Digimarc CORP
Form 10-K
February 27, 2009

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

(Mark One)

ý **Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the fiscal year ended December 31, 2008

OR

o **Transition Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

For the transition period from   to
Commission File Number 001-34108

DIGIMARC CORPORATION

(Exact name of registrant as specified in its charter)

Delaware	**26-2828185**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

9405 SW Gemini Drive, Beaverton, Oregon 97008
(Address of principal executive offices) (Zip Code)

(503) 469-4800
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:

Title of Each Class	Name of Each Exchange on Which Registered
Common Stock, $0.001 Par Value Per Share	The NASDAQ Stock Market LLC

Securities registered pursuant to Section 12(g) of the Act: **NONE**

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes o No ý

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes o No ý

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes ý No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ý

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer o	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller reporting company ý

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes o No ý

The Registrant's common stock began trading on the Nasdaq Global Market on October 17, 2008. Accordingly, the Registrant has not completed its second fiscal quarter in which its common equity was publicly traded. As of January 30, 2009, the aggregate market value of the Common Stock of the Registrant held by non-affiliates (based upon the closing price of the Common Stock as reported on the Nasdaq Global Market on January 30, 2009), was approximately $66 million.

As of January 30, 2009, there were 7,279,442 shares of the registrant's common stock outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Portions of the registrant's proxy statement pursuant to Regulation 14A (the "Proxy Statement") for its 2009 annual meeting of stockholders are incorporated by reference into Items 10, 11, 12, 13 and 14 of Part III of this Annual Report on Form 10-K. The registrant intends to file the Proxy Statement not later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

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PART I

The following discussion of Digimarc's business contains forward-looking statements relating to future events or the future financial performance of Digimarc. Our actual results could differ materially from those anticipated in these forward-looking statements. Please see the discussion regarding forward-looking statements included in this Annual Report on Form 10-K in Item 7, Management's Discussion and Analysis of Financial Condition and Results of Operations, under the caption "Forward-Looking Statements."

The following discussion of our business should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Annual Report on Form 10-K.

Unless the context otherwise requires, references in this Annual Report on Form 10-K to (i) "Digimarc," "we," "our" and "us" refer to Digimarc Corporation and (ii) "Old Digimarc" refers to the former Digimarc Corporation, which merged with and into a wholly owned subsidiary of L-1 Identity Solutions, Inc. ("L-1") on August 13, 2008, and its consolidated subsidiaries (other than us).

All dollar amounts are in thousands, unless otherwise noted.

This Annual Report on Form 10-K includes trademarks and registered trademarks of Digimarc Corporation.

ITEM 1: BUSINESS

The Separation of the Digital Watermarking Business from Old Digimarc

On August 1, 2008, Old Digimarc spun off the common stock of Digimarc, which held all of the assets and liabilities of Old Digimarc's Digital Watermarking Business.

Until August 1, 2008, we were a wholly owned subsidiary of DMRC LLC, which immediately prior to the spin-off was a wholly owned subsidiary of Old Digimarc. DMRC LLC was formed in Delaware on June 18, 2008, in anticipation of the spin-off of the Digital Watermarking Business. Prior to the spin-off, in a transaction which we refer to as the restructuring, Old Digimarc contributed all of the assets and liabilities related to its Digital Watermarking Business, together with all of Old Digimarc's cash, including cash received upon the exercise of stock options, to DMRC LLC. The restructuring did not result in the loss of any significant Digital Watermarking Business customers or contracts.

Following the restructuring, all of the limited liability company interests of DMRC LLC were transferred to a newly created trust for the benefit of Old Digimarc record holders on the basis of one limited liability company interest of DMRC LLC for every three and one-half shares of Old Digimarc common stock held by the stockholder as of the spin-off record date and time. DMRC LLC then merged with and into DMRC Corporation, and each limited liability company interest of DMRC LLC was converted into one share of common stock of DMRC Corporation. After completion of the acquisition of Old Digimarc by L-1, DMRC Corporation changed its name to Digimarc Corporation. As a result, upon effectiveness of the Form 10 on October 16, 2008, each Old Digimarc record holder received one share of Digimarc common stock for every three and one-half shares of Old Digimarc common stock held by the stockholder as of the spin-off record date and time, and we became an independent, publicly-traded company owning and operating the Digital Watermarking Business.

Overview

Digimarc Corporation enables governments and enterprises around the world to give digital identities to media and objects that computers can sense and recognize and to which they can react. Our technology provides the means to infuse persistent digital information, perceptible only to computers and digital devices, into all forms of media content. The unique digital identifier placed in media generally persists with it regardless of the distribution path and whether it is copied, manipulated

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or converted to a different format, and does not affect the quality of the content or the enjoyment or other traditional uses of it. Our technology permits computers and digital devices to quickly identify relevant data from vast amounts of media content.

Our technology, and those of our licensees, span the complete range of media content, enabling our customers and those of our partners to:

- Quickly identify and effectively manage music, movies, television programming, digital images, documents and other printed materials, especially in light of new non-linear distribution over the internet;
- Deter counterfeiting of money, media and goods, and piracy of movies and music;
- Support new digital media distribution models and methods to monetize media content;
- Leverage the power of intuitive computing to instantly link consumers to a wealth of information and/or interactive experiences related to the media and objects they encounter each day;
- Provide consumers with more choice and access to media content when, where and how they want it;
- Enhance imagery and video by associating metadata or authenticate media content for government and commercial uses; and
- Better secure identity documents to enhance national security and combat identity theft and fraud.

At the core of our intellectual property is a signal processing technology innovation known as "digital watermarking" which allows imperceptible digital information to be embedded in all forms of digitally designed, produced or distributed media content and some physical objects, including photographs, movies, music, television, personal identification documents, financial instruments, industrial parts and product packages. The digital information can be detected and read by a wide range of computers, mobile phones, and other digital devices.

We provide technology-based solutions directly and through our licensees. Our proprietary technology has proven to be a powerful element of document security, giving rise to our long-term relationship with a consortium of central banks, which we refer to as the Central Banks, and many leading companies in the information technology industry. We and our licensees have successfully propagated digital watermarking in music, movies, television broadcasts, images and printed materials. Digital watermarks have been used in these applications to improve media rights and asset management, reduce piracy and counterfeiting losses, improve marketing programs, permit more efficient and effective distribution of valuable media content and enhance consumer entertainment and commercial experiences.

To protect our significant efforts in creating our technology, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. We believe we have one of the world's most extensive patent portfolios in the field of digital watermarking and related media enhancement innovations, with over 490 U.S. and foreign patents and more than 400 U.S. and foreign patent applications on file as of December 31, 2008.

Financial information about geographic areas is included in Note 4 of our financial statements.

History

We were formed in Delaware on June 18, 2008 by Old Digimarc to hold and operate Old Digimarc's Digital Watermarking Business and to facilitate the separation of its Secure ID Business

through the spin-off and the merger of Old Digimarc with L-1. Old Digimarc was founded to commercialize a signal processing innovation known as "digital watermarking." Digital watermarking is a technology that allows our customers to infuse digital data into any media content that is digitally processed at some point during its lifecycle. The technology can be applied to printed materials, video, audio, and images. The inclusion of these digital data enables a wide range of improvements in security and media management, and new business models for distribution and consumption of media content. Over the years our technology and intellectual property portfolios have grown to encompass many related technologies.

Banknote counterfeit deterrence was the first commercially successful use of our technologies. Old Digimarc, in cooperation with the Central Banks, developed a system to use digital technologies to deter banknote counterfeiting. More recently, innovations based on Old Digimarc's digital watermarking technology and experience have been leveraged to create new products to deter counterfeiting and tampering of driver licenses and other government-issued secure credentials. In parallel, Old Digimarc's business partners, under patent or technology licenses from us, are delivering digital watermarking solutions to track and monitor the distribution of music, images, television and movies to consumers. In November of 2007, we announced a relationship with Nielsen to license our patents in support of their audience measurement across more than 95% of the television shows broadcast in the United States and to provide development services for Nielsen's new Digital Media Manager content identification and management system.

Customers and Business Partners

Our revenues are generated through commercial and government applications of our technology, including significant long-term contracts with the Central Banks and with The Nielsen Company. The remainder of our revenues are generated primarily from patent and technology license fees and royalties paid by commercial business partners providing media identification and management solutions to movie studios and music labels, television broadcasters, creative professionals and other customers around the world. Patent and technology licensing is expected to continue to contribute most of the revenues from non-government customers for the foreseeable future.

As part of our work with government customers, we must comply with and are affected by laws and regulations relating to the award, administration and performance of government contracts. Government contract laws and regulations affect how we do business with our customers and, in some instances, impose added costs on our business.

In some instances, these laws and regulations impose terms or rights that are more favorable to the government than those typically available to commercial parties in negotiated transactions. For example, the government agency may terminate any of our contracts and, in general, subcontracts, at its convenience, as well as for default based on performance. Upon termination for convenience of a fixed-price type contract, we normally are entitled to receive the purchase price for delivered items, reimbursement for allowable costs for work-in-process and an allowance for profit on the contract or adjustment for loss if completion of performance would have resulted in a loss. Upon termination for convenience of a cost reimbursement contract, we normally are entitled to reimbursement of allowable costs plus a portion of the fee.

In addition, our government contracts typically span one or more base years and multiple option years. The government agency generally has the right to not exercise option periods and may not exercise an option period if the agency is not satisfied with our performance on the contract.

Products and Services

We provide media identification and management solutions to commercial entities and government customers and license our technology to other solution providers. We license our technology primarily to commercial entities who use our technology and patented inventions to address opportunities in the media and entertainment industry. Our largest government customer is the Central Banks, with whom we have been developing, deploying, supporting and continuing to enhance a system to deter digital counterfeiting of currency using personal computers and digital reprographics for several years.

Commercial customers use secure media solutions from our business partners and us to identify, track, manage and protect content as it is distributed and consumed either digitally or physically and to enable new consumer applications to access networks and information from personal computers and mobile devices. Many movie studios, record labels, broadcasters, creative professionals and other customers rely on digital watermarking as a cost-effective means to:

- deter piracy and illegal use of movies, music and images;
- protect entertainment content from copyright infringement;
- track and monitor entertainment content for rights usage and licensing compliance;
- monitor advertisements to verify ad placement and measure return on investment;
- enhance information access, search and marketing capabilities related to media content; and
- enable fair and legitimate use of content by consumers.

Licensees of our technology or intellectual property include AquaMobile, Microsoft Corporation, Mobile Data Systems, Inc., The Nielsen Company, Civolution, Signum Technologies, Thomson Multimedia, S.A., USA Video, Verance Corporation, Verimatrix, Inc. and VCP (an affiliate of VEIL Interactive Technologies).

Technology and Intellectual Property

We develop and patent intellectual property ("IP") to differentiate our products and technology, mitigate infringement risks, and develop opportunities for licensing. Licensing of our technology is supported by a broad patent portfolio covering a wide range of methods, applications, system architectures and business processes.

Most of our patents relate to various methods for embedding digital information in video, audio, and images, whether the content is rendered in analog or digital formats. The digital information is generally embedded by making subtle modifications to the fundamental elements of the content itself, generally at a signal processing level. The changes necessary to embed this information are so subtle that they are generally not noticeable by people during normal use. Because the message is carried by the content itself, it is file-format independent. The embedded digital information generally survives most normal content transformation procedures, including compression, edits, rotation, scaling, re-sampling, file-format transformations, copying, scanning and printing.

Our patent portfolio contains a wealth of innovations in digital watermarking, pattern recognition (sometimes referred to as "fingerprinting"), digital rights management, and related fields. To protect our significant efforts in creating our technology, we have implemented an extensive intellectual property protection program that relies on a combination of patent, copyright, trademark and trade secret laws, and nondisclosure agreements and other contracts. As a result, we believe we have one of the world's most extensive patent portfolios in digital watermarking and related fields, with over 490 U.S. and foreign patents and more than 400 U.S. and foreign patent applications on file as of December 31, 2008. Separately, we own registered trademarks in both the U.S. and other countries and have applied for additional trademarks. We continue to develop and broaden our portfolio of patented technology in the fields of media identification and management technology and related applications and systems. We devote significant resources to developing and protecting our technology and continuously seek to identify and evaluate potential licensees for our patents.

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Markets

Our technology is used in various media identification and management products and solutions supporting a variety of media objects, from movies and music, to banknotes and secure credentials. Each media object enabled by our technology creates the potential for several applications, such as:

- counterfeiting and piracy deterrence;
- media management;
- authentication and monitoring;
- linking to networks and providing access to information; and
- enhanced services in support of mobile commerce.

We believe the market for such applications is in the early stages of development and that existing solutions represent only a small portion of the potential market for our products, services, and technology.

Competition

There is no single competitor or small number of competitors dominant in our industry. Our competitors vary depending on the application of our products and services. Our business partners and we generally compete with non-digital watermarking technologies for the security or marketing budgets of the producers and distributors of media objects, documents, products and advertising. These alternatives include, among other things, encryption based security systems and technologies and solutions based on fingerprinting and pattern recognition. Our competitive position within the digital watermarking industry is strong because of our large, high quality, sophisticated patent position in the proprietary technology of digital watermarking and our substantial and growing amount of intellectual property in related media security and management innovations that span basic technologies, applications, system designs, and business processes. Our intellectual property portfolio allows us to use proprietary technologies that are well regarded by our customers and partners and not available to our competitors. We compete with others in our industry based on the variety of features we offer and a traditional cost benefit analysis of our technologies against alternative technologies and solutions. We anticipate that our competitive position within certain markets may be affected by factors such as reluctance to adopt new technologies and, positively or negatively, by changes in government regulations.

Backlog

Based on projected commitments we have for the periods under contract with our respective customers, we anticipate our current contracts as of December 31, 2008 will generate approximately $59.5 million in revenue during the terms of these contracts, currently up to five years. We expect approximately $17.5 million of this amount to be recognized as revenue during 2009. Some factors that lead to increased backlog include:

- contracts with new customers;
- renewals with current customers;
- add-on orders to current customers; and
- contracts with longer contractual periods replacing contracts with shorter contractual periods.

Some factors that lead to decreased backlog include:

- recognition of revenue associated with backlog currently in place;

- contracts with shorter contractual periods replacing contracts with longer contractual periods; and

- contracts ending with existing customers.

The mix of these factors, among others, dictates whether our backlog increases or decreases for any given period. There is no assurance that our backlog will result in actual revenue in any particular period, because the orders, awards and contracts included in our backlog may be subject to modification, cancellation or suspension. We may not realize revenue on certain contracts, orders or awards included in our backlog or the timing of such realization may change.

Employees

There are two major drivers of revenue in our business: (1) licensing revenues resulting from licensing our patents and (2) services revenue resulting from the provision of development services to the Central Banks, Nielsen and other government and commercial customers. Service revenues are dependent upon billable hours worked by highly qualified technical and management resources assigned to these projects. At December 31, 2008, we had 87 full-time employees, including 21 in sales, marketing, technical support and customer support; 40 in research, development and engineering; and 26 in finance, administration, information technology and legal. Our future success will depend, in part, on our ability to continue to attract, retain and motivate highly qualified technical and management personnel, for whom competition is intense. We do not anticipate material turnover at this time or in the reasonably foreseeable future, especially among our technical personnel.

Our employees are not covered by any collective bargaining agreement, and we have never experienced a work stoppage. We believe that our relations with our employees are good.

Available Information

We make available through our website at *www.digimarc.com* our Annual Reports on Form 10-K, Quarterly Reports on Form 10-Q, Current Reports on Form 8-K, and amendments to these and other reports filed or furnished by us pursuant to Section 13(a) or 15(d) of the Securities Exchange Act of 1934 as soon as reasonably practicable after we file such materials with the Securities and Exchange Commission.

ITEM 1A: RISK FACTORS

The following risks relate principally to our business and our status as a publicly-traded company. The risks and uncertainties described below are those risks of which we are aware, that we consider to be material to our business. If any of the following risks and uncertainties develops into actual events, our business, financial condition or results of operations could be materially adversely affected. In that case, the trading price of our common stock could decline. Our business, financial condition, results of operations and cash flows may be affected by a number of factors, including the factors set forth below.

(1) We have limited operating history as a separate public company and our historical financial information prior to the spin-off is not necessarily representative of the results we would have achieved as a separate publicly-traded company, and may not be a reliable indicator of our future results.

