

2017 Annual Report

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Forward Looking Statements

When used in this annual report, or in any written or oral statement made by us or our officers, directors or employees, the words and phrases “will result,” “expect,” “will continue,” “anticipate,” “estimate,” “project,” or similar terms are intended to identify “forward-looking statements.” A variety of factors could cause our actual results and experiences to differ materially from the anticipated results or other expectations expressed in any forward-looking statements. Some of the risks and uncertainties that may affect our operations, performance, development and results, the interest rate sensitivity of our assets and liabilities, and the adequacy of our loan loss allowance, include, but are not limited to:

- deterioration in local, regional, national or global economic conditions which could result in, among other things, an increase in loan delinquencies, a decrease in property values, or a change in the real estate turnover rate;
- changes in market interest rates or changes in the speed at which market interest rates change;
- changes in laws and regulations affecting the financial service industry;
- changes in public policy initiatives and regulatory philosophy;
- adverse weather conditions or other severe climate occurrences;
- the acceptability of alternate quasi-currencies or other products that affect banks as financial intermediaries;
- technology developments and competition from alternate monetary systems based upon different technology;
- hacking, cyber attacks and other computer intrusion threats;
- changes in the public’s perception of financial institutions in general and banks in particular;
- changes in competition; and
- changes in consumer preferences by our customers or the customers of our business borrowers.

Please do not place undue reliance on any forward-looking statement, which speaks only as of the date made. There are many factors, including those described above, that could affect our future business activities or financial performance and could cause our actual future results or circumstances to differ materially from those we anticipate or project. We do not undertake any obligation to update any forward-looking statement after it is made.

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To Our Stockholders

We enter 2018 optimistically, as lower federal tax rate, a robust economy and the prospects for growth allows us to anticipate a strong year for our Company. Our net income climbed to \$2.6 million, or \$1.44 per common share, despite the one-time \$464,000 negative effect of the recently enacted federal tax rate, which reduced the value of our deferred tax asset. We increased our quarterly cash dividend to \$0.10 per common share. Our loan portfolio grew by \$11 million in 2017, a 9% jump over the previous year. We are still focused on commercial real estate and construction loans. Our total assets rose by \$17 million to \$350 million. Our non-performing assets dropped to \$593 thousand, which is the lowest level of the last ten years. We have increased our capital base by a net of \$2.0 million, while paying cash dividends of \$605,000.

The national economy has sustained growth, inflation has hovered around the 2% level, and the labor market is demonstrating signs of strength. This caused the Federal Reserve to raise short term rates by 75 basis points in 2017 and it is poised to raise rates an additional three times in 2018. The interest rate environment, especially intermediate and long-term rates, has been increasing in late 2017 and we expect that trend to continue in 2018. This will create more deposit interest rate pressure and we may be forced to raise our rates to remain competitive.

The real estate market has leveled off in some parts of New York City and the rapid growth experienced over the last few years appears to be abating. Average rental rates and resale prices for homes in New York City reportedly declined modestly in the fourth quarter of 2017. We are factoring in this issue when we are reviewing loan requests.

The growth of our loan portfolio, and the lower level of non-performing loans, has generated more interest income. We also shifted some cash into higher yielding investment securities. We continue to employ our cost containment program, which has moderated general expense growth. The recovery of loans previously charged off, a low level of loan charge-offs and our improved asset quality translated into reduced loan loss provision expense. These factors were the primary drivers in the \$299 thousand increase in net income for 2017. Excluding the negative effect in 2017 of the recently enacted federal tax reform, our net income would have been over \$3 million. We expect the lower tax rates in 2018 to more than offset the one-time 2017 deferred tax expense.

Total deposits, including escrow deposits, increased to \$315 million, an increase of \$15 million, or 5% during 2017. The increase was spread primarily among our demand and checking, and NOW accounts. One consequence of developing strong customer relationships is that we have a significant volume of business checking accounts, which enhance our profitability. As always, one of our strategic priorities is to provide the utmost level of customer service. We are planning a data processing system conversion in the third quarter of 2018, which we believe will provide our customers with a more modern and responsive banking experience. We will strive to make this change as seamless as possible to our customers.

We have repurchased 350,961 shares since we started buying back our shares, at an overall significant discount to book value. We just announced our forty-first consecutive cash dividend, and we have recently increased our cash dividend by 25%. Our dividend payout ratio remains relatively low at 24% of net income. Our book value per share stands at \$17.82. Our regulatory capital base remains well in excess of what is needed to be considered well capitalized by industry standards.

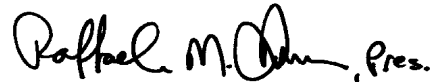
Our return on assets rose to 0.71% and our return on equity rose to 7.96%, which is a result of the growth of our loan and investment portfolio, moderate interest and provision expense and the constrained growth of general expenses. We are confident that we will continue to generate more loans and therefore increase our overall bottom-line.

2018 is poised to exceed our 2017 results. We have followed our strategic program for over 20 years, and that has generated strong stockholder value over that time period.

March 29, 2018



Joseph J. LiBassi
Chairman of the Board



Raffaele (Ralph) M. Branca
President and Chief Executive Officer

Business Description

VSB Bancorp, Inc. (referred to using terms such as “we,” “us,” or the “Company”) is the holding company for Victory State Bank (the “Bank”), a New York State chartered commercial bank. Our primary business is owning all of the issued and outstanding stock of the Bank. Victory State Bank is a New York State chartered commercial bank, founded in November 1997. The Bank is supervised by the New York State Department of Financial Services (“NYDFS”) and the Federal Deposit Insurance Corporation (“FDIC”). The Bank gathers deposits from individuals and businesses primarily in Staten Island and makes loans throughout that community. The Bank invests funds that are not used for lending primarily in government securities, mortgage backed securities and collateralized mortgage obligations. Customer deposits are insured, up to the applicable limit, by the FDIC. VSB Bancorp, Inc. common stock is quoted on the OTC Markets Group (“OTCQX”) under the symbol “VSBN”.

Our results of operations are dependent primarily on net interest income, which is the difference between the income we earn on our loan and investment portfolios and our costs of funds, consisting primarily of interest paid on our deposits. Our operating expenses principally consist of employee compensation and benefits, occupancy expenses, professional fees, advertising and marketing expenses and other general and administrative expenses. Our results of operations are significantly affected by general economic and competitive conditions, particularly the general strength of the local economy, changes in market interest rates, government policies and actions of regulatory authorities.

Since the Bank opened for business in 1997, the Board of Directors and management have pursued a strategy of growth and expansion in order to enhance the long term value of our banking franchise. The Board of Directors and management anticipate that an increase in customer deposits, and the resulting increase in funds we would have available to fund asset growth, will generate an increase in net interest income.

In order to support branch expansion and asset growth, we had not paid cash dividends. Our Board of Directors approved our first \$0.06 cash dividend during the fourth quarter of 2007, and we have paid dividends to stockholders every quarter since then. After increases in the first quarter of 2016, in the fourth quarter of 2016, and in the fourth quarter of 2017, our cash dividend reached \$0.10 per share per quarter by the end of 2017. In 2017, we paid \$605,219 of dividends out of net income of \$2,558,122, for a dividend payout ratio of 24% and in 2016 we paid \$510,533 of dividends out of net income of \$2,259,090, for a dividend payout ratio of 23%. Thus, we retained the majority of our net income to increase our capital base to support our efforts to expand our franchise in the future.

During 2017, we reduced our level of non-accrual loans. Our non-accrual loans decreased from 2016 to 2017, and totaled \$592,757, or 0.4% of total loans, at December 31, 2017. Our loans 90 days past due and still accruing increased to \$4.8 million in 2017, from \$1.8 Million in 2016. These are primarily matured constructions loans with interest being paid monthly, and we expect them to be repaid, modified, or extended without any concessions.

Deposit interest rates are expected to rise in 2018 as the Federal Reserve is expected to continue increasing short term rates. The real estate market has firmed. We incurred smaller provisions for loan losses due to the reduced level of delinquencies.

Management intends to exert efforts to continue growing our company in the future. However, both internal and external factors could adversely affect our future growth. We have expanded outside of Staten Island to originate some new loans that meet our underwriting standards. This may increase our level of higher-yielding loans and reduced our level of investments in lower-yielding asset categories.

An increase in market interest rates may have a negative impact on our net interest income. Furthermore, regulatory capital requirements could have a negative effect on our ability to grow if growth outpaces our ability to support that growth with increased capital.

Management's Discussion and Analysis of Financial Condition and Results of Operations

Since Victory State Bank opened for business, management has worked to grow its franchise. From no deposits, no loans and less than \$7.0 million of assets on the day it opened for business in 1997, the bank has grown to total assets of \$349.8 million, total deposits of \$315.6 million and capital of \$32.6 million by December 31, 2017.

Economic Conditions

In the past few years, the local and national economy has been gradually recovering from the recession of the last decade. However, many factors, including those of a local, national and international nature, create uncertainties. The intermediate and long term effect of the administration in Washington on economic growth, asset values, and other important economic factors is not yet known. The Federal Reserve has begun the process of raising interest rates from their historical lows, but both the speed and magnitude of future interest rate increases are unknown. These issues all contribute to the creation of uncertainty not only in the pact of economic growth, but its sustainability.

We draw a substantial portion of our customer base from local businesses, especially those in the building trades and related industries. If the local economy suffers due to any of these uncertainties, or as they are gradually resolved, it would become more difficult for us to conduct prudent and profitable business in our community.

Possible Adverse Effects on Our Net Income Due to Fluctuations in Market Rates

Our principal source of income is the difference between the interest income we earn on interest-earning assets, such as loans and securities, and our cost of funds, principally interest paid on deposits. These rates of interest change from time to time, depending upon a number of factors, including general market interest rates. However, the frequency of the changes varies among different types of assets

and liabilities. For example, for a five-year loan with an interest rate based upon the prime rate, the interest rate may change every time the prime rate changes. In contrast, the rate of interest we pay on a five-year certificate of deposit adjusts only every five years, based upon changes in market interest rates.

In general, the interest rates we pay on deposits adjust more slowly than the interest rates we earn on loans because our loan portfolio consists primarily of loans with interest rates that fluctuate based upon the prime rate. In contrast, although many of our deposit categories have interest rates that could adjust immediately, such as interest checking accounts and savings accounts, changes in the interest rates on those accounts are at our discretion. Thus, the rates on those accounts, as well as the rates we pay on certificates of deposit, tend to adjust more slowly. In the past two years, the prime rate began to rise at the end of 2015 from its long term low of 3.25% to 4.50% by the end of 2017. Deposit rates have fluctuated within a relatively narrow band during this time frame but may rise as the Federal Reserve increase short term rates.

Many of our prime-based loans have minimum interest rates, or floors, below which the interest rate does not decline despite further decreases in the prime rate. This helped stabilize our loan yields in a period of declining interest rates.

Based upon the Federal Reserve current projections, we expect that market interest rates will continue to increase. We anticipate that this will have an initial adverse effect on our net income because our deposit rates should begin to rise, soon thereafter as we respond to market pressures. In contrast, loan yields will remain relatively steady until the prime rate increases sufficiently that our loans begin to reprice above their interest rate floors. For most of our prime-rate based loans, this will not occur until the prime rate increases above 6%. Once our loan rates exceed their interest rate floors, increases in market interest rates should increase our net interest income because our cost of deposits should probably increase more slowly than the yields on our loans. However, customer preferences and competitive pressures may

negate this positive effect because customers may choose to move funds into higher-earning deposit types as higher interest rates make them more attractive, or competitors offer premium rates to attract deposits.

We have a substantial amount of investment securities with fixed rates of interest, most of which are mortgage-backed securities with an estimated average life of not more than 7 years. We receive regular cash flows from the repayment of our securities portfolios. These repayments were in excess of \$41.7 million in 2017 and \$36.5 million in 2016. Consistent and predictable securities repayments should allow us to invest in new securities at higher yields as market rates increase, thus mitigating the effect of the delay in repricing our loans with interest rate floors.

The Company Is Exposed to Cyber-Security Risks

Cyber-security risks include the possibility of wrongful intrusions into or disruptions of the Bank's computer systems. These may be in the form of denial of service attacks, hacking, the insertion of malware or crypto-locker attacks and identity theft, which could result in the disclosure, theft, wrongful encryption or destruction of critical internal information necessary for the operation of the company, or the release of private information about customers.

The Bank relies heavily on communications and information systems to conduct its business. This includes the use of networks, the internet, digital applications, and the telecommunications and computer systems of its own and of third parties to perform business activities. Additionally, customers interact with the Bank using electronic means, which increases the risk of information security breaches. Criminal elements are constantly attempting to find weaknesses and flaws in software or hardware that could allow them to criminally access the Bank's systems. Any failure, interruption or breach in security of these systems could result in disruptions to the Bank's accounting, deposit, loan and other systems, or result in the wrongful access to sensitive customer information, all of which could

adversely affect its customer relationships. While the Bank has implemented software and hardware systems to reduce the probability of adverse access to its systems, and has adopted policies and procedures designed to prevent or limit the effect of these possible events, there can be no assurance that any such failure, interruption or security breach will not occur or, if any does occur, that it can be sufficiently remediated.

Comparative Results for the Years Ended December 31, 2017 and December 31, 2016

Our results of operations depend primarily on net interest income, which is the difference between the income we earn on our loan and investment portfolios and our cost of funds, consisting primarily of interest we pay on customer deposits. Our operating expenses principally consist of employee compensation and benefits, occupancy expenses, professional fees, advertising and marketing expenses and other general and administrative expenses. Our results of operations are significantly affected by general economic and competitive conditions, particularly changes in market interest rates, government policies and actions of regulatory authorities.

General. We had net income of \$2,558,122 for the year ended December 31, 2017, compared to net income of \$2,259,090 for the comparable period in 2016. The principal categories which make up the 2017 net income are:

- Interest income of \$12,389,414
- Reduced by interest expense of \$925,033
- Reduced by a provision for loan losses of \$15,000
- Increased by non-interest income of \$2,576,052
- Reduced by non-interest expense of \$9,375,796
- Reduced by income tax expense of \$2,091,515

We discuss each of these categories individually and the reasons for the differences between the years ended December 31, 2017 and 2016 in the following paragraphs.

Interest Income. Interest income was \$12,389,414 for the year ended December 31, 2017, compared to \$10,790,616 for the year ended December 31, 2016, an increase of \$1,598,798 or 14.8%. The main reason for the increase was a \$13,996,870 or 11.9% increase in the average balance of loans. In addition, we had a \$6,655,995 or 3.9% increase in the average balance of investment securities. Also, there was an increase of \$9,363,610 or 29.8% in the average balance of other interest earning assets, although we reinvested a substantial portion of this increase in higher yielding loans and investment securities towards the end of 2017.

