

# ANNUAL REPORT

## 2016



ESTABLISHED 1910



Photo courtesy of Austin Walmsley

Peoples Bancorp, Inc.  
and Subsidiary  
The Peoples Bank,  
Fleetwood, Athey, Macbeth & McCown, Inc.  
Chestertown, Maryland

*106 years of "Peoples" Serving People*

PEOPLES BANCORP, INC. AND SUBSIDIARY

TABLE OF CONTENTS

DIRECTORS, OFFICERS AND OTHER PERSONNEL.....2  
LETTER TO THE SHAREHOLDERS.....3  
FINANCIAL HIGHLIGHTS AND COMMITTEES.....4  
REPORT OF INDEPENDENT AUDITORS.....6  
CONSOLIDATED FINANCIAL STATEMENTS  
CONSOLIDATED BALANCE SHEETS.....7  
CONSOLIDATED STATEMENTS OF INCOME.....8  
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY.....10  
CONSOLIDATED STATEMENTS OF CASH FLOWS.....11  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS.....13

BANK SERVICES

ATM SERVICE	MOBILE BANKING & DEPOSIT
BILL PAYING SERVICE	MONEY MARKET ACCOUNTS
CERTIFICATES OF DEPOSIT	MONEY ORDERS
CHECKING ACCOUNTS	NIGHT DEPOSIT SERVICES
CHRISTMAS CLUBS	NOW ACCOUNTS
DEBIT CARDS	REMOTE DEPOSIT CAPTURE
DIRECT DEPOSIT PAYROLL	SAFE DEPOSIT BOXES
DRIVE-IN SERVICE	SAVINGS ACCOUNTS
INDIVIDUAL RETIREMENT ACCOUNTS	SUPER NOW ACCOUNTS
INTERNET BANKING	TELEPHONE BANKING
LOANS, ALL TYPES	TRAVELERS CHEQUES
MERCHANT CARD SERVICES	VISA TRAVEL & GIFT CARDS

---

# PEOPLES BANCORP, INC. AND SUBSIDIARY

---

## PEOPLES BANCORP, INC.

### DIRECTORS

**E. Jean Anthony**  
Chestertown, Maryland

**Gary B. Fellows**  
Millington, Maryland

**Elizabeth A. Strong**  
Chestertown, Maryland

**Robert W. Clark, Jr.**  
Bertterton, Maryland

**Patricia Joan O. Horsey**  
Chestertown, Maryland

**William G. Wheatley**  
Worton, Maryland

**LaMonte E. Cooke**  
Chestertown, Maryland

**Martha F. Rasin**  
Annapolis, Maryland

**R. Allen Davis**  
Galena, Maryland

**Stefan R. Skipp**  
Arnold, Maryland

### OFFICERS

**E. Jean Anthony**  
Co-Chairperson of Bank Board

**Marion P. "Chip" Everett, Jr.**  
Senior Vice President

**Ina P. Reed**  
Vice President & Controller

**Eva W. Hickman**  
Assistant Vice President

**Donna H. Edwards**  
Assistant Cashier

**Stefan R. Skipp**  
Co-Chairperson of Bank Board

**Terri L. Garvey**  
Senior Vice President

**Cecil A. Unruh**  
Vice President

**Heidi L. Manning**  
Assistant Vice President

**Grace M. Eyler**  
Assistant Cashier

**William G. Wheatley**  
Executive Vice President & CLO  
Chairman of Bancorp Board

**Nancy L. Greenwood**  
Senior Vice President & CCO

**L. Susan Barnhardt**  
Assistant Vice President

**Jodi L. Richardson**  
Assistant Vice President

**Mary Ann Landa**  
Assistant Cashier

**Ralph W. Dowling**  
President & CEO

**Stephanie L. Usilton**  
Senior Vice President & HRO &  
Secretary of the Board

**Harriet P. Creighton**  
Assistant Vice President

**Carolyn L. Walls**  
Assistant Vice President

**Lori A. Larrimore**  
Assistant Cashier

**Richard C. Fleetwood, Jr.**  
President of FAM & M, Inc.

**R. Scott Bramble**  
Vice President of FAM&M, Inc.

**Katie E. DiSano**  
Assistant Vice President

**M. Kay McHenry**  
Assistant Secretary

**Mary Chandler Obrecht**  
Assistant Cashier

**H. Lawrence Lyons**  
Executive Vice President &  
Chief Operating Officer & Cashier

**David A. Bowman**  
Vice President

**Sheila M. Dwyer**  
Assistant Vice President

**Karen A. Burris**  
Assistant Cashier

**Jennifer J. Teat**  
Assistant Cashier

**Randall M. Robey**  
Executive Vice President & CFO

**S. Henrietta Maloney**  
Vice President

**Patricia A. Heinefield**  
Assistant Vice President

**Brandi C. Clark**  
Assistant Cashier

**Samantha M. Thompson**  
Assistant Cashier

### OTHER PERSONNEL

Bonnie L. Allen  
Kathleen E. Barnhart  
Leigh A. Blackiston  
Kathleen F. Bozarth  
Kimberly Tanya Brilz  
Roni Lynn Glenn  
Lori A. Goad  
Anjanette S. Graves  
Margaret K. Hammer  
Anita T. Hayes  
Evetta D. Hopkins

Lisa M. Jefferson  
Susan M. Joyner  
Donna M. Lins  
Tina P. Lusby  
Maleena E. "Liz" Meekins  
Jennifer L. Mancuso  
Lorraine Susan Molano  
Richard J. Newberry  
Megan C. O'Connell  
Brittany A. Patchett  
Marcey Peet

Tracy A. Piasecki  
Paula R. Ramirez  
Barbara J. Richardson  
Clara M. Ross  
Ashley M. Schuyler  
Lois Serio  
Jacquelyn V. Shields  
Heather L. Simpson  
Heather M. Spofford  
Michelle L. Stahl  
Sarah S. Sutton

Sharon L. Sutton  
Carol G. Taylor  
Noralene H. Thomas  
Tyler G. Tilghman  
Laurel A. Toth  
Deanna P. Usilton  
Karen A. Willis  
Kimberly S. Wood  
Daniel Zottarelli  
Brenda J. Yoder

---

PEOPLES BANCORP, INC. AND SUBSIDIARY

---

Greetings to our Shareholders,

As reflected by the information contained in this report, the Bank continues to progress on its plan to return to sound financial footing. While lingering legal and holding expenses associated with legacy problem assets continue to negatively impact core earnings, our bottom line improved significantly. We achieved a profit of \$1,317,424 for the year ended December 31, 2016, up from \$1,034,750 for the prior year, representing a 27% increase. Appropriately, the Board and I would like to acknowledge the efforts of our team of officers, Bank employees, and our insurance professionals at FAM&M for their contributions to this achievement.

Protecting and enhancing shareholder value remains our top strategic objective. The combination of enhanced profitability and reduction in problem assets over the last 48 months has resulted in a significant enhancement of shareholder value. With the resumption of dividend payments and the increase in value of the underlying stock, we have met or exceeded our initial goals. The over the counter (OTC) price for our stock (ticker symbol: PEBC) has increased from \$21.00 to \$23.75 over the last 12 months. We continue to work with broker/dealers in developing alternatives to expand the trading of our stock on the OTC market.

Despite great strides, our core earnings remain below our standards. In part, this relates to the cost of the previously referenced expenses associated with legacy problem assets; however, the primary reason for our earning challenges is directly attributable to the state of the real estate market in Kent County. Our ability to generate loans in our home market has been negatively impacted due to slow sales and prices lagging behind the regional and national markets. Our strategic plan to offset this challenge is diversification of our lending activity into adjacent, more robust markets.

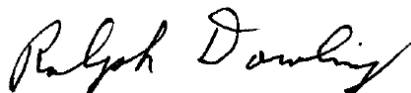
Consistent with this strategy, the opening of our Easton Office at 204 N. Washington Street occurred during the third quarter of 2016. This expansion is already contributing to profitability. We have significantly exceeded projections in both loan and deposit levels.

Our community reputation continues to pay dividends. The Bank was again nominated for the "2016 Community Service Award" by the Kent County Chamber of Commerce, two years after winning the award. Additionally, due to our efforts and involvement in the community, the Bank recently was again selected as the "Favorite Bank" by Kent County News readers. Our numerous community service projects continue to enhance our stature within our markets.

Looking forward to the remainder of 2017, we anticipate continued additional improvements in core earnings and asset quality. In addition to maintaining and enhancing our dominant presence in Kent County, we are planning to continue to expand our business development efforts into Talbot and Queen Anne's Counties.

Our winning formula for success is directly dependent upon our utilization of both our competitive products and our level of personal service.

I close again with our thanks to you and our great customer base. I look forward to visiting with you at the upcoming shareholder meeting and appreciate your continued support.