The predecessor financial statements have been "carved out" from Old Digimarc's consolidated financial statements and reflect assumptions and allocations made by Old Digimarc. The predecessor financial statements do not fully represent what the predecessor's financial position, results of operations and cash flow would have been had it operated as a stand-alone public company for the periods presented, or those that we expect to achieve in the future because, among other reasons, prior to the spin-off, the digital watermarking business was operated by Old Digimarc as part of a larger

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corporate organization. Significant changes may occur in our cost structure, tax structure, management, financing and business operations as a result of our operating as a public company separate from Old Digimarc. These changes may result in increased costs associated with reduced economies of scale, marketing expenses, the incurrence of debt and interest expense, stand-alone costs for services formerly provided by Old Digimarc, the need for additional personnel to perform services formerly provided by Old Digimarc, and the legal, accounting, compliance and other costs associated with being a public company with equity securities listed on a national exchange. As a result, the historical information included in this Annual Report on Form 10-K is not necessarily indicative of what our future financial position, results of operations and cash flow will be. For more information, see "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our financial statements and related notes included elsewhere in this Annual Report on Form 10-K.

(2) We have a history of losses and although we achieved profitability in 2008 we may not sustain profitability, particularly if we were to lose large contracts.

Old Digimarc's Digital Watermarking Business had incurred significant net losses from inception. Old Digimarc's accumulated deficit was $100 million as of December 31, 2007. For the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 we generated net income of $1,491. Achieving profitability in the future will depend upon a variety of factors, including our ability to maintain and obtain more significant partnerships like those with the Central Banks and Nielsen, growth in revenues of our licensees, and our efficiency in executing our business strategy and capitalizing on new opportunities. Various adverse developments, including the loss of large contracts or cost overruns on our existing contracts, could have a negative effect on our revenues, margins and profitability.

(3) The current capital and credit market conditions may adversely affect our access to capital, cost of capital and business operations.

Recently, the general economic and capital market conditions in the U.S. and other parts of the world have deteriorated significantly and have adversely affected access to capital and increased the cost of capital. If these conditions continue or become worse, our future cost of debt and equity capital and our access to capital markets could be adversely affected. Any inability to obtain adequate financing from debt or equity capital sources could force us to self-fund strategic initiatives or even forgo some opportunities, potentially harming our business operations and results.

In addition, our ability to find investments that are both safe and liquid and that provide a reasonable return may be impaired. This could result in lower interest income, longer investment tenures or higher other-than-temporary impairments.

(4) The current economic downturn may impair the financial soundness of our licensees and customers, which could adversely affect our business operations.

As a result of the current economic downturn and macro-economic challenges currently affecting the economy of the U.S. and other parts of the world, our customers and licensees may be negatively affected in ways that reduce our revenues and margins, quality of receivables, and cash flow.

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(5) A small number of customers account for a substantial portion of our revenues and the loss of any large contract could materially disrupt our business.

Historically, we have derived a significant portion of our revenues from a limited number of customers. Two customers, the Bank for International Settlements, acting on behalf of the Central Banks, and Nielsen, represented approximately 77% of our revenue for the year ended December 31, 2008. Most of our revenues come from long-term contracts generally having terms of three to five years, with some licenses for the life of the associated patents, which could be up to 20 years. Some contracts we enter into contain termination for convenience provisions. If we were to lose such a contract for any reason, our financial results could be adversely affected.

We expect to continue to depend upon a small number of customers for a significant portion of our revenues for the foreseeable future. The loss of, or decline in, orders or backlog from one or more major customers could reduce our revenues and have a material adverse effect on our financial results.

(6) A significant portion of our revenue is subject to commercial contracts and development of new markets that may involve unpredictable delays and other unexpected changes, which might limit our actual revenue in any given quarter or year.

We derive substantial portions of our revenue from commercial contracts tied to development schedules or development of new markets, which could shift for months, quarters or years as the needs of our customers and the markets in which they participate change. Government agencies and commercial customers also face budget pressures that introduce added uncertainty. Any shift in development schedules, the markets in which we or our licensees participate, or customer procurement processes, which are outside our control and may not be predictable, could result in delays in bookings forecasted for any particular period, could affect the predictability of our quarterly and annual results, and might limit our actual revenue in any given quarter or year, resulting in reduced and less predictable revenue and adversely affecting profitability.

(7) The market for our products is highly competitive and alternative technology or larger companies may undermine, limit or eliminate the market for our products' technologies, which would decrease our revenue and profits.

The markets in which we compete for business are intensely competitive and rapidly evolving. We expect competition to continue from both existing competitors and new market entrants. We face competition from other companies and from alternative technology. Because the market solutions based on our technologies are still in an early stage of development, we also may face competition from unexpected sources.

Alternative technology that may directly or indirectly compete with particular applications of our watermarking technologies include:

- Encryption securing data during distribution using a secret code so it cannot be accessed except by authorized users;
- Containers inserting a media object in an encrypted wrapper, which prevents the media object from being duplicated, used for content distribution and transaction management;
- DataGlyphs® a slightly visible modification of the characteristics of an image or document that is machine-readable;
- Scrambled Indicia® an optical refraction-based data-hiding technique that is inserted into an image and can be read with a lens;

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Traditional anti-counterfeiting technologies a number of solutions used by many governments (that compete for budgetary outlays) designed to deter counterfeiting, including optically sensitive ink, magnetic threads and other materials used in the printing of currencies;

Radio frequency tags embedding a chip that emits a signal when in close proximity with a receiver, used in some photo identification credentials, labels and tags;

Internet technologies numerous existing and potential Internet access and search methods are competitive with Digimarc Mobile systems and the searching capabilities of Digimarc for Images;

Digital fingerprints and signatures a metric, or metrics, computed solely from a source image or audio or video track, that can be used to identify an image or track, or authenticate the image or track;

Smart cards badges and cards including a semiconductor memory and /or processor, used for authentication and related purposes; and

Bar codes or QR codes data-carrying codes, typically visible in nature (but may be invisible if printed in ultraviolet- or infrared-responsive inks).

In the competitive environment in which we operate, product generation, development and marketing processes relating to technology are uncertain and complex, requiring accurate prediction of demand as well as successful management of various development risks inherent in technology development. In light of these dependencies, it is possible that failure to successfully accommodate future changes in technologies related to our technology could have a long-term effect on our growth and results of operations.

New developments are expected to continue, and discoveries by others, including current and potential competitors, possibly could render our services and products noncompetitive. Moreover, because of rapid technological changes, we may be required to expend greater amounts of time and money than anticipated to develop new products and services, which in turn may require greater revenue streams from these products and services to cover developmental costs. Many of the companies that compete with us for some of our business, as well as other companies with whom we may compete in the future, are larger and may have greater technical, financial, marketing, and political resources than we do. These resources could enable these companies to initiate severe price cuts or take other measures in an effort to gain market share or otherwise impede our progress. We may be unable to compete successfully against current or future participants in our market or against alternative technologies, and the competitive pressures we face could decrease our revenue and profits in the future.

(8) We depend on our management and key employees for our future success. If we are not able to retain, hire or integrate these employees, we may not be able to meet our commitments.

Our success depends to a significant extent on the performance and continued service of our management and our intellectual property team. The loss of the services of any of these employees could limit our growth or undermine customer relationships.

Due to the high level of technical expertise that our industry requires, our ability to successfully develop, market, sell, license and support our products, services, and intellectual property depends to a significant degree upon the continued contributions of our key personnel in engineering, sales, marketing, operations, legal and licensing, many of whom would be difficult to replace. We believe our future success will depend in large part upon our ability to retain our current key employees and our ability to attract, integrate and retain these personnel in the future. It may not be practical for us to match the compensation some of our employees could garner at other employment. In addition, we may encounter difficulties in hiring and retaining employees because of concerns related to our

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financial performance. These circumstances may have a negative effect on the market price of our common stock, and employees and prospective employees may factor in the uncertainties relating to our stability and the value of any equity-based incentives in their decisions regarding employment opportunities and decide to leave our employ. Moreover, our business is based in large part on patented technology, which is unique and not generally known. New employees require substantial training, involving significant resources and management attention. Competition for experienced personnel in our business can be intense. If we do not succeed in attracting new, qualified personnel or in integrating, retaining and motivating our current personnel, our growth and ability to deliver products and services that our customers require may be hampered. Although our employees generally have executed agreements containing non-competition clauses, we do not assure you that a court would enforce all of the terms of these clauses or the clauses generally. If these clauses were not fully enforced, our employees could be able to freely join our competitors. Although we generally attempt to control access to and distribution of our proprietary information by our employees, we do not assure you that the confidential nature of our proprietary information will be maintained in the course of such future employment. Any of these events could have a material adverse effect on our financial and business prospects.

(9) If leading companies in our industry or standard-setting bodies or institutions downplay, minimize, or reject the use of our technology, deployment may be slowed and we may be unable to achieve revenue growth, particularly in the media and entertainment sectors.

Many of our business endeavors, such as our licensing of intellectual property in support of audio and video copy-control applications, can be impeded or frustrated by larger, more influential companies or by standard-setting bodies or institutions downplaying, minimizing or rejecting the value or use of our technology. A negative position by these companies, bodies or institutions, if taken, may result in obstacles for us that we would be incapable of overcoming and may block or impede the adoption of digital watermarking, particularly in the media and entertainment market. In addition, potential customers in the media and entertainment industry may delay or reject initiatives that relate to deployment of our technology. Such a development would make the achievement of our business objectives in this market difficult or impossible.

(10) If we are unable to respond to regulatory or industry standards effectively, or if we are unable to develop and integrate new technologies effectively, our growth and the development of our products and services could be delayed or limited.

Our future success will depend in part on our ability to enhance and improve the responsiveness, functionality and features of our products and services, and those of our business partners, in accordance with regulatory or industry standards. Our ability to remain competitive will depend in part on our ability to influence and respond to emerging industry and governmental standards in a timely and cost-effective manner. If we are unable to influence these or other standards or respond to these standards effectively, our growth and the development of various products and services could be delayed or limited.

Our market is characterized by new and evolving technologies. The success of our business will depend on our ability to develop and integrate new technologies effectively and address the increasingly sophisticated technological needs of our customers in a timely and cost-effective manner. Our ability to remain competitive will depend in part on our ability to:

- enhance and improve the responsiveness, functionality and other features of the products and services we offer or plan to offer;

- continue to develop our technical expertise; and develop and introduce new services, applications and technologies to meet changing customer needs and preferences and to integrate new technologies.

We do not assure you that we will be successful in responding to these technological and industry challenges in a timely and cost-effective manner. If we are unable to develop or integrate new technologies effectively or respond to these changing needs, our margins could decrease, and our release of new products and services and the deployment of our watermarking technology could be adversely affected.

(11) We may need to retain additional employees or contract labor in the future in order to take advantage of new business opportunities arising from increased demand, which could increase costs and impede our ability to achieve or sustain profitability in the short term.

We have staffed our company with the intent of achieving and sustaining profitability. Our current staffing levels could affect our ability to respond to increased demand for our services. In addition, to meet any increased demand and take advantage of new business opportunities in the future, we may need to increase our workforce through additional employees or contract labor. Although we believe that increasing our workforce would potentially support anticipated growth and profitability, it would increase our costs. If we experience such an increase in costs, we may not succeed in achieving or sustaining profitability in the short term.

(12) Our future growth will depend to some extent on our successful implementation of our technology in solutions provided by third parties, including partners and suppliers.

Our business and strategy rely substantially on deployment of our technology by third-party software developers and original equipment manufacturers. For example, one form of our technology is commonly deployed in image editing applications to permit users of these products to read data embedded in imagery, and thereby identify ownership and discern the identities of image owners. Another form of our technology is used in our anti-counterfeiting products. If third parties who include our technology in their products cease to do so, or we fail to obtain other partners who will incorporate, embed, integrate or bundle our technology, or these partners are unsuccessful in their efforts, our efforts to expand deployment of our technology would be adversely affected and, consequently, our ability to increase revenues would be adversely affected and we may suffer other adverse effects to our business. In addition, if our technology does not perform according to market expectations, our future sales would suffer as customers seek other providers.

(13) Our growth of IP licensing revenues depends on successful implementation of solutions by our licensees and third parties and successful development of new markets for our technology.

Our IP licensing business and strategy rely, in part, on successful deployment of our technology by our licensees and other third-party software developers and original equipment manufacturers. For example, our technology is being deployed as part of Digital Cinema systems to theatres around the world by companies that integrate technologies and subsystems. If third parties who license our intellectual property for their products cease to do so, or we fail to obtain other partners who will incorporate, embed, integrate or bundle our technology and intellectual property, or these partners are unsuccessful in their efforts, our ability to increase licensing revenues would be adversely affected. In addition, if our technology does not perform according to market expectations, our future sales would suffer as customers seek other providers.

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(14) An increase in our operations outside of the U.S. subjects us to risks additional to those to which we are exposed in our domestic operations.

We believe that revenue from sales of products and services to commercial, governmental and other customers outside the U.S. could represent a growing percentage of our total revenue in the future. International sales and services are subject to a number of risks that can adversely affect our sales of products and services to customers outside of the U.S., including the following:

- changes in foreign government regulations and security requirements;
- export license requirements, tariffs and taxes;
- trade barriers;
- difficulty in protecting intellectual property;
- difficulty in collecting accounts receivable;
- currency fluctuations;
- longer payment cycles than those for customers in the U.S.;
- difficulty in managing foreign operations; and
- political and economic instability.

We do not have an extensive operational infrastructure for international business. We generally depend on local or international business partners and subcontractors for performance of substantial portions of our business. These factors may result in greater risk of performance problems or of reduced profitability with respect to our international programs in these markets. In addition, if foreign customers, in particular foreign government authorities, terminate or delay the implementation of our products and services, it may be difficult for us to recover our potential losses.

(15) The terms and conditions of our contracts could subject us to damages, losses and other expenses if we fail to meet delivery and other performance requirements.

Our service contracts typically include provisions imposing:

- development, delivery and installation schedules and milestones;
- customer acceptance and testing requirements; and
- other performance requirements.

To the extent these provisions involve performance over extended periods of time, risks of noncompliance may increase. From time to time we have experienced delays in system implementation, timely acceptance of programs, concerns regarding program performance and other contractual disputes. If we fail to meet contractual milestones or other performance requirements as promised, or to successfully resolve customer disputes, we could incur liability for damages, as well as increased costs, lower margins, or compensatory obligations in addition to other losses, such as harm to our reputation. Any unexpected increases in costs to meet our contractual obligations or any other requirements necessary to address claims and damages with regard to our customer contracts could have a material adverse effect on our business and financial results.

(16) Products deploying our technology could have unknown defects or errors, which may give rise to claims against us, divert application of our resources from other purposes or increase our project implementation and support costs.

Products and services as complex as those we offer or develop may contain undetected defects or errors. Furthermore, we often provide complex implementation, integration, customization, consulting and other technical services in connection with the implementation and ongoing maintenance of our products. Despite testing, defects or errors in our products and services may occur, which could result in delays in the development and implementation of products and systems, inability to meet customer requirements or expectations in a timely manner, loss of revenue or market share, increased implementation and support costs, failure to achieve market acceptance, diversion of development resources, injury to our reputation, increased insurance costs, increased service and warranty costs and warranty or breach of contract claims. Although we attempt to reduce the risk of losses resulting from warranty or breach of contract claims through warranty disclaimers and liability limitation clauses in our sales agreements when we can, these contractual provisions are sometimes not included and may not be enforceable in every instance. If a court refuses to enforce the liability-limiting provisions of our contracts for any reason, or if liabilities arise that were not contractually limited or adequately covered by insurance, the expense associated with defending these actions or paying the resultant claims could be significant.

(17) The security systems used in our product and service offerings may be circumvented or sabotaged by third parties, which could result in the disclosure of sensitive information or private personal information or cause other business interruptions that could damage our reputation and disrupt our business.

Our business relies on computers and other information technologies, both internal and at customer locations. The protective measures that we use may not prevent security breaches, and failure to prevent security breaches may disrupt our business, damage our reputation, and expose us to litigation and liability. A party who is able to circumvent security measures could misappropriate sensitive or proprietary information or materials or cause interruptions or otherwise damage our products, services and reputation, and the property of our customers. If unintended parties obtain sensitive data and information, or create bugs or viruses or otherwise sabotage the functionality of our systems, we may receive negative publicity, incur liability to our customers or lose the confidence of our customers, any of which may cause the termination or modification of our contracts. Further, our insurance coverage may be insufficient to cover losses and liabilities that may result from these events.

In addition, we may be required to expend significant capital and other resources to protect ourselves against the threat of security breaches or to alleviate problems caused by these breaches. Any protection or remedial measures may not be available at a reasonable price or at all, or may not be entirely effective if commenced.

(18) We are subject to risks encountered by companies developing and relying upon new technologies, products and services for substantial amounts of their growth or revenue.