Interest income on loans increased by \$901,287 as a result of the increase of \$14.0 million in the average balance of loans from the year ended December 31, 2016 to the year ended December 31, 2017 and a 4 basis point increase in the average yield. Due to management's efforts to increase our loan portfolio, we booked new loans at slightly higher rates while maintaining our underwriting standards. The loan portfolio represented 37.7% of average interest earning assets in 2017 compared to 36.9% in 2016.

Our non-performing loans decreased from \$1.8 million at December 31, 2016 to \$592,757 million at December 31, 2017. Non-performing loans continue to be included in the calculation of average loan yield, but with an effective yield of zero. We estimate that if all non-performing loans were performing according to their contractual terms during the year ended December 31, 2017, our average loan yield would have been approximately 4 basis points higher. In contrast, we estimate that the comparable effect in 2016 would have been approximately a 9 basis point increase in average loan yield. Substantially all of the non-accrual loans are secured by mortgages on real estate.

Interest income on investment securities was \$3,901,097 for the year ended December 31, 2017, compared to \$3,479,511 for the year ended December 31, 2016, an increase of \$421,586 or 12.1%. The average balance of our investment portfolio increased by \$6.7 million or 3.9%, between the periods. We also experienced a 13

basis point increase in the average yield on our investment securities portfolios, from 2.08% to 2.21%, due to the purchase of new investment securities, primarily balloon securities with stated maturities of seven years or less and CMOs with an average life of 5 years or less, at higher market rates than the rates we had been earning on the investment securities previously purchased that were gradually being repaid. The investment securities portfolios represented 50.59% of average interest earning assets in 2017 compared to 53.27% in 2016.

Interest income from other interest earning assets (principally overnight investments) increased by \$275,925 due to the combined efforts of a \$9.4 million increase in average other interest earning assets between the periods, and a 56 basis point increase in the average rates we earned on our overnight investments from 2016 to 2017. The average yield increase corresponded to the Federal Reserve's increase in the target federal funds rate between the periods. Other interest earning assets represented 11.7% of average interest earning assets in 2017 compared to 9.9% in 2016.

Interest Expense. Interest expense was \$925,033 for the year ended December 31, 2017, compared to \$934,052 for the year ended December 31, 2016, a decrease of \$9,019 or 1.0%. The decrease in interest expense was principally due to a \$39,305 decrease in interest expense on time accounts as the average cost decreased by 3 basis points and the average balance between periods decreased by \$4.7 million. We also experienced a \$21,310 decrease in interest expense on money market accounts due to a \$1.1 million decrease in average volume and a 3 basis point decrease in average cost. These were partially offset by an \$45,993 increase in interest expense on NOW accounts as the average cost increased by 5 basis points and the average balance increased by \$11.7 million.

Average interest-bearing deposits increased by \$8.7 million, and average demand deposits, an interest free source of funds for us to invest, increased \$19.0 million, or 15.8%. This resulted in a combined \$27.8 million increase in average total deposits from 2016 to 2017.

Demand deposits represented approximately 43% of average total deposits in 2017.

Net Interest Income Before Provision for Loan Losses. Net interest income before the provision for loan losses was \$11,464,381 for the year ended December 31, 2017, compared to \$9,856,564 for the year ended December 31, 2016, an increase of \$1,607,817, or 16.3%. The increase in our interest income resulted in a rise in net interest income as detailed above.

The average yield on interest earning assets increased by 17 basis points and the average cost of funds decreased by 3 basis points. Overall, our interest rate spread increased 20 basis points, from 2.85% to 3.05% between the periods. Our net interest margin increased to 3.29% for the year ended December 31, 2017 from 3.09% in the same period of 2016. The margin is higher than the spread because it takes into account the effect of interest free demand deposits and capital.

The spread and margin both increased principally because of the increase of our average loan balance, which is our highest yielding asset category. This positive effect was amplified by increases in the average yields on other asset categories. As yields rose, our non-interest bearing demand deposits became even more valuable as a source of funds. These positive factors were complemented by a modest decline in the average cost of deposits due to low markets rates. An increase in noninterest-bearing demand deposits as a percentage of total deposits from 40.3% in 2016 to 42.7% in 2017 also had a positive effect on our net interest margin.

Provision for Loan Losses. The provision for loan losses in any period depends upon the amount necessary to bring the allowance for loan losses to the level management believes is appropriate, after taking into account charge offs and recoveries. We took a provision for loan losses of \$15,000 for the year ended December 31, 2017 compared to a provision for loan losses of \$265,000 for the same period in 2016. The \$250,000 decrease in the provision was a due to a lower level of non-performing loans, a lower

level of loans charged-off and a higher level of recoveries when comparing 2016 to 2017.

Our non-performing loans decreased from \$1.8 million at December 31, 2016 to \$592,757 at December 31, 2017. All of those loans are secured by real estate. We individually evaluated the non-performing mortgage loans based primarily upon updated appraisals as part of our analysis of the appropriate level of our allowance for loan and lease losses. We charged off \$32,252 of loans in 2017 as compared to \$240,337 in 2016. We also had recoveries (which are added back to the allowance for loan losses) of \$207,383 for the year ended December 31, 2017 as compared to \$59,341 in the same period of 2016.

After considering available information, we determined that the level of our allowance at December 31, 2017 was appropriate to address probable incurred losses. Our allowance for loan losses increased from \$1,374,567 or 1.09% of total loans, at December 31, 2016 to \$1,564,698 or 1.14% of total loans, at December 31, 2017. There can be no assurance that a higher level, or a higher provision for loan losses, will not be necessary in the future.

Non-interest Income. Non-interest income was \$2,576,052 for the year ended December 31, 2017, compared to \$2,690,745 during the same period last year. The \$114,693, or 4.3% decrease in non-interest income was a direct result of a decreases of \$109,885 in service charges on deposits. Service charges on deposits consist mainly of insufficient fund fees, which are inherently volatile, and are based upon the number of items being presented for payment against insufficient funds. We also experienced a decrease of \$144,422 in the gain on the sale of other assets due to a sale that occurred in 2016 partially offset by an increase in loan fees of \$126,033, due to a higher level of loan prepayments.

Non-interest Expense. Non-interest expense was \$9,375,796 for the year ended December 31, 2017, compared to \$8,806,686 for the year ended December 31, 2016, an increase of \$569,110 or 6.5%. The principal shifts in the individual categories were:

- a \$231,410 increase in salaries and benefits due the acceleration of stock option expenses as a result of a director resignation, severance paid to departing employees and a higher level of staff,
 - a \$119,248 increase in legal expenses due to an increase in collection and litigation,
 - a \$117,773 increase in professional fees due to the use of a recruitment agency for certain new officer hires and the retention of a third party to review some of our Bank Secrecy Act compliance systems, and
 - a \$81,346 increase in occupancy expenses due principally to the payment of partial rent on our new branch under construction.
- a \$30,365,220 increase in investment securities,
 - a \$10,793,812 increase in loans receivable, net, partially offset by
 - a \$24,319,814 decrease in cash and cash equivalents.

In addition to these changes in major asset categories, we also experienced changes in other asset categories due to normal fluctuations in operations.

Our deposits (including escrow deposits) were \$315,559,968 at December 31, 2017, an increase of \$14,686,574 or 4.9%, from December 31, 2016. The principal components of this increase were increases of \$11,580,907 in NOW accounts and \$7,728,243 in non-interest demand deposits, partially offset by a decrease of \$4,849,735 in time deposits. We exert special efforts to maintain and increase the level of non-interest bearing demand (checking) deposits as a source of low cost funds.

In addition to these changes, we also experienced changes in the various other non-interest expense categories due to normal fluctuations in operations.

Income Tax Expense. Income tax expense was \$2,091,515 for the year ended December 31, 2017, compared to income tax expense of \$1,216,533 for the same period ended 2016. The increase in income tax expense was due to the \$1,174,014 increase in income before taxes in the 2017 period. Also, in 2017 we recorded a \$337,569 federal tax valuation allowance related to our deferred tax asset due to the recently enacted federal tax law. The law dropped the corporate tax rate beginning in 2018, which made our deferred asset for future tax deductions less valuable. We were required to recalculate our deferred tax asset based upon the lower 21% rate in 2017, the year law changed, not the year the change became effective. This valuation allowance, a component of tax expense, also resulted in a one-time effective tax rate increase in 2017. Our effective tax rate for 2017 was 45.0% and 2016 was 35.0%.

Total stockholders' equity was \$32,600,340 at December 31, 2017, an increase of \$2,027,985, or 6.6%, from December 31, 2016. The increase reflected: (i) a \$1,952,903 increase in retained earnings due to net income of \$2,558,122 for the year ended December 31, 2017, partially offset by \$605,219 of dividends paid in 2017; (ii) a reduction of \$100,125 in Unearned ESOP shares reflecting the gradual payment of the loan we made to fund the ESOP's purchase of our stock; (iii) an increase in the net unrealized loss on securities of \$249,621 and (iv) a \$96,525 increase in treasury shares representing the cost of 5,250 shares of common stock that we repurchased.

The unrealized gain or loss on the available for sale and held to maturity securities portfolios are excluded from the calculation of regulatory capital. Management does not anticipate selling securities in these portfolios, but changes in market interest rates or in the demand for funds may change management's plans with respect to the securities portfolios. If there is a material increase in interest rates, the market value of the securities portfolios may decline.

Changes in Financial Condition

Total assets were \$349,763,676 at December 31, 2017, an increase of \$16,690,717, or 5.0%, from December 31, 2016. The principal changes resulting in the increase in assets can be summarized as follows:

Liquidity and Capital Resources

Our primary sources of funds are increases in deposits, proceeds from the repayment of investment securities, and the repayment of loans. We use these funds to purchase new investment securities and to fund new and renewing loans in our loan portfolio. Remaining funds are invested in short-term liquid assets such as overnight federal funds loans and bank deposits.

During the year ended December 31, 2017, we had a net increase in total deposits of \$14,686,574 due to increases of \$11,580,907 in NOW accounts, \$7,728,243 in non-interest demand deposits, \$940,961 in savings accounts and \$36,721 in escrow deposits, partially offset by decreases of \$4,849,735 in time deposits and \$750,523 in money market accounts. These are all what are commonly known as “retail” deposits that we obtain through the efforts of our branch network rather than “wholesale” deposits that some banks obtain from deposit brokers or deposit listing services. We also received proceeds from repayment of investment securities of \$41,694,453. We used \$72,963,433 of available funds to purchase new investment securities and we had a net loan increase of \$10,635,373. These changes resulted in an overall decrease in cash and cash equivalents of \$24,319,814. Total cash and cash equivalents at December 31, 2017 were \$12,920,547.

In contrast, in 2016, we had a net increase in total deposits of \$24,569,131 due to increases of \$21,912,737 in non-interest demand deposits, \$10,060,796 in NOW accounts, \$1,638,916 in savings accounts and \$188,184 in escrow deposits, partially offset by decreases of \$5,268,014 in money market accounts and \$3,963,488 in time deposits. These are also all “retail” deposits. We also received proceeds from repayment of investment securities of \$36,486,588. We used \$20,132,821 of available funds to purchase new investment securities and we had a net loan increase of \$21,872,842. These changes resulted in an overall increase in cash and cash equivalents of \$22,395,265. Total cash and cash equivalents at December 31, 2016 were \$37,240,361.

At December 31, 2017, cash and cash equivalents represented 3.7% of total assets. Our cash and cash equivalents decreased during the year. We deployed a portion of the funds received from maturing securities and our increase in deposits into loans, which enabled us to generate higher interest income. We invested most of the remainder into investment securities, which have higher yields than overnight liquid investments. We anticipate, based upon historical experience that cash and cash equivalents, combined with cash inflows we anticipate from payments on our loan and investment securities portfolios, will be sufficient to fund loan growth and unanticipated deposit outflows. Depending upon competitive pressures, we may need to implement interest-paying business checking in order to maintain demand deposits at historical levels or to increase such deposits.

As a secondary source of liquidity, at December 31, 2017 we had \$46.1 million of investment securities classified available for sale. The disposition of these securities prior to maturity is an option available to us in the event, which we believe is unlikely, that our primary sources of liquidity and expected cash flows are insufficient to meet our need for funds. Additionally, we have the ability to borrow funds at the Federal Home Loan Bank of New York and the Federal Reserve Bank of New York using the securities in our investment portfolios as collateral if the need arises. Based upon our asset size and the amount of our securities portfolios that qualifies as eligible collateral, we had more than \$96 million of unused borrowing capability from the FHLBNY at December 31, 2017. Victory State Bank also has a \$5 million unsecured credit facility with Atlantic Central Bankers Bank, which the Bank has not drawn upon. We do not anticipate a need for additional capital resources and do not expect to raise funds through a stock offering in the near future. Based upon past experience, we believe that we have sufficient resources to allow us to continue to make loans as appropriate opportunities arise to support our lending activities.

Victory State Bank satisfied all capital ratio requirements of the Federal Deposit Insurance Corporation at December 31, 2017, with a Tier I Leverage Capital ratio of 9.02%, a Common Equity Tier I to Risk Weighted Assets ratio of 18.05%, a

Tier I Capital to Risk-Weighted Assets ratio of 18.05%, and a Total Capital to Risk-Weighted Assets ratio of 18.92%.

VSB Bancorp, Inc. satisfied all capital ratio requirements of the Federal Reserve Bank of New York at December 31, 2017, with a Tier I Leverage Capital ratio of 9.18%, a Common Equity Tier I to Risk Weighted Assets ratio of 18.26%, a Tier I Capital to Risk-Weighted Assets ratio of 18.42%, and a Total Capital to Risk-Weighted Assets ratio of 19.29%.

Non-Performing Loans

The following is information about the two largest non-performing loans, totaling \$422,171 or 71.2% of our non-performing loans at December 31, 2017. Management believes it has taken appropriate steps with a view towards maximizing recovery and minimizing loss, if any, on these loans.

- \$251,663 in a commercial real estate loan secured by a second mortgage on a residential property in Staten Island, NY. The loan is guaranteed personally by the principal of the borrower. The borrower has filed a petition in bankruptcy and the collateral is expected to be sold in that

venue with sufficient funds to pay off the principal balance.

- \$170,507 in a commercial real estate loan. The loan is secured by a first mortgage on a mixed use commercial property in Staten Island, NY. The loan is guaranteed by the principal of the borrower. It is in the process of foreclosure.

From time to time, the Bank will enter into agreements with borrowers to modify the terms of their loans when we believe that a modification will maximize our recovery. In most cases, we do not agree to reduce the rate of interest or forgive the repayment of principal when we agree to the loan modification, and we did not do so in any of the modifications described above. Instead, we seek to modify terms on an interim basis to allow the borrower to reduce payments for a short duration and thus give the borrower an opportunity to get back on its feet. We prefer to develop repayment plans for our borrowers that provide them with cash flow relief while requiring that they ultimately pay all amounts that they owe. However, we are not averse to commencing legal action to foreclose on mortgages or obtain personal judgments against obligors when we perceive that as the appropriate strategy.