Ralph Dowling  
President and CEO

PEOPLES BANCORP, INC. AND SUBSIDIARY

**Financial Highlights**

**Five years ended December 31, 2016**

	<u>2016</u>	<u>2015</u>	<u>2014</u>	<u>2013</u>	<u>2012</u>
	(dollars in thousands except per share amounts)				
Deposits	<b>\$216,757</b>	\$202,315	\$196,523	\$201,174	\$206,325
Investments, including stock	<b>37,576</b>	23,530	12,097	16,118	8,140
Loans (net of the allowance for loan losses)	<b>156,306</b>	146,667	134,817	138,019	164,423
Stockholders' equity	<b>23,574</b>	24,336	23,361	22,754	22,047
Assets	<b>254,661</b>	239,907	234,698	241,748	248,952
Net income (loss)	<b>1,317</b>	1,035	563	304	(2,616)
Return on average assets	<b>0.54%</b>	0.45%	0.24%	0.13%	-1.05%
Return on average equity	<b>5.47%</b>	4.42%	2.48%	1.38%	-11.64%
Earnings (loss) per share	<b>1.71</b>	1.33	0.72	0.39	(3.36)
Dividends per share	<b>0.68</b>	-	-	-	-
Book value per share	<b>32.34</b>	31.22	29.97	29.19	28.28
Number of shares outstanding	<b>728,918</b>	779,512	779,512	779,512	779,512

---

PEOPLES BANCORP, INC. AND SUBSIDIARY

---

**COMMITTEES**

**AUDIT COMMITTEE**

E. Jean Anthony, Chairperson  
Robert W. Clark, Jr.  
Gary B. Fellows  
Patricia Joan O. Horsey  
Randall M. Robey, Advisor

**CAPITAL COMMITTEE**

Stefan R. Skipp, Chairperson  
Patricia Joan O. Horsey  
Martha F. Rasin  
William G. Wheatley  
Ralph Dowling, Advisor

**GOVERNANCE/NOMINATING COMMITTEE**

Stefan R. Skipp, Chairperson  
R. Allen Davis  
Gary B. Fellows  
Martha F. Rasin

**TRUSTEES OF THE PEOPLES BANK**

**DEFINED BENEFIT PLAN**

E. Jean Anthony, Chairperson  
Elizabeth A. Strong  
H. Lawrence Lyons

**LOAN COMMITTEE**

William G. Wheatley, Chairperson  
Robert W. Clark, Jr.  
Patricia Joan O. Horsey  
Martha F. Rasin  
Ralph Dowling, Advisor

**PERSONNEL/COMPENSATION COMMITTEE**

LaMonte E. Cooke, Chairperson  
E. Jean Anthony  
R. Allen Davis  
Elizabeth A. Strong

**RISK MANAGEMENT COMMITTEE**

Robert W. Clark, Jr., Chairperson  
E. Jean Anthony  
Patricia Joan O. Horsey  
LaMonte E. Cooke  
Randall M. Robey, Advisor

The Board of Directors and Stockholders  
Peoples Bancorp, Inc.  
Chestertown, Maryland

## **Report of Independent Auditors**

### ***Report on the Financial Statements***

We have audited the accompanying consolidated financial statements of Peoples Bancorp, Inc. and Subsidiary, which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for the years then ended, and the related notes to the financial statements.

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

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of 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 audits 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 Company'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 Company'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 Peoples Bancorp, Inc. and Subsidiary as of December 31, 2016 and 2015, 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.

*Rowles & Company, LLP*

Baltimore, Maryland  
February 28, 2017

PEOPLES BANCORP, INC. AND SUBSIDIARY

**CONSOLIDATED BALANCE SHEETS**

**ASSETS**

**DECEMBER 31,**

	2016	2015
Cash and due from banks	\$ 49,685,967	\$ 58,579,879
Securities available for sale	36,874,318	22,774,214
Securities held to maturity (fair value of \$127 and \$58,862)	127	59,322
Federal Home Loan Bank and CBB Financial Corp. stock, at cost	701,100	696,300
Loans, less allowance for loan losses of \$4,303,583 and \$5,183,007	156,306,289	146,666,702
Premises and equipment	5,757,395	4,383,255
Accrued interest receivable	490,106	524,661
Deferred income taxes	1,929,393	2,415,622
Other real estate owned	1,995,826	2,991,492
Goodwill	272,932	272,932
Intangible assets	-	55,000
Other assets	647,345	487,557
	<b>\$254,660,798</b>	<b>\$239,906,936</b>

**LIABILITIES AND STOCKHOLDERS' EQUITY**

	2016	2015
Deposits		
Noninterest bearing checking	\$ 69,541,575	\$ 57,469,558
Savings and NOW	69,658,150	62,396,833
Money market	15,287,991	15,013,048
Other time	62,269,748	67,435,506
	216,757,464	202,314,945
Securities sold under repurchase agreements	2,180,252	1,254,358
Federal Home Loan Bank advances	10,000,000	10,000,000
Accrued interest payable	136,201	156,283
Other liabilities	2,012,486	1,845,293
	231,086,403	215,570,879
Stockholders' equity		
Common stock, par value \$10 per share; authorized 1,000,000 shares; issued and outstanding 728,918 and 779,512 shares	7,289,180	7,795,120
Additional paid-in capital	2,212,550	2,920,866
Retained earnings	14,917,414	14,130,058
Accumulated other comprehensive income		
Unrealized gain (loss) on securities available for sale	(68,918)	20,064
Unfunded liability for defined benefit plan	(775,831)	(530,051)
	23,574,395	24,336,057
	<b>\$254,660,798</b>	<b>\$239,906,936</b>

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



PEOPLES BANCORP, INC. AND SUBSIDIARY

**CONSOLIDATED STATEMENTS OF INCOME**

**YEARS ENDED DECEMBER 31,**

	<u>2016</u>	<u>2015</u>
<b>Interest and dividend revenue</b>		
Loans, including fees	\$7,179,942	\$7,291,335
U.S. government agency securities	336,682	399,997
Other	<u>268,291</u>	<u>132,967</u>
Total interest and dividend revenue	<u>7,784,915</u>	<u>7,824,299</u>
 <b>Interest expense</b>		
Deposits	579,534	746,551
Borrowed funds	<u>445,516</u>	<u>447,848</u>
Total interest expense	<u>1,025,050</u>	<u>1,194,399</u>
 Net interest income	 6,759,865	 6,629,900
 <b>Provision for loan losses</b>	 <u>(900,000)</u>	 <u>(600,000)</u>
Net interest income after provision for loan losses	<u>7,659,865</u>	<u>7,229,900</u>
<b>Noninterest revenue</b>		
Service charges on deposit accounts	720,402	711,597
Insurance commissions	1,862,531	1,714,653
Gain on sale of other real estate owned	252,142	72,493
Other noninterest revenue	<u>234,411</u>	<u>241,327</u>
Total noninterest revenue	<u>3,069,486</u>	<u>2,740,070</u>
<b>Noninterest expense</b>		
Salaries	3,952,605	3,694,890
Employee benefits	983,403	994,252
Occupancy	502,620	486,186
Furniture and equipment	337,087	378,229
Data processing and correspondent fees	596,644	589,343
Other real estate owned expense	502,387	338,564
Professional fees	391,846	395,960
Other operating	<u>1,368,538</u>	<u>1,474,066</u>
Total noninterest expense	<u>8,635,130</u>	<u>8,351,490</u>
 <b>Income before income taxes</b>	 2,094,221	 1,618,480
 Income tax expense	 <u>776,797</u>	 <u>583,730</u>
 <b>Net income</b>	 <u>\$1,317,424</u>	 <u>\$1,034,750</u>
 Earnings per common share - basic and diluted	 <u>\$ 1.71</u>	 <u>\$ 1.33</u>

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

PEOPLES BANCORP, INC. AND SUBSIDIARY

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	<b>YEARS ENDED DECEMBER 31,</b>	
	<b>2016</b>	<b>2015</b>
<b>Net income</b>	<b>\$1,317,424</b>	<b>\$1,034,750</b>
<b>Other comprehensive income (loss)</b>		
Unrealized loss on investment securities available for sale	(146,943)	(16,404)
Income tax relating to unrealized loss on investment securities available for sale	57,961	4,640
	<b>(88,982)</b>	<b>(11,764)</b>
Change in underfunded status of defined benefit plan	(405,878)	(66,255)
Income tax relating to change in underfunded status of defined benefit plan	160,098	18,742
	<b>(245,780)</b>	<b>(47,513)</b>
Total other comprehensive loss	<b>(334,762)</b>	<b>(59,277)</b>
<b>Total comprehensive income</b>	<b>\$ 982,662</b>	<b>\$ 975,473</b>

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

PEOPLES BANCORP, INC. AND SUBSIDIARY

**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY  
YEARS ENDED DECEMBER 31, 2016 and 2015**

	Common stock		Additional	Retained	Accumulated	Total
	Shares	Par value	paid-in capital	earnings	other comprehensive income	stockholders' equity
<b>Balance, December 31, 2014</b>	779,512	\$7,795,120	\$2,920,866	\$13,095,308	\$(450,710)	\$23,360,584
Net income	-	-	-	1,034,750	-	1,034,750
Change in underfunded status of defined benefit plan net of income taxes of \$18,742	-	-	-	-	(47,513)	(47,513)
Unrealized loss on investment securities available for sale net of income taxes of \$4,640	-	-	-	-	(11,764)	(11,764)
<b>Balance, December 31, 2015</b>	779,512	7,795,120	2,920,866	14,130,058	(509,987)	24,336,057
Net income	-	-	-	<b>1,317,424</b>	-	<b>1,317,424</b>
Change in underfunded status of defined benefit plan net of income taxes of \$160,098	-	-	-	-	<b>(245,780)</b>	<b>(245,780)</b>
Unrealized loss on investment securities available for sale net of income taxes of \$57,961	-	-	-	-	<b>(88,982)</b>	<b>(88,982)</b>
Repurchase of stock	<b>(50,594)</b>	<b>(505,940)</b>	<b>(708,316)</b>	-	-	<b>(1,214,256)</b>
Cash dividend, \$0.68 per share	-	-	-	<b>(530,068)</b>	-	<b>(530,068)</b>
<b>Balance, December 31, 2016</b>	<b><u>728,918</u></b>	<b><u>\$7,289,180</u></b>	<b><u>\$2,212,550</u></b>	<b><u>\$14,917,414</u></b>	<b><u>\$(844,749)</u></b>	<b><u>\$23,574,395</u></b>

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

PEOPLES BANCORP, INC. AND SUBSIDIARY

**CONSOLIDATED STATEMENTS OF CASH FLOWS**

**YEARS ENDED DECEMBER 31,**

	<u>2016</u>	<u>2015</u>
<b>Cash flows from operating activities</b>		
Interest received	\$ 7,992,919	\$ 8,091,408
Fees and commissions received	2,819,997	2,667,577
Interest paid	(1,045,132)	(1,219,503)
Cash paid to suppliers and employees	(8,502,348)	(8,087,919)
Income taxes paid	(72,508)	(48,036)
	<u>1,192,928</u>	<u>1,403,527</u>
<b>Cash flows from investing activities</b>		
Proceeds from maturities and calls of investment securities		
Held to maturity	1,760,880	839
Available for sale	10,776,943	22,279,693
Purchase of investment securities		
Held to maturity	(1,701,685)	(58,446)
Available for sale	(25,195,910)	(34,484,107)
(Purchase) redemption of Federal Home Loan Bank stock	(4,800)	121,300
Loans made, net of principal collected	(9,139,463)	(11,314,028)
Purchase of premises, equipment, and software	(1,653,380)	(225,710)
Proceeds from the sale of COLI	-	470,081
Improvements to other real estate owned	-	(3,561)
Proceeds from sale of premises and equipment	2,000	-
Proceeds from sale of other real estate owned	1,444,486	1,003,881
	<u>(23,710,929)</u>	<u>(22,210,058)</u>
<b>Cash flows from financing activities</b>		
Net increase (decrease) in		
Time deposits	(5,165,758)	(5,187,637)
Other deposits	19,608,277	10,979,181
Securities sold under repurchase agreements	925,894	(1,459,192)
Repurchase of stock	(1,214,256)	-
Dividends paid	(530,068)	-
	<u>13,624,089</u>	<u>4,332,352</u>
Net decrease in cash and cash equivalents	(8,893,912)	(16,474,179)
Cash and cash equivalents at beginning of year	<u>58,579,879</u>	<u>75,054,058</u>
Cash and cash equivalents at end of year	<u>\$49,685,967</u>	<u>\$58,579,879</u>