Our business and prospects must be considered in light of the risks and uncertainties to which companies with new and rapidly evolving technology, products and services are exposed. These risks include the following:

- we may be unable to develop sources of new revenue or sustainable growth in revenue because our current and anticipated technologies, products and services may be inadequate or may be unable to attract or retain customers;

- the intense competition and rapid technological change in our industry could adversely affect the market's acceptance of our existing and new products and services;

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- we may be unable to develop and maintain new technologies upon which our existing and new products and services are dependent in order for our products and services to be sustainable and competitive and in order for us to expand our revenue and business; and

- our licensees may not be able to successfully enter new markets or grow their businesses, limiting the royalties payable to us and our associated revenues and profits.

Some of our key technology and solutions from our patent or technology licensees are in the development stage. Consequently, products incorporating our technology and solutions are undergoing technological change and are in the early stage of introduction in the marketplace. Delays in the adoption of these products or adverse competitive developments may result in delays in the development of new revenue sources or the growth in our revenue. In addition, we may be required to incur unanticipated expenditures if product changes or improvements are required. Additionally, new industry standards might redefine the products that we or our licensees are able to sell, especially if these products are only in the prototype stage of development. If product changes or improvements are required, success in marketing these products by us or our licensees and achieving profitability from these products could be delayed or halted. We also may be required to fund any changes or improvements out of operating income, which could adversely affect our profitability.

(19) We may not be able to protect adequately our intellectual property, and we may be subject to infringement claims and other litigation, which could adversely affect our business.

Our success depends in part on licensing our proprietary technology. To protect our intellectual property portfolio, we rely on a combination of patent, copyright, trademark and trade secret rights, confidentiality procedures and licensing arrangements. Unlicensed copying and use of our intellectual property or infringement of our intellectual property rights may result in the loss of revenue to us. Although we devote significant resources to developing and protecting our technologies, and periodically evaluate potential competitors of our technologies for infringement of our intellectual property rights, these infringements may nonetheless go undetected or may arise in the future.

We face risks associated with our patent position, including the potential need from time to time to engage in significant legal proceedings to enforce our patents, the possibility that the validity or enforceability of our patents may be challenged, and the possibility that third parties will be able to compete against us without infringing our patents. Budgetary concerns may cause us not to file or continue litigation against known infringers of our patent rights, or may cause us not to file for, or pursue, patent protection for all of our inventive technology in jurisdictions where they may have value. Some governmental entities that might infringe our intellectual property rights may enjoy sovereign immunity from such claims. Failure to reliably enforce our patent rights against infringers may make licensing more difficult. If we fail to protect our intellectual property rights and proprietary technology adequately, if there are changes in applicable laws that are adverse to our interests, or if we become involved in litigation relating to our intellectual property rights and proprietary technology or relating to the intellectual property rights of others, our business could be seriously harmed because the value ascribed to our intellectual property could diminish and result in a lower stock price, or we may incur significant costs in bringing legal proceedings against third parties who are infringing our patents.

Effective protection of intellectual property rights may be unavailable or limited. Patent protection throughout the world is generally established on a country-by-country basis. We have applied for patent protection in the U.S and in various other countries. We do not assure you, however, that pending patents will be issued or that issued patents will be valid or enforceable. Failure to obtain these patents or failure to enforce those patents that are obtained may result in a loss of revenue to us. We do not assure you that the protection of our proprietary rights will be adequate or that our competitors will not independently develop similar technologies, duplicate our services or design around any of our patents or other intellectual property rights.

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We are the exclusive licensee under some third-party patents, and may need the assistance of these parties if we choose to enforce any of these patent rights. The cooperation of these third parties cannot be assured. Although we rely on some of these technologies for our products or for our licenses to third parties to date, the licensed patents have not been material to our operations.

As more companies engage in business activities relating to digital watermarking, and develop corresponding intellectual property rights, it is increasingly likely that claims may arise which assert that some of our products or services infringe upon other parties' intellectual property rights. These claims could subject us to costly litigation, divert management resources and result in the invalidation of our intellectual property rights. These claims may require us to pay significant damages, cease production of infringing products, terminate our use of infringing technology or develop non-infringing technologies. In these circumstances, continued use of our technology may require that we acquire licenses to the intellectual property that is the subject of the alleged infringement, and we might not be able to obtain these licenses on commercially reasonable terms or at all. Our use of protected technology may result in liability that threatens our continuing operation.

Some of our contracts include provisions regarding our non-infringement of third-party intellectual property rights. As deployment of our technology increases, and more companies enter our markets, the likelihood of a third party lawsuit resulting from these provisions increases. If an infringement arose in a context governed by such a contract, we may have to refund to our customer amounts already paid to us or pay significant damages, or we may be sued by the party allegedly infringed upon. Similarly, as we seek to broaden the number of companies licensed under our patent portfolio, some may seek contractual assurances that we will pursue by litigation if necessary their competitors who use our patented technology but are not licensed to do so. Compliance with any such contract provisions may require that we pursue litigation where our costs exceed our likely recovery.

As part of our confidentiality procedures, we generally enter into non-disclosure agreements with our employees, directors, consultants and corporate partners, and attempt to control access to and distribution of our technology, solutions, documentation and other proprietary information. Despite these procedures, third parties could copy or otherwise obtain and make unauthorized use of our technology, solutions or other proprietary information or independently develop similar technologies, solutions or information. The steps that we have taken to prevent misappropriation of our solutions, technology or other proprietary information may not prevent their misappropriation.

(20) Our internal controls and procedures may not succeed in achieving their stated goals under all potential future conditions, regardless of how remote.

We have deployed significant resources to design, implement, and maintain effective internal controls and procedures, including disclosure controls and procedures. Although our internal controls and procedures are designed to provide reasonable assurance of achieving their objectives, the design of any system of controls is based in part upon various assumptions about the likelihood of future events, and our system may not succeed in achieving its stated goals under all potential future conditions, regardless of how remote. Any failure to maintain adequate controls or to adequately implement required new or improved controls could harm our operating results or cause us to fail to meet our reporting obligations in a timely and accurate manner.

(21) If our revenue models and pricing structures relating to products and services that are under development do not gain market acceptance, the products and services may fail to attract or retain customers and we may not be able to generate new or sustain existing revenue.

Some of our business involves embedding digital watermarks in traditional and digital media, including identification documents, secure documents, audio, video and imagery, and licensing our intellectual property. Our revenue stream is based primarily on a combination of development, consulting, subscription and license fees from copyright protection and counterfeit deterrence applications. We have not fully developed revenue models for some of our future digital watermarking applications and licensing endeavors. Because some of our products and services are not yet well-established in the marketplace, and because some of these products and services will not directly displace existing solutions, we cannot be certain that the pricing structure for these products and services will gain market acceptance or be sustainable over time or that the marketing for these products and services will be effective.

(22)While we currently have no material claims, litigation or regulatory actions filed or pending by or against us, future claims, litigation or enforcement actions could arise, and any obligation to pay a judgment or damages could materially harm our business or financial condition.

From time to time, Old Digimarc had been engaged in litigation and incurred significant costs relating to these matters. The inherent uncertainties of litigation, and the ultimate cost and outcome of litigation cannot be predicted. We carry director and officer liability insurance and other insurance policies that provide protection against various liabilities relating to claims against us and our executive officers and directors up to prescribed policy limits. If these policies do not adequately cover expenses and liabilities relating to future lawsuits, our financial condition could be materially harmed. In addition, if this insurance coverage becomes unavailable to us or premiums increase significantly in the future, it could make it more difficult for us to retain and attract officers and directors and could expose us to potentially self-funding certain future liabilities ordinarily mitigated by director and officer liability insurance.

(23) Our common stock price may be volatile, and you could lose all or part of your investment in shares of our common stock.

The price of shares of our common stock may fluctuate as a result of changes in our operating performance or prospects and other factors. Some specific factors that may have a significant effect on the price of shares of our common stock include:

- the public's reaction to our public disclosures;
- actual or anticipated changes in our operating results or future prospects;
- strategic actions by us or our competitors, such as acquisitions or restructurings;
- new laws or regulations or new interpretations of existing laws or regulations applicable to our business;
- changes in accounting standards, policies, guidance, interpretations or principles applicable to us;
- conditions of the industry as a result of changes in financial markets or general economic or political conditions;
- the failure of securities analysts to cover our common stock in the future, or changes in financial estimates by analysts;
- changes in analyst recommendations or earnings estimates regarding us, other comparable companies or the industry generally, and our ability to meet those estimates;
- future issuances of our common stock or the perception that future sales could occur; and
- volatility in the equity securities market.

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(24) We have the ability to issue additional equity securities, which would lead to dilution of our issued and outstanding common stock.

The issuance of additional equity securities or securities convertible into equity securities would result in dilution of our existing stockholders' equity interests. We are authorized to issue, without stockholder approval, up to 2,500,000 shares of preferred stock, par value $0.001 per share, in one or more series, which may give other stockholders dividend, conversion, voting, and liquidation rights, among other rights, which may be superior to the rights of holders of our common stock. In addition, we are authorized to issue up to 50,000,000 shares of common stock, par value $0.001 per share. We are authorized to issue, without stockholder approval except as required by law or Nasdaq regulations, securities convertible into either common stock or preferred stock.

Following the spin-off, we issued to our executive officers an aggregate of 10,000 shares of Series A Redeemable Nonvoting Preferred stock. In the event of our liquidation, dissolution or other winding up, before any payment or distribution is made to the holders of common stock, holders of the Series A Redeemable Nonvoting Preferred stock will be entitled to receive a value of $5.00 per share of Series A Redeemable Nonvoting Preferred stock held by the stockholder. The Series A Redeemable Nonvoting Preferred has no voting rights, and may be redeemed by us at any time on or after June 18, 2013.

(25) Our corporate governance documents as well as Delaware law may delay or prevent an acquisition of us that stockholders may consider favorable, which could decrease the value of your shares.

Our certificate of incorporation and bylaws and Delaware law contain provisions that could make it more difficult for a third party to acquire us without the consent of our board of directors. These provisions include supermajority voting requirements for stockholders to amend our organizational documents and limitations on actions by our stockholders by written consent. In addition, our board of directors has the right to issue preferred stock without stockholder approval, which could be used to dilute the stock ownership of a potential hostile acquirer. Delaware law also imposes some restrictions on mergers and other business combinations between any holder of 15% or more of our outstanding common stock and us. Although we believe these provisions protect our stockholders from coercive or otherwise unfair takeover tactics and thereby provide for an opportunity to receive a higher bid by requiring potential acquirers to negotiate with our board of directors, these provisions apply even if the offer may be considered beneficial by some stockholders.

ITEM 1B: UNRESOLVED STAFF COMMENTS

None.

ITEM 2: PROPERTIES

We lease our principal administrative, marketing, research, and intellectual property development facility, which is located in Beaverton, Oregon.

	Square Feet	Expires
Beaverton, Oregon	46,000	August 2011

ITEM 3: LEGAL PROCEEDINGS

From time to time in our normal course of business we are a party to various legal claims, actions and complaints. We do not have any pending litigation that we consider material.

ITEM 4: SUBMISSION OF MATTERS TO A VOTE OF SECURITY HOLDERS

None.

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PART II

ITEM 5: MARKET FOR REGISTRANT'S COMMON EQUITY, RELATED STOCKHOLDER MATTERS AND ISSUER PURCHASES OF EQUITY SECURTIES

Trading in our common stock commenced on the Nasdaq Stock Market LLC on October 17, 2008, under the symbol "DMRC." The closing price of our common stock on the Nasdaq Global Market was $9.27 on February 18, 2009. The following table lists the high and low sales prices of our common stock for the periods indicated, as reported by The Nasdaq Global Market.

	Year Ended December 31, 2008	
	High	Low
Fourth quarter	$11.50	$7.93

At February 18, 2009, we had 165 stockholders of record of our common stock, as shown in the records of our transfer agent. Since many holders hold shares in "street name," we believe that there is a significantly larger number of beneficial owners of our common stock than the number of record holders.

We have never declared or paid cash dividends on our capital stock and we do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings, if any, to finance the future growth of our business.

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STOCK PERFORMANCE GRAPH

The following graph compares the performance of our common stock with the performance of (i) the Nasdaq U.S. Index and (ii) a peer group selected by us. The comparison assumes $100 was invested on October 17, 2008, the first day of trading in our common stock at the closing price on such date and in each of the other two indices at the closing price on such date and assumes reinvestment of any dividends. We believe that the companies in the peer group are more comparable to us in terms of line-of-business, market capitalization, revenues, and number of employees and, therefore, comprise a more appropriate peer group for purposes of comparing stock performance. The comparisons in the graph are based on historical data and are not indicative of, nor intended to forecast, future performance of our common stock.

	Base Period	INDEXED RETURNS Months Ending		
Company Name/Index	**10/17/08**	**10/31/08**	**11/30/08**	**12/31/08**
Digimarc Corporation	**100**	105.82	95.24	106.03
Nasdaq Index	**100**	100.56	89.74	92.36
Peer Group	**100**	98.55	82.34	86.50

Companies included in the peer group index of the stock performance graph are as follows:

ADAM INC
AETRIUM INC
ALLIANCE FIBER OPTIC PRODUCT
AWARE INC
CHYRON CORP
CLEARONE COMMUNICATIONS INC
DATA I/O CORP
EASYLINK SERVICES INTL CORP
ESPEY MFG & ELECTRONICS CORP
INSIGNIA SYSTEMS INC
MEDIA SCIENCES INTL INC
MICRONETICS INC
MOCON INC
NEW ULM TELECOM INC
OI CORP
PEERLESS SYSTEMS CORP
SRS LABS INC
TELESTONE TECHNOLOGIES
VERSANT CORP

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ITEM 6: SELECTED FINANCIAL DATA

The selected financial data set forth below should be read in conjunction with the financial statements and the notes to the financial statements and "Management's Discussion and Analysis of Financial Condition and Results of Operations," which are included elsewhere in this report. The following tables set forth our selected financial information as of and for each of the years in the five-year period ended December 31, 2008, which has been derived from (a) audited financial statements as of December 31, 2008, 2007, 2006, and 2005, and for the period August 2, 2008 through December 31, 2008 and years ended December 31, 2007, 2006 and 2005; and (b) unaudited financial information as of August 1, 2008 and December 31, 2004 and for the period January 1, 2008 through August 1, 2008 and for the year ended December 31, 2004. In our opinion, the information derived from our unaudited financial statements is presented on a basis consistent with the information in our audited financial statements. The selected financial information presented may not reflect the results of operations or financial condition that would have resulted had we been operating as an independent, publicly-traded company during the periods presented, and is not necessarily indicative of our future performance as an independent company. See "Risk Factors."

The Company has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future.

Statement of Operations Data(1)

	Successor	Predecessor	Total*	Predecessor	Predecessor	Predecessor	Predecessor
				Year Ended December 31,			
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	2008	2007	2006	2005	2004
	(audited)	(unaudited)	(unaudited)	(audited)	(audited)	(audited)	(unaudited)
Operating revenues	$ 7,832	$ 11,950	$ 19,782	$ 13,025	$ 11,071	$ 11,119	$ 11,184
Gross profit percentage	70%	69%	70%	69%	66%	69%	68%
Operating income (loss)	$ (357)	$ 836	$ 479	$ (1,310)	$ (3,908)	$ (5,770)	(2)
Net income (loss)	$ 76	$ 1,415	$ 1,491	$ 55	$ (2,687)	$ (4,842)	(2)
Earnings per share:							
Net income per share basic and diluted	$ 0.01						
Weighted average shares outstanding basic and diluted	7,156						
Pro-forma earnings (loss) per share:							
Net income (loss) per share basic and diluted		$ 0.20	$ 0.21	$ 0.01	$ (0.38)	$ (0.68)	(2)
Weighted average shares outstanding basic and diluted		7,143	7,143	7,143	7,143	7,143	7,143

* Used for comparative purposes

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Balance Sheet Data(1)

	Successor	Predecessor	Predecessor	Predecessor	Predecessor	Predecessor
				Year Ended December 31,		
	As of December 31, 2008	As of August 1, 2008	2007	2006	2005	2004
	(audited)	(unaudited)	(audited)	(audited)	(audited)	(unaudited)
Cash, cash equivalents and short-term marketable securities	$ 40,168	$ 54,749	$ 32,713	$ 33,073	$ 31,982	$ 51,836
Long-term marketable securities	$ 5,744	$	$	$	$	$
Total assets	$ 52,441	$ 64,111	$ 38,451	$ 37,658	$ 36,896	$ 56,210
Long-term liabilities	$ 257	$ 237	$ 215	$ 294	$ 295	$ 160
Redeemable preferred stock	$ 50	$	$	$	$	$

(1)

The Old Digimarc/L-1 merger agreement provided that all cash and cash equivalents, short-term marketable securities and restricted cash, collectively referred to as the aggregate cash, of Old Digimarc was treated as cash retained by Digimarc in its carved-out financial statements. As a result, the presentation of the financial statements and operating data of Digimarc during the carve-out periods reflect the cash flow of Old Digimarc, including its Secure ID Business, combined with Digimarc. For 2004 through 2007, the consolidated results of Old Digimarc reflected operating losses of $9.5 million, $23.6 million, $13.1 million and $1.6 million respectively. Cash provided by (used in) operations for those same periods was $4.7 million, ($3.2) million, $9.3 million and $16.3 million, respectively. Also, capital expenditures for those periods were $39.7 million, $15.5 million, $10.5 million and $17.7 million, respectively. In addition, aggregate cash balances were reduced from $43.6 million at the end of 2004 to $32.7 million at the end of 2007, reflecting the funding of operating losses for the combined Secure ID Business and Digital Watermarking Business and for funding capital expenditures, the majority being for the Secure ID Business.