Average Balance Sheet

The following table sets forth certain information relating to our consolidated statements of financial condition and the consolidated statements of earnings for the fiscal years ended December 31, 2017 and 2016 and reflects the average yield on assets and average cost of liabilities for the periods indicated. Such yields and costs are derived by dividing income or expense by the average balance of assets or liabilities, respectively, for the periods shown. Average balances are derived from average daily balances. The average balance of loans receivable include loans on which we have discontinued accruing interest. The yields and costs include net fees, which are considered adjustments to yields. No tax equivalent adjustments have been made.

	Year Ended December 31,			Year Ended December 31,		
	2017		Yield/	2016		Yield/
	Average	Interest ¹	Cost	Average	Interest ¹	Cost
	Balance			Balance		
Assets:						
Interest-earning assets:						
Loans receivable	\$ 131,565,761	\$ 8,047,482	6.12 %	\$ 117,568,891	\$ 7,146,195	6.08 %
Other interest earning assets	40,842,680	440,835	1.08	31,479,070	164,910	0.52
Investment securities	<u>176,553,215</u>	<u>3,901,097</u>	2.21	<u>169,897,220</u>	<u>3,479,511</u>	2.08
Total interest-earning assets	348,961,656	12,389,414	3.55	318,945,181	10,790,616	3.38
Non-interest earning assets	<u>11,388,549</u>			<u>11,092,864</u>		
Total assets	<u>\$ 360,350,205</u>			<u>\$ 330,038,045</u>		
Liabilities and equity:						
Interest-bearing liabilities:						
Savings accounts	\$ 24,868,152	53,505	0.22	\$ 22,118,106	47,930	0.22
Time accounts	54,066,712	299,344	0.55	58,725,038	338,649	0.58
Money market accounts	57,021,384	446,973	0.78	58,126,292	468,283	0.81
Now accounts	50,454,805	125,183	0.25	38,761,010	79,190	0.20
Short term borrowings	<u>2,055</u>	<u>28</u>	1.36	-	-	-
Total interest-bearing liabilities	186,413,108	925,033	0.50	177,730,446	934,052	0.53
Checking accounts	139,502,132			120,497,896		
Escrow Deposits	<u>604,954</u>			<u>491,801</u>		
Total	326,520,194			298,720,143		
Other liabilities	<u>1,705,507</u>			<u>1,346,442</u>		
Total liabilities	328,225,701			300,066,585		
Equity	<u>32,124,504</u>			<u>29,971,460</u>		
Total liabilities and equity	<u>\$ 360,350,205</u>			<u>\$ 330,038,045</u>		
Net interest income/net interest rate spread		<u>\$ 11,464,381</u>	<u>3.05 %</u>		<u>\$ 9,856,564</u>	<u>2.85 %</u>
Net interest earning assets/net interest margin	<u>\$ 162,548,548</u>		<u>3.29 %</u>	<u>\$ 141,214,735</u>		<u>3.09 %</u>
Ratio of interest-earning assets to to interest-bearing liabilities	<u>1.87 x</u>			<u>1.79 x</u>		
Return On Average Equity:			<u>7.96 %</u>			<u>7.54 %</u>
Equity To Assets:			<u>9.32 %</u>			<u>9.18 %</u>
Dividend Payout Ratio			<u>23.66 %</u>			<u>22.60 %</u>

1 - Interest on loans includes \$231,461 in 2017 and \$38,104 in 2016 representing interest received during the year on non-accrual loans that is attributable to prior years. Those amounts were excluded in calculating the average loan yield for the year in which they were received but were not added to the prior period interest in calculating the yield in the prior period.

Market for Common Equity and Related Stockholder Matters.

Our common stock has been quoted on the OTC Marketplace under the symbol "VSBN" since December 23, 2013. Since February 9, 2015 our common stock has been quoted on the OTCQX Best Market, continuing under the symbol "VSBN". Prior to December 23, 2013, we were listed on the NASDAQ Global Market under the same symbol.

The following table reflects the high and low sales prices for our common stock during each calendar quarter of the last two fiscal years.

	<u>2017</u>			
	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
High Price.....	\$16.20	\$16.25	\$18.84	\$19.75
Low Price.....	\$14.35	\$14.45	\$16.25	\$18.00

	<u>2016</u>			
	<u>First Quarter</u>	<u>Second Quarter</u>	<u>Third Quarter</u>	<u>Fourth Quarter</u>
High Price.....	\$13.08	\$12.48	\$13.10	\$15.99
Low Price.....	\$12.11	\$12.15	\$12.41	\$12.91

We have approximately 124 stockholders of record. We paid our first cash dividend of \$0.06 per common share on January 2, 2008 to stockholders of record on November 29, 2007, and we paid quarterly dividends of \$0.06 per share with respect to each calendar quarter thereafter through the end of 2015. In the first quarter of 2016, we increased our cash dividend rate, by \$0.01 per a share, to \$0.07 per a share. In the fourth quarter of 2016, we again increased our cash dividend rate, by \$0.01 per a share, to \$0.08 per a share. In the fourth quarter of 2017, we again increased our cash dividend rate, by \$0.02 per a share, to \$0.10 per a share.

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Stockholders
VSB Bancorp, Inc.
Staten Island, New York

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of VSB Bancorp, Inc. (the "Company"), which comprise the consolidated statements of financial condition as of December 31, 2017 and 2016, and the related consolidated statements of earnings, comprehensive income, stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2017 and 2016, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

/s/Crowe Horwath LLP

Livingston, New Jersey
March 15, 2018

VSBC BANCORP, INC.
CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION
DECEMBER 31, 2017 AND 2016

ASSETS	2017	2016
Cash and cash equivalents	\$ 12,920,547	\$ 37,240,361
Investment securities, available for sale	46,080,113	42,588,960
Investment securities, held to maturity (fair value of \$144,168,074 at 2017 and \$118,656,123 at 2016)	145,853,876	118,979,809
Loans receivable (net of allowance for loan losses of \$1,564,698 at 2017 and \$1,374,567 at 2016, respectively)	135,615,686	124,821,874
Accrued interest receivable	888,936	756,277
Premises and equipment, net	1,086,569	1,418,054
Bank owned life insurance	5,433,064	5,316,199
Prepaid and other assets	1,929,175	1,951,425
	<u>349,807,966</u>	<u>333,072,959</u>
Total assets	<u>\$ 349,807,966</u>	<u>\$ 333,072,959</u>
 LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Deposits		
Non-interest bearing	\$ 131,582,216	\$ 123,817,252
Interest bearing	183,977,752	177,056,142
Total deposits	<u>315,559,968</u>	<u>300,873,394</u>
Accounts payable, accrued expenses and other liabilities	1,647,658	1,627,210
	<u>317,207,626</u>	<u>302,500,604</u>
Total liabilities	<u>317,207,626</u>	<u>302,500,604</u>
Commitments and contingent liabilities (Note 14)	-	-
 STOCKHOLDERS' EQUITY		
Common stock (\$.0001 par value, 10,000,000 shares authorized, 2,092,926 issued, 1,829,465 outstanding at December 31, 2017 and 2,086,509 issued, 1,828,298 outstanding at December 31, 2016)	209	209
Additional paid-in capital	10,590,557	10,269,454
Retained earnings	25,722,467	23,769,564
Treasury stock, at cost (263,461 shares at December 31, 2017 and 258,211 shares at December 31, 2016)	(2,813,653)	(2,717,128)
Unearned Employee Stock Ownership Plan shares	(634,125)	(734,250)
Accumulated other comprehensive loss, net of taxes of \$142,754 and \$8,343, respectively	(265,115)	(15,494)
	<u>32,600,340</u>	<u>30,572,355</u>
Total stockholders' equity	<u>32,600,340</u>	<u>30,572,355</u>
Total liabilities and stockholders' equity	<u>\$ 349,807,966</u>	<u>\$ 333,072,959</u>

See notes to consolidated financial statements.

VSB BANCORP, INC.**CONSOLIDATED STATEMENTS OF EARNINGS FOR THE YEARS ENDED DECEMBER 31,
2017 AND 2016**

	<u>2017</u>	<u>2016</u>
INTEREST INCOME:		
Loans receivable	\$ 8,047,482	\$ 7,146,195
Investment securities	3,901,097	3,479,511
Other interest income	440,835	164,910
Total interest income	<u>12,389,414</u>	<u>10,790,616</u>
INTEREST EXPENSE:		
Deposits	925,033	934,052
Total interest expense	<u>925,033</u>	<u>934,052</u>
Net interest income	11,464,381	9,856,564
PROVISION FOR LOAN LOSSES	15,000	265,000
Net interest income after provision for loan losses	<u>11,449,381</u>	<u>9,591,564</u>
NON-INTEREST INCOME:		
Deposit service fees	1,920,788	2,030,673
Other income	655,264	660,072
Total non-interest income	<u>2,576,052</u>	<u>2,690,745</u>
NON-INTEREST EXPENSES:		
Salaries and employee benefits	4,830,687	4,599,277
Occupancy and equipment	1,413,896	1,332,550
Data processing service fees	422,171	405,250
Legal fees	312,728	193,480
Professional fees	483,346	365,573
Director fees	240,001	246,575
FDIC and NYSBD assessments	182,000	188,000
Supplies and service	305,762	279,258
Checkbook charges	168,729	172,165
Other	1,016,476	1,024,558
Total non-interest expenses	<u>9,375,796</u>	<u>8,806,686</u>
INCOME BEFORE INCOME TAXES	<u>4,649,637</u>	<u>3,475,623</u>
PROVISION/(BENEFIT) FOR INCOME TAXES:		
Current	1,719,486	1,417,782
Deferred	372,029	(201,249)
Total income taxes	<u>2,091,515</u>	<u>1,216,533</u>
NET INCOME	<u>\$ 2,558,122</u>	<u>\$ 2,259,090</u>
Earnings per share:		
Basic	<u>\$ 1.44</u>	<u>\$ 1.29</u>
Diluted	<u>\$ 1.43</u>	<u>\$ 1.28</u>
Comprehensive income	<u>\$ 2,308,501</u>	<u>\$ 2,167,011</u>

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
DECEMBER 31, 2017 AND 2016

	<u>2017</u>	<u>2016</u>
Net Income	\$ 2,558,122	\$ 2,259,090
Other comprehensive income/(loss):		
Unrealized gains on securities, AFS:		
Change in unrealized gain (loss) on securities , AFS	(273,583)	46,656
Amortization on unrealized gains on HTM securities	(110,449)	(188,316)
Tax effects	(134,411)	(49,581)
Net of tax	<u>(249,621)</u>	<u>(92,079)</u>
Comprehensive income	<u>\$ 2,308,501</u>	<u>\$ 2,167,011</u>

See notes to consolidated financial statements.

VSB BANCORP, INC.
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY FOR THE YEARS ENDED
DECEMBER 31, 2017 AND 2016

	Number of Common Shares	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock, at cost	Unearned ESOP Shares	Accumulated Other Comprehensive Gain /(Loss)	Total Stockholders' Equity
Balance at January 1, 2016	<u>1,799,398</u>	<u>\$ 208</u>	<u>\$ 10,512,041</u>	<u>\$ 22,021,007</u>	<u>\$ (2,976,175)</u>	<u>\$ (834,375)</u>	<u>\$ 76,585</u>	<u>\$ 28,799,291</u>
Exercise of stock options	8,000	1	92,574					92,575
Stock-based compensation			145,383					145,383
Amortization of earned portion of ESOP common stock			18,256			100,125		118,381
Cash dividends declared (\$0.29 per share)				(510,533)				(510,533)
Purchase of treasury stock, at cost	(19,100)				(239,753)			(239,753)
Contribution to RRP Trust from treasury shares	40,000		(498,800)		498,800			-
Net income				2,259,090				2,259,090
Other comprehensive loss	-	-	-	-	-	-	(92,079)	(92,079)
Balance at December 31, 2016	<u>1,828,298</u>	<u>\$ 209</u>	<u>\$ 10,269,454</u>	<u>\$ 23,769,564</u>	<u>\$ (2,717,128)</u>	<u>\$ (734,250)</u>	<u>\$ (15,494)</u>	<u>\$ 30,572,355</u>
Exercise of stock options	6,417		77,658					77,658
Stock-based compensation			202,942					202,942
Amortization of earned portion of ESOP common stock			40,503			100,125		140,628
Cash dividends declared (\$0.34 per share)				(605,219)				(605,219)
Purchase of treasury stock, at cost	(5,250)				(96,525)			(96,525)
Net income				2,558,122				2,558,122
Other comprehensive loss	-	-	-	-	-	-	(249,621)	(249,621)
Balance at December 31, 2017	<u>1,829,465</u>	<u>\$ 209</u>	<u>\$ 10,590,557</u>	<u>\$ 25,722,467</u>	<u>\$ (2,813,653)</u>	<u>\$ (634,125)</u>	<u>\$ (265,115)</u>	<u>\$ 32,600,340</u>

See notes to consolidated financial statements.

VSB BANCORP, INC.**CONSOLIDATED STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31,
2017 and 2016**

	<u>2017</u>	<u>2016</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,558,122	\$ 2,259,090
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	464,620	488,469
Premium amortization, net of discount accretion	346,288	455,246
ESOP compensation expense	140,628	118,381
Stock-based compensation expense	202,942	145,383
Provision for loan losses	15,000	265,000
Gain on sale of other real estate	-	(128,251)
Changes in operating assets and liabilities:		
Increase in cash surrender value of BOLI	(116,865)	(121,254)
(Increase)/decrease in prepaid and other assets	(197,773)	13,711
Increase in accrued interest receivable	(132,659)	(12,902)
Decrease/(increase) in deferred income taxes	398,725	(205,536)
Increase in accrued expenses, income tax payable and other liabilities	(23,842)	327,922
Net cash provided by operating activities	<u>3,655,186</u>	<u>3,605,259</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net change in loans receivable	(10,635,373)	(21,872,842)
Available-for-sale securities:		
Proceeds from repayments and calls of investment securities	12,550,830	15,411,813
Purchase of investment securities	(16,444,949)	-
Held-to-maturity securities:		
Proceeds from repayments and calls of investment securities	29,143,623	21,074,775
Purchase of investment securities	(56,518,484)	(20,132,821)
Proceeds from sale of other real estate	-	775,270
Purchases of premises and equipment, net	(133,135)	(377,609)
Net cash used in investing activities	<u>(42,037,488)</u>	<u>(5,121,414)</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Net increase in deposits	14,686,574	24,569,131
Cash dividends paid	(605,219)	(510,533)
Exercise of stock options	77,658	92,575
Purchase of treasury stock, at cost	(96,525)	(239,753)
Net cash provided by financing activities	<u>14,062,488</u>	<u>23,911,420</u>
NET (DECREASE)/INCREASE CASH AND CASH EQUIVALENTS	(24,319,814)	22,395,265
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	37,240,361	14,845,096
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 12,920,547</u>	<u>\$ 37,240,361</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	\$ 926,924	\$ 842,204
Income taxes	<u>\$ 1,564,411</u>	<u>\$ 1,359,085</u>

See notes to consolidated financial statements.