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

PEOPLES BANCORP, INC. AND SUBSIDIARY

**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**

**YEARS ENDED DECEMBER 31,**

	<u>2016</u>	<u>2015</u>
<b>Reconciliation of net income to net cash provided by operating activities</b>		
Net income	<b>\$1,317,424</b>	\$1,034,750
<b>Adjustments to reconcile net income to net cash provided by operating activities</b>		
Amortization of premiums and accretion of discounts	<b>171,919</b>	218,204
Provision for loan losses	<b>(900,000)</b>	(600,000)
Depreciation and software amortization	<b>304,433</b>	344,460
Amortization of intangible assets	<b>55,000</b>	55,000
Write-down of other real estate owned	<b>201,668</b>	89,500
Gain on sale of other real estate owned	<b>(252,142)</b>	(72,493)
Loss on sale of premises and equipment	<b>2,648</b>	-
Decrease (increase) in		
Accrued interest receivable	<b>34,555</b>	24,967
Deferred income taxes	<b>704,289</b>	539,780
Other assets	<b>(189,629)</b>	(76,760)
Deferred origination costs, net	<b>1,530</b>	23,938
Increase (decrease) in		
Accrued interest payable	<b>(20,082)</b>	(25,104)
Other liabilities	<b>(238,685)</b>	(152,715)
	<b><u>\$1,192,928</u></b>	<b><u>\$1,403,527</u></b>
 Non cash transactions		
Transfer of foreclosed loans to other real estate owned	<b><u>\$ 398,346</u></b>	<b><u>\$ 40,315</u></b>

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. Summary of Significant Accounting Policies

The accounting and reporting policies reflected in the accompanying financial statements of Peoples Bancorp, Inc. and its subsidiary, The Peoples Bank, a Maryland commercial bank (the "Bank") and its subsidiaries, Fleetwood, Athey, MacBeth & McCown, Inc., an insurance agency (the "Insurance Subsidiary") and PB Land Trust, a trust to maintain foreclosed real estate owned by the company (the "Land Trust"), conform to accounting principles generally accepted in the United States of America ("GAAP") and to general practices within the banking industry. As used in these notes, unless the context requires otherwise, the term "the Company" refers collectively to Peoples Bancorp, Inc., the Bank, the Insurance Subsidiary, and the Land Trust.

#### **Principles of consolidation**

The consolidated financial statements include the accounts of the Peoples Bancorp, Inc. and the Bank, the Insurance Subsidiary, and the Land Trust. Intercompany balances and transactions have been eliminated.

#### **Nature of business**

Peoples Bancorp, Inc. and its subsidiary operate primarily in Kent, Cecil, Queen Anne's and Talbot Counties, Maryland. The Bank, which operates out of a main office and six branches, offers deposit services and loans to individuals, small businesses, associations, and government entities. Other services include direct deposit of payroll and social security checks, automatic drafts from accounts, automated teller machine services, cash management services, safe deposit boxes, money orders, travelers cheques, and on-line banking with bill payment service. In July the Bank opened a branch in Easton, Maryland expanding the Bank's service area to Talbot County.

The Insurance Subsidiary operates from one location in Kent County and one in Cecil County. They provide a full range of insurance products to businesses and consumers. Product lines include property, casualty, life, marine, long-term care and health insurance.

#### **Use of estimates**

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements. These estimates and assumptions may affect the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

#### **Cash and cash equivalents**

For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, and federal funds sold. Generally, federal funds are sold for one-day periods.

#### **Investment securities**

As securities are purchased, management determines if the securities should be classified as held to maturity or available for sale. Securities which management has the intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost which is cost adjusted for amortization of premiums and accretion of discounts to maturity, or over the expected life in the case of mortgage-backed securities. Amortization and accretion are recorded using the interest method. Securities which may be sold before maturity are classified as available for sale and carried at fair value with unrealized gains and losses excluded from earnings and reported in other comprehensive income.

Gains and losses on the sale of securities are determined using the specific identification method.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. **Summary of Significant Accounting Policies (Continued)**

**Federal Home Loan Bank stock and CBB Financial Corp. stock**

Federal Home Loan Bank stock and CBB Financial Corp. stock are carried at cost. As a member of the Federal Home Loan Bank, the Bank is required to purchase stock based on its total assets. Additional stock is purchased and redeemed based on the outstanding Federal Home Loan Bank advances to the Bank.

**Loans and allowance for loan losses**

Loans are stated at their outstanding unpaid principal balance adjusted for deferred origination costs, deferred origination fees, and the allowance for loan losses.

Interest on loans is accrued based on the principal amounts outstanding. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method. The accrual of interest is discontinued when it is not reasonable to expect collection of interest under the original terms. As a result of management's ongoing review of the loan portfolio, loans are classified as nonaccrual when it is not reasonable to expect collection of interest under the original terms. These loans are classified as nonaccrual even though the presence of collateral or the borrower's financial strength may be sufficient to provide for ultimate repayment. Interest on nonaccrual loans is recognized only when received. A loan is generally placed in nonaccrual status when it is specifically determined to be impaired or it becomes 90 days or more past due. When a loan is placed in nonaccrual status, all interest that had been accrued on the loan but remains unpaid is reversed and deducted from earnings as a reduction of reported interest revenue. No additional interest is accrued on the loan balance until the collection of both principal and interest becomes reasonably certain. A loan will be returned to accrual status when all of the principal and interest amounts contractually due are brought current and management believes that future principal and interest amounts contractually due are reasonably assured, which belief is typically evidenced by a sustained period (at least six months) of repayment performance by the borrower.

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes a loan is uncollectible. Subsequent recoveries, if any, are credited to the allowance.

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

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 1. Summary of Significant Accounting Policies (Continued)

#### **Loans and allowance for loan losses (Continued)**

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as impaired. For loans that are classified as impaired, an allowance is established when the collateral value, if the loan is collateral dependent, or the discounted cash flows of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A loan is considered impaired when, based on current information and events, management believes that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Impairment is measured on a loan-by-loan basis. Reserves are determined using the net present value of cash flows, or if the loan is collateral dependent, the fair value of the collateral less cost to sell.

As a general rule, a loan, or a portion thereof, is deemed uncollectible and is charged-off as and when required by bank regulatory guidelines, which provide that the loan, or portion thereof, should be charged-off when the Company becomes aware of the loss. The Company becomes aware of a loss upon the occurrence of one or more triggering events, including, among other things, the receipt of new information about the borrower's intent and/or ability to repay the loan, the severity of delinquency, the borrower's bankruptcy, the detection of fraud, or the borrower's death.

#### **Premises and equipment**

Premises and equipment are recorded at cost less accumulated depreciation. Depreciation is computed using the straight-line method over estimated useful lives of three to ten years for furniture and equipment, ten to forty years for premises, and three years for software.

#### **Other real estate owned**

Real estate acquired through foreclosure is recorded at the lower of cost or fair value on the date acquired. In general, cost equals the Company's investment in the property at the time of foreclosure. Losses incurred at the time of acquisition of the property are charged to the allowance for loan losses. Subsequent reductions in the estimated value of the property are included in other operating expense.

#### **Goodwill and intangible assets**

The Company recorded goodwill of \$273,000 and other intangible assets of approximately \$550,000 as the result of the acquisition of the Insurance Subsidiary in 2007.

Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Other intangible assets represent purchased assets that lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset is capable of being sold or exchanged either on its own or in combination with a related contract, asset or liability. Goodwill is not ratably amortized into the income statement over an estimated life, but rather is tested at least annually for impairment. Intangible assets that have finite lives are amortized over their estimated useful lives and are also subject to impairment testing. The Company's intangible assets have finite lives and are amortized on a straight-line basis over periods not exceeding 10 years.



**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. Summary of Significant Accounting Policies (Continued)**

**Income taxes**

The provision for income taxes includes taxes payable for the current year and deferred income taxes. Deferred income taxes are provided for the temporary differences between financial and taxable income.

The Company recognizes deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Deferred tax assets and liabilities are determined based on the difference between the financial statement and tax bases of assets and liabilities using enacted tax rates in effect for the year in which the differences are expected to reverse.

**Per share data**

Basic earnings per share is calculated by dividing net income available to common stockholders by the weighted-average number of common shares outstanding and does not include the effect of any potentially dilutive common stock equivalents. Diluted earnings per share is calculated by dividing net income by the weighted-average number of shares outstanding, adjusted for the dilutive effect of stock-based awards. The weighted average number of shares outstanding were 769,255 and 779,512 for 2016 and 2015 respectively. There were no dilutive common stock equivalents outstanding in 2016 or 2015.

**Subsequent Events**

The Company has evaluated events and transactions occurring subsequent to the balance sheet date of December 31, 2016 through February 28, 2017, the date these financial statements were available to be issued, for items that should potentially be recognized or disclosed in these financial statements. No significant subsequent events were identified that would affect the presentation of the financial statements.

**2. Cash and Due From Banks**

The Bank normally carries balances with other banks that exceed the federally insured limit. The average balances carried in excess of the limit, including unsecured federal funds sold to the same banks, were \$8,256,360 for 2016 and \$8,056,911 for 2015.

Deposits held in noninterest-bearing transaction accounts are aggregated with any interest-bearing deposits the owner may hold in the same category. The combined total is insured up to \$250,000.