Prior to the acquisition of the Secure ID Business from Polaroid by Old Digimarc in late December 2001, Digimarc operated as a separate entity. Its revenues for 2000 and 2001 were $11.9 million and $13.2 million, respectively, and its operating losses exceeded $20 million in each of those years. In the years after the acquisition and up through the date of the acquisition of Old Digimarc by L-1, Old Digimarc's business, including Digimarc, began to benefit from a shared services operating model where its general and administrative costs, among others, could be spread more efficiently across multiple operating activities. In addition, in mid-2005, after incurring significant operating losses in 2004 and projecting further significant losses in the future, Old Digimarc began a reorganization of its business to focus on its core strengths while significantly reducing its cost of operations in all areas, and growing revenues in both the Secure ID Business and Digital Watermarking Business. The change in the operating results of Digimarc since its early loss years prior to Old Digimarc's acquisition of the Secure ID Business began to benefit from the shared services operating model in 2002, and later, beginning in 2005, as operating costs were reduced and revenues began to rise to current levels. As a result, Digimarc's operating losses reduced over the years to $1.3 million in 2007, and eventually achieved an operating profit (loss) of $0.8 million and $(0.4) million for the periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008, respectively.

(2)

Certain financial data for the year ended December 31, 2004 have been omitted from this information statement because they are not available without unreasonable effort and expense. We believe these financial data for the year ended December 31, 2004 are not material to an understanding of our financial performance and related trends.

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ITEM 7: MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following Management's Discussion and Analysis of Financial Condition and Results of Operations contains forward-looking statements relating to future events or the future financial performance of Digimarc, which involve risks and uncertainties. Our actual results could differ materially from those anticipated in these forward-looking statements. Please see the discussion regarding forward-looking statements included at the end of this discussion, under the caption "Forward-Looking Statements" and Item 1A, "Risk Factors" for a discussion of some of the uncertainties, risks and assumptions associated with these statements.

The following discussion should be read in conjunction with our consolidated financial statements and the related notes and other financial information appearing elsewhere in this Annual Report on Form 10-K.

All dollar amounts are in thousands, unless otherwise noted.

Overview

Digimarc Corporation enables governments and enterprises around the world to give digital identities to media and objects that computers can sense and recognize and to which they can react. Our technology provides the means to infuse persistent digital information, perceptible only to computers and digital devices, into all forms of media content. The unique digital identifier placed in media generally persists with it regardless of the distribution path and whether it is copied, manipulated or converted to a different format, and does not affect the quality of the content or the enjoyment or other traditional uses of it. Our technology permits computers and digital devices to quickly identify relevant data from vast amounts of media content.

Critical Accounting Policies and Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. ("U.S. GAAP") requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. On an on-going basis, we evaluate our estimates, including those related to bad debts fixed assets, intangible assets, income taxes, long-term service contracts, marketable securities, and contingencies and litigation. We base our estimates on historical experience and on various other assumptions we believe to be reasonable under the circumstances. Actual results may differ from these estimates under different assumptions or conditions.

Some of our accounting policies require higher degrees of judgment than others in their application. These include revenue recognition on long-term service contracts, revenue recognition on license and subscription arrangements, impairments and estimation of useful lives of long-lived assets, reserves for uncollectible accounts receivable, contingencies and litigation and stock- based compensation. We believe the following critical accounting policies affect our more significant judgments and estimates used in the preparation of our financial statements:

Basis of Accounting; Predecessor Financial Statements

The predecessor financial statements include certain accounts of Old Digimarc and the assets, liabilities and results of operations of Old Digimarc's Digital Watermarking Business that were separated, or "carved-out," from Old Digimarc. The operating expenses included in the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of the expenses was not practicable. The common costs include expenses from Old Digimarc related to various operating shared services cost centers, including: executive, finance and accounting, human resources, legal, marketing, intellectual property, facilities

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and information technology. Management believes that the assumptions underlying the predecessor financial statements are reasonable. The cost allocation methods applied to certain shared services common cost centers include the following:

Specific identification. Where the amounts were specifically identified to the predecessor or Old Digimarc's Secure ID Business, they were classified accordingly.

Reasonable allocation. Where the amounts were not clearly or specifically identified, we determined if a reasonable allocation method could be applied. For example, in the shared services human resources ("HR") cost center we allocated the costs based on the relative headcount of the predecessor and Old Digimarc's Secure ID Business. This allocation was based on the assumption that HR support costs should be relatively equal per employee. In the intellectual property cost center we allocated the costs based on the relative number of patents that were used by each business.

General allocation approach. For consistency, when specific identification or a reasonable allocation method did not seem to fit the situation, we used a general allocation approach. This approach consisted of a blended rate based on what we determined to be the primary drivers for shared services:

Revenue ratio between the businesses.

Property and equipment balances, which served as a proxy for capital expenditures. The effort expended on capital projects is a factor in the expense and effort of shared services. To avoid fluctuations that occur in capital spending, we believe that these allocated balances represent a relative trend of capital spending between the businesses. In determining the relative balances of property, we excluded the central information technology assets because they supported the entire organization.

Headcount between the businesses.

Other key assumptions differing from the historical accounting of Old Digimarc:

Cash: All cash balances of Old Digimarc are treated as retained by Digimarc, consistent with the merger agreement between Old Digimarc and L-1. Accordingly, restricted cash on the books of Old Digimarc that related directly to its operations flowed through to Digimarc in these financial statements as non-restricted cash included in cash and cash equivalents in the predecessor financial statements. The letters of credit that required the restricted cash remained with Old Digimarc following its acquisition by L-1.

Incentive compensation allocations to cost of services: Cost of incentive compensation related to bonus and stock compensation charges for employees in the research, development and engineering cost centers was not considered significant to Old Digimarc's consolidated operations during the periods reported and were treated as research, development and engineering costs in Old Digimarc's financial statements. For Digimarc's reporting purposes, these incentive compensation costs have been allocated to cost of services to the extent that their pro rata salary allocations were made to the cost of services expense category. The impact for the reported periods ranged from a 1% to 3% reduction in margins compared to the results had the allocations not been made.

Pro-forma e*arnings (loss) per share (unaudited):* The weighted average shares outstanding basic and diluted of 7,143,442 was calculated based on a distribution ratio of one share of Digimarc common stock for every three and one-half shares of Old Digimarc common stock, excluding shares held in treasury, outstanding at August 1, 2008, the date of the spin-off of Digimarc from Old Digimarc.

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Stock activity: All stock activity (transactions from stock options, restricted stock, employee stock purchase plan and stock compensation) was carried on the books of Old Digimarc. All net cash from these activities was retained by Digimarc and stock-based compensation expense associated with stock activity was allocated to the predecessor in accordance with the basis of accounting methodology outlined above.

Capital leases: Digimarc shares various infrastructure activities with Old Digimarc and was charged for its allocated share of capital lease costs in the form of allocated depreciation and interest expense. The assets and liabilities associated with the capital leases were carried on the books of Old Digimarc.

Leasehold improvements: Digimarc occupies the majority of Old Digimarc's Beaverton facility and assumed the lease and most all related furniture, fixtures and leasehold improvements when Old Digimarc completed the spin-off of Digimarc. The leasehold was recorded as part of property and equipment on the balance sheet of Digimarc, and as a result, pro rata depreciation and rent expenses were allocated to Old Digimarc.

Intercompany transactions: With the retention by Digimarc of all of Old Digimarc cash, Digimarc's cash balances effectively funded the operations, if needed, of Old Digimarc. The net difference of cash needs for operating and capital expenditures to and from Old Digimarc is shown as "net activity with Parent" in the Statement of Stockholders' Equity. All intercompany transactions were eliminated.

Merger related costs: All Old Digimarc costs related to the merger of Old Digimarc with L-1 were allocated to Old Digimarc. Digimarc was responsible for payment of the majority of these costs

Commitments and contingencies: Commitments and contingencies related to the predecessor operations are included in these financial statements, and those relating to Old Digimarc were excluded.

Stock compensation expense: Stock-based compensation is accounted for in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock- based awards made to employees and directors, including stock options, employee stock purchases under a stock purchase plan and restricted stock awards based on estimated fair values. Stock compensation expense was allocated to the predecessor based on a combination of specific and shared services resource allocations from Old Digimarc.

The financial information in the predecessor financial statements does not include all of the expenses that would have been incurred had the predecessor been a separate, stand-alone public entity. As such, the predecessor financial information does not reflect the financial position, results of operations and cash flows of Digimarc's current business had the predecessor operated as a separate, stand-alone public entity during the periods presented in the predecessor financial statements. Additionally, the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of these expenses was not practicable. It is expected that the initial operating costs of Digimarc on a stand-alone basis will be higher than those allocated to the predecessor operations under the shared services methodology applied in the predecessor financial statements. Consequently, the financial position, results of operations and cash flows reflected in the predecessor financial statements may not be indicative of those that would have been achieved had the predecessor operated as a separate, stand-alone entity for the periods reflected in the predecessor financial statements.

Revenue recognition: Some customer arrangements encompass multiple deliverables, such as software, hardware sales, consumables sales, maintenance fees, and software development fees. We account for these arrangements in accordance with Emerging Issues Task Force ("EITF") Issue No. 00-21. If the deliverables meet the criteria in EITF Issue No. 00-21, the deliverables are divided into separate units of accounting and revenue is allocated to the deliverables based on their relative fair values. The criteria specified in EITF Issue No. 00-21 are as follows:

(i) the delivered item has value to the customer on a stand-alone basis;

(ii) there is objective and reliable evidence of the fair value of the undelivered item; and

(iii) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.

For our purposes, fair value is generally defined as the price at which a customer could purchase each of the elements independently from other vendors or as the price that we have sold the element separately to another customer. Management applies judgment to ensure appropriate application of EITF Issue No. 00-21, including value allocation among multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among others. Revenue is recognized in accordance with SAB 104 when the following four criteria are met:

(i) persuasive evidence of an arrangement exists,

(ii) delivery has occurred,

(iii) the fee is fixed or determinable, and

(iv) collection is probable.

AICPA SOP No. 98-9 requires that revenue be recognized using the "residual method" in circumstances when vendor specific objective evidence ("VSOE") exists only for undelivered elements. Under the residual method, revenue is recognized as follows: (1) the total fair value of undelivered elements, as indicated by VSOE, is deferred and subsequently recognized in accordance with the relevant sections of AICPA SOP No. 97-2, and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Revenue recognition on long-term service contracts: Revenue from professional service arrangements is generally determined based on time and materials or a cost plus a profit margin measure. Revenue for professional services is recognized as the services are performed. Losses on contracts, if any, are provided for in the period in which the loss becomes determinable. Invoicing for services rendered generally occurs within one to two weeks after each month end that the services are provided. Revenue earned which has not been invoiced at the last day of the period is included in the balance of trade receivables, net in the balance sheets.

Revenue recognition on license and subscription arrangements: Royalty revenue is recognized when the royalty amounts owed to Digimarc have been earned, are determinable, and collection is probable. These revenues are earned through the licensing of digital watermarking products and services for use in:

- authenticating documents;

detecting fraudulent documents and deterring unauthorized duplication or alteration of high-value documents;

communicating copyright, asset management and business-to-business image commerce solutions, and connecting analog media to a digital environment.

Licensing and subscription revenues are paid in advance and recognized ratably over the term of the license or subscription period.

Impairments and estimation of useful lives of long-lived assets: We periodically assess long-lived assets for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable, in accordance with the provisions of SFAS No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If the assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Also, we periodically review the useful lives of long-lived assets whenever events or changes in circumstances indicate that the useful life may have changed. If the estimated useful lives of the assets do change, we adjust the depreciation or amortization period to a shorter or longer period, based on the circumstances identified.

Contingencies and litigation: We periodically evaluate all pending or threatened contingencies or commitments, if any, that are reasonably likely to have a material adverse effect on our operations or financial position. We assess the probability of an adverse outcome and determine if it is remote, reasonably possible or probable as defined in accordance with the provisions of SFAS No. 5, *Accounting for Contingencies*. If information available prior to the issuance of our financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of our financial statements, and the amount of the loss, or the range of probable loss can be reasonably estimated, then the loss is accrued and charged to operations. If no accrual is made for a loss contingency because one or both of the conditions pursuant to SFAS No. 5 are not met, but the probability of an adverse outcome is at least reasonably possible, we will disclose the nature of the contingency and provide an estimate of the possible loss or range of loss, or state that such an estimate cannot be made.

Patent Costs: Costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at award date, which varies depending on the pendency period of the application, generally approximating seventeen years. Capitalized patent costs include internal legal labor, professional legal fees, government filing fees and translation fees related to obtaining the Company's patent portfolio. These costs were expensed in the predecessor financial statements.

Costs associated with the maintenance and annuity fees of patents are accounted for as prepaid assets at the time of payment and amortized over the respective periods, generally from one to four years. These costs were expensed in the predecessor financial statements.

Stock-based compensation: We account for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock- based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. We use the Black-Scholes option pricing model as our method of valuation for stock- based awards. Our determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected life of the award, our expected stock price, volatility over the term of the award and actual and projected exercise behaviors.

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Although the fair value of stock-based awards is determined in accordance with SFAS 123(R), the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results. The fair value of restricted stock awards granted is based on the fair market value of our common stock on the date of the grant (measurement date), and is being recognized over the vesting period of the related restricted stock using the straight-line method.

Results of Operations Periods January 1, 2008 through August 1, 2008 (predecessor) and August 2, 2008 through December 31, 2008 (successor) compared to the Year Ended December 31, 2007 (predecessor)

The following tables present our statements of operations data for the periods indicated.

	Successor	Predecessor	Total*	Predecessor
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	Year Ended December 31, 2008	Year Ended December 31, 2007
Revenue:				
Service	$ 4,064	$ 6,456	$ 10,520	$ 7,806
License and subscription	3,768	5,494	9,262	5,219
Total revenue	7,832	11,950	19,782	13,025
Cost of revenue:				
Service	2,248	3,519	5,767	3,815
License and subscription	114	145	259	217
Total cost of revenue	2,362	3,664	6,026	4,032
Gross profit	5,470	8,286	13,756	8,993
Operating expenses:				
Sales and marketing	1,154	1,928	3,082	2,453
Research, development and engineering	1,772	2,071	3,843	2,912
General and administrative	2,877	2,349	5,226	3,345
Intellectual property	304	1,102	1,406	1,593
Transitional services	(280)		(280)	
Total operating expenses	5,827	7,450	13,277	10,303
Operating income (loss)	(357)	836	479	(1,310)
Other income, net	443	590	1,033	1,387
Income before provision for income taxes	86	1,426	1,512	77
Provision for income taxes	(10)	(11)	(21)	(22)
Net income	$ 76	$ 1,415	$ 1,491	$ 55

* Used for comparative purposes

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	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008	Total* Year Ended December 31, 2008	Predecessor Year Ended December 31, 2007
Revenue:				
Service	52%	54%	53%	60%
License and subscription	48	46	47	40
Total revenue	100	100	100	100
Cost of revenue:				
Service	29	30	29	29
License and subscription	1	1	1	2
Total cost of revenue	30	31	30	31
Gross profit	70	69	70	69
Operating expenses:				
Sales and marketing	15	16	16	19
Research, development and engineering	23	17	19	22
General and administrative	37	20	26	26
Intellectual property	4	9	7	12
Transitional services	(4)		(1)	
Total operating expenses	75	62	67	79
Operating income (loss)	(5)	7	3	(10)
Other income, net	6	5	5	11
Income before provision for income taxes	1	12	8	1
Provision for income taxes				
Net income	1%	12%	8%	1%

* Used for comparative purposes

Our revenue for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 increased 52% to $19.8 million from $13.0 million for the year ended December 31, 2007. The increase is primarily the result of a change in revenue mix. In 2008, higher margin license revenues, the majority of which are attributable to the Nielsen contract, comprised a greater percentage of total revenues. The increase in revenues was offset by increased bonuses and related expenses in 2008, compared to no incentive compensation in 2007, and higher operating expenses in the period August 2, 2008 through December 31, 2008, the period during which we operated as a stand-alone company.