VSB BANCORP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS FOR THE YEARS ENDED DECEMBER 31, 2017 and 2016

1. GENERAL

VSB Bancorp, Inc. (referred to using terms such as “we,” “us,” or the “Company”) is the holding company for Victory State Bank (the “Bank”), a New York chartered commercial bank. Our primary business is owning all of the issued and outstanding stock of the Bank. Our common stock is quoted on the OTCQX Best Market. We trade under the symbol “VSBN”.

Through the Bank, the Company is primarily engaged in the business of commercial banking, and to a lesser extent retail banking. The Bank gathers deposits from individuals and businesses primarily in Staten Island, New York and makes loans primarily throughout that community. Therefore, the Company’s exposure to credit risk is significantly affected by changes in the local Staten Island economic and real estate markets. The Bank invests funds that are not used for lending primarily in government securities, mortgage backed securities and collateralized mortgage obligations. Customer deposits are insured, up to the applicable limit, by the Federal Deposit Insurance Corporation (“FDIC”). The Bank is supervised by the New York State Department of Financial Services (“NYDFS”) and the FDIC.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The following is a description of the significant accounting and reporting policies followed in preparing and presenting the accompanying consolidated financial statements. These policies conform with accounting principles generally accepted in the United States of America (“GAAP”).

Principles of Consolidation - The consolidated financial statements of the Company include the accounts of the Company, including its subsidiary Victory State Bank. All significant inter-company accounts and transactions between the Company and Bank have been eliminated in consolidation.

Subsequent Events - The Company has evaluated subsequent events for recognition and disclosure through March 15, 2018, which is the day the financial statements were available to be issued.

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 the disclosure of contingent assets and liabilities at the date of the financial statements and the amounts of revenues and expenses during the reporting period. Actual results can differ from those estimates.

Reclassifications – Some items in the prior year financial statements were reclassified to conform to the current presentation.

Cash and Cash Equivalents – Cash and cash equivalents consist of cash on hand, due from banks and interest-bearing deposits. Interest-bearing deposits with original maturities of 90 days or less are included in this category. Customer loan and deposit transactions are reported on a net cash basis. Regulation D of the Board of Governors of the Federal Reserve System requires that Victory State Bank maintain interest-bearing deposits or cash on hand as reserves against its demand deposits. The amount of reserves which Victory State Bank is required to maintain depends upon its level of transaction accounts. During the fourteen day period from December 21, 2017 through January 3, 2018, Victory State Bank was required to maintain reserves, after deducting vault cash, of \$8,940,000. Reserves are required to be maintained on a fourteen day basis, so, from time to time, Victory State Bank may use

available cash reserves on a day to day basis, so long as the fourteen day average reserves satisfy Regulation D requirements. Victory State Bank is required to report transaction account levels to the Federal Reserve on a weekly basis.

Interest-bearing bank balances – Interest-bearing bank balances mature overnight and are carried at cost.

Investment Securities - Investment securities, available for sale, are to be held for an unspecified period of time and include securities that management intends to use as part of its asset/liability strategy. Investment securities, held to maturity are carried at amortized cost when management has the positive intent and ability to hold them to maturity. Investment securities, available for sale may be sold in response to changes in interest rates, prepayments or other factors and are carried at estimated fair value. Gains or losses on the sale of such securities are determined by the specific identification method. Interest income includes amortization of purchase premium and accretion of purchase discount. Premiums and discounts are recognized in interest income using a method that approximates the level yield method without anticipating prepayments, except for mortgage-backed securities where prepayments are estimated. Unrealized holding gains or losses, net of deferred income taxes, are excluded from earnings and reported as other comprehensive income in a separate component of stockholders' equity until realized.

For debt securities with other than temporary impairment (OTTI) that management does not intend to sell or expect to be required to sell, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

The Company invests primarily in agency collateralized mortgage-Backed obligations ("CMOs") with estimated average lives primarily under 7 Years and mortgage-backed securities. These securities are primarily issued by the Federal National Mortgage Association ("FNMA"), the Government National Mortgage Association ("GNMA") or the Federal Home Loan Mortgage Corporation ("FHLMC") and are primarily comprised of mortgage pools guaranteed by FNMA, GNMA or FHLMC. The Company also invests in whole loan CMOs, collateralized loan obligations ("CLO") and asset backed securities, all of which are AAA rated at the time of purchase, as well as corporate bonds, which are typically rated A or better at the time of purchase. These securities expose the Company to risks such as interest rate, prepayment and credit risk and thus pay a higher rate of return than comparable treasury issues.

Loans Receivable - Loans receivable, that management has the intent and ability to hold for the foreseeable future or until maturity or payoff, are stated at unpaid principal balances, adjusted for deferred net origination and commitment fees and the allowance for loan losses. Interest income on loans is credited as earned.

It is the policy of the Company to provide a valuation allowance for probable incurred losses on loans based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations which may affect the borrower's ability to repay, estimated value of underlying collateral and current economic conditions in the Company's lending area. The allowance is increased by provisions for loan losses charged to earnings and is reduced by charge-offs, net of recoveries. While management uses available information to estimate losses on loans, future additions to the allowance may be necessary based upon the expected growth of the loan portfolio and any changes in economic conditions beyond management's control. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Bank's allowance for loan losses. Such agencies may require the Bank to recognize additions to the allowance based on judgments different from those of

management. Management believes, based upon all relevant and available information, that the allowance for loan losses is appropriate.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-impaired loans and is based for all portfolio segments on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations.

The Company has a policy that all loans 90 days past due are placed on non-accrual status. It is the Company's policy to cease the accrual of interest on loans to borrowers past due less than 90 days where a probable loss is estimated and to reverse out of income all interest that is due but has not been paid. Past due status is based on the contractual terms of the loan. The Company applies payments received on non-accrual loans to the outstanding principal balance due before applying any amount to interest, until the loan is restored to an accruing status. On a limited basis, the Company may apply a payment to interest on a non-accrual loan if there is no impairment or no estimated loss on these assets. The Company continues to accrue interest on construction loans that are 90 days past contractual maturity date if the loan is expected to be paid in full in the next 60 days and all interest is paid up to date.

Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current, there has been a history of prompt payments and future payments are reasonably assured.

Loan origination fees and certain direct loan origination costs are deferred and the net amount recognized over the contractual loan terms using the level-yield method, adjusted for periodic prepayments in certain circumstances.

The Company considers a loan to be impaired when, when full payment under the loan terms is not expected. Commercial and commercial real estate loans are individually evaluated for impairment. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Impairment is measured on a loan by loan basis for commercial and commercial real estate loans. Impaired loans are measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral. The fair value of the collateral, as reduced by costs to sell, is utilized if a loan is collateral dependent. The fair value of the collateral is estimated by obtaining a new appraisal, if the loan amount exceeds \$100,000, or by adjusting the most recent appraisal to reflect the current market if the loan is less than \$100,000 or a more recent appraisal has yet to be received. Loans with modified terms that the Company would not normally consider, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired. Large groups of homogeneous loans are collectively evaluated for impairment.

Long-Lived Assets - The Company periodically evaluates the recoverability of long-lived assets, such as premises and equipment, to ensure the carrying value has not been impaired. In performing the review for recoverability, the Company would estimate the future cash flows expected to result from the use of the asset. If the sum of the expected future cash flows is less than the carrying amount, an

impairment will be recognized. The Company reports these assets at the lower of the carrying value or fair value.

Premises and Equipment - Premises, leasehold improvements, and furniture and equipment are stated at cost less accumulated depreciation and amortization. Depreciation and amortization are accumulated by the straight-line method over the estimated useful lives of the respective assets, which range from three to fifteen years. Leasehold improvements are amortized at the lesser of their useful life or the term of the lease.

Federal Home Loan Bank (FHLB) Stock - The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment. Because this stock is viewed as a long term investment, impairment is based on ultimate recovery of par value, which is the price the Bank pays for the FHLB Stock. Both cash and stock dividends are reported as income.

Bank-Owned Life Insurance - The Company has purchased life insurance policies on certain employees. These bank-owned life insurance policies ("BOLI") policies are recorded in the Consolidated Statements of Condition at their cash surrender value. Income from these policies and changes in the cash surrender value are recorded in "Non-interest income" in the Consolidated Statements of Earnings. The Company's investment in BOLI was \$5,433,064 at December 31, 2017 and \$5,316,199 at December 31, 2016. The company's initial purchase of BOLI was recorded on July 1, 2014. The Company's investment in BOLI generated income of \$116,965 and \$121,254 during the years ended December 31, 2017 and 2016.

Income Taxes - The Company utilizes the liability method to account for income taxes. Under this method, deferred tax assets and liabilities are determined on differences between financial reporting and the tax bases of assets and liabilities and are measured using the enacted tax rates and laws expected to be in effect when the differences are expected to reverse. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. As such, a tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

Financial Instruments - In the ordinary course of business, the Company has entered into off-balance sheet financial instruments, primarily consisting of commitments to extend credit. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded.

Basic and Diluted Net Income Per Common Share - The Company has stock compensation awards with non-forfeitable dividend rights which are considered participating securities. As such, earnings per share is computed using the two-class method. Basic earnings per common share is computed by dividing net income allocated to common stock by the weighted average number of common shares outstanding during the period which excludes the participating securities. Diluted earnings per common share includes the dilutive effect of additional potential common shares from stock-based compensation plans, but excludes awards considered participating securities. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the financial statements.

Basic net income per share of common stock is based on 1,734,552 shares and 1,722,188 shares, the weighted average number of common shares outstanding for the years ended December 31, 2017 and 2016, respectively. Diluted net income per share of common stock is based on 1,752,039 and 1,728,934, the weighted average number of common shares outstanding plus potentially dilutive common shares for the years ended December 31, 2017 and 2016, respectively. The weighted average number of potentially dilutive common shares excluded in calculating diluted net income per common share due to the anti-dilutive effect is 0 and 0 shares for the years ended December 31, 2017 and 2016, respectively. Common stock equivalents were calculated using the treasury stock method.

The reconciliation of the numerators and the denominators of the basic and diluted per share computations for the years ended December 31, are as follows:

Reconciliation of EPS

	Year ended December 31, 2017	Year ended December 31, 2016
<u>Basic</u>		
Net Income allocated to common stock	\$ 2,558,122	\$ 2,259,090
Undistributed earnings allocated to participating securities	(53,619)	(38,303)
Net earnings allocated to common stock	<u>\$ 2,504,503</u>	<u>\$ 2,220,787</u>
Weighted common shares outstanding including participating securities	1,771,687	1,751,892
Less: Participating securities	(37,135)	(29,704)
Weighted average shares	<u>1,734,552</u>	<u>1,722,188</u>
Basic EPS	<u>\$ 1.44</u>	<u>\$ 1.29</u>
<u>Diluted</u>		
Net earnings allocated to common stock	<u>\$ 2,504,503</u>	<u>\$ 2,220,787</u>
Weighted average shares for basic	1,734,552	1,722,188
Dilutive effects of:		
Stock Options	17,487	6,746
Unvested shares not considered participating securities	-	-
	<u>1,752,039</u>	<u>1,728,934</u>
Diluted EPS	<u>\$ 1.43</u>	<u>\$ 1.28</u>

Net earnings allocated to common stock for the period are distributed earnings during the period, such as dividends on common shares outstanding, plus a proportional amount of retained income for the period based on restricted shares granted but unvested compared to the total common shares outstanding.

Stock Based Compensation - The Company records compensation expense for stock options provided to employees in return for employment service. The cost is measured at the fair value of the options when granted, and this cost is expensed over the employment service period, which is normally the vesting period of the options.

Employee Stock Ownership Plan ("ESOP") - The cost of shares issued to the ESOP, but not yet allocated to participants, is shown as a reduction of stockholders' equity. Compensation expense is based on the market price of shares as they are committed to be released to participant accounts. Cash dividends on allocated ESOP shares reduce retained earnings; cash dividends on unearned ESOP shares reduce debt and accrued interest.

Stock Repurchase Programs – On September 8, 2008, the Company announced that its Board of Directors had authorized a Rule 10b5-1 stock repurchase program for the repurchase of up to 100,000 shares of the Company’s common stock. On April 21, 2009, the Company announced that its Board of Directors had authorized a second Rule 10b5-1 stock repurchase program for the repurchase of up to an additional 100,000 shares of the Company’s common stock. On September 14, 2011, the Company announced that its Board of Directors had authorized a third Rule 10b5-1 stock repurchase program for the repurchase of up to an additional 100,000 shares of the Company’s common stock. On June 11, 2015, the Company announced that its Board of Directors had authorized a fourth Rule 10b5-1 stock repurchase program for the repurchase of up to an additional 100,000 shares of the Company’s common stock. At December 31, 2017, the Company had repurchased a total of 350,961 shares of its common stock under the stock repurchase programs. Stock repurchases under the programs have been accounted for using the cost method, in which the Company will reflect the entire cost of repurchased shares as a separate reduction of stockholders’ equity on its balance sheet.

Retention and Recognition Plan – In 2010, the stockholders of VSB Bancorp, Inc. approved the 2010 Retention and Recognition Plan (the “RRP”). The RRP authorized the award of up to 50,000 shares of its common stock to directors, officers and employees. In April 2016, the stockholders approved the addition of 50,000 more shares to the RRP. The recipient of an award will not be required to make any payment to receive the award or the stock covered by the award. Upon the approval of the increase in 2016, each director with five years of service was awarded 5,000 shares for a total of 40,000 shares. These awards vest over three years and only after the Company’s total assets exceed \$400 million. The Company recognizes compensation expense for the shares awarded under the RRP gradually as the shares vest, based upon the market price of the shares on the date of the award.

Comprehensive Income - Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses, net of taxes, on our securities’ portfolios which are also recognized as separate components of equity. Amortization of unrealized gains on HTM securities is a separate component.

Adoption of New Accounting Standards and Newly Issued Not Yet Effective Accounting Standards - In May 2014, the Financial Accounting Standards Board (“FASB”) issued Accounting Standards Update (“ASU”) 2014-09 “Revenue from Contracts with Customers.” The amendments in ASU 2014-09 provide a comprehensive framework for addressing revenue recognition issues that can be applied to all contracts with customers. The amendments in ASU 2014-09 also include improved disclosures to enable users of financial statements to better understand the nature, amount, timing and uncertainty of revenue that is recognized. For public entities, ASU 2014-09, as amended, is effective for interim and annual reporting periods beginning after December 15, 2017. While the guidance in ASU 2014-09 supersedes most existing industry-specific revenue recognition accounting guidance, much of the Bank’s revenue comes from financial instruments such as debt securities and loans that are outside the scope of the guidance. The Company adopted ASU 2014-09 on January 1, 2018 and it did not have a material impact on the Company’s consolidated financial position, results of operations or disclosures..