Banks are required to carry noninterest-bearing cash reserves at specified percentages of deposit balances. The Bank's normal amount of cash on hand and on deposit with other banks is sufficient to satisfy the reserve requirements.

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Investment Securities

Investment securities are summarized as follows:

<b>December 31, 2016</b>	Amortized cost	Unrealized gains	Unrealized losses	Fair value
<b>Available for sale</b>				
U.S. government agency	\$ 31,001,014	\$ -	\$ 185,414	\$ 30,815,600
Mortgage-backed securities	<u>5,987,115</u>	<u>76,602</u>	<u>4,999</u>	<u>6,058,718</u>
	<u>\$ 36,988,129</u>	<u>\$ 76,602</u>	<u>\$ 190,413</u>	<u>\$ 36,874,318</u>
<b>Held to maturity</b>				
Mortgage-backed securities	<u>\$ 127</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 127</u>
<hr/>				
December 31, 2015				
<b>Available for sale</b>				
U.S. government agency	\$ 15,027,488	\$ 2,180	\$ 25,778	\$ 15,003,890
Mortgage-backed securities	<u>7,713,594</u>	<u>73,823</u>	<u>17,093</u>	<u>7,770,324</u>
	<u>\$ 22,741,082</u>	<u>\$ 76,003</u>	<u>\$ 42,871</u>	<u>\$ 22,774,214</u>
<b>Held to maturity</b>				
State, County & Municipal securities	\$ 58,446	\$ -	\$ 475	\$ 57,971
Mortgage-backed securities	<u>876</u>	<u>15</u>	<u>-</u>	<u>891</u>
	<u>\$ 59,322</u>	<u>\$ 15</u>	<u>\$ 475</u>	<u>\$ 58,862</u>

Contractual maturities and the amount of pledged securities are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties. Mortgage-backed securities are paid monthly.

	Available for sale		Held to maturity	
	Amortized cost	Fair value	Amortized cost	Fair value
<b>December 31, 2016</b>				
<b>Maturing</b>				
Within one year	\$ 5,005,892	\$ 5,004,460	\$ -	\$ -
Over one to five years	<u>25,995,122</u>	<u>25,811,140</u>	<u>-</u>	<u>-</u>
	<u>\$ 31,001,014</u>	<u>\$ 30,815,600</u>	<u>\$ -</u>	<u>\$ -</u>
Pledged securities	<u>\$ 3,675,543</u>	<u>\$ 3,670,754</u>	<u>\$ -</u>	<u>\$ -</u>
<hr/>				
December 31, 2015				
<b>Maturing</b>				
Over one to five years	<u>\$ 15,027,488</u>	<u>\$ 15,003,890</u>	<u>\$ 58,446</u>	<u>\$ 57,971</u>
Pledged securities	<u>\$ 3,341,392</u>	<u>\$ 3,337,686</u>	<u>\$ -</u>	<u>\$ -</u>

Investments are pledged to secure the deposits of federal and local governments and as collateral for repurchase agreements.

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

3. Investment Securities (Continued)

Securities in a continuous unrealized loss position at December 31, 2016 and 2015, are as follows:

	Less than 12 months		12 months or longer		Total	
	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value
<b>December 31, 2016</b>						
<b>Available for sale</b>						
U.S. government agency	\$ 185,414	\$30,815,600	\$ -	\$ -	\$ 185,414	\$30,815,600
Mortgage-backed securities	<u>3,976</u>	<u>1,180,899</u>	<u>1,023</u>	<u>1,113,447</u>	<u>4,999</u>	<u>2,294,346</u>
	<u>\$ 189,390</u>	<u>\$31,996,499</u>	<u>\$ 1,023</u>	<u>\$1,113,447</u>	<u>\$ 190,413</u>	<u>\$33,109,946</u>
<u>December 31, 2015</u>						
Available for sale						
U.S. government agency	\$ 25,778	\$ 7,981,710	\$ -	\$ -	\$ 25,778	\$ 7,981,710
Mortgage-backed securities	<u>17,093</u>	<u>2,327,545</u>	<u>-</u>	<u>-</u>	<u>17,093</u>	<u>2,327,545</u>
	<u>\$ 42,871</u>	<u>\$10,309,255</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 42,871</u>	<u>\$10,309,255</u>
Held to maturity						
State, County & Municipal securities	<u>\$ 475</u>	<u>\$ 57,971</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 475</u>	<u>\$ 57,971</u>

All unrealized losses on securities as of December 31, 2016 and 2015, are considered to be temporary losses. Each security will be redeemed at face value at, or prior to, maturity. In most cases, the temporary impairment in value is caused by market interest rate fluctuations.

There were no sales of securities in 2016 or 2015.

4. Loans and Allowance for Loan Losses

Major classifications of loans as of December 31, are as follows:

	<u>2016</u>	<u>2015</u>
Real estate		
Residential	\$ 75,135,181	\$ 69,667,681
Commercial	48,369,362	43,529,874
Other	17,881,451	19,216,049
Construction and land development	7,182,993	8,962,526
Commercial	11,146,044	9,332,928
Consumer	<u>880,875</u>	<u>1,125,155</u>
	<b>160,595,906</b>	151,834,213
Deferred costs, net of deferred fees	13,966	15,496
Allowance for loan losses	<u>(4,303,583)</u>	<u>(5,183,007)</u>
	<u><b>\$156,306,289</b></u>	<u>\$146,666,702</u>

## NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

### 4. Loans and Allowance for Loan Losses (Continued)

#### *Loan Origination/Risk Management*

The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, loan delinquencies and nonperforming and potential problem loans.

Residential real estate loans are underwritten subject to the borrower's ability and willingness to repay, and a loan-to-value ratio of offered collateral of not more than 80% of the appraised value of the collateral.

#### Real Estate Loans

Real estate loans are broken into the following categories: Residential; Commercial; Construction and Land Development; and Other Loans.

Commercial real estate loans are subject to underwriting standards and processes similar to commercial loans, in addition to those of real estate loans. These loans are assessed primarily based on cash flow and secondarily on the underlying real estate collateral. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is generally largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral and cash flow. With respect to loans to developers and builders that are secured by non-owner occupied properties that the Company may originate from time to time, the Company generally requires the borrower to have had an existing relationship with the Company and have a proven record of success.

Construction, including land development, loans are underwritten based on financial analyses of the developers and property owners, and estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

Commercial Loans

Commercial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and to prudently expand its business. The Company's management examines current and projected cash flows to determine the ability of the borrower to repay its obligations as agreed. Commercial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis.

Consumer Loans

The Company originates consumer loans. To monitor and manage consumer loan risk, underwriting policies and procedures are developed and modified as needed. The Company believes that its monitoring activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk.

The Company obtains an independent loan review from a third-party vendor that reviews and evaluates the credit risk program on a periodic basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

The rate repricing and maturity distribution of the loan portfolio at December 31, is as follows:

	<u>2016</u>
Within ninety days	\$ 12,355,319
Over ninety days to one year	14,980,427
Over one year to five years	82,846,235
Over five years	<u>50,413,925</u>
	<u>\$ 160,595,906</u>
Variable rate loans included in above	<u>\$ 23,022,226</u>

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

The following table illustrates total impaired loans segmented by those with and without a related allowance as of December 31, 2016 and 2015.

**Total Impaired Loans Segmented by With and Without a Related Allowance Recorded**

Description of Loans	December 31, 2016					
	Number of loans	Recorded Investment	Unpaid Contractual Balance	Related Allowance	Interest Income Recognized	Average Recorded Investment
<b>With Related Allowance Recorded</b>						
Residential real estate	7	\$ 889,721	\$ 1,200,616	\$303,443	\$ 22,955	\$ 1,047,858
Commercial real estate	-	-	-	-	-	-
Other real estate	-	-	-	-	-	-
Construction and land development	2	52,714	71,247	20,090	469	54,572
Commercial loans	-	-	-	-	-	-
Consumer loans	-	-	-	-	-	-
	<u>9</u>	<u>942,435</u>	<u>1,271,863</u>	<u>323,533</u>	<u>23,424</u>	<u>1,102,430</u>
<b>With No Related Allowance Recorded</b>						
Residential real estate	33	3,023,486	5,005,475	-	194,533	4,076,605
Commercial real estate	11	4,125,215	5,097,664	-	158,058	4,496,822
Other real estate	6	1,331,396	1,752,123	-	94,610	1,612,093
Construction and land development	1	2,790	15,665	-	310	14,269
Commercial loans	2	202,710	267,276	-	12,291	241,528
Consumer loans	1	14,376	14,439	-	844	15,246
	<u>54</u>	<u>8,699,973</u>	<u>12,152,642</u>	<u>-</u>	<u>460,646</u>	<u>10,456,563</u>
<b>TOTAL</b>						
Residential real estate	40	3,913,207	6,206,091	303,443	217,488	5,124,463
Commercial real estate	11	4,125,215	5,097,664	-	158,058	4,496,822
Other real estate	6	1,331,396	1,752,123	-	94,610	1,612,093
Construction and land development	3	55,504	86,912	20,090	779	68,841
Commercial loans	2	202,710	267,276	-	12,291	241,528
Consumer loans	1	14,376	14,439	-	844	15,246
Total impaired loans	<u>63</u>	<u>\$9,642,408</u>	<u>\$13,424,505</u>	<u>\$323,533</u>	<u>\$ 484,070</u>	<u>\$11,558,993</u>

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

4. Loans and Allowance for Loan Losses (Continued)

Total Impaired Loans Segmented by With and Without a Related Allowance Recorded

Description of Loans	December 31, 2015					
	Number of loans	Recorded Investment	Unpaid Contractual Balance	Related Allowance	Interest Income Recognized	Average Recorded Investment
<b>With Related Allowance Recorded</b>						
Residential real estate	9	\$1,186,290	\$ 1,468,624	\$318,851	\$ 62,353	\$ 1,330,651
Commercial real estate	-	-	-	-	-	-
Other real estate	-	-	-	-	-	-
Construction and land development	1	20,289	23,375	1,689	-	20,011
Commercial loans	1	2,685	10,360	2,685	636	8,767
Consumer loans	-	-	-	-	-	-
	<u>11</u>	<u>1,209,264</u>	<u>1,502,359</u>	<u>323,225</u>	<u>62,989</u>	<u>1,359,429</u>
<b>With No Related Allowance Recorded</b>						
Residential real estate	32	3,077,153	4,773,509	-	207,355	4,019,614
Commercial real estate	8	1,976,511	2,714,165	-	130,479	2,321,478
Other real estate	6	1,398,750	1,767,995	-	98,145	1,654,011
Construction and land development	1	36,136	47,656	-	-	46,360
Commercial loans	2	214,169	278,177	-	12,934	251,889
Consumer loans	1	16,141	16,211	-	938	16,921
	<u>50</u>	<u>6,718,860</u>	<u>9,597,713</u>	<u>-</u>	<u>449,851</u>	<u>8,310,273</u>
<b>TOTAL</b>						
Residential real estate	41	4,263,443	6,242,133	318,851	269,708	5,350,265
Commercial real estate	8	1,976,511	2,714,165	-	130,479	2,321,478
Other real estate	6	1,398,750	1,767,995	-	98,145	1,654,011
Construction and land development	2	56,425	71,031	1,689	-	66,371
Commercial loans	3	216,854	288,537	2,685	13,570	260,656
Consumer loans	1	16,141	16,211	-	938	16,921
Total impaired loans	<u>61</u>	<u>\$7,928,124</u>	<u>\$11,100,072</u>	<u>\$323,225</u>	<u>\$ 512,840</u>	<u>\$ 9,669,702</u>

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

The following table summarizes activity in the allowance for loan losses and allocations based on loans that are individually evaluated for impairment and loan balances collectively evaluated for impairment.