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Revenue

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008	Total* Year Ended December 31, 2008	Predecessor Year Ended December 31, 2007	Dollar Increase	Percent Increase
Revenue:						
Service	$ 4,064	$ 6,456	$ 10,520	$ 7,806	$ 2,714	35%
License and subscription	3,768	5,494	9,262	5,219	4,043	77%
Total	$ 7,832	$ 11,950	$ 19,782	$ 13,025	$ 6,757	52%
Revenue (as % of total revenue):						
Service	52%	54%	53%	60%		
License and subscription	48%	46%	47%	40%		
Total	100%	100%	100%	100%		

* Used for comparative purposes

Service. Service revenue consists primarily of software development and consulting services. The majority of service revenue arrangements are structured as time and materials consulting agreements, or fixed price consulting agreements. The majority of our services revenue is derived from contracts with an international consortium of Central Banks, Nielsen, and other government agencies. The agreements can range from several months to several years in length, and our longer term contracts are subject to work plans that are reviewed and agreed upon at least annually. These contracts generally provide for billing hours worked at predetermined rates and, to a lesser extent, for cost reimbursement for third party costs and services. The increases or decreases in the services are generally subject to both volume and price changes. The volume of work is generally negotiated at least annually and can be modified as the needs of the customers arise. We also have provisions in our longer term contracts that allow for specific hourly rate price increases on an annual basis to account for cost of living variables. Contracts with other government agencies are generally shorter term in nature, are less linear in billings and less predictable than our longer terms contracts since they are subject to government budgets and funding.

The increase in service revenue for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 30, 2008 compared to the year ended December 31, 2007 was due primarily to increased consulting revenues related to our new contract with Nielsen.

License and subscription. License revenue originates primarily from licensing our technology and patents where we receive royalties as our income stream. Subscription revenue consists primarily of royalty revenue from the sale of our web-based subscriptions related to various software products, which are more recurring in nature. Revenues from our licensed products have minimal associated direct costs, and thus are highly profitable.

The increase in license and subscription revenue for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 was due primarily to increased license revenues as a result of the contract with Nielsen.

We anticipate continued revenue growth in 2009, but at lower than the double digit percentage rate we experienced in 2008.

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Revenue by Geography

	Successor	Predecessor	Total*	Predecessor		
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	Year Ended December 31, 2008	Year Ended December 31, 2007	Dollar Increase	Percent Increase
Revenue by geography:						
Domestic	$ 3,425	$ 6,274	$ 9,699	$ 3,696	$ 6,003	162%
International	4,407	5,676	10,083	9,329	754	8%
Total	$ 7,832	$ 11,950	$ 19,782	$ 13,025	$ 6,757	52%
Revenue (as % of total revenue):						
Domestic	44%	53%	49%	28%		
International	56%	47%	51%	72%		
Total	100%	100%	100%	100%		

* Used for comparative purposes

Domestic revenue increased for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 primarily as a result of additional service and license revenues associated with the Nielsen contract.

International revenue slightly increased for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 primarily as a result of increased service revenue from our agreement with the consortium of Central Banks.

Cost of Revenue

Service. Cost of service revenue primarily includes costs that are allocated from research, development, engineering and sales and marketing that relate directly to producing revenue under our customer contracts, and to a lesser extent direct costs of program delivery for both personnel and operating expenses. Allocated costs include:

- salaries, a payroll tax and benefit factor, incentive compensation and related costs of our software developers, quality assurance personnel, product managers, business development managers and other personnel where we bill our customers for time and materials costs;
- payments to outside contractors that are billed to customers;
- charges for equipment directly used by the customer;
- depreciation charges for machinery, equipment and software; and
- travel costs directly attributable to service and development contracts.

License and subscription. Cost of license and subscription revenue primarily includes:

- patent or software license costs for any patents licensed from third parties where the party receives a portion of royalties or license revenue received by Digimarc; and

- internet service provider connectivity charges and image search data fees to support the services offered to our subscription customers.

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Gross Profit

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008	Total* Year Ended December 31, 2008	Predecessor Year Ended December 31, 2007	Dollar Increase	Percent Increase
Gross Profit:						
Service	$ 1,816	$ 2,937	$ 4,753	$ 3,991	$ 762	19%
License and subscription	3,654	5,349	9,003	5,002	4,001	80%
Total	$ 5,470	$ 8,286	$ 13,756	$ 8,993	$ 4,763	53%
Gross Profit (as % of related revenue components):						
Service	45%	45%	45%	51%		
License and subscription	97%	97%	97%	96%		
Total	70%	69%	70%	69%		

* Used for comparative purposes

Although the overall gross profit as a percentage of revenue for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 remained relatively consistent, the gross profit percentage of the revenue components reflect the following primary changes:

- an increase in the cost of services component where we incurred higher incentive compensation of $0.1 million under our incentive bonus program for which no accrual was made for the 2007 period; and, to a lesser extent
- a slight increase in the mix of lower margin, pass-through third party services, primarily hardware acquisition related.

The effect of these items was offset to some extent by a change in revenue mix where higher margin license revenues, the majority of which are attributable to the Nielsen contract, comprised a greater percentage of total revenues.

Operating Expenses

The financial information in the predecessor financial statements does not include all of the expenses that would have been incurred had the predecessor operated as a separate, stand-alone public entity. As such, the predecessor financial information does not reflect the operating expenses of Digimarc's current business had the predecessor been a separate, stand-alone public entity during the periods presented in the predecessor's financial statements. Additionally, the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of these expenses was not practicable. It is expected that the initial operating costs of Digimarc on a stand-alone basis will be higher than those allocated to the predecessor operations under the shared services methodology applied in the predecessor financial statements. Consequently, the operating expenses reflected in the predecessor financial statements may not be indicative of those that would have been achieved had the predecessor operated as a separate, stand-alone entity for the periods reflected in the predecessor financial statements.

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Sales and marketing

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008	Total* Year Ended December 31, 2008	Predecessor Year Ended December 31, 2007	Dollar Increase	Percent Increase
Sales and marketing	$ 1,154	$ 1,928	$ 3,082	$ 2,453	$ 629	26%
Sales and marketing (as % of total revenue)	15%	16%	16%	19%		

* Used for comparative purposes

Sales and marketing expenses consist primarily of:

- compensation, benefits and related costs of sales and marketing employees and product managers;
- travel and market research costs, and costs associated with marketing programs, such as trade shows, public relations and new product launches;
- incentive compensation in the form of bonuses and stock-based compensation expense; and
- charges for infrastructure and centralized costs of facilities and information technology.

We allocate certain costs of sales and marketing to cost of service revenue when they relate directly to our service contracts. For direct billable labor hours, we allocate to cost of service revenue:

- salaries;
- a payroll tax and benefits factor; and
- incentive compensation related to our bonus and stock compensation plans.

We record all remaining, or "residual," costs as sales and marketing costs.

The increase in sales and marketing expense for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 resulted primarily from:

- the shared services allocation methodology applied in the predecessor financial statements;
- a write-off of an investment of an international cash basis customer; and

increase in accrued benefits primarily related to incentive bonuses of $0.3 million compared to no corporate incentive bonus earned or accrued in 2007.

We anticipate that we will continue to incur sales and marketing costs at approximately existing levels to support ongoing sales initiatives.

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Research, development and engineering

	Successor	Predecessor	Total*	Predecessor		
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	Year Ended December 31, 2008	Year Ended December 31, 2007	Dollar Increase	Percent Increase
Research, development and engineering	$ 1,772	$ 2,071	$ 3,843	$ 2,912	$ 931	32%
Research, development and engineering (as % of total revenue)	23%	17%	19%	22%		

* Used for comparative purposes

Research, development and engineering expenses arise primarily from three areas that support our business model:

Fundamental Research:

- Investigation of new watermarking algorithms to increase robustness and/or computational efficiency;
- Mobile device usage models and imaging sub-systems in camera-phones;
- Industry conference participation and authorship of papers for industry journals;
- Development of new intellectual property, including documentation of claims and production of supporting diagrams and materials;
- Video watermarking research focused on low-bit rate video applications; and
- Research in fingerprinting and other content identification technologies.

Platform Development:

- Continued development and porting to different operating systems of the Digimarc Global Software Development Kit, or SDK (DGSDK), which packages the core image watermarking algorithms for Print & Imaging applications;
- Development and support of the Geo-Spatial SDK (GEOSDK) for geospatial imaging applications;

- Tuning and optimization of implementation models to improve resistance to non-malicious attacks and routine transformations, such as JPEG, cropping and printing; and

- Creation of a platform to encapsulate fixed point watermarking algorithms, optimized for mobile devices.

Product Development:

- Migration of applications to new platforms, specifically linking Digimarc for Images (formerly known as ImageBridge) to DGSDK and Digimarc Mobile;

- Updating Digimarc for Images Plug-Ins for Photoshop CS4, including new interfaces and translation into 27 languages;

- Porting of Digimarc for Images SDK and related applications such as the Digimarc for Images Reader to various operating systems, including Vista, Linux & OS X;

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- Development of Digimarc Mobile reader prototype for new mobile devices; and
- Prototype UGC site ingest, queue, and content management system to demonstrate potential applications of digital watermarking.

Research, development and engineering expenses consist primarily of:

- compensation, benefits and related costs of software developers and quality assurance personnel;
- payments to outside contractors;
- the purchase of materials and services for product development;
- incentive compensation in the form of bonuses and stock-based compensation expense; and
- charges for infrastructure and centralized costs of facilities and information technology.

We allocate certain costs of research, development and engineering to cost of service revenue when they relate directly to our service contracts. For direct billable labor hours, we allocate to cost of service revenue:

- salaries;
- a payroll tax and benefits factor; and
- incentive compensation related to our bonus and stock compensation plans.

We record all remaining, or "residual," costs as research, development and engineering costs.

The increase in research, development and engineering expense for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 resulted primarily from:

- the shared services allocation methodology applied in the predecessor financial statements; and
- an increase in accrued benefits primarily related to incentive bonuses of $0.4 million compared to no corporate incentive bonus earned or accrued in 2007.

We anticipate that we will continue to invest in research, development and engineering expenses at approximately existing levels in the near term to support certain ongoing product initiatives, and expect to moderate spending in the longer term.

General and administrative

	Successor Period August 2, 2008	**Predecessor Period January 1,**	**Total* Year Ended December 31,**	**Predecessor Year Ended December 31,**	**Dollar Increase**	**Percent Increase**

	through December 31, 2008	2008 through August 1, 2008	2008	2007		
General and administrative	$ 2,877	$ 2,349	$ 5,226	$ 3,345	$ 1,881	56%
General and administrative (as % of total revenue)	37%	20%	26%	26%		

* Used for comparative purposes

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We incur general and administrative costs in the functional areas of finance, legal, human resources, executive and board of directors. Costs for facilities and information technology are also managed as part of the general and administrative processes and are allocated to this area as well as each of the areas in costs of services, sales and marketing, and research development and engineering. General and administrative expenses consist primarily of:

compensation, benefits and related costs;

third party and professional fees associated with legal, accounting, human resources and costs associated with being a public company;

incentive compensation in the form of bonuses and stock-based compensation expense; and

charges for infrastructure and centralized costs of facilities and information technology.

The increase in general and administrative expenses for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 resulted primarily from:

the shared services allocation methodology applied in the predecessor financial statements; and

an increase in accrued benefits primarily related to incentive bonuses of $0.4 million compared to no corporate incentive bonus earned or accrued in 2007.

We anticipate that we will continue to incur general and administrative expenses at least at existing or higher levels in the near term due to the loss of synergies as a result of our spin-off from Old Digimarc, while we continue to examine means to reduce general and administrative expenses as a percentage of revenue in the longer term.

Intellectual property

	Successor	Predecessor	Total*	Predecessor		
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	Year Ended December 31, 2008	Year Ended December 31, 2007	Dollar Decrease	Percent Decrease
Intellectual property	$ 304	$ 1,102	$ 1,406	$ 1,593	$ (187)	(12)%
Intellectual property (as % of total revenue)	4%	9%	7%	12%		

* Used for comparative purposes

We incur intellectual property expenses that arise primarily from costs associated with documenting, applying for, and maintaining domestic and international patents and trademarks:

Gross expenditures for intellectual property costs, before reflecting the effect of capitalized patent costs, primarily consist of:

- compensation, benefits and related costs of attorneys and legal assistants;

- third party costs including filing and governmental regulatory fees and fees for outside legal counsel and translation costs, each incurred in the patent process;

- incentive compensation in the form of bonuses and stock-based compensation expense; and

- charges for infrastructure and centralized costs of facilities and information technology.

Prior to August 2, 2008, the predecessor accounted for gross expenditures for intellectual property costs as expenses. On August 2, 2008 we began capitalizing patent application and award costs.

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The decrease in intellectual property expenses for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 resulted primarily from:

- capitalized patent application and award costs aggregating $0.4 million; offset somewhat by

- an increase in accrued benefits primarily related to incentive bonuses of $0.1 million compared to no corporate incentive bonus earned or accrued in 2007.

We anticipate that we will continue to invest in intellectual property expenses at current levels or higher.

Transitional services

In connection with the sale of Old Digimarc's Secure ID Business and the spin-off of the Digital Watermarking Business, Old Digimarc and Digimarc entered into a transition services agreement to provide one another with transition services and other assistance substantially consistent with the services provided before the spin-off.

To enable Old Digimarc to continue its operation of the Secure ID Business and facilitate the effective transition of the Digital Watermarking Business to Digimarc, under the transition services agreement Old Digimarc provides the following services or support to Digimarc: information technology services and legal services. Similarly, Digimarc provides the following services or support to Old Digimarc: accounting and tax services, information technology services, legal services, human resource services and facilities.

The fees for the transition services generally are intended to cover each party's reasonable costs incurred in connection with providing the transition services. Hourly rates for personnel performing transition services were determined based on fully loaded costs, taking into account base pay, a bonus based on obtaining target earnings, payroll taxes, benefit costs, a pro rata portion of overhead charges paid by Old Digimarc or Digimarc, as applicable, and the current year stock compensation charge for the individual, divided by the total hours available for the employee for the year, taking into account the need for administrative time.

The net transitional services expenses reimbursed to Digimarc aggregated $0.3 million for the period August 2, 2008 through December 31, 2008 and are expected to decline through mid-2009 as the amount of transition services decline.

Stock-based compensation

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008	Total* Year Ended December 31, 2008	Predecessor Year Ended December 31, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
Cost of revenue	$ 5	$ 99	$ 104	$ 102	$ 2	2%
Sales and marketing	38	208	246	287	(41)	(14)%
Research, development and engineering	51	34	85	47	38	81%
General and administrative	422	537	959	728	231	32%
Intellectual property	16	35	51	45	6	13%
Total	$ 532	$ 913	$ 1,445	$ 1,209	$ 236	20%

*

Used for comparative purposes

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Old Digimarc accounted for stock-based compensation in accordance with SFAS No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock- based awards made to employees and directors, including stock options, employee stock purchases under a stock purchase plan and restricted stock awards based on estimated fair values. Stock compensation expense was allocated to the predecessor based on a combination of specific and shared services resource allocations from Old Digimarc.

The increase in stock-based compensation expense for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 resulted primarily from the expensing of the initial layer of stock-based awards for Digimarc pursuant to SFAS 123(R).

The predecessor incurred additional stock-based compensation expense from Old Digimarc through August 1, 2008, pursuant to the described allocation process.

Other income, net

	Successor	Predecessor	Total*	Predecessor		
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	Year Ended December 31, 2008	Year Ended December 31, 2007	Dollar Decrease	Percent Decrease
Other income, net	$ 443	$ 590	$ 1,033	$ 1,387	$ (354)	(26)%

* Used for comparative purposes

Other income, net consists primarily of interest income from our cash and short term marketable securities.

The decrease in other income (expense), net for the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 resulted primarily from lower interest earned on cash and investment balances, reflecting lower interest rates available.

Provision for Income Taxes.

Old Digimarc. The provision for income taxes reflects expected tax expense from profitability in certain foreign jurisdictions. The predecessor recorded a full valuation allowance against net deferred tax assets at August 1, 2008 due to the uncertainty of realization of net operating losses. As a separate legal entity, we will not benefit from any of the carry-forward tax attributes of Old Digimarc, including net operating loss carry-forwards.

