturity date of the cash flow hedge is September 24, 2030.

The following table summarizes the effect of the Corporation’s derivative financial instrument on net income for the twelve months ended December 31, 2020: (In thousands)

<u>Derivative designated as hedging instrument</u>	<u>Amount of Loss Reclassified from AOCI Into Income</u>	<u>Location of Loss Recognized from AOCI Into Income</u>
Cash flow hedge	\$ -	Not Applicable

Interest Expense (Income):

Financial statement line	2020 (in thousands)
Interest expense: Short-term borrowings	\$ 35

Cash collateral held at another institution for swaps was \$1.2 million at December 31, 2020. Collateral posted and received is dependent on the market valuation of the underlying hedge.

The Corporation had no derivative instrument activity during 2019.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 - CONTINGENCIES

The Corporation is subject to claims and lawsuits which arise primarily in the ordinary course of business. Based on information presently available and advice received from legal counsel representing the Corporation in connection with any such claims and lawsuits, it is the opinion of management that the disposition or ultimate determination of any such claims and lawsuits will not have a material adverse effect on the consolidated financial position, consolidated results of operations or liquidity of the Corporation.

NOTE 16 - CONDENSED FINANCIAL INFORMATION FOR PARENT COMPANY ONLY

BALANCE SHEETS

	December 31,	
	2020	2019
	(In Thousands)	
ASSETS		
Cash	\$ 318	\$ 202
Investment in bank subsidiary	59,310	53,977
Investment in unconsolidated subsidiary trust	155	155
Securities available for sale	1,306	1,269
Other assets	40	105
	<u>61,129</u>	<u>55,708</u>
Total Assets	<u>\$ 61,129</u>	<u>\$ 55,708</u>
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities	\$ 179	\$ 194
Junior subordinated debt	5,155	5,155
Shareholders' equity	55,795	50,359
	<u>61,129</u>	<u>55,708</u>
Total Liabilities and Shareholders' Equity	<u>\$ 61,129</u>	<u>\$ 55,708</u>

STATEMENTS OF INCOME

	Years Ended December 31,	
	2020	2019
	(In Thousands)	
Dividends from bank subsidiary	\$ 2,177	\$ 2,151
Other dividends	49	50
Unrealized loss on equity securities	38	119
	<u>2,264</u>	<u>2,320</u>
Expenses	184	256
	<u>2,080</u>	<u>2,064</u>
Equity in undistributed earnings in bank subsidiary	1,985	1,493
	<u>4,065</u>	<u>3,557</u>
Net Income	<u>\$ 4,065</u>	<u>\$ 3,557</u>
Total Comprehensive Income	<u>\$ 7,412</u>	<u>\$ 5,944</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 16 - CONDENSED FINANCIAL INFORMATION FOR PARENT COMPANY ONLY (CONTINUED)

STATEMENTS OF CASH FLOWS

	Years Ended December 31,	
	2020	2019
	(In Thousands)	
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 4,065	\$ 3,557
Equity in undistributed earnings of bank subsidiary	(1,985)	(1,493)
Unrealized gain on securities	(38)	(119)
Decrease (increase) in other assets	65	(50)
Increase (decrease) in other liabilities	(15)	21
	<u>2,092</u>	<u>1,916</u>
Net Cash Provided by Operating Activities		
CASH FLOWS FROM FINANCING ACTIVITIES		
Purchase of treasury stock	-	(103)
Cash dividends paid	(1,976)	(1,948)
	<u>(1,976)</u>	<u>(2,051)</u>
Net Cash Used in Financing Activities		
	116	(135)
Net Increase (Decrease) in Cash		
CASH - BEGINNING	<u>202</u>	<u>337</u>
CASH - ENDING	<u><u>\$ 318</u></u>	<u><u>\$ 202</u></u>

SUMMARY OF SELECTED FINANCIAL DATA

(Amounts in Thousands, Except Per Share Data)