<b>December 31, 2016</b>	Residential	Commercial	Other	Construction	Commercial	Consumer	Overdraft	Unallocated	Total
	Real Estate	Real Estate	Real Estate	and Land Development					
Allowance for loan losses									
Beginning balance	\$1,835,359	\$ 680,929	\$191,578	\$ 770,810	\$ 245,322	\$ 9,278	\$ 268	\$1,449,463	\$5,183,007
Charge-offs	(198,758)	-	-	(11,376)	-	(306)	(816)	-	(211,256)
Recoveries	99,376	35,168	-	11,900	77,056	7,805	527	-	231,832
Provision	9,206	238,814	21,216	(666,025)	(73,444)	(5,422)	637	(424,982)	(900,000)
Ending balance	<u>\$1,745,183</u>	<u>\$ 954,911</u>	<u>\$212,794</u>	<u>\$ 105,309</u>	<u>\$ 248,934</u>	<u>\$11,355</u>	<u>\$ 616</u>	<u>\$1,024,481</u>	<u>\$4,303,583</u>

Ending balance allocated to:

Loans individually evaluated for impairment	\$ 303,443	\$ -	\$ -	\$ 20,090	\$ -	\$ -	\$ -	\$ -	\$ 323,533
Loans collectively evaluated for impairment	<u>1,441,740</u>	<u>954,911</u>	<u>212,794</u>	<u>85,219</u>	<u>248,934</u>	<u>11,355</u>	<u>616</u>	<u>1,024,481</u>	<u>3,980,050</u>
	<u>\$1,745,183</u>	<u>\$ 954,911</u>	<u>\$212,794</u>	<u>\$ 105,309</u>	<u>\$ 248,934</u>	<u>\$11,355</u>	<u>\$ 616</u>	<u>\$1,024,481</u>	<u>\$4,303,583</u>

December 31, 2015	Residential	Commercial	Other	Construction	Commercial	Consumer	Overdraft	Unallocated	Total
	Real Estate	Real Estate	Real Estate	and Land Development					
Allowance for loan losses									
Beginning balance	\$1,274,669	\$ 938,778	\$164,499	\$ 525,518	\$ 353,017	\$ 8,694	\$ 769	\$2,160,724	\$5,426,668
Charge-offs	(190,988)	(20,486)	-	(196)	(94)	(17,110)	(692)	-	(229,566)
Recoveries	172,387	186,992	-	8,363	212,844	5,023	296	-	585,905
Provision	579,291	(424,355)	27,079	237,125	(320,445)	12,671	(105)	(711,261)	(600,000)
Ending balance	<u>\$1,835,359</u>	<u>\$ 680,929</u>	<u>\$191,578</u>	<u>\$ 770,810</u>	<u>\$ 245,322</u>	<u>\$ 9,278</u>	<u>\$ 268</u>	<u>\$1,449,463</u>	<u>\$5,183,007</u>

Ending balance allocated to:

Loans individually evaluated for impairment	\$ 318,851	\$ -	\$ -	\$ 1,689	\$ 2,685	\$ -	\$ -	\$ -	\$ 323,225
Loans collectively evaluated for impairment	<u>1,516,508</u>	<u>680,929</u>	<u>191,578</u>	<u>769,121</u>	<u>242,637</u>	<u>9,278</u>	<u>268</u>	<u>1,449,463</u>	<u>4,859,782</u>
	<u>\$1,835,359</u>	<u>\$ 680,929</u>	<u>\$191,578</u>	<u>\$ 770,810</u>	<u>\$ 245,322</u>	<u>\$ 9,278</u>	<u>\$ 268</u>	<u>\$1,449,463</u>	<u>\$5,183,007</u>



PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

As part of the on-going monitoring of the quality of the Bank's loan portfolio, management tracks certain credit quality indicators. The Bank risk rates all loans. Loans are risk rated based on the scale below:

Grade 1 through 4 – These grades include "pass grade" loans to borrowers of acceptable credit quality and risk.

Grade 5 – This grade includes loans that are on Management's "watch list" and is intended to be utilized on a temporary basis for pass grade borrowers where a significant risk-modifying action is anticipated in the near future.

Grade 6 – This grade is for "Other Assets Especially Mentioned" or "Special Mention" in accordance with regulatory guidelines. This grade is intended to be temporary and includes loans to borrowers whose credit quality has clearly deteriorated and are at risk of further decline unless active measures are taken to correct the situation. This grade may include loans not fully secured where a specific valuation allowance may be necessary.

Grade 7 through 9 – This grade includes "Substandard" loans, in accordance with regulatory guidelines, for which accrual of interest may have stopped. This grade includes loans that are past due or not fully secured where a specific valuation allowance may be necessary.

The following table illustrates classified loans by class. Classified loans included loans in Risk Grades 5, 6, and 7 through 9.

<b>December 31, 2016</b>	Pass	Pass/Watch	Special Mention	Substandard	Total
Residential real estate	\$ 64,007,889	\$ 6,315,058	\$ 1,673,061	\$ 3,139,173	\$ 75,135,181
Commercial real estate	37,800,261	5,722,991	788,884	4,057,226	48,369,362
Other real estate	16,789,570	673,759	-	418,122	17,881,451
Construction and land development	7,082,091	-	-	100,902	7,182,993
Commercial	10,304,292	272,529	323,222	246,001	11,146,044
Consumer	879,375	500	1,000	-	880,875
	<u>\$136,863,478</u>	<u>\$12,984,837</u>	<u>\$ 2,786,167</u>	<u>\$ 7,961,424</u>	<u>\$160,595,906</u>

December 31, 2015	Pass	Pass/Watch	Special Mention	Substandard	Total
Residential real estate	\$ 57,050,318	\$ 5,733,664	\$ 1,988,777	\$ 4,894,922	\$ 69,667,681
Commercial real estate	31,019,701	7,502,481	3,454,188	1,553,504	43,529,874
Other real estate	16,461,958	2,302,979	-	451,112	19,216,049
Construction and land development	7,704,348	-	1,154,766	103,412	8,962,526
Commercial	7,935,234	866,319	265,755	265,620	9,332,928
Consumer	1,116,868	7,287	1,000	-	1,125,155
	<u>\$121,288,427</u>	<u>\$16,412,730</u>	<u>\$ 6,864,486</u>	<u>\$ 7,268,570</u>	<u>\$151,834,213</u>

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

The following table analyzes the age of past due loans, including both accruing and nonaccruing loans, segregated by class of loans as of December 31, 2016 and 2015.

<b>December 31, 2016</b>	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans
Residential real estate	\$534,499	\$119,346	\$ 993,005	\$1,646,850	\$ 73,488,331	\$ 75,135,181
Commercial real estate	318,467	-	2,762,056	3,080,523	45,288,839	48,369,362
Other real estate	-	-	-	-	17,881,451	17,881,451
Construction and land development	-	-	55,503	55,503	7,127,490	7,182,993
Commercial loans	13,772	-	-	13,772	11,132,272	11,146,044
Consumer loans	-	-	-	-	880,875	880,875
Total	<u>\$866,738</u>	<u>\$119,346</u>	<u>\$3,810,564</u>	<u>\$4,796,648</u>	<u>\$155,799,258</u>	<u>\$160,595,906</u>

December 31, 2015	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days	Total Past Due	Current	Total Loans
Residential real estate	\$258,772	\$558,756	\$1,095,642	\$1,913,170	\$ 67,754,511	\$ 69,667,681
Commercial real estate	-	-	520,950	520,950	43,008,924	43,529,874
Other real estate	-	-	-	-	19,216,049	19,216,049
Construction and land development	-	-	56,425	56,425	8,906,101	8,962,526
Commercial loans	-	2,000	-	2,000	9,330,928	9,332,928
Consumer loans	-	-	-	-	1,125,155	1,125,155
Total	<u>\$258,772</u>	<u>\$560,756</u>	<u>\$1,673,017</u>	<u>\$2,492,545</u>	<u>\$149,341,668</u>	<u>\$151,834,213</u>

Loans on which the accrual of interest has been discontinued or reduced, and the interest that would have been accrued at December 31, are as follows:

	<u>2016</u>	<u>2015</u>
Residential real estate	<b>\$2,689,435</b>	\$3,301,220
Commercial real estate	<b>3,114,834</b>	918,992
Other real estate	<b>124,154</b>	155,211
Construction and land development	<b>55,503</b>	56,425
Commercial loans	<b>797</b>	5,515
Consumer loans	-	-
Total	<u><b>\$5,984,723</b></u>	<u>\$4,437,363</u>
Interest not accrued on nonaccrual loans	<u><b>\$ 334,553</b></u>	<u>\$ 237,831</u>

There were no loans over 90 days past due and accruing at December 31, 2016 and 2015.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

A loan will be returned to accrual status when all of the principal and interest amounts contractually due are brought current and management believes that future principal and interest amounts contractually due are reasonably assured, which belief is typically evidenced by a sustained period (at least six months) of repayment performance by the borrower.