In January 2016, the FASB issued ASU 2016-01 “Financial Instruments – Overall.” The amendments in ASU 2016-01 are intended to improve the recognition, measurement, presentation and disclosure of financial assets and liabilities to provide users of financial statements with information that is more useful for decision-making purposes. Among other changes, ASU 2016-01 would require equity securities to be measured at fair value with changes in fair value recognized through net income but would allow equity securities that do not have readily determinable fair values to be re-measured at fair value either upon the occurrence of an observable price change or upon identification of an impairment. The amendments would simplify the impairment assessment of such equity securities and would require enhanced disclosure about these investments. ASU 2016-01 would also require separate presentation of financial

assets and liabilities by measurement category and type of instrument, such as securities or loans, on the balance sheet or in the notes, and would eliminate certain other disclosures relating to the methods and assumptions used to estimate fair value. For public entities, the amendments in ASU 2016-01 are effective for interim and annual reporting periods beginning after December 15, 2017. Early adoption is not permitted. The Company adopted ASU 2016-01 on January 1, 2018 and it did not have a material impact on the Company's consolidated financial position, results of operations or disclosures..

In February 2016, the FASB issued ASU 2016-02 "Leases." ASU 2016-02 affects any entity that enters into a lease and is intended to increase the transparency and comparability of financial statements among organizations. The ASU requires, among other changes, a lessee to recognize on its balance sheet a lease asset and a lease liability for those leases previously classified as operating leases. The lease asset would represent the right to use the underlying asset for the lease term and the lease liability would represent the discounted value of the required lease payments to the lessor. The ASU would also require entities to disclose key information about leasing arrangements. ASU 2016-02 is effective for interim and annual reporting periods beginning after December 15, 2018. Early adoption is permitted. The Company currently leases six branches. ASU 2016-02 will result in the establishment of a right to use asset and corresponding lease obligation, the materiality of which has yet to be determined by management; however the ASU is not expected to have a material impact on the Company's consolidated results of operations or disclosures.

In March 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") No. 2016-09, "Compensation – Stock Compensation (Topic 718): Improvements to Employee Share Based-Based Payment Accounting." ASU 2016-09 simplifies several aspects of the accounting for employee share-based payment transactions for both public and nonpublic entities, including the accounting for income taxes, forfeitures, and statutory tax withholding requirements, as well as classification in the statement of cash flows. ASU 2016-09 is effective for annual periods, and interim periods within those annual periods, beginning after December 15, 2016. The Company adopted ASU 2016-09 in the first quarter of 2017. The adoption of ASU 2016-09 did not have a material impact on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13 "Measurement of Credit Losses on Financial Instruments." ASU 2016-13 affects entities holding financial assets that are not accounted for at fair value through net income, including loans, debt securities, and other financial assets. The ASU requires financial assets measured at amortized cost basis to be presented at the net amount expected to be collected by recording an allowance for current expected credit losses. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2020. Early adoption is permitted beginning after December 15, 2019, including interim periods within those fiscal years. Management is currently evaluating the impact that ASU 2016-13 will have on the Company's consolidated financial position, results of operations and disclosures.

In March 2017, the FASB issued ASU 2017-08 "Receivables - Non-Refundable Fees and Other Costs (Subtopic 310-20): Premium Amortization on Purchased Callable Debt Securities." The ASU requires premiums on callable debt securities to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. ASU 2017-08 is effective for interim and annual reporting periods beginning after December 15, 2019. Early adoption is permitted beginning after December 15, 2018, including interim periods within those fiscal years. ASU 2017-08 is not expected to have a material impact on the Company's consolidated financial position, results of operations or disclosures.

In February 2018, the FASB amended existing guidance to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act ("Tax Act"). Consequently, the amendments eliminate the stranded tax effects resulting

from the Tax Act and will improve the usefulness of information reported to financial statement users. However, because the amendments only relate to the reclassification of the income tax effects of the Tax Act, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. The amendments in this Update are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption, including adoption in an interim period, permitted. The Company adopted ASU 2018-02 at the beginning of the first quarter 2018 and reclassified \$57,101 from accumulated other comprehensive income to retained earnings.

3. INVESTMENT SECURITIES

The following table summarizes the amortized cost and fair value of securities available-for-sale and securities held-to-maturity at December 31, 2017 and December 31, 2016 and the corresponding amounts of unrealized and unrecognized gains and losses herein:

	December 31, 2017			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Available-for-Sale				
FNMA MBS - Residential	\$ 198,738	\$ 8,328	\$ -	\$ 207,066
Whole Loan MBS - Residential	129	-	-	129
Collateralized mortgage obligations	35,295,870	13,174	(544,679)	34,764,365
Corporate bonds	9,524,259	33,231	(15,674)	9,541,816
Other debt securities	1,552,375	14,362	-	1,566,737
Total Available-for-Sale	\$ 46,571,371	\$ 69,095	\$ (560,353)	\$ 46,080,113

	December 31, 2017			
	Amortized Cost	Unrecognized Gains	Unrecognized Losses	Fair Value
Held-to-Maturity				
FNMA MBS - Residential	\$ 73,118,530	\$ 108,548	\$ (750,463)	\$ 72,476,615
GNMA MBS - Residential	1,131,505	4,654	(11,379)	1,124,780
FHLMC MBS - Residential	1,975,370	-	(40,722)	1,934,648
Collateralized mortgage obligations	49,086,462	20,192	(939,597)	48,167,057
Corporate Notes	20,542,009	39,240	(116,275)	20,464,974
Total Held-to-Maturity	\$ 145,853,876	\$ 172,634	\$ (1,858,436)	\$ 144,168,074

	December 31, 2016			
	Amortized Cost	Unrealized Gains	Unrealized Losses	Fair Value
Available-for-Sale				
FNMA MBS - Residential	\$ 352,620	\$ 16,988	\$ -	\$ 369,608
Whole Loan MBS - Residential	1,729	6	-	1,735
Collateralized mortgage obligations	28,203,078	83,107	(228,465)	28,057,720
Collateralized loan obligations	2,750,000	-	-	2,750,000
Corporate bonds	9,532,540	32,560	(115,964)	9,449,136
Other debt securities	1,966,669	-	(5,908)	1,960,761
Total Available-for-Sale	\$ 42,806,636	\$ 132,661	\$ (350,337)	\$ 42,588,960

	December 31, 2016			
	Amortized Cost	Unrecognized Gains	Unrecognized Losses	Fair Value
Held-to-Maturity				
FNMA MBS - Residential	\$ 56,968,872	\$ 343,432	\$ (252,386)	\$ 57,059,918
GNMA MBS - Residential	1,642,993	4,773	(5,271)	1,642,495
FHLMC MBS - Residential	2,357,886	-	(37,104)	2,320,782
Collateralized mortgage obligations	40,488,247	94,151	(410,351)	40,172,047
Corporate Notes	17,521,811	56,040	(116,970)	17,460,881
Total Held-to-Maturity	\$ 118,979,809	\$ 498,396	\$ (822,082)	\$ 118,656,123

There were no sales of investment securities for the years ended December 31, 2017 and 2016.

The amortized cost and fair value of the investment securities portfolio are shown by expected maturity. Expected maturities may differ from contractual maturities, especially for collateralized mortgage obligations, if borrowers have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2017	
	Amortized Cost	Fair Value
Available-for-Sale		
Less than one year	\$ 34,978	\$ 35,264
Due after one year through five years	2,524,259	2,528,750
Due after five years through ten years	16,460,910	16,351,551
Due after ten years	27,551,224	27,164,548
Available-for-Sale	\$ 46,571,371	\$ 46,080,113

	December 31, 2017	
	Amortized Cost	Fair Value
Held-to-maturity		
Less than one year	\$ 9,177,048	\$ 9,171,047
Due after one year through five years	53,084,258	52,657,083
Due after five years through ten years	34,732,566	34,396,674
Due after ten years	48,860,004	47,943,270
Held-to-maturity	\$ 145,853,876	\$ 144,168,074

The following table summarizes the investment securities with unrealized losses at December 31, 2017 and December 31, 2016 by aggregated major security type and length of time in a continuous unrealized loss position:

December 31, 2017	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Available-for-Sale						
Collateralized mortgage obligations	\$ 22,251,526	\$ (299,184)	\$ 10,084,265	\$ (245,495)	\$ 32,335,791	\$ (544,679)
Corporate bonds	1,991,586	(8,414)	2,492,740	(7,260)	4,484,326	(15,674)
Available-for-Sale	\$ 24,243,112	\$ (307,598)	\$ 12,577,005	\$ (252,755)	\$ 36,820,117	\$ (560,353)

December 31, 2017	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Held-to-Maturity						
FNMA MBS	\$ 52,187,529	\$ (575,923)	\$ 14,487,193	\$ (174,540)	\$ 66,674,722	\$ (750,463)
GNMA MBS	-	-	615,190.00	(11,379.00)	615,190	(11,379)
FHLMC MBS	-	-	1,934,648	(40,722)	1,934,648	(40,722)
Collateralized mortgage obligations	16,758,292	(322,954)	28,435,519	(616,643)	45,193,811	(939,597)
Corporate notes	6,004,692	(3,025)	2,386,750	(113,250)	8,391,442	(116,275)
Held-to-Maturity	\$ 74,950,513	\$ (901,902)	\$ 47,859,300	\$ (956,534)	\$ 122,809,813	\$ (1,858,436)

December 31, 2016	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Available-for-Sale						
Collateralized mortgage obligations	\$ 19,614,339	\$ (202,966)	\$ 2,678,372	\$ (25,499)	\$ 22,292,711	\$ (228,465)
Corporate bonds	-	-	6,916,577	(115,964)	6,916,577	(115,964)
Other debt securities	-	-	1,960,761	(5,908)	1,960,761	(5,908)
Available-for-Sale	\$ 19,614,339	\$ (202,966)	\$ 11,555,710	\$ (147,371)	\$ 31,170,049	\$ (350,337)

December 31, 2016	Less than 12 months		More than 12 months		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Held-to-Maturity						
FNMA MBS	\$ 26,921,257	\$ (245,329)	\$ 4,768,690	\$ (7,057)	\$ 31,689,947	\$ (252,386)
GNMA MBS	823,599	(5,271)	-	-	823,599	(5,271)
FHLMC MBS	2,320,782	(37,104)	-	-	2,320,782	(37,104)
Collateralized mortgage obligations	33,079,475	(322,848)	2,652,905	(87,503)	35,732,380	(410,351)
Corporate notes	3,996,899	(3,970)	2,387,000	(113,000)	6,383,899	(116,970)
Held-to-Maturity	\$ 67,142,012	\$ (614,522)	\$ 9,808,595	\$ (207,560)	\$ 76,950,607	\$ (822,082)

The Company 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 the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. In analyzing an issuer's financial condition, the Company may consider whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition.

At December 31, 2017, the unrealized loss on investment securities was caused by a rise in intermediate and long term market interest rates generally. We expect that these securities, at maturity, will be settled for the amortized cost of the investment. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the securities and it is not more likely than not that the Company will be required to sell the securities before recovery of the amortized cost basis less any current-period loss, these investments are not considered other-than-temporarily impaired. At December 31, 2017, there were no debt securities with unrealized losses with aggregate depreciation of 5% or more from the Company's amortized cost basis.

Securities pledged had a fair value of \$62,460,840 and \$64,686,784 at December 31, 2017 and 2016, respectively and were pledged to secure public deposits and balances in excess of the deposit insurance limit on certain customer accounts.

During the second quarter of 2013, \$74,540,643 of securities was transferred from the available for sale portfolio to the held to maturity portfolio. These securities were transferred at fair value with the unrealized gain/loss remaining in accumulated other comprehensive income to be accreted or amortized through other comprehensive income over the remaining life of the securities. As of December 31, 2017 and 2016, the unrealized gain on the transferred securities was \$83,390 and \$193,839, respectively.

4. LOANS RECEIVABLE, NET

Loans receivable, net at December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Commercial loans (principally variable rate):		
Secured	\$ 1,159,567	\$ 1,684,399
Unsecured	16,964,651	16,698,573
Total commercial loans	<u>18,124,218</u>	<u>18,382,972</u>
Real estate loans:		
Commercial	90,359,444	82,481,784
Residential	1,956,499	2,040,174
Total real estate loans	<u>92,315,943</u>	<u>84,521,958</u>
Construction loans (net of undisbursed funds of \$11,545,128 and \$12,388,374, respectively)	25,676,057	22,123,126
Consumer loans	475,877	726,446
Other loans	744,966	510,916
	<u>1,220,843</u>	<u>1,237,362</u>
Total loans receivable	137,337,061	126,265,418
Less:		
Unearned loans fees, net	(156,677)	(68,977)
Allowance for loan losses	<u>(1,564,698)</u>	<u>(1,374,567)</u>
Total	<u>\$ 135,615,686</u>	<u>\$ 124,821,874</u>

Lending Risk

The principal business of the Bank is lending, primarily in commercial real estate mortgage loans and commercial and industrial loans. The Bank considers its primary lending area to be Staten Island, New York, and a substantial portion of the Bank's loans are secured by real estate in this area. Accordingly, the ultimate collectability of such a loan portfolio is susceptible to changes in market and economic conditions in this region. A weakened economy and resultant decreased consumer and/or business spending will have an adverse effect on credit quality in all classes of loans.

Commercial Real Estate

Loans in this classification include income producing investment properties and owner occupied real estate used for business purposes. The underlying properties are generally located largely in our primary market area. The cash flows of the income producing investment properties are adversely impacted by a downturn in the economy as evidenced by increased vacancy rates, which in turn, will have an effect on credit quality. Generally, management seeks to obtain annual financial information for borrowers in this category.

Construction

Loans in this classification include investment properties and owner occupied real estate that are being developed for business and residential purposes. The underlying properties are generally located largely in Bank's primary market area. Repayment on construction loans is expected to come from the sale of

the underlying collateral, or from permanent financing once the property is stabilized. The sales of the underlying properties, and the ability to rent the completed buildings, could be adversely impacted by a downturn in the economy as evidenced by lack of qualified borrowers, tightening of credit terms and increased vacancy rates, which in turn, will have an effect on credit quality. Generally, management seeks to obtain annual financial information for borrowers in this category.

Commercial & Industrial

Loans in this classification are made to businesses. Generally, these loans are unsecured and repayment is expected from the cash flows of the business.