Digimarc. For the period from August 2, 2008 through December 31, 2008 the provision for income taxes reflects withholding tax expense in various foreign jurisdictions. These withholding taxes are computed by our customers and paid to foreign jurisdictions on our behalf. There was no provision for income taxes related to net income because the computation of taxable income resulted in a net operating loss for the period. Furthermore, a valuation allowance has been recorded to offset our net deferred tax assets until such time that we are able to predict that it is more likely than not the tax assets or portions thereof will be realized.

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Years Ended December 31, 2007 and 2006

The following table presents our statements of operations data for the periods indicated as a percentage of total revenue.

	Year Ended December 31, 2007	Year Ended December 31, 2006
Revenue:		
Service	60%	62%
License and subscription	40	38
Total revenue	100	100
Cost of revenue:		
Service	29	33
License and subscription	2	1
Total cost of revenue	31	34
Gross profit	69	66
Operating expenses:		
Sales and marketing	19	34
Research, development and engineering	22	22
General and administrative	26	31
Intellectual property	12	14
Total operating expenses	79	101
Operating loss	(10)	(35)
Other income, net	11	11
Income (loss) before provision for income taxes	1	(24)
Provision for income taxes	0	0
Net income (loss)	1%	(24)%

Revenue

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase	Percent Increase
Revenue:				
Service	$ 7,806	$ 6,812	$ 994	15%
License and subscription	5,119	4,159	960	23%
Total	$13,025	$11,071	$ 1,954	18%
Revenue (as % of total revenue):				
Service	60%	62%		
License and subscription	40%	38%		
Total	100%	100%		

The increase in service revenue for the year was primarily due to increases in consulting revenue. Our Central Banks consortium accounted for more than two-thirds of the increase, followed by Nielsen and, to a lesser extent, contracts with various other government agencies. Increased revenues from the Central Banks resulted primarily from volume increases in the work plans with some minor increases attributable to change in billing rate mix and pass through of third party costs and expenses. We entered into our contract with Nielsen in late 2007.

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The increase in license and subscription revenue for the year was primarily attributable to higher license revenues from customers whose revenues fluctuate from period to period and a combination of growing levels of fixed and variable royalties from a larger customer base.

Revenue by Geography

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase	Percent Increase
Revenue by geography:				
Domestic	$ 3,696	$ 2,414	$ 1,182	53%
International	9,329	8,657	672	8%
Total	$13,025	$11,071	$ 1,954	18%
Revenue (as % of total revenue):				
Domestic	28%	22%		
International	72%	78%		
Total	100%	100%		

The increase in domestic revenue for the year was due primarily to increases in service and license revenues from Nielsen.

The increase in international revenue for the year was due primarily to growing license revenues from various international customers.

Gross Profit

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase	Percent Increase
Gross profit:				
Service	$3,991	$3,179	$ 812	26%
License and subscription	5,002	4,123	879	21%
Total	$8,993	$7,302	$ 1,691	23%
Gross profit (as % of related revenue component):				
Service	51%	47%		
License and subscription	96%	97%		
Total	69%	66%		

The overall improvement of gross profit and gross profit as a percentage of revenue for the year primarily reflects:

- a higher volume of consulting services that improved our cost mix, thus contributing to the increased service gross profit and gross profit margins, and

- a change in revenue mix where both increased and higher margin license revenues constituted a greater percentage of total revenue.

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Operating Expenses

Sales and marketing

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Decrease	Percent Decrease
Sales and marketing	$2,453	$3,740	$ (1,287)	(34)%
Sales and marketing (as % of total revenue)	19%	34%		

The decrease in sales and marketing expense for the year primarily reflects:

a reduction of overall sales and marketing costs resulting from the cost reduction initiatives that began in the second half of 2005 and accelerated further in the second half of 2006,

lower shared-services marketing costs allocated to us due to an increased focus on the Secure ID Business unit, and, to a lesser extent,

a decrease in the costs of our incentive bonus program by $0.2 million, reflecting no bonus accrual for the 2007 period.

Research, development and engineering

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase	Percent Increase
Research, development and engineering	$2,912	$2,448	$ 464	19%
Research, development and engineering (as % of total revenue)	22%	22%		

The increase in research, development and engineering expense for the year reflects:

increased costs to support a growing business and the enhancement of current or new products and solutions being offered to the market, offset by

a decrease in the costs of our incentive bonus program, reflecting no bonus accrual for the 2007 period.

General and administrative

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Decrease	Percent Decrease
General and administrative	$3,345	$3,433	$ (88)	(3)%
General and administrative (as % of total revenue)	26%	31%		

The slight decrease in general and administrative expense for the year reflects a decrease in our incentive bonus program, reflecting no bonus accrual for the 2007 period.

Intellectual property

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase	Percent Increase

Intellectual Property	$1,593	$1,589	$ 4	0%
Intellectual Property (as % of total revenue)	12%	14%		

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Intellectual property expense remained relatively consistent from year to year.

Stock-based compensation

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
Cost of service	$ 102	$ 42	$ 60	143%
Sales and marketing	287	172	115	67%
Research, development and engineering	47	51	(4)	(8)%
General and administrative	728	495	233	47%
Intellectual property	45	30	15	50%
Total	$1,209	$790	$ 419	53%

The increase in stock-based compensation expense for the year was primarily due to an additional layer of stock-based awards expensed pursuant to the adoption of SFAS 123(R).

Other income, net

	Year Ended December 31, 2007	Year Ended December 31, 2006	Dollar Increase	Percent Increase
Other income, net	$1,387	$1,242	$ 145	12%

The increase in other income, net for the year reflects higher average interest rates on our cash and investment balances.

Liquidity and Capital Resources

	Successor December 31, 2008	Predecessor August 1, 2008	Predecessor December 31, 2007
Working capital	$ 41,099	$ 46,502	$ 33,455
Current (liquidity) ratio	11.9:1	3.9:1	10.8:1
Cash, cash equivalents and short-term marketable securities	$ 40,168	$ 54,749	$ 32,713
Long-term marketable securities	$ 5,744		

Cash flow generated by Old Digimarc, which flowed to Digimarc, and improved operating results contributed to our improved cash, cash equivalents, marketable securities and working capital positions over the periods presented. The $5.4 million reduction in working capital from August 1, 2008 to December 31, 2008 related primarily to investing in longer term, marketable securities with maturities of less than two years.

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Operating Cash Flow. The components of operating cash flows were:

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008	Total* Year Ended December 31, 2008	Predecessor Year Ended December 31, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
Net income	$ 76	$ 1,415	$ 1,491	$ 55	$ 1,436	2,611%
Non-cash items	730	1,844	2,574	1,821	753	41%
Changes in operating assets and liabilities	(9,119)	8,951	(168)	(851)	683	80%
Net cash provided by (used in) operating activities	$ (8,313)	$ 12,210	$ 3,897	$ 1,025	$ 2,872	280%

* Used for comparative purposes

Net income (loss). The improved operating results reflect:

- increased revenues reflecting a growing business; offset somewhat by
- higher operational costs incurred by Digimarc compared to the benefits received from the shared services cost allocation methodology in the predecessor financial statements; and
- incentive compensation expense for 2008 aggregating $1.2 million compared to none accrued or paid for 2007.

Non-cash charges. The increase in non-cash charges in each of the comparable periods is primarily the result of:

- increased depreciation and amortization expense primarily as a result of our information technology investments
- increased stock compensation expense as a result of the expensing of the initial layer of stock-based awards pursuant to SFAS 123(R); and
- the impairment write-off of $0.3 million related to an investment in one of our international cash basis customers.

Operating assets and liabilities. The major changes in the operating assets and liabilities for the comparable periods primarily reflect timing differences for:

- the timing and mix of service revenues, which generally carry a longer collection period than license revenues, as well as the collection of receivables related to deferred revenues. Billings for revenues that are made in advance, as provided in our contracts, and the related collections of receivables, result in deferred revenues. The timing of these billings and collections fluctuates and can change from period to period based on individual customer requirements; and the accrual for and payment of liabilities related to payroll and related costs, such as our incentive bonus programs. These costs and associated liabilities are traditionally accrued during each quarterly period and increase throughout each year and then are paid out to participants in the first quarter after each year end. For 2007, there were no incentive bonus accruals and accordingly no incentive bonus payment was made after year end.

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Cash flows from investing activities. The major changes in our investing activities are the result of:

investments made in property and equipment, primarily in our information technology area for computer systems and related equipment used to operate our business;

investments made in the patent application and granting process beginning August 2, 2008; and

net activity from investing our cash and cash equivalents and short- and long-term marketable securities.

Cash flows from financing activities. The major changes in our financing activities are the result of cash transactions associated with Old Digimarc in accordance with the basis of accounting used in our financial statements. Specifically,

all cash received from Old Digimarc's stock activity, primarily from the exercise of stock options, flows through to Digimarc; and

all cash flow generated or used by Old Digimarc flowed into or out of Digimarc.

In 2007, the cash used in financing activities related primarily to funding capital needs of Old Digimarc's Secure ID Business. In 2008, the capital needs of that business unit were lower.

Commitments and Contingencies.

Our significant commitments consist of obligations under non-cancelable operating leases for our facilities, rent and various equipment leases, which totaled $2.3 million as of December 31, 2008 and are payable in monthly installments through July 2011. Our significant commitments and payment obligations under non-cancelable operating leases at December 31, 2008 are as follows:

Contractual Obligations

	Payment Due by Period				
	Total	**Less than 1 year**	**1-3 years**	**3-5 years**	**More than 5 years**
Total contractual obligations	$2,337	$ 856	$ 1,481	$	$

Future Cash Expectations.

We believe that our current cash, cash equivalents, and short-term marketable securities balances will satisfy our projected working capital and capital expenditure requirements for at least the next 12 months. Thereafter, we anticipate continuing to use cash, cash equivalents and short-term marketable securities balances to satisfy our projected working capital and capital expenditure requirements.

We may use cash resources to fund acquisitions or investments in complementary businesses, technologies or product lines. In order to take advantage of opportunities, we may find it necessary to obtain additional equity financing, debt financing, or credit facilities. We do not believe at this time, however, that our long-term working capital and capital expenditures would require us to take steps to remedy any such potential deficiencies. If it were necessary to obtain additional financing or credit facilities, we may not be able to do so, or if these funds are available, they may not be available on satisfactory terms.

Adjusted EBITDA

We define Adjusted EBITDA as net earnings before interest expense, income taxes, depreciation, amortization and non-cash expenditures for stock compensation. Adjusted EBITDA is not a measure of financial performance under GAAP. Management uses Adjusted EBITDA in internal analyses as a

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supplemental measure of our financial performance to assist it in determining performance comparisons against its peer group of companies, as well as capital spending and other investing decisions. Adjusted EBITDA is also a common alternative measure of performance used by investors, financial analysts, and rating agencies to evaluate financial performance. Adjusted EBITDA should not be considered in isolation or as a substitute for net earnings, operating income, cash flows provided by operating activities or other income or cash flow data prepared in accordance with U.S. GAAP and this non-GAAP measure may not be comparable to similarly titled measures of other companies.

The following table presents a reconciliation of Adjusted EBITDA to net earnings:

	Successor	Predecessor	Total*	Predecessor		
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008	Year Ended December 31, 2008	Year Ended December 31, 2007	Dollar Increase (Decrease)	Percent Increase (Decrease)
Net income	$ 76	$ 1,415	$ 1,491	$ 55	$ 1,436	2,611%
Adjustments:						
Provision for income taxes	10	11	21	22	(1)	(5)%
Interest income, net	(462)	(590)	(1,052)	(1,387)	335	24%
Depreciation and amortization	198	568	766	612	154	25%
Stock compensation	532	913	1,445	1,209	236	20%
Adjusted EBITDA	$ 354	$ 2,317	$ 2,671	$ 511	$ 2,160	423%

* Used for comparative purposes

	Predecessor Year Ended December 31, 2007	Predecessor Year Ended December 31, 2006	Dollar Increase (Decrease)	Percent Increase (Decrease)
Net income (loss)	$ 55	$ (2,687)	$ 2,742	202%
Adjustments:				
Provision for income taxes	22	21	1	5%
Interest income, net	(1,387)	(1,255)	(132)	(11)%
Depreciation and amortization	612	616	(4)	(1)%
Stock compensation	1,209	790	419	53%
Adjusted EBITDA	$ 511	$ (2,515)	$ 3,026	220%

The increase in Adjusted EBITDA for both the combined periods January 1, 2008 through August 1, 2008 and August 2, 2008 through December 31, 2008 compared to the year ended December 31, 2007 and for the year ended December 31, 2007 compared to the year ended December 31, 2006 were due primarily to improved operating results from increased revenues as our business has grown.

Off-Balance Sheet Arrangements

We do not have any off-balance sheet arrangements that have or are reasonably likely to have a current or future effect on our financial condition, changes in financial condition, revenue or expenses, results of operations, liquidity, capital expenditures or capital resources that is material to investors.

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Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective the first fiscal year beginning after November 15, 2007. The Company has applied the provisions of this standard regarding the framework of measuring fair value and noted no material effect on the current financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2). FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope, and was effective upon initial adoption of SFAS No. 157. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. We are currently evaluating the impact that SFAS No. 157 will have on our financial statements when it is applied to non-financial assets and non-financial liabilities that are not measured at fair value on a recurring basis, beginning in the first quarter of 2009.

In October 2008, the FASB issued FSP 157-3 "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" (FSP 157-3). FSP 157-3 clarifies the application of SFAS No. 157 in a market that is not active, and addresses application issues such as the use of internal assumptions when relevant observable data does not exist, the use of observable market information when the market is not active, and the use of market quotes when assessing the relevance of observable and unobservable data. FSP 157-3 is effective for all periods presented in accordance with SFAS No. 157. The adoption of FSP 157-3 did not have a significant impact on our financial statements or the fair values of our financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for the Financial Assets and Financial Liabilities,* which permits entities to choose to measure certain financial assets and liabilities at fair value. SFAS No. 159 is effective the first fiscal year beginning after November 15, 2007. The Company has elected not to measure certain financial assets and liabilities at fair value as permitted by SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "*Business Combinations*" (SFAS No. 141(R)). Under SFAS No. 141(R), an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred; that restructuring costs generally be expensed in periods subsequent to the acquisition date; and that changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be recognized as a component of provision for taxes. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. The provisions of SFAS No. 141(R) are applicable to business combinations consummated in fiscal years beginning on or after December 15, 2008. Early application is prohibited. The provision of SFAS No. 141(R) will have a significant impact in the accounting for future business combinations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements-on Amendment of ARB No. 51*. SFAS No. 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary. SFAS No. 160 is effective for financial

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statements issued for fiscal years beginning after December 15, 2008, and interim statements within those fiscal years. Among other things, SFAS No. 160 requires non-controlling interest to be included as a component of shareholders' equity. The Company does not currently have any material non-controlling interests.

Staff Accounting Bulletin 110 (SAB 110), *Shared-Based Payment*, issued by the U.S. Securities and Exchange Commission (SEC) was effective for us beginning in the first quarter of 2008. SAB 110 amends the SEC's views discussed in Staff Accounting Bulletin 107 (SAB 107) regarding the use of the simplified method in developing estimates of the expected lives of share options in accordance with SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123(R)). The amendment, in part, allowed the continued use, subject to specific criteria, of the simplified method in estimating expected lives of share options granted after December 31, 2007. We will continue to use the simplified method until we have the historical data necessary to provide reasonable estimates of expected lives in accordance with SAB 107, as amended by SAB 110.

In April 2008, the FASB issued FSP No. 142-3 *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of this Staff Position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (revised 2007), *Business Combinations*, and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company does not expect the adoption of this Staff Position to have a material effect on its financial position, results of operations or cash flows.

Forward-Looking Statements

This Annual Report on Form 10-K includes "forward-looking statements" within the meaning of Section 21E of the Securities Exchange Act of 1934 and Section 27A of the Securities Act of 1933. Words such as "may," "plan," "should," "could," "expect," "anticipate," "intend," "believe," "project," "forecast," "estimate," "continue," variations of such terms or similar expressions are intended to identify such forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. These forward-looking statements, or other statements made by us, are made based on our expectations and beliefs concerning future events impacting us, and are subject to uncertainties and factors (including those specified below), which are difficult to predict and, in many instances, are beyond our control. As a result, our actual results could differ materially from those expressed in or implied by any such forward-looking statements, and investors are cautioned not to place undue reliance on such statements. We believe that the following factors, among others (including those described in "Item 1A. Risk Factors"), could affect our future performance and the liquidity and value of our securities and cause our actual results to differ materially from those expressed or implied by forward-looking statements made by us or on our behalf:

- concentration of revenues with few customers comprising a large majority of the revenues;
- trends and expectations in revenue growth;
- our future level of investment in our business, including investment in development of products and technology, acquisition of new customers and development of new market opportunities;
- our ability to improve margins;
- anticipated expenses, costs, margins and investment activities in the foreseeable future;
- anticipated revenue to be generated from current contracts and as a result of new programs;

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- our profitability in future periods;
- business opportunities that could require that we seek additional financing;
- the size and growth of our markets;
- the existence of international growth opportunities and our future investment in such opportunities;
- the source of our future revenue;
- our expected short-term and long-term liquidity positions;
- our ability to fund our working capital needs through cash flow from operations;
- capital market conditions, including the recent economic crisis, interest rate volatility and other limitations on the availability of capital, which could have an impact on our cost of capital and our ability to access the capital markets
- our use of cash in upcoming quarters;
- anticipated levels of backlog and bid activity in future periods; and
- other risks detailed in our filings with the Securities and Exchange Commission, including the risk factors set forth in "Item 1A. Risk Factors."