The modification of terms on a loan (restructuring) is considered a "troubled debt restructuring" if it is done to accommodate a borrower who is experiencing financial difficulties. The lender may forgive principal, lower the interest rate or payment amount, or may modify the payment due dates or maturity date of the loan for a troubled borrower. The Company's troubled debt restructurings at December 31, 2016 and 2015, are set forth in the following tables:

**TROUBLED DEBT RESTRUCTURINGS**

<b>December 31, 2016</b>	Number of Contracts	Contract Balance	Paying as Agreed Under Modified Terms	Number of Past Due Contracts	Past Due 30 Days or More or Nonaccruing
Troubled debt restructurings					
Residential real estate	36	\$2,906,957	\$ 1,659,040	20	\$ 1,247,917
Commercial real estate	8	1,856,809	1,010,382	3	846,427
Other real estate	4	913,274	913,274	-	-
Construction and land development	1	18,955	-	1	18,955
Commercial loans	-	-	-	-	-
Consumer loans	1	14,376	14,376	-	-
	<u>50</u>	<u>\$5,710,371</u>	<u>\$ 3,597,072</u>	<u>24</u>	<u>\$ 2,113,299</u>

<b>December 31, 2015</b>	Number of Contracts	Contract Balance	Paying as Agreed Under Modified Terms	Number of Past Due Contracts	Past Due 30 Days or More or Nonaccruing
Troubled debt restructurings					
Residential real estate	37	\$3,254,357	\$ 1,720,631	24	\$ 1,533,726
Commercial real estate	8	1,976,511	1,057,519	3	918,992
Other real estate	4	944,627	944,627	-	-
Construction and land development	1	20,289	-	1	20,289
Commercial loans	-	-	-	-	-
Consumer loans	1	16,141	16,141	-	-
	<u>51</u>	<u>\$6,211,925</u>	<u>\$ 3,738,918</u>	<u>28</u>	<u>\$ 2,473,007</u>

In 2016 and 2015, there were no new troubled debt restructurings.

At December 31, 2016, formal foreclosure procedures were in process for eight loans totaling \$2,905,795.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**4. Loans and Allowance for Loan Losses (Continued)**

Outstanding loan commitments, unused lines of credit, and letters of credit as of December 31, are as follows:

	<u>2016</u>	<u>2015</u>
Check loan lines of credit	\$ 480,097	\$ 466,321
Mortgage lines of credit and loan commitments	9,577,397	7,616,799
Other lines of credit and commitments	14,401,837	13,119,812
Undisbursed construction loan commitments	<u>2,304,009</u>	<u>3,096,022</u>
	<u>\$ 26,763,340</u>	<u>\$ 24,298,954</u>
Standby letters of credit	<u>\$ 1,541,362</u>	<u>\$ 1,957,729</u>

Loan commitments and lines of credit are agreements to lend to a customer as long as there is no violation of any condition to the contract. Loan commitments generally have interest rates fixed at current market rates, fixed expiration dates, and may require payment of a fee. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time.

Letters of credit are commitments issued to guarantee the performance of a customer to a third party.

Loan commitments, lines of credit, and letters of credit are made on the same terms, including collateral, as outstanding loans. The Bank's exposure to credit loss in the event of nonperformance by the borrower is represented by the contract amount of the commitment. Management is not aware of any fact that could cause the Bank to incur an accounting loss as a result of funding these commitments.

The Company lends to customers located primarily in and near Kent County, Queen Anne's County, Cecil County, and Talbot County, Maryland. Although the loan portfolio is diversified, its performance will be influenced by the economy of the region.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**5. Premises and Equipment**

A summary of premises and equipment and related depreciation expense as of December 31, is as follows:

	<u>2016</u>	<u>2015</u>
Land	\$ 2,658,141	\$ 1,773,232
Premises	4,827,711	4,283,662
Furniture and equipment	<u>2,488,802</u>	<u>2,423,907</u>
	9,974,654	8,480,801
Accumulated depreciation	<u>4,217,258</u>	<u>4,097,546</u>
Net premises and equipment	<u>\$ 5,757,396</u>	<u>\$ 4,383,255</u>
Depreciation expense	<u>\$ 274,592</u>	<u>\$ 292,555</u>

Computer software included in other assets and the related amortization are as follows:

	<u>2016</u>	<u>2015</u>
Cost	\$ 256,530	\$ 250,574
Accumulated amortization	<u>229,270</u>	<u>200,860</u>
Net computer software	<u>\$ 27,260</u>	<u>\$ 49,714</u>
Amortization expense	<u>\$ 29,841</u>	<u>\$ 51,905</u>

**6 Intangibles and Goodwill**

The Company recorded a \$550,000 intangible asset and \$272,932 in goodwill in connection with the Insurance Subsidiary acquisition in 2007. The intangible asset is fully amortizable on a straight-line basis over 10 years for financial statement purposes and 15 years for income tax purposes. Goodwill is not amortized, but is annually evaluated for impairment.

Information relating to intangible assets at December 31, is as follows:

	<u>2016</u>	<u>2015</u>
Intangible asset	\$ 550,000	\$ 550,000
Accumulated amortization	<u>(550,000)</u>	<u>(495,000)</u>
Net intangible asset	<u>\$ -</u>	<u>\$ 55,000</u>
Amortization expense	<u>\$ 55,000</u>	<u>\$ 55,000</u>
Estimated amortization expense:		
2017	<u>\$ -</u>	

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**7. Other Time Deposits**

Maturities of other time deposits as of December 31, are as follows:

	<u>2016</u>	<u>2015</u>
Within one year	<b>\$ 10,321,479</b>	\$ 19,445,271
Over one to two years	<b>11,610,683</b>	6,451,531
Over two to three years	<b>13,076,168</b>	12,334,190
Over three to four years	<b>12,319,066</b>	13,525,516
Over four to five years	<b>14,932,631</b>	15,670,898
Over five years	<b>9,721</b>	8,100
	<b><u>\$ 62,269,748</u></b>	<b><u>\$ 67,435,506</u></b>

Included in other time deposits are certificates of deposit in amounts of \$250,000 or more of \$4,054,892 and \$1,451,143 as of December 31, 2016 and 2015, respectively.

**8. Securities Sold Under Repurchase Agreements**

Securities sold under repurchase agreements represent borrowings from customers. The government agency securities that are the collateral for these agreements are owned by the Bank and are maintained in the custody of an unaffiliated bank. Additional information is as follows:

	<u>2016</u>	<u>2015</u>
Maximum month-end amount outstanding	<b>\$ 3,668,547</b>	\$ 5,085,851
Average amount outstanding	<b>1,542,732</b>	1,740,438
Average rate paid during the year	<b>0.23%</b>	0.41%
Investment securities underlying agreements at year-end		
Book value	<b>2,173,592</b>	2,842,794
Fair value	<b>2,170,072</b>	2,841,318

**9. Notes Payable and Lines of Credit**

The Bank may borrow up to approximately \$29,988,000 from the Federal Home Loan Bank (the "FHLB") through any combination of notes or line of credit advances. Both the notes payable and the line of credit are secured by a floating lien on all of the Bank's real estate mortgage loans. As of December 31, 2016, the Bank had \$19,988,293 of mortgage loans available to pledge as collateral to the FHLB. The Bank was required to purchase shares of capital stock in the FHLB as a condition to obtaining the line of credit.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**9. Notes Payable and Lines of Credit (Continued)**

The Bank's borrowings from the Federal Home Loan Bank as of December 31, 2016 and 2015, are summarized as follows:

Maturity date	Interest rate	2016 Balance	2015 Balance
January 26, 2017	4.36%	<b>\$ 5,000,000</b>	\$ 5,000,000
August 2, 2017	4.34%	<b>5,000,000</b>	5,000,000
		<b><u>\$10,000,000</u></b>	<b><u>\$10,000,000</u></b>

The outstanding advances require interest payments quarterly with principal due at maturity.

In addition to the borrowing capacity available from the FHLB, the Bank has a line of credit of \$8,000,000 in secured overnight federal funds at December 31, 2016. As of December 31, 2016, the Bank had pledged mortgage loans totaling \$5,349,565 to the Federal Reserve Bank of Richmond to provide a borrowing capacity of \$3,763,408 under its discount window program.

**10. Income Taxes**

The components of income tax expense are as follows:

	2016	2015
Current		
Federal	\$ 27,127	\$ -
State	<b>45,382</b>	43,950
	<b>72,509</b>	43,950
Deferred	<b>704,288</b>	539,780
	<b><u>\$ 776,797</u></b>	<b><u>\$ 583,730</u></b>

The components of the deferred income tax expense (benefit) are as follows:

Allowance for loan losses and bad debts	\$ 355,005	\$ 236,670
Prepaid pension costs	<b>86,093</b>	46,400
Depreciation and amortization	<b>(3,378)</b>	(18,118)
Nonaccrual interest	<b>(38,153)</b>	(13,736)
Deferred compensation	<b>77,906</b>	2,019
Foreclosed real estate impairment	<b>158,446</b>	9,365
Net operating loss (NOL) and alternative minimum tax (AMT) carryovers	<b>68,369</b>	277,180
	<b><u>\$ 704,288</u></b>	<b><u>\$ 539,780</u></b>

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**10. Income Taxes (Continued)**

The components of the net deferred income tax asset are as follows:

	<u>2016</u>	<u>2015</u>
Deferred income tax assets		
Allowance for loan losses	\$ 762,543	\$ 1,117,548
Deferred compensation	105,391	183,297
Pension liability	319,590	245,585
Nonaccrual interest	131,965	93,812
Foreclosed real estate impairment	277,356	435,802
Unrealized loss on investment securities available for sale	44,892	-
Income tax carryovers	<u>290,410</u>	<u>358,779</u>
	<u>1,932,147</u>	<u>2,434,823</u>
Deferred income tax liabilities		
Depreciation and amortization	2,754	6,132
Unrealized gain on investment securities available for sale	<u>-</u>	<u>13,069</u>
	<u>2,754</u>	<u>19,201</u>
Net deferred income tax asset	<u>\$1,929,393</u>	<u>\$ 2,415,622</u>

A reconciliation of the provisions for income taxes from statutory federal rates to effective rates follows:

	<u>2016</u>	<u>2015</u>
Tax at statutory federal income tax rate	34.0 %	34.0 %
Tax effect of		
Tax-exempt income	(2.7)	(3.6)
State income taxes, net of federal benefit	5.2	5.0
Other, net	<u>0.6</u>	<u>0.6</u>
	<u>37.1 %</u>	<u>36.0 %</u>

The Company has a net operating loss carryover of \$90,616 for federal income taxes that begins to expire in 2032 and an alternative minimum tax credit carryover of \$157,403 that can be used when the regular federal income tax exceeds tax computed using the AMT formula. The Company has not recorded a valuation allowance against the net deferred tax asset, based on the Company's assessment that it is more likely than not that the deferred tax asset will be realized in future periods. In evaluating the Company's ability to realize its net deferred tax asset, the Company considers all available positive and negative evidence, including operating results, ongoing tax planning, and forecasts of future taxable income.