Nonaccrual loans outstanding at December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Nonaccrual loans:		
Commercial real estate	\$ 592,757	\$ 1,786,260
Commercial unsecured	-	51,520
Total nonaccrual loans	<u>\$ 592,757</u>	<u>\$ 1,837,780</u>

	<u>2017</u>	<u>2016</u>
Interest income that would have been recorded during the period on nonaccrual loans outstanding in accordance with original terms	<u>\$ 53,679</u>	<u>\$107,557</u>

At December 31, 2017, there were six loans 90 days past due and still accruing interest and at December 31, 2016, there was one loan 90 days past due and still accruing interest.

The following table presents the aging of the past due loan balances as of December 31, 2017 and 2016 by class of loans:

December 31, 2017	<u>Total</u>	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater than 90 Days Past Due</u>	<u>Total Past Due</u>	<u>Loans Not Past Due</u>
Commercial loans:						
Unsecured	\$16,964,651	\$ 178,042	\$ 9,750	\$ -	\$ 187,792	\$16,776,859
Secured	1,159,567	35,000	-	-	35,000	1,124,567
Real Estate loans						
Commercial	90,359,444	1,021,474	-	1,145,691	2,167,165	88,192,279
Residential	1,956,499	-	68,490	385,000	453,490	1,503,009
Construction loans	25,676,057	-	-	3,887,200	3,887,200	21,788,857
Consumer loans	475,877	-	-	-	-	475,877
Other loans	744,966	-	-	-	-	744,966
Total loans	<u>\$137,337,061</u>	<u>\$1,234,516</u>	<u>\$78,240</u>	<u>\$5,417,891</u>	<u>\$6,730,647</u>	<u>\$130,606,414</u>

December 31, 2016	Total	30-59 Days Past Due	60-89 Days Past Due	Greater than 90 Days Past Due	Total Past Due	Loans Not Past Due
Commercial loans:						
Unsecured	\$16,698,573	\$ 130,340	\$ 5,000	\$ 51,520	\$ 186,860	\$16,511,713
Secured	1,684,399	-	-	-	-	1,684,399
Real Estate loans						
Commercial	82,481,784	1,889,150	-	3,536,260	5,425,410	77,056,374
Residential	2,040,174	-	76,942	-	76,942	1,963,232
Construction loans	22,123,126	-	-	-	-	22,123,126
Consumer loans	726,446	-	-	-	-	726,446
Other loans	510,916	1,254	-	-	1,254	509,662
Total loans	<u>\$126,265,418</u>	<u>\$2,020,744</u>	<u>\$81,942</u>	<u>\$3,587,780</u>	<u>\$5,690,466</u>	<u>\$120,574,952</u>

Nonaccrual loans include smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

Loans individually evaluated for impairment were as follows:

	December 31, 2017	December 31, 2016
Loans with no allocated allowance for loan losses:		
Commercial real estate	\$ 2,764,228	\$ 4,025,666
Loans with allocated allowance for loan losses:		
Commercial unsecured	-	51,520
	<u>\$ 2,764,228</u>	<u>\$ 4,077,186</u>
Amount of the allowance for loan losses allocated:		
Commercial unsecured	\$ -	\$ 10,304
	<u>\$ -</u>	<u>\$ 10,304</u>

The following table sets forth certain information about impaired loans with a measured impairment:

	Year Ended December 31, 2017	Year Ended December 31, 2016
Average of individually impaired loans during period:		
Commercial real estate	\$ 3,578,307	\$ 3,538,525
Commercial unsecured	21,222	78,663
Consumer	105	-
	<u>\$ 3,599,634</u>	<u>\$ 3,617,188</u>
Interest income recognized during time period that loans were impaired, either using accrual or cash-basis method of accounting	<u>\$ 147,940</u>	<u>\$ 157,492</u>

Troubled Debt Restructurings:

The Company has not allocated specific reserves to customers whose loan terms have been modified in troubled debt restructurings (“TDRs”) as of December 31, 2017 and 2016, respectively. The Company has not committed to lend any additional amounts to customers with outstanding loans that are classified as TDRs.

The outstanding principal balance of trouble debt restructurings at December 31, 2017 was \$2,576,964 and at December 31, 2016 was \$2,644,899. None of the loans currently classified as TDRs have defaulted during this period. These TDRs are all current and are paying under the modified arrangements.

There were no loans that were modified during the years ended December 31, 2017 and 2016 that met the definition of a TDR. Modification of loans that do not meet the definition of a TDR involve either a modification of the terms of a loan to borrowers who were not experiencing financial difficulties or a delay in a payment that was considered to be insignificant.

In order to determine whether a borrower is experiencing financial difficulty, an evaluation is performed of the probability that the borrower will be in payment default on any of its debt in the foreseeable future without the modification.

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debts such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

Special Mention. Loans categorized as special mention have a potential weakness that deserves management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution’s credit position as some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristics that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and values, highly questionable and improbable.

The following table sets forth at December 31, 2017 and 2016, the aggregate carrying value of our assets categorized as Special Mention, Substandard and Doubtful according to asset type:

At December 31, 2017

	Special Mention	Substandard	Doubtful	Not Classified	Total
Commercial Loans:					
Secured	\$ -	\$ -	\$ -	\$ 1,159,567	\$ 1,159,567
Unsecured	615,071	556,322	-	15,793,258	16,964,651
Commercial Real Estate	4,644,960	3,239,081	-	82,475,403	90,359,444
Residential Real Estate	-	1,888,009	-	68,490	1,956,499
Construction	-	-	-	25,676,057	25,676,057
Consumer	-	-	-	475,877	475,877
Other	-	-	-	744,966	744,966
Total loans	<u>\$ 5,260,031</u>	<u>\$ 5,683,412</u>	<u>\$ -</u>	<u>\$ 126,393,618</u>	<u>\$ 137,337,061</u>
Real estate owned	-	43,351	-	-	43,351
Total assets	<u>\$ 5,260,031</u>	<u>\$ 5,726,763</u>	<u>\$ -</u>	<u>\$ 126,393,618</u>	<u>\$ 137,380,412</u>

At December 31, 2016

	Special Mention	Substandard	Doubtful	Not Classified	Total
Commercial Loans:					
Secured	\$ -	\$ -	\$ -	\$ 1,684,399	\$ 1,684,399
Unsecured	892,463	57,247	-	15,748,863	16,698,573
Commercial Real Estate	3,678,539	4,535,107	-	74,268,138	82,481,784
Residential Real Estate	-	1,963,232	-	76,942	2,040,174
Construction	-	-	-	22,123,126	22,123,126
Consumer	589	-	-	725,857	726,446
Other	-	-	-	510,916	510,916
Total loans	<u>\$ 4,571,591</u>	<u>\$ 6,555,586</u>	<u>\$ -</u>	<u>\$ 115,138,241</u>	<u>\$ 126,265,418</u>
Real estate owned	-	50,851	-	-	50,851
Total assets	<u>\$ 4,571,591</u>	<u>\$ 6,606,437</u>	<u>\$ -</u>	<u>\$ 115,138,241</u>	<u>\$ 126,316,269</u>

The following table presents the balance in the allowance for loan losses and the recorded balance in loans, by portfolio segment, and based on impairment method as of December 31, 2017 and 2016:

December 31, 2017

	Commercial Unsecured	Commercial Secured	Construction	Commercial Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Collectively evaluated for impairment	373,928	10,839	265,673	839,648	37,251	37,359	1,564,698
Total ending allowance balance	<u>\$ 373,928</u>	<u>\$ 10,839</u>	<u>\$ 265,673</u>	<u>\$ 839,648</u>	<u>\$ 37,251</u>	<u>\$ 37,359</u>	<u>\$ 1,564,698</u>
Loans:							
Individually evaluated for impairment	\$ -	\$ -	\$ -	\$ 2,764,228	\$ -	\$ -	\$ 2,764,228
Collectively evaluated for impairment	16,964,651	1,159,567	25,676,057	87,595,216	1,956,499	1,220,843	134,572,833
Total ending loans balance	<u>\$ 16,964,651</u>	<u>\$ 1,159,567</u>	<u>\$ 25,676,057</u>	<u>\$ 90,359,444</u>	<u>\$ 1,956,499</u>	<u>\$ 1,220,843</u>	<u>\$ 137,337,061</u>

December 31, 2016

	Commercial Unsecured	Commercial Secured	Construction	Commerical Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Ending allowance balance attributable to loans							
Individually evaluated for impairment	\$ 10,304	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 10,304
Collectively evaluated for impairment	427,957	13,810	191,409	666,339	38,679	26,069	1,364,263
Total ending allowance balance	<u>\$ 438,261</u>	<u>\$ 13,810</u>	<u>\$ 191,409</u>	<u>\$ 666,339</u>	<u>\$ 38,679</u>	<u>\$ 26,069</u>	<u>\$ 1,374,567</u>
Loans:							
Individually evaluated for impairment	\$ 51,520	\$ -	\$ -	\$ 4,025,666	\$ -	\$ -	\$ 4,077,186
Collectively evaluated for impairment	16,647,053	1,684,399	22,123,126	78,456,118	2,040,174	1,237,362	122,188,232
Total ending loans balance	<u>\$ 16,698,573</u>	<u>\$ 1,684,399</u>	<u>\$ 22,123,126</u>	<u>\$ 82,481,784</u>	<u>\$ 2,040,174</u>	<u>\$ 1,237,362</u>	<u>\$ 126,265,418</u>

The following table presents the activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2017 and 2016.

Year ended December 31, 2017

	Commercial Unsecured	Commercial Secured	Construction	Commerical Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Beginning balance	\$ 438,261	\$ 13,810	\$ 191,409	\$ 666,339	\$ 38,679	\$ 26,069	\$ 1,374,567
Provision for loan losses	(188,876)	(2,971)	74,264	121,295	(1,428)	12,716	15,000
Loans charged-off	(30,826)	-	-	-	-	(1,426)	(32,252)
Recoveries	155,369	-	-	52,014	-	-	207,383
Total ending allowance balance	<u>\$ 373,928</u>	<u>\$ 10,839</u>	<u>\$ 265,673</u>	<u>\$ 839,648</u>	<u>\$ 37,251</u>	<u>\$ 37,359</u>	<u>\$ 1,564,698</u>

Year ended December 31, 2016

	Commercial Unsecured	Commercial Secured	Construction	Commerical Real Estate	Residential Real Estate	Other Loans	Total
Allowance for loan losses:							
Beginning balance	\$ 397,619	\$ 26,779	\$ 114,359	\$ 679,172	\$ 41,415	\$ 31,219	\$ 1,290,563
Provision for loan losses	228,275	(12,969)	77,050	(41,149)	(2,736)	16,529	265,000
Loans charged-off	(215,609)	-	-	(3,049)	-	(21,679)	(240,337)
Recoveries	27,976	-	-	31,365	-	-	59,341
Total ending allowance balance	<u>\$ 438,261</u>	<u>\$ 13,810</u>	<u>\$ 191,409</u>	<u>\$ 666,339</u>	<u>\$ 38,679</u>	<u>\$ 26,069</u>	<u>\$ 1,374,567</u>

5. ACCRUED INTEREST RECEIVABLE

Accrued interest receivable at December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Due from banks	\$ 7,615	\$ 8,844
Loans receivable	400,554	357,980
Investment securities	<u>480,767</u>	<u>389,453</u>
Total	<u>\$ 888,936</u>	<u>\$ 756,277</u>

6. PREMISES AND EQUIPMENT

Premises and equipment at December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Leasehold improvements	\$ 2,595,122	\$ 2,597,876
Computer equipment and software	270,811	385,683
Furniture, fixtures and equipment	372,901	566,289
Other	84,643	84,643
	<u>3,323,477</u>	<u>3,634,491</u>
Less accumulated depreciation and amortization	<u>(2,236,908)</u>	<u>(2,216,437)</u>
Total	<u>\$ 1,086,569</u>	<u>\$ 1,418,054</u>

Depreciation and amortization expense amounted to \$464,620 and \$488,469 for the years ended December 31, 2017 and 2016, respectively.

At December 31, 2017, the Company was obligated under six non-cancelable operating leases on property used for banking purposes and at December 31, 2016, the Company was obligated under five non-cancelable operating leases on property used for banking purposes. Rental expense under these leases was \$515,784 for the year ended December 31, 2017 and \$437,404 for the year ended December 31, 2016.

The projected minimum rental payments under the terms of the leases at December 31, 2017 are summarized as follows:

<u>Year Ending December 31,</u>	<u>Amount</u>
2018	\$ 561,693
2019	609,254
2020	479,074
2021	315,214
2022	185,881
Thereafter	<u>1,526,904</u>
Total	<u>\$ 3,678,020</u>

7. PREPAID AND OTHER ASSETS

Prepaid and other assets at December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Accounts receivable and other assets	\$ 190,139	\$ 57,504
Security deposit receivable	11,200	11,200
Prepaid assets	528,804	369,865
Equity securities, primarily FHLB stock	294,100	343,600
Deferred income taxes, net	792,272	1,033,968
Late charges receivable	69,309	84,437
Other real estate owned	43,351	50,851
	<u>\$ 1,929,175</u>	<u>\$ 1,951,425</u>

8. DEPOSITS

Deposits are summarized, according to their original terms, at December 31, 2017 and 2016 as follows:

	2017			2016		
	Amount	Percent	Weighted Average Stated Rate	Amount	Percent	Weighted Average Stated Rate
Checking	\$ 131,300,711	41.60 %	- %	\$ 123,572,468	41.08 %	- %
Variable-rate money market	54,894,238	17.40	0.28	55,644,761	18.49	0.30
Statement savings	23,715,892	7.52	0.20	22,774,931	7.57	0.20
Interest-bearing checking	53,070,471	16.81	0.11	41,489,564	13.79	0.12
	262,981,312	83.33	0.10	243,481,724	80.93	0.11
Time deposits:						
Less than six months	5,732,668	1.82	0.29	5,791,863	1.93	0.40
Six months to one year	29,872,326	9.47	0.64	36,929,718	12.27	0.63
More than one year	16,692,157	5.29	1.11	14,425,305	4.79	1.10
	52,297,151	16.58	0.75	57,146,886	18.99	0.73
Other deposits	281,505	0.09	-	244,784	0.08	-
Total	\$ 315,559,968	100.00 %	0.21 %	\$ 300,873,394	100.00 %	0.21 %

Scheduled maturities of time deposits at December 31, 2017 are as follows:

	Amount	Percent
Within six months	\$ 34,438,083	65.85 %
Six months to one year	2,884,034	5.51
Over one year to two years	4,944,944	9.46
Over two years to three years	2,618,097	5.01
Over three years to four years	2,458,494	4.70
Over four years to five years	4,953,499	9.47
Total	\$ 52,297,151	100.00 %

Time deposits that meet or exceed the FDIC Insurance limit of \$250,000 at year end 2017 and 2016 were \$38,010,017 and \$41,821,306, respectively.