Investors should understand that it is not possible to predict or identify all risk factors and that there may be other factors that may cause our actual results to differ materially from the forward-looking statements. All forward-looking statements made by us or by persons acting on our behalf apply only as of the date of this Annual Report. We do not undertake any obligation to publicly update or revise any forward-looking statements to reflect future events, information or circumstances that arise after the date of the filing of this Annual Report on Form 10-K.

ITEM 7A: QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Our exposure to market risk for changes in interest rates relates primarily to the increase or decrease in the amount of interest income we can earn on our investment portfolio and on the increase or decrease in the amount of any interest expense we must pay with respect to outstanding debt instruments. The risk associated with fluctuating interest expense is limited, however, to the exposure related to those debt instruments and credit facilities that are tied to market rates. We do not plan to use derivative financial instruments in our investment portfolio. We plan to ensure the safety and preservation of our invested principal funds by limiting default risk, market risk and investment risk. We plan to mitigate default risk by investing in low-risk securities. At December 31, 2008, we had an investment portfolio of money market funds, commercial securities and U.S. Government securities, including those classified as cash and cash equivalents, and short- and long-term marketable securities, of $18.9 million. The original maturities of our investment portfolio range from 44 to 547 days with an average interest rate of 2.1%. We had capital lease obligations of approximately $39 at December 31, 2008. If market interest rates were to increase immediately and uniformly by 10% from levels as of December 31, 2008, the decline of the fair market value of the fixed income portfolio and interest expense associated with capital leases would not be material. To a lesser extent, we are also subject to foreign currency exchange risk in the form of exposures to fluctuations in currency exchange rates.

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ITEM 8: FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

Our Financial Statements and the accompanying Notes that are filed as part of this Annual Report are listed under Part IV, Item 15, Exhibits and Financial Statement Schedules and are set forth beginning on page F-1 immediately following the signature page of this Form 10-K.

ITEM 9: CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A(T): CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures

Our management, with the participation of our Chief Executive Officer and Chief Financial Officer, have evaluated the effectiveness of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) of the Securities Exchange Act of 1934) as of the end of the period covered by this Form 10-K. Based on that evaluation, our Chief Executive Officer and Chief Financial Officer have concluded that our disclosure controls and procedures, as of the end of the period covered by this Form 10-K, were effective in ensuring that information required to be disclosed by us in reports that we file or submit under the Securities Exchange Act of 1934 is (i) recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (ii) accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate to allow timely decisions regarding required disclosure.

Management's Report on Internal Control Over Financial Reporting

This Annual Report does not include a report of management's assessment regarding internal control over financial reporting or an attestation report of the company's registered public accounting firm due to a transition period established by rules of the Securities and Exchange Commission for new public companies.

Changes in Internal Control Over Financial Reporting

There was no change in our internal control over financial reporting (as defined in Rule 13a-15(f) and 15d-15(f) of the Securities Exchange Act of 1934) that occurred during the year ended December 31 2008 that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

ITEM 9B: OTHER INFORMATION

None.

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PART III

Certain information required by Part III of this Annual Report on Form 10-K is incorporated herein by reference to the Proxy Statement for our 2009 annual meeting of stockholders, which we intend to file no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K.

ITEM 10: DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Code of Ethics

We have adopted a Code of Business Conduct that applies to our principal executive officer, principal financial officer and controller, as well as a Code of Ethics for Financial Professionals that applies to our principal financial officer and controller. We have made these codes available in the Corporate Governance section of our website at *www.digimarc.com/about/governance*. If we waive, or implicitly waive, any material provision of the codes, or substantively amend the codes, we will disclose that fact on our website within four business days.

The other information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K under the captions "Election of Directors," "Report of the Governance and Nominating Committee of the Board of Directors Audit Committee," and "Section 16(a) Beneficial Ownership Reporting Compliance."

ITEM 11: EXECUTIVE COMPENSATION

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, under the captions "Director Compensation," "Compensation Committee Interlocks and Insider Participation," "Compensation Committee Report" and "Executive Compensation."

ITEM 12: SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDER MATTERS

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, under the captions "Security Ownership of Certain Beneficial Owners and Management" and "Equity Compensation Plan Information."

ITEM 13: CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K under the caption "Election of Directors Determination of Independence, and "Related Person Transactions."

ITEM 14: PRINCIPAL ACCOUNTANT FEES AND SERVICES

The information required by this item is incorporated herein by reference to the information in the Proxy Statement, which we intend to file with the SEC no later than 120 days after the end of the fiscal year covered by this Annual Report on Form 10-K, under the caption "Audit Fees."

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ITEM 15: EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(a)(1) Financial Statements

The following documents are filed as part of this Annual Report on Form 10-K:

(i) Report of Independent Registered Public Accounting Firm

(ii) Balance Sheets as of December 31, 2008, August 1, 2008 and December 31, 2007

(iii) Statements of Operations for the Period August 2, 2008 through December 31, 2008, for the Period January 1, 2008 through August 1, 2008 and for the years ended December 31, 2007 and 2006

(iv) Statements of Stockholders' Equity as of December 31, 2008, August 1, 2008 and December 31, 2007

(v) Statements of Cash Flows for the Period August 2, 2008 through December 31, 2008, for the Period January 1, 2008 through August 1, 2008 and for the years ended December 31, 2007 and 2006

(vi) Notes to Financial Statements

(a)(2) Financial Statement Schedules

All schedules have been omitted since they are not required or are not applicable or the required information is shown in the financial statements or related notes.

(a)(3) Exhibits

See the Exhibit Index at page E-1 of this Annual Report on Form 10-K.

In reviewing the agreements included as exhibits to this Annual Report on Form 10-K, please remember they are included to provide you with information regarding their terms and are not intended to provide any other factual or disclosure information about Digimarc or the other parties to the agreements. The agreements may contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other party or parties to the applicable agreement and:

- should not in all instances be treated as categorical statements of fact, but rather as a means of allocating the risk to one of the parties if those statements prove to be inaccurate;

- may have been qualified by disclosures that were made to the other party or parties in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;

- may apply standards of materiality in a manner that is different from what may be viewed as material to you or other investors; and were made only as of the date of the applicable agreement or other date or dates that may be specified in the agreement and are subject to more recent developments.

Accordingly, there representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time. Additional information about Digimarc may be found elsewhere in this Annual Report on Form 10-K and in Digimarc's other public filings, which are available without charge through the SEC's website at *http://www.sec.gov*.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

DIGIMARC CORPORATION

Date: February 27, 2009	By:	/s/ MICHAEL MCCONNELL
		Michael McConnell *Title: Chief Financial Officer*

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

Signature	Title	Date
/s/ BRUCE DAVIS Bruce Davis	Chief Executive Officer and Chairman of the Board of Directors (Principal Executive Officer)	February 27, 2009
/s/ MICHAEL MCCONNELL Michael McConnell	Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)	February 27, 2009
/s/ PETER W. SMITH Peter W. Smith	Director	February 27, 2009
/s/ JAMES T. RICHARDSON James T. Richardson	Director	February 27, 2009
/s/ WILLIAM J. MILLER William J. Miller	Director	February 27, 2009
/s/ BERNARD WHITNEY Bernard Whitney	Director	February 27, 2009

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DIGIMARC CORPORATION INDEX TO FINANCIAL STATEMENTS

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Digimarc Corporation

We have audited the accompanying balance sheet of Digimarc Corporation (a Delaware corporation) as of December 31, 2008 and the related statements of operations, stockholders' equity, and cash flows for the period from August 2, 2008 through December 31, 2008. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Digimarc Corporation as of December 31, 2008, and the results of their operations and cash flows for the period from August 2, 2008 through December 31, 2008 in conformity with accounting principles generally accepted in the United States of America.

/S/ GRANT THORNTON LLP

Portland, Oregon
February 27, 2009

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Report of Independent Registered Public Accounting Firm

Board of Directors and Stockholders
Digimarc Corporation

We have audited the accompanying balance sheet of New Digimarc Corporation (the "Predecessor", a carved-out business unit of Old Digimarc Corporation) as of December 31, 2007 and the related statements of operations, stockholders' equity, and cash flows for each of the two years in the period ended December 31, 2007. These financial statements are the responsibility of the Predecessor's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Predecessor is not required to have, nor were we engaged to perform an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Predecessor's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Predecessor as of December 31, 2007, and the results of their operations and cash flows for each of the two years in the period ended December 31, 2007 in conformity with accounting principles generally accepted in the United States of America.

As more fully described in Note 1 to the financial statements, certain expenses of the Predecessor represent allocations from Old Digimarc Corporation. The accompanying financial statements include such allocations and may not necessarily be representative of the financial position or results of operations had the Predecessor operated as an unaffiliated company during the periods presented.

/S/ GRANT THORNTON LLP

Portland, Oregon
June 20, 2008

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DIGIMARC CORPORATION

BALANCE SHEETS

(In thousands, except share data)

	Successor December 31, 2008	Predecessor August 1, 2008 (unaudited)	Predecessor December 31, 2007
ASSETS			
Current assets:			
Cash and cash equivalents	$ 18,928	$ 50,900	$ 29,145
Marketable securities	21,240	3,849	3,568
Trade accounts receivable, net	3,839	3,077	3,752
Other current assets	875	4,757	387
Total current assets	44,882	62,583	36,852
Marketable securities	5,744		
Property and equipment, net	1,212	1,341	1,227
Intangibles, net	456		
Other assets, net	147	187	372
Total assets	$ 52,441	$ 64,111	$ 38,451
LIABILITIES AND STOCKHOLDERS' EQUITY			
Current liabilities:			
Accounts payable and other accrued liabilities	$ 937	$ 1,208	$ 464
Accrued payroll and related costs	42	2,053	199
Accrued merger related liabilities	386	10,766	
Deferred revenue	2,418	2,054	2,734
Total current liabilities	3,783	16,081	3,397
Long-term liabilities	257	237	215
Total liabilities	4,040	16,318	3,612
Commitments and contingencies (Note 14)			
Stockholders' equity:			
Net parent's investment		47,793	34,839
Preferred stock (10,000 shares issued and outstanding at December 31, 2008)	50		
Common stock (7,279,442 shares issued and outstanding at December 31, 2008)	7		
Additional paid-in capital	48,268		
Retained earnings	76		
Total stockholders' equity	48,401	47,793	34,839
Total liabilities and stockholders' equity	$ 52,441	$ 64,111	$ 38,451

See Notes to Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008 (unaudited)	Predecessor Year Ended December 31, 2007	Predecessor Year Ended December 31, 2006
Revenue:				
Service	$ 4,064	$ 6,456	$ 7,806	$ 6,812
License and subscription	3,768	5,494	5,219	4,259
Total revenue	7,832	11,950	13,025	11,071
Cost of revenue:				
Service	2,248	3,519	3,815	3,633
License and subscription	114	145	217	136
Total cost of revenue	2,362	3,664	4,032	3,769
Gross profit	5,470	8,286	8,993	7,302
Operating expenses:				
Sales and marketing	1,154	1,928	2,453	3,740
Research, development and engineering	1,772	2,071	2,912	2,448
General and administrative	2,877	2,349	3,345	3,433
Intellectual property	304	1,102	1,593	1,589
Transitional services	(280)			
Total operating expenses	5,827	7,450	10,303	11,210
Operating income (loss)	(357)	836	(1,310)	(3,908)
Other income, net	443	590	1,387	1,242
Income (loss) before provision for income taxes	86	1,426	77	(2,666)
(Provision) benefit for income taxes	(10)	(11)	(22)	(21)
Net income (loss)	$ 76	$ 1,415	$ 55	$ (2,687)
Earnings per share:				
Net income per share basic	$ 0.01			
Net income per share diluted	$ 0.01			
Weighted average shares outstanding basic	7,156			
Weighted average shares outstanding diluted	7,156			
Pro-forma earnings (loss) per share:				
Net income (loss) per share basic		$ 0.20	$ 0.01	$ (0.38)
Net income (loss) per share diluted		$ 0.20	$ 0.01	$ (0.38)
		7,143	7,143	7,143

Weighted average shares outstanding basic			
Weighted average shares outstanding diluted	7,143	7,143	7,143

See Notes to Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF STOCKHOLDERS' EQUITY

(In thousands, except share data)

	Preferred stock Shares	Preferred stock Amount	Common stock Shares	Common stock Amount	Additional paid-in capital	Retained Earnings	Net Parent Investment	Total stockholders' equity
PREDECESSOR								
BALANCE AT DECEMBER 31, 2007		$		$	$	$	$ 34,839	$ 34,839
Cash from Parent stock activity							23,862	23,862
Stock compensation allocated from Parent							914	914
Net activity with Parent							(13,237)	(13,237)
Net income							1,415	1,415
BALANCE AT AUGUST 1, 2008, (unaudited)		$		$	$	$	$ 47,793	$ 47,793
SUCCESSOR								
August 2, 2008: Stock issued through spin-off of Digimarc	10,000	$ 50	7,143,442	$ 7	$ 47,736	$	$ (47,793)	$
Issuance of common stock			15,000					
Issuance of restricted common stock			121,000					
Stock compensation expense					532			532
Net income						76		76
BALANCE AT DECEMBER 31, 2008	10,000	$ 50	7,279,442	$ 7	$ 48,268	$ 76	$	$ 48,401

See Notes to Financial Statements.

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DIGIMARC CORPORATION

STATEMENTS OF CASH FLOWS

(In thousands)

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008 (unaudited)	Predecessor Year Ended December 31, 2007	Predecessor Year Ended December 31, 2006
Cash flows from operating activities:				
Net income (loss)	$ 76	$ 1,415	$ 55	$ (2,687)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:				
Depreciation and amortization	198	568	612	616
Stock-based compensation expense	532	913	1,209	790
Increase (decrease) in allowance for doubtful accounts		(43)		(13)
Other non-cash charges		405		
Changes in operating assets and liabilities:				
Trade accounts receivable, net	(762)	718	(1,311)	199
Other current assets	3,882	(4,370)	(78)	63
Other assets, net	40	(103)	(9)	
Accounts payable and other accrued liabilities	(272)	744	23	(147)
Accrued payroll and related costs	(2,011)	1,854	(574)	(206)
Accrued merger related liabilities	(10,380)	10,766		
Deferred revenue	366	(677)	(1,098)	(382)
Other liabilities	24	20		
Net cash provided by (used in) operating activities	(8,307)	12,210	1,025	(1,767)
Cash flows from investing activities:				
Purchase of property and equipment	(76)	(799)	(367)	(536)
Capitalized patent costs	(448)			
Sale or maturity of marketable securities	95,553	136,767	150,775	136,946
Purchase of marketable securities	(118,688)	(137,048)	(154,343)	(136,207)
Net cash provided by (used in) investing activities	(23,659)	(1,080)	(3,935)	203
Cash flows from financing activities:				
Cash from Parent stock activity		23,862	2,187	242
Net activity with Parent		(13,237)	(3,205)	3,152
Principal payments under capital lease obligations	(6)			
Net cash provided by (used in) financing activities	(6)	10,625	(1,018)	3,394
Net increase (decrease) in cash and cash equivalents	(31,972)	21,755	(3,928)	1,830
Cash and cash equivalents at beginning of period	50,900	29,145	33,073	31,243
	$ 18,928	$ 50,900	$ 29,145	$ 33,073

Cash and cash equivalents at end of period								
Supplemental disclosure of cash flow information:								
Cash paid for interest	$	2	$	7	$		$	
Cash paid for income taxes	$	10	$	11	$		$	

See Notes to Financial Statements.

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies

Description of Business

Digimarc Corporation ("Digimarc" or the "Company") enables governments and enterprises around the world to give digital identities to media and objects that computers can sense and recognize and to which they can react. The Company's technology provides the means to infuse persistent digital information, perceptible only to computers and digital devices, into all forms of media content. The unique digital identifier placed in media generally persists with it regardless of the distribution path and whether it is copied, manipulated or converted to a different format, and does not affect the quality of the content or the enjoyment or other traditional uses of it. The Company's technology permits computers and digital devices to quickly identify relevant data from vast amounts of media content.