The Company does not have material uncertain tax positions and did not recognize any adjustments for unrecognized tax benefits. The Company remains subject to examination of income tax returns for the years ending after December 31, 2012.



PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**11. Profit Sharing Plan**

The Company has a profit sharing plan qualifying under section 401(k) of the Internal Revenue Code that covers all of the Company's employees with one year of service who have attained age 21. The Company matches 50% of employee contributions to the Plan, up to a maximum of 6% of pay. The Company may make discretionary contributions to the Plan in amounts approved by its Board of Directors. Plan expenses, included in employee benefits expense for 2016 and 2015, were \$80,844 and \$76,899, respectively.

**12. Pension**

The Bank has a defined benefit pension plan covering substantially all of the employees of the Bank. Benefits are based on years of service and the employee's highest average rate of earnings for five consecutive years during the final ten full years before retirement. The Bank's funding policy is to contribute annually the maximum amount that can be deducted for income tax purposes, determined using the projected unit credit cost method. As of March 22, 2013, the Bank has frozen the plan. Participant benefits stopped accruing as of the date of the freeze.

The following table sets forth the financial status of the plan at December 31:

	<u>2016</u>	<u>2015</u>
Change in plan assets		
Fair value of plan assets at beginning of year	<b>\$3,118,313</b>	\$3,120,582
Actual return on plan assets	<b>195,466</b>	24,701
Employer contribution	<b>250,000</b>	138,312
Benefits paid	<b>(86,256)</b>	(165,282)
Fair value of plan assets at end of year	<b><u>3,477,523</u></b>	<u>3,118,313</u>
Change in benefit obligation		
Projected benefit obligation at beginning of year	<b>3,740,151</b>	3,781,342
Service cost	-	-
Interest cost	<b>166,366</b>	166,441
Benefits paid	<b>(86,256)</b>	(165,282)
Actuarial loss (gain)	<b>467,478</b>	(42,350)
Projected benefit obligation at end of year	<b><u>4,287,739</u></b>	<u>3,740,151</u>
Funded status	<b>(810,216)</b>	(621,838)
Unrecognized net loss	<b><u>1,281,200</u></b>	<u>875,322</u>
Prepaid pension expense included in other assets	<b><u>\$ 470,984</u></b>	<u>\$ 253,484</u>
Accumulated benefit obligation	<b><u>\$4,287,739</u></b>	<u>\$3,740,151</u>

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

12. Pension (Continued)

Net pension expense includes the following components:

	<u>2016</u>	<u>2015</u>
Service cost	\$ -	\$ -
Interest cost	166,366	166,441
Expected return on assets	(173,811)	(170,891)
Amortization of prior service cost	-	-
Amortization of loss	<u>39,945</u>	<u>25,377</u>
Net pension expense	<u>\$ 32,500</u>	<u>\$ 20,927</u>

Assumptions used in the accounting for net pension expense were:

Discount rates	4.50%	4.50%
Rate of increase in compensation level	N/A	N/A
Long-term rate of return on assets	5.50%	5.50%

The Bank intends to contribute approximately \$250,000 to the plan in 2017.

The plan's assets are allocated as follows at December 31:

	<u>2016</u>	<u>2015</u>
Equity securities	39 %	52 %
Fixed income securities	<u>61 %</u>	<u>48 %</u>
	<u>100 %</u>	<u>100 %</u>

The fair value of plan assets are considered to be valued using level 1 inputs.

Projected benefits expected to be paid from the plan are as follows:

<u>Year</u>	<u>Amount</u>
2017	\$ 774,136
2018	79,819
2019	174,288
2020	235,149
2021	365,090
2022-2028	1,493,414

The long-term rate of return on assets assumption considers the current earnings on assets of the plan as well as the effects of asset diversification. The plan's investment strategy is to earn a reasonable return while safeguarding the benefits promised to employees. All assets of the plan are maintained in mutual funds with MML Investor services.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**13. Other Operating Expenses**

Other operating expenses consist of the following:

	<u>2016</u>	<u>2015</u>
Advertising	\$ 57,261	\$ 51,858
Deposit services	168,657	160,864
Directors' fees	136,242	169,878
Insurance	96,785	110,844
Office supplies and printing	96,042	77,755
Postage	103,023	97,266
Public relations and contributions	108,161	73,895
Regulatory assessments	186,302	323,255
Telephone	61,120	55,445
Other	354,945	353,006
	<u>\$ 1,368,538</u>	<u>\$ 1,474,066</u>

**14. Related-Party Transactions**

In the normal course of banking business, loans are made to officers and directors of the Company as well as to companies and individuals affiliated with those officers and directors. The terms of these transactions are substantially the same as the terms provided to other borrowers entering into similar loan transactions. In the opinion of management, these loans are consistent with sound banking practices, are within regulatory lending limitations, and do not involve more than normal credit risk.

A summary of these loans is as follows:

	<u>2016</u>	<u>2015</u>
Beginning loan balances	\$ 2,729,268	\$ 2,603,276
Advances	153,435	1,637,286
Repayments	(1,076,480)	(978,151)
Change in related parties	(7,314)	(533,143)
Ending loan balances	<u>\$ 1,798,909</u>	<u>\$ 2,729,268</u>

In addition to the outstanding balances listed above, the officers and directors and their related interests had \$494,731 and \$2,379,973 in unused loans committed but not funded as of December 31, 2016 and 2015, respectively.

Deposits from officers and directors and their related interests were \$4,071,412 and \$7,057,534 as of December 31, 2016 and 2015, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

15. Capital Standards

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

The Basel III Capital Rules became effective for the Bank on January 1, 2015 (subject to a phase-in period for certain provisions). Quantitative measures established by the Basel III Capital Rules to ensure capital adequacy require the maintenance of minimum amounts and ratios (set forth in the following table) of Common Equity Tier 1 capital, Tier 1 capital, and Total capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital to adjusted quarterly average assets (as defined).

In connection with the adoption of the Basel III Capital Rules, the Bank elected to opt-out of the requirement to include accumulated other comprehensive income in Common Equity Tier 1 capital. Common Equity Tier 1 capital for the Bank is reduced by goodwill and other intangible assets, net of associated deferred tax liabilities and subject to transition provisions.

Under the revised prompt corrective action requirements, as of January 1, 2015, insured depository institutions are required to meet the following in order to qualify as "well capitalized:" (1) a common equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8%; (3) a total risk-based capital ratio of 10%; and (4) a Tier 1 leverage ratio of 5%. Management believes that, as of December 31, 2015, the Bank met all capital adequacy requirements under the Basel III Capital Rules on a fully phased-in basis as if such requirements were fully in effect.

The implementation of the capital conservation buffer began on January 1, 2016, at the 0.625% level and will be phased in over a four-year period (increasing by that amount on each subsequent January 1, until it reaches 2.5% on January 1, 2019). The Basel III Capital Rules also provide for a "countercyclical capital buffer" that is applicable to only certain covered institutions and does not have any current applicability to the Bank.

The aforementioned capital conservation buffer is designed to absorb losses during periods of economic stress. Banking institutions with a ratio of Common Equity Tier 1 capital to risk-weighted assets above the minimum but below the conservation buffer (or below the combined capital conservation buffer and countercyclical capital buffer, when the latter is applied) will face constraints on dividends, equity repurchases, and compensation based on the amount of the shortfall.

The following table presents actual and required capital ratios as of December 31, 2016 and 2015, for the Bank under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of December 31, 2016 and 2015, based on the phase-in provisions of the Basel III Capital Rules. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**15. Capital Standards (Continued)**

As of December 31, 2016, the most recent notification from the FDIC has categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain ratios as set forth in the table. There have been no conditions or events since that notification that management believes have changed the Bank's category.

The FDIC, through formal or informal agreement, has the authority to require an institution to maintain higher capital ratios than those provided by statute, to be categorized as well capitalized under the regulatory framework for prompt corrective action.

(in thousands)	Actual		Minimum capital adequacy		To be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<b>December 31, 2016</b>						
Tier 1 leverage ratio	\$23,601	9.300%	\$10,115	4.000%	\$12,644	5.000%
Tier 1 capital (to risk-weighted assets)	\$23,601	15.800%	\$ 9,903	6.625%	\$11,958	8.000%
Common equity tier 1 capital ratio (to risk-weighted assets)	\$23,601	15.800%	\$ 7,661	5.125%	\$ 9,716	6.500%
Total capital ratio (to risk-weighted assets)	\$25,501	17.100%	\$12,892	8.625%	\$14,948	10.000%
<b>December 31, 2015</b>						
Tier 1 leverage ratio	\$23,802	10.100%	\$ 9,455	4.000%	\$11,819	5.000%
Tier 1 capital (to risk-weighted assets)	\$23,802	17.100%	\$ 8,369	6.000%	\$11,159	8.000%
Common equity tier 1 capital ratio (to risk-weighted assets)	\$23,802	17.100%	\$ 6,277	4.500%	\$ 9,067	6.500%
Total capital ratio (to risk-weighted assets)	\$25,591	18.300%	\$11,159	8.000%	\$13,949	10.000%

Tier 1 capital consists of common stock, additional paid capital, and undivided profits less disallowed deferred tax assets. Total capital includes a limited amount of the allowance for loan losses. In calculating risk-weighted assets, specified risk percentages are applied to each category of asset and off-balance sheet items.