9. INCOME TAXES

The Company files consolidated federal, state and local income tax returns on a calendar-year basis. For federal, state and local income tax purposes, the Company uses the Internal Revenue Code Section 585 reserve method in computing its federal, state and local tax bad debt deduction.

The basis for the determination of New York and New York City tax is the greater of a calculated income tax liability, a tax liability based upon average equity capital or a minimum filing fee. Federal and New Jersey income tax provisions were determined based on the tax computed on book taxable income for the years ended December 31, 2017 and 2016.

The components of the income tax expense/(benefit) for the years ended December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Current:		
Federal	\$ 1,711,941	\$ 1,377,199
State and local	<u>7,545</u>	<u>5,810</u>
	1,719,486	1,383,009
Deferred:		
Federal	331,654	(142,195)
State and local	<u>(44,897)</u>	<u>(63,341)</u>
	286,757	(205,536)
Valuation Allowance	<u>85,272</u>	<u>39,060</u>
	<u>\$ 2,091,515</u>	<u>\$ 1,216,533</u>

The components of the deferred income tax asset/(liability), net as of December 31, 2017 and 2016 are summarized as follows:

	<u>2017</u>	<u>2016</u>
Deferred tax assets:		
Excess book depreciation	\$ 382,100	\$ 419,875
Deferred loan fees	125,527	171,287
Excess book allowance for loan losses	313,013	420,109
Nonaccrual loan interest income	85,269	147,668
Unrealized loss on investment securities	85,652	8,342
Other	138,280	118,984
Valuation allowance	<u>(337,569)</u>	<u>(252,297)</u>
	792,272	1,033,968
Deferred tax liabilities:		
Unrealized gain on investment securities	<u>-</u>	<u>-</u>
Net deferred tax asset:	<u>\$ 792,272</u>	<u>\$ 1,033,968</u>

Effective January 1, 2015, New York and New York City enacted comprehensive tax reform provisions with significant impact on financial institutions. As a result of this legislation, beginning in 2015, the Bank calculates its tax obligation to New York and New York City based upon the largest of a calculated income tax liability, a tax liability based upon average equity capital or a minimum filing fee. Also, effective January 1, 2015, banks under \$8 billion in total assets are permitted to claim a subtraction from New York and New York City taxable income equal to 50% of the net interest income on loans secured by residential real estate located within these respective jurisdictions. Based upon the forecasted impact of this subtraction on the Bank's state and city taxable income, it is more likely than not that the Bank will generate income tax losses in future years and therefore calculate its New York and New York City tax liability on the basis of average equity capital or a fixed minimum fee. Consequently, the Bank recorded a valuation allowance against its New York and New York City deferred tax assets as of January 1, 2015 as it is unlikely these deferred tax assets will impact the Bank's tax liability in future years.

At December 31, 2017 and December 31, 2016, the Company had no unrecognized tax benefits recorded. The Company does not expect the total amount of unrecognized tax benefits to significantly

increase in the next twelve months. The Company recognizes interest and penalties on unrecognized tax benefits as a component of income tax expense.

The Company is subject to United States federal income tax, New York, New Jersey and New York City income tax. The Company is no longer subject to examination by taxing authorities for years before 2014.

On December 22, 2017, H.R.1, commonly known as the Tax Cuts and Jobs Act (the "Act"), was signed into law. The Act includes many provisions that will affect our income tax expense, including reducing our federal tax rate from 35% to 21% effective January 1, 2018. As a result of the rate reduction, we are required to re-measure, through income tax expense in the period of enactment, our deferred tax assets and liabilities using the enacted rate at which we expect them to be recovered or settled. The re-measurement of our net deferred tax asset resulted in additional 2017 income tax expense of \$423,318.

The Company's effective tax rates differ from the statutory Federal tax rate for the years ended December 31, 2017 and 2016 are as follows:

	<u>2017</u>		<u>2016</u>	
Federal income tax provision				
at statutory rates	\$ 1,580,877	34.00 %	\$ 1,181,712	34.00 %
Enactment of Tax Reform	423,318	9.10	-	-
State and local taxes, net of				
Federal income tax benefit	(80,204)	(1.72)	(37,971)	(1.09)
Valuation allowance	85,272	1.83	39,060	1.12
Other	82,252	1.77	33,732	0.97
	<u>\$ 2,091,515</u>	<u>44.98 %</u>	<u>\$ 1,216,533</u>	<u>35.00 %</u>

10. REGULATORY MATTERS

The Bank is a New York State chartered stock form commercial bank. The Bank's deposits are insured by the Federal Deposit Insurance Corporation ("FDIC"). The Bank is subject to certain FDIC capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possibly 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 certain specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance sheet items calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015 with full compliance with requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital.

Beginning January 1, 2016, financial institutions are required to maintain a capital conservation buffer on Common Equity Tier 1 capital under Basel III in order to avoid restrictions on capital distributions and other payments. The buffer is .625% in 2016, 1.25% in 2017, 1.875% in 2018 and 2.5% in 2019. The bank is currently well above the required buffer level.

As of the latest notification from the FDIC, the Bank was classified as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” the Bank must maintain Tier 1 Leverage, Common Equity Tier 1, Risk-Based, Tier 1 Risk-Based and minimum Total Risk-based ratios as set forth in the table below. There are no conditions or events since that notification that management believes would have changed the Bank’s category. Management believes, as of December 31, 2017, that the Bank meets all capital adequacy requirements to which it is subject.

The Bank is subject to certain restrictions on the availability of its undistributed earnings for payment of dividends to stockholders.

In accordance with the New York State Banking Law and the New York State Superintendent of Financial Services Regulations, the Bank credits 10% of quarterly net income to regulatory surplus and is required to do so until such time as shareholders’ equity is equal to 10% of amounts due to depositors. As of December 31, 2017, regulatory surplus equals 10% of deposits.

The following table is the Bank’s actual capital amounts and ratios, as well as the minimum required levels for both “capital adequacy purposes” and to be considered “well capitalized”. No deductions were made for qualitative judgments by regulators:

	Actual		For capital adequacy purposes		To be well-capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2017:						
Tier 1 Capital						
(to Average Assets)	\$ 32,522,000	9.02 %	\$ 14,427,247	4.00 %	\$ 18,034,059	5.00 %
Common Equity Tier 1						
(to Risk Weighted Assets)	32,522,000	18.05	8,105,850	4.50	11,708,450	6.50
Tier 1 Capital						
(to Risk Weighted Assets)	32,522,000	18.05	10,807,800	6.00	14,410,400	8.00
Total Capital						
(to Risk Weighted Assets)	34,087,000	18.92	14,410,400	8.00	18,013,000	10.00

	Actual		For capital adequacy purposes		To be well-capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2016:						
Tier 1 Capital						
(to Average Assets)	\$ 30,231,000	8.88 %	\$ 13,727,525	4.00 %	\$ 17,159,406	5.00 %
Common Equity Tier 1						
(to Risk Weighted Assets)	30,231,000	18.27	7,436,125	4.50	10,741,070	6.50
Tier 1 Capital						
(to Risk Weighted Assets)	30,231,000	18.27	9,914,833	6.00	13,219,778	8.00
Total Capital						
(to Risk Weighted Assets)	31,606,000	19.10	13,219,778	8.00	16,524,722	10.00

The Company's consolidated capital ratios as of December 31, 2017 were as follows: Tier 1 Capital to Average Assets of 9.18%; Common Equity Tier 1 to Risk Weighted Assets of 18.26%, Tier 1 Capital to Risk Weighted Assets of 18.42%; and Total Capital to Risk Weighted Assets of 19.29%, which are not substantially different than the Bank's capital ratios at December 31, 2016 and therefore are not presented separately.

11. EMPLOYEE BENEFITS

The Company sponsors an incentive savings plan (401(k) plan) which started March 1, 1999. All eligible employees, who have reached the age of 21, have at least one year of service and work a minimum of 1,000 hours per year are permitted to make tax deferred contributions up to certain limits. The Bank may reduce or cease matching contributions if it determines that the current or accumulated net earnings or undivided profits of the Bank are insufficient to pay the full contributions in a plan year. The Bank contributed \$139,525 to the 401(k) plan in 2017 and \$145,263 in 2016.

Stock Options

Stockholders have approved six different stock option plans. Options may no longer be granted under four of those plans and options to purchase 19,927 shares remain available to be granted under the two remaining plans, subject to increase in the event of forfeitures. Options to buy stock are granted to directors, officers and employees under the VSB Bancorp, Inc. 2010 Incentive Plan, the 2000 Incentive Plan, the 1998 Incentive Plan, the 2004 Directors' Plan, the 2000 Directors' Plan and the 1998 Directors' Plan which, in the aggregate, provide for issue up to 293,750 options. The exercise price of all options is the market price at the date of grant, and compensation expense is recognized in the income statement over the vesting period. The maximum option term is ten years, and the options vesting period is up to five years.

The Company granted no stock options in 2017 or 2016. Total compensation expense for the stock option plans charged against income for 2017 and 2016 was \$2,138 and \$11,475, respectively.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model. Expected volatilities are based on historical volatilities of the Company's common stock. The Company uses historical data to estimate option exercise and post-vesting termination behavior. Employee and management options are tracked separately. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes into account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on the U.S. Treasury yield curve in effect at the time of the grant.

The unrecognized compensation expense at December 31, 2017 was \$0.

The changes in stock options outstanding under the plans during 2017 are as follows:

	2017		
	Shares	Weighted Average Exercise Price	Aggregate Intrinsic Value
Options outstanding at the beginning of the year	84,550	\$11.42	
Exercised	(6,417)	11.32	
Forfeited	<u>(2,083)</u>	11.25	
Options outstanding at the end of the year	<u>76,050</u>	<u>\$11.43</u>	<u>\$ 588,627</u>
Options exercisable at the end of the year	<u>76,050</u>	<u>\$11.43</u>	<u>\$ 588,627</u>
Weighted average remaining contractual life of options outstanding at the end of the year		4.3 Years	

All non-vested options are expected to vest.

Described below is the range of exercise prices for options granted and outstanding at December 31, 2017:

<u>Plan Description</u>	<u>Number of Exercisable Shares</u>	<u>Weighted Average Exercise Price</u>	<u>Weighted Average Contractual Life</u>
2000 Incentive Stock Option Plan	4,727	\$ 11.10	2.08
2004 Director Stock Option Plan	48,250	11.46	5.34
2010 Incentive Stock Option Plan	<u>23,073</u>	<u>11.45</u>	<u>2.50</u>
All Plans	<u>76,050</u>	<u>\$ 11.43</u>	<u>4.28</u>

Post-Retirement Benefits

The Company offers post-retirement benefits related to its Bank-owned life insurance plan to certain employees. The costs of such benefits are accrued during the years that an employee renders the service.

12. EMPLOYEE STOCK OWNERSHIP PLAN

Employees participate in an Employee Stock Ownership Plan ("ESOP"). VSB Bancorp, Inc. ESOP Trust was formed on May 1, 2004. The ESOP borrowed from the Company to purchase 92,900 shares of stock at \$18.20 per share. The ESOP completed the repayment of this loan on April 30, 2014. On May 5, 2014, the ESOP \$ borrowed from the Company to purchase 89,000 shares of stock at \$11.25 per share. The Company makes discretionary contributions to the ESOP and pays dividends on unallocated shares to the ESOP. The ESOP uses these funds to repay the loan. When loan payments are made, a pro rata portion of ESOP shares that had been pledged as collateral for the loan are released and are

then allocated to participants based on their relative compensation. The Company then records compensation expense. Dividends on allocated shares increase participant accounts.

Shares allocated to each participant and the earnings thereon, to the extent vested, are distributed to the participant upon termination of employment. As required by federal law, a participant may require the Company to repurchase shares so distributed unless the stock is traded on an established market. Since the Company shares are traded on the OTCQX, which is considered an established market, the Company does not now have such a repurchase obligation.

The contribution to the ESOP was \$100,125 for the year ended December 31, 2017 and for the year ended December 31, 2016. ESOP expense was \$158,862 and \$123,728 for the years ended December 31, 2017 and 2016, respectively.

Shares held by the ESOP at December 31, 2017 and 2016 were as follows:

	<u>2017</u>	<u>2016</u>
Shares allocated to participants	128,384	119,030
Shares released to participants	(35,686)	(32,754)
Unearned shares	<u>53,516</u>	<u>62,870</u>
Total ESOP Shares	<u>146,214</u>	<u>149,146</u>
Fair value of unearned shares	<u>\$ 1,025,902</u>	<u>\$ 990,203</u>

13. RETENTION AND RECOGNITION PLAN

The stockholders of VSB Bancorp, Inc. approved the adoption of the 2010 Retention and Recognition Plan (the "RRP"). The RRP authorizes the award of up to 50,000 shares of its common stock to directors, officers and employees. On November 10, 2015, 500 shares were awarded to each of five key Vice Presidents of the Bank who each have tenure over 10 years. The awards will vest over three years. At the April 26, 2016 Annual Meeting, the stockholders of VSB Bancorp, Inc. approved the addition of 50,000 shares of our common stock to our 2010 Retention and Recognition Plan and approved the grant of 5,000 of those shares to each of the eight directors who has at least five years of service. These new awards will vest over three years, provided that vesting will be delayed until Victory State Bank's total assets exceed \$400 million at quarter end.

The recipient of an award will not be required to make any payment to receive the award or the stock covered by the award. The Company recognizes compensation expense for the shares awarded under the RRP gradually as the shares vest, based upon the market price of the shares on the date of the award. For the years ended December 31, 2017 and 2016, the Company recognized \$200,804 and \$133,908 of compensation expense related to the shares awarded. The income tax benefit resulting from this expense was \$44,177 and \$46,868 for the years ended December 31, 2017 and 2016. As of December 31, 2017, there was approximately \$188,778 of unrecognized compensation costs related to the shares awarded. These costs are expected to be recognized over the next 15 months.

A summary of the status of the Company's non-vested plan shares as of December 31, 2017 is as follows:

For the Year Ended December 31, 2017:

	<u>Shares</u>	<u>Weighted Average Grant Date Share Value</u>
Non vested at beginning of period	41,665	\$ 12.36
Granted	-	-
Vested	<u>5,835</u>	12.37
Non vested at end of period	<u><u>35,830</u></u>	\$ 12.35

14. COMMITMENTS, CONTINGENCIES AND FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business in order to meet the financing needs of its customers. Such financial instruments primarily include commitments to extend credit.

A summary of these commitments and contingent liabilities, all of which are variable rate commitments tied to prime, at December 31:

	<u>2017</u>	<u>2016</u>
	<u>Amount</u>	<u>Amount</u>
Commitments to fund secured construction loans	\$ 11,545,128	\$ 12,503,374
Commitments to fund all other commercial loans	<u>32,144,045</u>	<u>41,386,060</u>
	<u><u>\$ 43,689,173</u></u>	<u><u>\$ 53,889,434</u></u>

Commitments to extend credit are legally binding agreements to lend to a customer. Commitments are issued following the Company's evaluation of each applicant's creditworthiness on a case-by-case basis. The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument is represented by the contractual notional amount of those instruments.