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Income Statement Data					
Net interest income	\$ 15,640	\$ 14,607	\$ 14,927	\$ 14,228	\$ 14,116
Provision for loan losses	600	450	345	-	400
Gains on sales of securities	249	139	5	62	186
Other income	3,148	3,085	2,964	2,697	2,434
Other expenses	<u>13,859</u>	<u>13,364</u>	<u>12,695</u>	<u>11,855</u>	<u>11,659</u>
Income before Income Taxes	4,578	4,017	4,856	5,132	4,677
Income tax expense	<u>513</u>	<u>460</u>	<u>622</u>	<u>1,537</u>	<u>811</u>
Net Income	<u>\$4,065</u>	<u>\$ 3,557</u>	<u>4,234</u>	<u>3,595</u>	<u>\$ 3,866</u>
Balance Sheet Data (Period End)					
Total assets	\$ 608,291	\$ 542,414	\$ 511,921	\$ 505,601	\$ 477,924
Loans, net	380,726	351,877	341,492	345,610	321,210
Investments:					
Available for sale	169,701	142,163	131,429	118,900	119,302
Deposits	494,263	452,355	422,623	403,799	388,118
Short-term borrowings	3,827	2,802	6,670	6,781	2,728
Long-term debt	49,155	32,155	32,155	46,155	40,155
Shareholders' equity	55,795	50,359	46,466	44,977	43,071
Per Share Data					
Basic earnings	\$1.44	\$1.26	\$1.50	\$1.27	\$1.37
Cash dividends declared	0.70	0.69	0.68	0.61	0.585
Book value	19.76	17.83	16.43	15.93	15.25
Weighted average common shares outstanding	2,824	2,824	2,824	2,824	2,825
Selected Ratios					
Return on average assets	0.70 %	0.67 %	0.84 %	0.73 %	0.82 %
Return on average shareholders' equity	7.65 %	7.25 %	9.34 %	8.03 %	8.89 %
Average equity to average assets	9.15 %	9.25 %	8.95 %	9.12 %	9.19 %
Allowance for loan losses to total loans at end of period	1.20 %	1.11 %	1.10 %	1.06 %	1.19 %
Dividend payout ratio	48.61 %	54.77 %	45.37 %	47.92 %	42.73 %

SUMMARY OF SELECTED FINANCIAL DATA (CONTINUED)

The following represents summarized unaudited quarterly financial data of the Corporation which in the opinion of management, reflects adjustments (comprising only normal recurring accruals) necessary for fair presentation:

	Three Months Ended			
	December 31	September 30	June 30	March 31
	(In Thousands, Except per Share Amounts)			
2020:				
Interest income	\$ 5,141	\$ 5,019	\$ 4,841	\$ 5,087
Interest expense	920	967	1,163	1,398
Net interest income	4,221	4,052	3,678	3,689
Provision for loan losses	50	350	200	0
Provision for income taxes	194	135	74	110
Net income	1,275	1,107	806	877
Net income per share, basic	0.45	0.39	0.29	0.31
2019:				
Interest income	\$ 5,152	\$ 5,210	\$ 5,039	\$ 4,966
Interest expense	1,486	1,507	1,474	1,293
Net interest income	3,666	3,703	3,565	3,673
Provision for loan losses	0	225	175	50
Provision for income taxes	107	118	82	153
Net income	867	903	757	1,030
Net income per share, basic	0.31	0.32	0.27	0.36

DIRECTORS

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Chairman of the Board of Directors of the Company and the Bank; Vice President of JPH Enterprises, LLC, Port Royal, PA

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President and Chief Executive Officer of the Company and the Bank

DAVID L. SWARTZ

Secretary of the Board of Directors of the Company and the Bank; Assistant Director for Animal Systems Programs for Penn State Extension

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Co-Owner of Benner's Butcher Shoppe LLC, Benner's Swine Barn LLC and Benner's Mobile Court LLC, Thompsontown, PA

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CFO at Mammoth Restoration, Inc., Pleasant Gap, PA

ROBIN HOLMAN LOY

Attorney-at-Law, New Bloomfield, PA

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Owner of David McMillen Custom Contracting, Inc., Loysville, PA

JAMES M. SHEAFFER

Owner and Dealer Principal, Sheaffer Dodge-Chrysler-Jeep-Ram, Mexico, PA

TIMOTHY P. STAYER

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SVP and Market Executive

DRAGAN DODIK

SVP and Market Executive

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BILLIE JO DEITER

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Accounting Specialist

BRENDA M. L. COMP

IT Manager

NATHAN L. COOK

Branch Executive Officer, West Shore Office

BRENDA C. DUNCAN

Loan Documentation Officer

STACY P. DURBIN

Relationship Banker

GWYN R. GEPHART

Data Processing Supervisor

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Assistant Secretary/Corporate Relations and Senior Marketing Officer

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Credit Analyst

TAMMY S. MARSHALL

Credit Analyst

HOLLY N. TUSING

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Portfolio Manager

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CHARLES C. NYCE
CHARLES C. SMITH
JAMES E. SWENSON

BANK LOCATIONS

First Community Financial Corporation and Wholly Owned Subsidiary, Pennian Bank

Pennian Bank is a full-service financial institution serving customers in Cumberland, Juniata and Perry Counties.