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**16. Other Real Estate Owned**

Activity in other real estate owned is as follows:

	<u>2016</u>	<u>2015</u>
Beginning of year balance	\$ 2,991,492	\$ 3,968,504
Additions and improvements	398,346	43,876
Write downs	(201,668)	(89,500)
Proceeds from sales	(1,444,486)	(1,003,881)
Gain (loss) on sales	<u>252,142</u>	<u>72,493</u>
End of year balance	<u>\$ 1,995,826</u>	<u>\$ 2,991,492</u>

**17. Fair Value Measures**

The fair value of an asset or a liability is the price that would be received to sell that asset or paid to transfer that liability in an orderly transaction occurring in the principal market (or most advantageous market in the absence of a principal market) for such asset or liability. In estimating fair value, the Company utilizes valuation techniques that are consistent with the market approach, the income approach and/or the cost approach. Such valuation techniques are consistently applied. Inputs to valuation techniques include the assumptions that market participants would use in pricing an asset or liability. FASB ASC valuation techniques include the assumptions that market participants would use in pricing an asset or a liability. FASB ASC Topic 820 establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

*Level 1 inputs* – Unadjusted quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date.

*Level 2 inputs* – Inputs other than quoted prices included in Level 1 that are observable for the asset or liability, either directly or indirectly. These might include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability (such as interest rates, volatilities, prepayment speeds, credit risks, etc.) or inputs that are derived principally from or corroborated by market data by correlation or other means.

*Level 3 inputs* – Unobservable inputs for determining the fair values of assets or liabilities that reflect an entity's own assumptions about the assumptions that market participants would use in pricing the assets or liabilities.

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

17. Fair Value Measures (Continued)

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the issuer's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. Although management believes the Company's valuation methodologies are appropriate and consistent with those used by other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Furthermore, the reported fair value amounts have not been comprehensively revalued since the presentation dates, and, therefore, estimates of fair value after the balance sheet date may differ significantly from the amounts presented herein. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstance that caused the transfer, which generally coincides with the Company's monthly and quarterly valuation process.

*Fair value measured on a recurring basis*

The Company measures securities available for sale at fair value on a recurring basis. The following table summarizes securities available for sale measured at fair value on a recurring basis, segregated by the level of the valuation inputs within the fair value hierarchy utilized to measure fair value. If quoted prices are available in an active market for identical securities, securities are classified within Level 1 of the hierarchy. If quoted market prices are not available, the fair values are estimated using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. The Company has categorized its securities available for sale as follows:

<b>December 31, 2016</b>	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
<b>Available for sale</b>				
U.S. government agency	\$ -	\$30,815,600	\$ -	\$ 30,815,600
Mortgage-backed securities	-	6,058,718	-	6,058,718
	<u>\$ -</u>	<u>\$36,874,318</u>	<u>\$ -</u>	<u>\$36,874,318</u>
<b>December 31, 2015</b>				
<b>Available for sale</b>				
U.S. government agency	\$ -	\$15,003,890	\$ -	\$ 15,003,890
Mortgage-backed securities	-	7,770,324	-	7,770,324
	<u>\$ -</u>	<u>\$22,774,214</u>	<u>\$ -</u>	<u>\$22,774,214</u>

The fair values of investment securities are determined using market quotations, pricing models, quoted prices of securities with similar characteristics or discounted cash flows.

PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**17. Fair Value Measures (Continued)**

*Fair values on a nonrecurring basis*

The Company's foreclosed real estate and impaired loans are measured at fair value on a nonrecurring basis, which means that the assets are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of reduced property value).

Other real estate owned measured at fair value on a nonrecurring basis is reported at the fair value of the property, assuming that the sale prices of the properties will be their current appraised values. Appraised values are estimated using Level 3 inputs based on observable market data and current property tax assessments. Impaired loans were measured at fair value during the same period and are reported at the fair value of the loan's collateral. Fair value is generally determined using Level 3 inputs based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds.

<u>December 31, 2016</u>	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total
Other real estate owned	\$ -	\$ -	\$ 1,995,826	\$ 1,995,826
Impaired loans	-	-	9,318,875	9,318,875
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 11,314,701</u>	<u>\$ 11,314,701</u>
<u>December 31, 2015</u>				
Other real estate owned	\$ -	\$ -	\$ 2,991,492	\$ 2,991,492
Impaired loans	-	-	7,604,899	7,604,899
	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 10,596,391</u>	<u>\$ 10,596,391</u>

FASB ASC Topic 825 requires disclosure of the fair value of financial assets and financial liabilities, including those financial assets and financial liabilities that are not measured and reported at fair value on a recurring basis or nonrecurring basis.



PEOPLES BANCORP, INC. AND SUBSIDIARY

**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**17. Fair Value Measures (Continued)**

The Company does not measure the fair value of any of its other financial assets or liabilities on a recurring or nonrecurring basis. The fair value of financial instruments and the carrying value of the instruments are as follows:

	December 31, 2016		December 31, 2015	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Investment securities held to maturity	\$ 127	\$ 127	\$ 59,322	\$ 58,862
Federal Home Loan Bank and CBB				
Financial Corp. stock	701,100	701,100	696,300	696,300
COLI and mutual funds	-	-	-	-
Loans, net	156,306,289	156,674,394	146,666,702	146,893,972
Financial liabilities				
Noninterest-bearing deposits	\$ 69,541,575	\$ 69,541,575	\$ 57,469,558	\$ 57,469,558
Interest-bearing deposits	147,215,889	146,422,551	144,845,387	144,011,176
Short-term borrowings	2,180,252	2,180,252	1,254,358	1,254,358
Federal Home Loan				
Bank advances	10,000,000	10,134,592	10,000,000	10,462,863

The fair value of investment securities held to maturity are determined using market quotations, pricing models, quoted prices of securities with similar characteristics or discounted cash flows.

The fair value of fixed-rate loans is estimated to be the present value of scheduled payments discounted using interest rates currently in effect. The fair value of variable-rate loans, including loans with a demand feature, is estimated to equal the carrying amount of the loan. The valuation of loans is adjusted for probable loan losses.

The fair value of interest-bearing checking, savings, and money market deposit accounts is equal to the carrying amount. The fair value of fixed-maturity time deposits and borrowings is estimated based on interest rates currently offered for deposits and borrowings of similar remaining maturities.

It is not practicable to estimate the fair value of outstanding loan commitments, unused lines of credit, and letters of credit.

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

**18. Parent Company Financial Information**

The balance sheets, statements of income, and statements of cash flows for Peoples Bancorp, Inc. (Parent Only) follow:

<i>Balance Sheets</i>	December 31,	<u>2016</u>	<u>2015</u>
	Assets		
Cash		\$ 288,395	\$ 386,408
Investment in Bank Subsidiary		23,284,541	23,959,734
Other assets		<u>8,817</u>	<u>3,261</u>
Total assets		<u>\$ 23,581,753</u>	<u>\$ 24,349,403</u>
	Liabilities and Stockholders' Equity		
Other liabilities		\$ 7,358	\$ 13,346
Total liabilities		<u>7,358</u>	<u>13,346</u>
Stockholders' equity			
Common stock		7,289,180	7,795,120
Additional paid-in capital		2,212,550	2,920,866
Retained earnings		14,917,414	14,130,058
Accumulated other comprehensive income (loss)		<u>(844,749)</u>	<u>(509,987)</u>
Total stockholders' equity		<u>23,574,395</u>	<u>24,336,057</u>
Total liabilities and stockholders' equity		<u>\$ 23,581,753</u>	<u>\$ 24,349,403</u>
	Years Ended December 31,		
<i>Statements of Income</i>	<u>2016</u>	<u>2015</u>	
Interest revenue	\$ 374	\$ 414	
Dividends from Bank Subsidiary	1,675,000	-	
Equity in undistributed income of Bank Subsidiary	<u>(340,430)</u>	<u>1,041,085</u>	
	<u>1,334,944</u>	<u>1,041,499</u>	
Expenses			
Professional fees	9,708	-	
Other	<u>16,629</u>	<u>10,012</u>	
	<u>26,337</u>	<u>10,012</u>	
Income before income tax benefit	1,308,607	1,031,487	
Income tax (benefit)	<u>(8,817)</u>	<u>(3,263)</u>	
Net income	<u>\$ 1,317,424</u>	<u>\$ 1,034,750</u>	

PEOPLES BANCORP, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

18. Parent Company Financial Information (Continued)

<i>Statements of Cash Flows</i>	Years Ended December 31,	
	<u>2016</u>	<u>2015</u>
<b>Cash flows from operating activities</b>		
Interest and dividends received	\$ 1,675,374	\$ 414
Cash paid for operating expenses	<u>(29,063)</u>	<u>(106,307)</u>
	<u>1,646,311</u>	<u>(105,893)</u>
 <b>Cash flows from financing activities</b>		
Dividends paid	(530,068)	-
Stock repurchase	<u>(1,214,256)</u>	<u>-</u>
	<u>(1,744,324)</u>	<u>-</u>
 Net increase (decrease) in cash	(98,013)	(105,893)
 Cash at beginning of year	<u>386,408</u>	<u>492,301</u>
 Cash at end of year	<u>\$ 288,395</u>	<u>\$ 386,408</u>
 <b>Reconciliation of net income to net cash provided by operating activities</b>		
Net income	\$ 1,317,424	\$ 1,034,750
<b>Adjustments to reconcile net income to net cash provided by operating activities</b>		
Undistributed net income of subsidiary	340,431	(1,041,085)
(Increase) decrease in other assets	(5,556)	-
Increase (decrease) in other liabilities	<u>(5,988)</u>	<u>(99,558)</u>
	<u>\$ 1,646,311</u>	<u>\$ (105,893)</u>

---

**106 YEARS**  
**OF**  
**INDEPENDENT**  
**COMMUNITY BANKING**  
MEMBER F.D.I.C.

---

100 Spring Avenue  
PO Box 210  
Chestertown, MD21620-0210  
410.778.3500 FAX #410.778.2089  
Email:main@pbkc.com  
Website: www.pbkc.com



PRINTED ON RECYCLED PAPER

Printed by:  
The UPS Store