Victory State Bank currently has a \$5 million unsecured credit facility with Atlantic Central Bankers Bank which the Bank has not drawn upon.

VSB Bancorp, Inc. is not involved in any pending legal proceedings. The Bank, from time to time, is involved in routine collection proceedings in the ordinary course of business on loans in default. Management believes that such other routine legal proceedings in the aggregate are immaterial to our financial condition or results of operations.

15. FAIR VALUE

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of FASB ASC 820, "Financial Instruments". The estimated fair value amounts have been determined by the Company using available market information and appropriate valuation methodologies. However, considerable judgment is necessarily required to interpret market data to develop the estimates of fair value. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Company could realize in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following methods and assumptions were used by the Company in estimating fair values of financial instruments:

Interest-bearing Bank Balances – Interest-bearing bank balances mature within one year and are carried at cost, which are estimated to be reasonably close to fair value.

Money Market Investments – The fair value of these securities approximates their carrying value due to the relatively short time to maturity.

Investment Securities, Available For Sale and Held To Maturity – The estimated fair value of these securities is determined by using available market information and appropriate valuation methodologies. The estimates presented herein are not necessarily indicative of the amounts that the Company could realize in a current market exchange.

Federal Home Loan Bank Stock - It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans Receivable - The fair value of commercial and construction loans is approximated by the carrying value as the loans are tied directly to the Prime Rate and are subject to change on a daily basis, subject to the applicable interest rate floors. The fair value of the remainder of the portfolio is determined by discounting the future cash flows of the loans using the appropriate discount rate.

Other Financial Assets - The fair value of these assets, principally accrued interest receivable, approximates their carrying value due to their short maturity.

Non-Interest Bearing and Interest Bearing Deposits - The fair value disclosed for non-interest bearing deposits is equal to the amount payable on demand at the reporting date. The fair value of interest bearing deposits is based upon the current rates for instruments of the same remaining maturity. Interest bearing deposits with a maturity of greater than one year are estimated using a discounted cash flow approach that applies interest rates currently being offered.

Other Financial Liabilities - The estimated fair value of other financial liabilities, which primarily include accrued interest payable, approximates their carrying amount.

The carrying amounts and estimated fair values of financial instruments, at December 31, 2017 and December 31, 2016 are:

Fair Value Measurements at December 31, 2017 Using					
Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	
Financial Assets:					
Cash and cash equivalents	\$ 12,920,547	\$ 3,146,218	\$ 9,774,329	\$ -	\$ 12,920,547
Investment securities, available for sale	46,080,113	-	46,080,113	-	46,080,113
Investment securities, held to maturity	145,853,876	-	144,168,074	-	144,168,074
Loans receivable	135,615,686	-	-	136,076,329	136,076,329
Accrued interest receivable	888,936	-	488,382	400,554	888,936
Total Financial Assets	\$ 341,359,158	\$ 3,146,218	\$ 200,510,898	\$ 136,476,883	\$ 340,133,999
Financial Liabilities:					
Deposits	\$ 315,559,968	\$ 131,582,216	\$ 183,722,818	\$ -	\$ 315,305,034
Accrued interest payable	139,594	-	139,594	-	139,594
Total Financial Liabilities	\$ 315,699,562	\$ 131,582,216	\$ 183,862,412	\$ -	\$ 315,444,628

Fair Value Measurements at December 31, 2016 Using					
Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Total	
Financial Assets:					
Cash and cash equivalents	\$ 37,240,361	\$ 1,217,796	\$ 36,022,565	\$ -	\$ 37,240,361
Investment securities, available for sale	42,588,960	-	42,588,960	-	42,588,960
Investment securities, held to maturity	118,979,809	-	118,656,123	-	118,656,123
Loans receivable	124,821,874	-	-	125,275,181	125,275,181
Accrued interest receivable	756,277	-	398,297	357,980	756,277
Total Financial Assets	\$ 324,387,281	\$ 1,217,796	\$ 197,665,945	\$ 125,633,161	\$ 324,516,902
Financial Liabilities:					
Deposits	\$ 300,873,394	\$ 123,817,252	\$ 176,865,742	\$ -	\$ 300,682,994
Accrued interest payable	141,485	-	141,485	-	141,485
Total Financial Liabilities	\$ 301,014,879	\$ 123,817,252	\$ 177,007,227	\$ -	\$ 300,824,479

ASC 820 establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

Level 1: Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2: Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3: Significant unobservable inputs that reflect a reporting entity's own assumptions about the assumptions that market participants would use in pricing and asset or liability.

The fair value of securities available for sale and held to maturity is determined by obtaining quoted prices on nationally recognized securities exchanges (Level 1 inputs) or using matrix pricing, which is a mathematical technique widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

The tables below present a reconciliation of all assets measured at fair value on a recurring basis using significant observable inputs (Level 2) for the years ended December 31, 2017 and 2016:

Fair Value Measurements at December 31, 2017 Using				
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale:				
FNMA MBS - Residential	\$ 207,066	\$ -	\$ 207,066	\$ -
Whole Loan MBS- Residential	129	-	129	-
Collateralized mortgage obligations	34,764,365	-	34,764,365	-
Corporate bonds	9,541,816	-	9,541,816	-
Other debt securities	1,566,737	-	1,566,737	-
Total Available for sale Securities	\$ 46,080,113	\$ -	\$ 46,080,113	\$ -

Fair Value Measurements at December 31, 2016 Using				
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Available for sale:				
FNMA MBS - Residential	\$ 369,608	\$ -	\$ 369,608	\$ -
Whole Loan MBS- Residential	1,735	-	1,735	-
Collateralized mortgage obligations	28,057,720	-	28,057,720	-
Collateralized loan obligations	2,750,000	-	2,750,000	-
Corporate bonds	9,449,136	-	9,449,136	-
Other debt securities	1,960,761	-	1,960,761	-
Total Available for sale Securities	\$ 42,588,960	\$ -	\$ 42,588,960	\$ -

During the years-ended December 31, 2017 and 2016, there were no transfers between levels.

Assets Measured on a Non-Recurring Basis

Certain financial assets are measured at fair value on a nonrecurring basis, that is, the instruments 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 impairment).

Assets measured at a fair value on a non-recurring basis are summarized below:

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually or bona fide purchase offers that are accepted. (which would be level 2). These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant and typically result in a Level 3 classification of the inputs for determining fair value.

	Fair Value Measurements at December 31, 2017 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Other real estate owned	\$ 43,351	-	\$ 43,351	-

	Fair Value Measurements at December 31, 2016 Using			
	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets:				
Other real estate owned	\$ 50,851	-	\$ 50,851	-

As of December 31, 2017 and 2016, we had no impaired loans with specific reserves that were collateral dependent.

16. RELATED PARTIES

The Bank at times has had loans, and other financial transactions, with its executive officers and directors. At December 31, 2017, the aggregate amount of loans outstanding to directors and director affiliated companies was \$2,479,036. There were no loans granted to executive officers.

The change in aggregate amount of loans outstanding to directors as of December 31, 2017 and 2016 is as follows:

	2017	2016
Beginning balance	\$ 550,000	\$ 1,430,000
Originations	3,660,456	753,975
Payments	(1,731,420)	(1,633,975)
Ending balance	<u>\$ 2,479,036</u>	<u>\$ 550,000</u>

The interest income that was paid on these loans was \$84,559 and \$87,848 for 2017 and 2016, respectively.

Executive officers and directors own, in the aggregate, 29.1% and 31.4% of the common shares outstanding, calculated in accordance with SEC beneficial ownership rules, at December 31, 2017 and 2016, respectively.

17. CONDENSED FINANCIAL STATEMENTS OF THE PARENT COMPANY ONLY

VSB BANCORP, INC.

STATEMENTS OF FINANCIAL CONDITION DECEMBER 31, 2017 and 2016

	<u>2017</u>	<u>2016</u>
ASSETS		
Cash and cash equivalents	\$ 1,100	\$ 1,100
Money market	330,403	313,153
Investment in subsidiaries	32,256,591	30,215,447
Deferred taxes	66,121	52,625
Other assets	<u>26,287</u>	<u>20,870</u>
Total assets	<u>\$ 32,680,502</u>	<u>\$ 30,603,195</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES:		
Accounts payable, accrued expenses and other liabilities	<u>\$ 80,162</u>	<u>\$ 30,840</u>
Total liabilities	<u>80,162</u>	<u>30,840</u>
COMMITMENTS AND CONTINGENT LIABILITIES		
STOCKHOLDERS' EQUITY		
Common stock (\$.0001 par value, 10,000,000 shares authorized, 2,092,926 issued, 1,829,465 outstanding at December 31, 2017 and 2,086,509 issued, 1,828,298 outstanding at December 31, 2016)	209	209
Additional paid-in capital	10,590,557	10,269,454
Retained earnings	25,722,467	23,769,564
Treasury stock, at cost (263,461 shares at December 31, 2017 and 258,211 shares at December 31, 2016)	(2,813,653)	(2,717,128)
Unearned Employee Stock Ownership Plan shares	(634,125)	(734,250)
Accumulated other comprehensive loss, net of taxes of \$142,754 and \$8,343, respectively	<u>(265,115)</u>	<u>(15,494)</u>
Total stockholders' equity	<u>32,600,340</u>	<u>30,572,355</u>
Total liabilities and stockholders' equity	<u>\$ 32,680,502</u>	<u>\$ 30,603,195</u>

VSB BANCORP, INC.

STATEMENTS OF OPERATIONS FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

	<u>2017</u>	<u>2016</u>
INTEREST INCOME:		
Loans receivable	\$ 23,854	\$ 27,108
Other interest income	2,479	2,291
Total interest income	<u>26,333</u>	<u>29,399</u>
INTEREST EXPENSE:		
Total interest expense	-	-
Net interest income	<u>26,333</u>	<u>29,399</u>
NON-INTEREST INCOME:		
Dividend income	500,000	500,000
Other	-	-
	<u>500,000</u>	<u>500,000</u>
NON-INTEREST EXPENSES:		
Salaries and benefits	202,942	145,383
Legal fees	36,000	42,000
Other	58,910	76,557
Total non-interest expenses	<u>297,852</u>	<u>263,940</u>
INCOME BEFORE INCOME TAXES	<u>228,481</u>	<u>265,459</u>
PROVISION/(BENEFIT) FROM INCOME TAXES:		
Current	(49,234)	(47,006)
Deferred	(13,496)	(44,510)
Total income taxes	<u>(62,730)</u>	<u>(91,516)</u>
EQUITY IN UNDISTRIBUTED EARNINGS, NET OF TAXES	<u>2,266,911</u>	<u>1,902,115</u>
NET INCOME	<u>\$ 2,558,122</u>	<u>\$ 2,259,090</u>

VSB BANCORP, INC.

STATEMENTS OF CASH FLOWS FOR THE YEARS ENDED DECEMBER 31, 2017 AND 2016

	<u>2017</u>	<u>2016</u>
CASH FLOWS FROM OPERATING ACTIVITIES:		
Net income	\$ 2,558,122	\$ 2,259,090
Adjustments to reconcile net income to net cash used in operating activities:		
Changes in operating assets and liabilities:		
ESOP compensation expense	40,503	18,256
Stock-based compensation expense	202,942	145,383
Undistributed income of subsidiaries	(2,266,911)	(1,902,115)
(Increase in other assets	(5,417)	(3,530)
Decrease in deferred income taxes	(13,496)	(44,510)
Increase/(decrease) in accounts payable, accrued expenses, and other liabilities	25,468	(29,327)
Net cash provided by operating activities	<u>541,211</u>	<u>443,247</u>
CASH FLOWS FROM INVESTING ACTIVITIES:		
Net decrease in loan receivable	100,125	100,125
Net increase/(decrease) in money market deposit	(17,250)	114,339
Net cash provided by investing activities	<u>82,875</u>	<u>214,464</u>
CASH FLOWS FROM FINANCING ACTIVITIES:		
Exercise of stock options	77,658	92,575
Purchase of treasury stock, at cost	(96,525)	(239,753)
Payment of dividends	(605,219)	(510,533)
Net cash used in financing activities	<u>(624,086)</u>	<u>(657,711)</u>
NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS	-	-
CASH AND CASH EQUIVALENTS, BEGINNING OF YEAR	<u>1,100</u>	<u>1,100</u>
CASH AND CASH EQUIVALENTS, END OF YEAR	<u>\$ 1,100</u>	<u>\$ 1,100</u>
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION:		
Cash paid during the period for:		
Interest	<u>\$ -</u>	<u>\$ -</u>
Income taxes	<u>\$ -</u>	<u>\$ -</u>

BOARD OF DIRECTORS

Joseph J. LiBassi
Chairman of the Board
Private Investor

Raffaele M. Branca
President & CEO
VSB Bancorp, Inc. and
Victory State Bank

Joan Nerlino Caddell
Attorney, Owner
Joan Nerlino Caddell &
Associates, PLLC

Alfred C. Johnsen, CPA
Private Practice
Alfred C. Johnsen, CPA

Robert P. Moore
Retired Vice President
KeySpan

Dr. Carlos M. Perez
Medical Doctor

Bruno Savo
Builder/Developer
Savo Brothers, Inc.

DIRECTORS EMERITI

Savino Savo
Builder/Developer

Robert S. Cutrona, Sr.
President
Maintenance Company
Project One Services, Inc.

VICTORY STATE BANK SENIOR OFFICERS

Raffaele M. Branca
President &
Chief Executive Officer

Richard P. Boyle
Senior Vice President
Chief Lending Officer

Elizabeth Scarano
Senior Vice President
Chief Operations Officer

Robert Russo
1st Vice President
Chief Financial Officer

Philip Stropoli
1st Vice President
Branch Administrator

Anna Williams
1st Vice President
Compliance

Kathleen Cassiliano
Vice President
Branch Manager

Johnny Reyes
Vice President
Business Development

Toni Scarito
Vice President
Human Resources

Isaac Zahavi
Vice President
IT Manager

INDEPENDENT AUDITOR

Crowe Horwath LLP

TRANSFER AGENT AND REGISTRAR

Computershare Trust
Company, N.A.
250 Royall Street
Canton, MA 02021

STOCKHOLDER INFORMATION

Raffaele M. Branca
(718) 979-1100

STOCK QUOTATION

OTC Market Place OTCQX
Symbol: VSBN

BRANCHES

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755 Forest Avenue
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One Hyatt Street
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1762 Hylan Boulevard
Dongan Hills
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1065 Bay Street
Rosebank
(718) 981-1200

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