JUNIATA COUNTY

MAIN OFFICE

2 North Main Street
Mifflintown, PA 17059
717-436-2144

DELAWARE OFFICE

24021 Rt. 333
Thomsontown, PA 17094
717-535-5158

EAST WATERFORD OFFICE

9775 Rt. 75 South
East Waterford, PA 17021
717-734-2400

FERMANAGH OFFICE

50 Stop Plaza Drive
Mifflintown, PA 17059
717-436-8968

TUSCARORA VALLEY OFFICE

5804 William Penn Highway
Port Royal, PA 17082
717-436-8947

TRUST & INVESTMENT SERVICES

146 Stoney Creek Drive
Mifflintown, PA 17059
717-436-2144

PERRY COUNTY

BLOOMFIELD BOROUGH OFFICE

216 South Carlisle Street
New Bloomfield, PA 17068
717-582-3977

ICKESBURG OFFICE

250 Tuscarora Path
Ickesburg, PA 17037
717-438-3050

LOYSVILLE OFFICE

3544 Shermans Valley Road
Loysville, PA 17047
717-789-2400

NEWPORT OFFICE

75 Red Hill Road
Newport, PA 17074
717-567-2380

CUMBERLAND COUNTY

WEST SHORE OFFICE

559 North 12th Street
Lemoyne, PA 17043
717-510-7201

ONLINE

pennianbank.com

TOLL FREE

1-866-950-2144



Follow us on Facebook, Instagram and LinkedIn!

STOCK AND DIVIDEND INFORMATION

The Corporation has only one class of common stock authorized, issued and outstanding. Although shares of the Corporation's common stock are traded from time to time in private transactions, and in the over-the-counter market, there is no established public trading market for the stock. The Corporation's common stock is not listed on any stock exchange or automated quotation system and there are no present plans to so list the stock. There can be no assurance that, at any given time, any persons will be interested in acquiring shares of the Corporation's common stock. Price quotations for the Corporation's common stock do not appear regularly in any generally recognized investment media.

The Corporation pays dividends on the outstanding shares of our common stock as determined by the Board of Directors from time to time. It has been the practice of the Board of Directors to declare cash dividends on a quarterly basis. Future dividends will depend upon our earnings, financial position, cash requirements and such other factors as the Board of Directors may deem relevant. The following table sets forth the cash dividends declared per share of the Corporation's common stock and the highest and lowest per share prices at which the Corporation's common stock has traded in private transactions and in the over-the-counter market during the periods indicated. To the best of management's knowledge, such prices do not include any retail mark-up, mark-down or commission. Shares may have been sold in other transactions, the price and terms of which are not known to the Corporation. Therefore, the per share prices at which the Corporation's stock has previously traded may not necessarily be indicative of the true market value of the shares.

Quarter	Per Share Sales Price		Dividends per Share
	High	Low	
First, 2020	\$25.58	\$22.10	\$0.14
Second	25.25	24.50	0.14
Third	25.00	24.50	0.14
Fourth	25.00	23.50	0.28
First, 2019	\$29.95	\$26.00	\$0.14
Second	27.50	26.00	0.14
Third	27.00	25.00	0.14
Fourth	25.50	24.00	0.27

The authorized common stock of the Corporation consists of 10,000,000 shares of common stock, par value \$5.00 per share, of which 2,823,567 shares were outstanding at December 31, 2020. There were no shares of the Corporation's common stock (i) that are subject to outstanding options, warrants or securities convertible into common stock; (ii) that the Corporation has agreed to register under the Securities Act for sale by security holders; or (iii) that are or have been proposed to be publicly offered by the Corporation. The Corporation had approximately 759 shareholders of record as of December 31, 2020.

Notice of Annual Meeting

In light of the continuing coronavirus outbreak, our Board of Directors has determined that it is in the best interests of our shareholders and staff not to gather for our annual meeting at the Cedar Grove Brethren in Christ Church. Rather, while the annual meeting will be held on April 13, 2021, it will be convened virtually from our Board Room, whereby shareholders will be given the opportunity to attend via telephone call in and possibly through an internet video conference link. We will provide additional details on how you may join the meeting virtually in our dividend notification which will be mailed to you in approximately two weeks.



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