Acquisition of Old Digimarc and Separation of DMRC Corporation

On June 29, 2008, the former Digimarc Corporation ("Old Digimarc") entered into an amended and restated merger agreement, as amended by Amendment No. 1 dated as of July 17, 2008, which we refer to as the Old Digimarc/L-1 merger agreement, with L-1 Identity Solutions, Inc. and Dolomite Acquisition Co., a wholly owned subsidiary of L-1, pursuant to which Dolomite, in a transaction which we refer to as the offer, purchased more than 90% of the outstanding shares of Old Digimarc common stock, together with the associated preferred stock purchase rights, for $12.25 per share. On August 13, 2008, following the completion of the offer, Dolomite merged with and into Old Digimarc with Old Digimarc continuing as the surviving company and a wholly owned subsidiary of L-1.

On August 1, 2008, prior to the initial expiration of the offer, Old Digimarc contributed all of the assets and liabilities related to its digital watermarking business, which we refer to as the Digital Watermarking Business, together with all of Old Digimarc's cash, to DMRC LLC. Following the restructuring, all of the limited liability company interests of DMRC LLC were transferred to a newly created trust for the benefit of Old Digimarc record holders. DMRC LLC then merged with and into DMRC Corporation, and each limited liability company interest of DMRC LLC was converted into one share of common stock of DMRC Corporation. After completion of the Old Digimarc/L-1 merger, DMRC Corporation changed its name to Digimarc Corporation. The shares of Digimarc common stock were held by the trust until the Form 10, *General Form for Registration of Securities*, was declared effective by the Securities and Exchange Commission ("SEC") on October 16, 2008, at which time the shares were distributed to Old Digimarc record holders, as beneficiaries of the trust, pro rata in accordance with their ownership of shares of Old Digimarc common stock on August 1, 2008 at 5:30 pm Eastern time, the spin-off record date and time. Each Old Digimarc record holder was entitled to receive one share of Digimarc common stock for every three and one half shares of Old Digimarc common stock held by the stockholder as of the spin-off record date and time.

Basis of Accounting; Predecessor Financial Statements

The predecessor financial statements include certain accounts of Old Digimarc and the assets, liabilities and results of operations of Old Digimarc's Digital Watermarking Business that were separated, or "carved-out" from Old Digimarc. The operating expenses included in the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of the expenses was not practicable. The common costs include expenses from Old Digimarc related to various operating shared services cost centers, including

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies (Continued)

executive, finance and accounting, human resources, legal, marketing, intellectual property, facilities and information technology.

Management believes that the assumptions underlying the predecessor financial statements are reasonable. The cost allocation methods applied to certain shared services common cost centers include the following:

Specific identification. Where the amounts were specifically identified to the predecessor or Old Digimarc's Secure ID Business, they were classified accordingly.

Reasonable allocation. Where the amounts were not clearly or specifically identified, management determined if a reasonable allocation method could be applied. For example, in the shared services human resources ("HR") cost center, management allocated the costs based on the relative headcount of the predecessor and Old Digimarc's Secure ID Business. This allocation was based on the assumption that HR support costs should be relatively equal per employee. In the intellectual property cost center, management allocated the costs based on the relative number of patents that were used by each business.

General allocation approach. For consistency, when specific identification or the reasonable allocation method did not seem to fit the situation, management used a general allocation approach. This approach consisted of a blended rate based on what management determined to be the primary drivers for shared services:

Revenue ratio between the businesses.

Property and equipment balances, which served as a proxy for capital expenditures. The effort expended on capital projects is a factor in the expense and effort of shared services. To avoid fluctuations that occur in capital spending, management believes that these allocated balances represent a relative trend of capital spending between the businesses. In determining the relative balances of property, management excluded the central information technology assets because they supported the entire organization.

Headcount between the businesses.

Other key assumptions differing from the historical accounting of Old Digimarc:

Cash: All cash balances of Old Digimarc are treated as retained by Digimarc, consistent with the merger agreement between Old Digimarc and L-1. Accordingly, restricted cash on the books of Old Digimarc that related directly to its operations flowed through to Digimarc in these financial statements as non-restricted cash included in cash and cash equivalents in the predecessor financial statements. The letters of credit that required the restricted cash remained with Old Digimarc following its acquisition by L-1.

Incentive compensation allocations to cost of services: Cost of incentive compensation related to bonus and stock compensation charges for employees in the research, development and engineering cost centers was not considered significant to Old Digimarc's consolidated operations during the periods reported and were treated as research, development and engineering costs in Old Digimarc's financial statements. For Digimarc's reporting purposes,

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies (Continued)

these incentive compensation costs have been allocated to cost of services to the extent that their pro rata salary allocations were made to the cost of services expense category. The impact for the reported periods ranged from a 1% to 3% reduction in margins compared to the results had the allocations not been made.

Pro-forma earnings (loss) per share (unaudited): The weighted average shares outstanding basic and diluted of 7,143,442 was calculated based on a distribution ratio of one share of Digimarc common stock for every three and one-half shares of Old Digimarc common stock, excluding shares held in treasury, outstanding at August 1, 2008, the date of the spin-off of Digimarc from Old Digimarc.

Stock activity: All stock activity (transactions from stock options, restricted stock, employee stock purchase plan and stock compensation) was carried on the books of Old Digimarc. All net cash from these activities was retained by Digimarc and stock-based compensation expense associated with stock activity was allocated to the predecessor in accordance with the basis of accounting methodology outlined above.

Capital leases: Digimarc shares various infrastructure activities with Old Digimarc and was charged for its allocated share of capital lease costs in the form of allocated depreciation and interest expense. The assets and liabilities associated with the capital leases were carried on the books of Old Digimarc.

Leasehold improvements: Digimarc occupies the majority of Old Digimarc's Beaverton facility and assumed the lease and most all related furniture, fixtures and leasehold improvements when Old Digimarc completed the spin-off of Digimarc. The leasehold was recorded as part of property and equipment on the balance sheet of Digimarc, and as a result, pro rata depreciation and rent expenses were allocated to Old Digimarc.

Intercompany transactions: With the retention by Digimarc of all of Old Digimarc cash, Digimarc's cash balances effectively funded the operations, if needed, of Old Digimarc. The net difference of cash needs for operating and capital expenditures to and from Old Digimarc is shown as "net activity with Parent" in the Statement of Stockholders' Equity. All intercompany transactions were eliminated.

Merger related costs: All Old Digimarc costs related to the merger of Old Digimarc with L-1 were allocated to Old Digimarc. Digimarc was responsible for the payment of the majority of these costs.

Commitments and contingencies: Commitments and contingencies related to the predecessor operations are included in these financial statements, and those relating to Old Digimarc were excluded.

Stock compensation expense: Stock-based compensation is accounted for in accordance with Statement of Financial Accounting Standards ("SFAS") No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock- based awards made to employees and directors, including stock options, employee stock purchases under a stock purchase plan and restricted stock awards based on estimated fair

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies (Continued)

values. Stock compensation expense was allocated to the predecessor based on a combination of specific and shared services resource allocations from Old Digimarc.

The financial information in the predecessor financial statements does not include all of the expenses that would have been incurred had the predecessor been a separate, stand-alone public entity. As such, the predecessor financial information does not reflect the financial position, results of operations and cash flows of Digimarc's current business, had the predecessor operated as a separate, stand-alone public entity during the periods presented in the predecessor financial statements. Additionally, the predecessor financial statements include proportional allocations of various shared services common costs of Old Digimarc because specific identification of these expenses was not practicable. It is expected that the initial operating costs of Digimarc on a stand-alone basis will be higher than those allocated to the predecessor operations under the shared services methodology applied in the predecessor financial statements. Consequently, the financial position, results of operations and cash flows reflected in the predecessor financial statements may not be indicative of those that would have been achieved had the predecessor operated as a separate, stand-alone entity for the periods reflected in the predecessor financial statements.

Use of Estimates

The preparation of financial statements in accordance with accounting principles generally accepted in the U.S. requires Digimarc to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses, and related disclosure of contingent assets and liabilities. Certain of the Company's accounting policies require higher degrees of judgment than others in their application. These include revenue recognition on long-term service contracts, impairments and estimation of useful lives of long-lived assets and patent costs, contingencies and litigation and stock-based compensation. Digimarc bases its estimates on historical experience and on various other assumptions that are believed to be reasonable in the circumstances, the results of which form the basis for making judgments about the carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates under different assumptions or conditions.

Cash Equivalents

The Company considers all highly liquid marketable securities with original maturities of 90 days or less at the date of acquisition to be cash equivalents. Cash equivalents include money market funds, certificates of deposit, commercial paper, and investments in government bonds totaling $18,928, $50,900 (unaudited) and $29,145 at December 31, 2008, August 1, 2008 and December 31, 2007, respectively. Cash equivalents are carried at cost or amortized cost, which approximates market.

Marketable Securities

The Company considers all investments with original maturities over 90 days that mature in less than one year to be short-term marketable securities. Both short- and long-term marketable securities include federal agency notes, company notes, and commercial paper. The Company's marketable securities are classified as held-to-maturity as of the balance sheet date and are reported at amortized

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies (Continued)

cost, which approximates market. The book value of these investments approximates fair market value and, accordingly, no amounts have been recorded to other comprehensive income.

A decline in the market value of any security below cost that is deemed to be other-than-temporary results in a reduction in carrying amount of fair value. The impairment is charged to earnings and a new cost basis for the security is established. To determine whether an impairment is other-than-temporary, the Company considers whether it has the ability and intent to hold the investment until a market price recovery and considers whether evidence indicating that the cost of the investment is recoverable outweighs evidence to the contrary. There have been no other-than-temporary impairments identified or recorded by the Company.

Premiums and discounts are amortized or accreted over the life of the related security as an adjustment to yield using a method that approximates the effective-interest method. Under this method, dividend and interest income are recognized when earned.

Fair Value of Financial Instruments

The carrying amounts of cash and cash equivalents, short- and long-term marketable securities, trade accounts receivable, accounts payable and accrued payroll approximate fair value due to the short-term nature of these instruments. The carrying amounts of capital leases approximate fair value because the stated interest rates approximate current market rates. Fair value estimates are made at a specific point in time, based on relevant market information about the financial instrument when available. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and, therefore, cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Concentrations of Business and Credit Risk

A significant portion of our business depends on a limited number of large contracts. The loss of any large contract may result in loss of revenue and margin on a prospective basis.

Financial instruments that potentially subject Digimarc to concentrations of credit risk consist primarily of cash and cash equivalents, marketable securities, and trade accounts receivable. Digimarc places its cash and cash equivalents with major banks and financial institutions and at times deposits may exceed insured limits. Other than cash used for operating needs, which may include short-term marketable securities with our principal banks, our investment policy limits its credit exposure to any one financial institution or type of financial instrument by limiting the maximum of 5% or $1,000, whichever is greater, to be invested in any one issuer except for the U.S. Government and U.S. federal agencies, which have no limits, at the time of purchase.

Software Development Costs

Under SFAS No. 86, *Accounting for the Cost of Computer Software to Be Sold, Leased, or Otherwise Marketed,* software development costs are to be capitalized beginning when a product's technological feasibility has been established and ending when a product is made available for general release to customers. To date, the establishment of technological feasibility of the Company's products has occurred shortly before general release and, therefore, software development costs qualifying for

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies (Continued)

capitalization have been immaterial. Accordingly, the Company has not capitalized any software development costs and has charged all such costs to research and development expense.

Impairment of Long-Lived Assets

The Company accounts for long-lived assets in accordance with the provisions of Statement of Financial Accounting Standards ("SFAS") No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*. This statement requires that long-lived assets and certain identifiable intangibles be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to future net undiscounted cash flows expected to be generated by the asset. If such assets are considered to be impaired, the impairment to be recognized is measured by the amount by which the carrying amount of the assets exceeds the fair value of the assets. Fair value is determined based on discounted cash flows or appraised values, depending on the nature of the asset. Assets to be disposed of are reported at the lower of the carrying amount or fair value less costs to sell.

Research and Development

Research and development costs are expensed as incurred as defined in SFAS No. 2, *Accounting for Research and Development Costs*. Digimarc accounts for amounts received under its funded research and development arrangements in accordance with the provisions of SFAS No. 68, *Research and Development Arrangements*. Under the terms of the arrangements, Digimarc is not obligated to repay any of the amounts provided by the funding parties. As a result, Digimarc recognizes revenue as the services are performed.

Patent Costs

Effective August 2, 2008, costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at award date, which varies depending on the pendency period of the application, generally approximating seventeen years. Capitalized patent costs include internal legal labor, professional legal fees, government filing fees and translation fees related to obtaining the Company's patent portfolio. Such costs were expensed in the predecessor financial statements.

Effective August 2, 2008, costs associated with the maintenance and annuity fees of patents are accounted for as prepaid assets at the time of payment and amortized over the respective periods, generally from one to four years. These costs were expensed in the predecessor financial statements.

Revenue Recognition

The Company's revenue consists of service revenue and license and subscription revenue, which includes term-based software licenses, royalties and revenues from the licensing of digital watermarking products. The Company's revenue recognition policy follows SEC Staff Accounting Bulletin ("SAB") No. 104 *Revenue Recognition,* SOP No. 97-2, *Software Revenue Recognition,* as amended by SOP No. 98-9, *Modification of SOP No. 97-2, Software Recognition, With Respect to Certain Transactions,*

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(1) Description of Business and Summary of Significant Accounting Policies (Continued)

SOP 81-1 *Accounting for the Performance of Construction Type and Certain Production-Type Contracts,* and Emerging Issues Task Force ("EITF") Issue No. 00-21, *Revenue Arrangements with Multiple Deliverables.*

Other income (expense), net

The Company's other income (expense), net consists primarily of interest income earned on cash and marketable securities. Some minor amounts are included in this category that relate to interest expense for capital lease allocations from Old Digimarc and for other non-operating items.

Stock-Based Compensation

On August 2, 2008, the Company adopted SFAS No. 123(R), *Share-Based Payment (Revised 2004)*, which requires the measurement and recognition of compensation for all stock-based awards made to employees and directors including stock options and employee stock purchases under a stock purchase plan based on estimated fair values. SFAS 123(R) supersedes previous accounting under Accounting Principles Board ("APB") Opinion No. 25, *Accounting for Stock Issued to Employees*, for periods beginning in fiscal 2006. In March 2005, the Securities and Exchange Commission issued SAB No. 107 relating to application of SFAS 123(R). The Company has applied the provisions of SAB 107 in the adoption of SFAS 123(R).

The Company adopted SFAS 123(R), which requires the application of the accounting standard as of August 2, 2008, the first day of its 2008 fiscal year. The Company uses the Black-Scholes option pricing model as its method of valuation for stock-based awards. The Company's determination of the fair value of stock-based awards on the date of grant using an option pricing model is affected by our stock price as well as assumptions regarding a number of highly complex and subjective variables. These variables include, but are not limited to, the expected life of the award, our expected stock price volatility over the term of the award and actual and projected exercise behaviors. Although the fair value of stock-based awards is determined in accordance with SFAS 123(R) and SAB 107, the Black-Scholes option pricing model requires the input of highly subjective assumptions, and other reasonable assumptions could provide differing results.

Income Taxes

The Company accounts for income taxes under the asset and liability method. Under the asset and liability method, deferred income taxes reflect the future tax consequences of differences between the tax bases of assets and liabilities and their financial reporting amounts at each year-end. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date. Valuation allowances are established when necessary to reduce tax assets to the amount expected to be realized.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(2) Recent Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued SFAS No. 157, *Fair Value Measurements,* which defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value. This statement does not require any new fair value measurements, but provides guidance on how to measure fair value by providing a fair value hierarchy used to classify the source of the information. SFAS No. 157 is effective the first fiscal year beginning after November 15, 2007. The Company has applied the provisions of this standard regarding the framework of measuring fair value and noted no material effect on the current financial statements.

In February 2008, the FASB issued FASB Staff Position (FSP) 157-1, "Application of FASB Statement No. 157 to FASB Statement No. 13 and Other Accounting Pronouncements That Address Fair Value Measurements for Purposes of Lease Classification or Measurement under Statement 13" (FSP 157-1) and FSP 157-2, "Effective Date of FASB Statement No. 157" (FSP 157-2). FSP 157-1 amends SFAS No. 157 to remove certain leasing transactions from its scope, and was effective upon initial adoption of SFAS No. 157. FSP 157-2 delays the effective date of SFAS No. 157 for all non-financial assets and non-financial liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until the beginning of the first quarter of fiscal 2009. We are currently evaluating the impact that SFAS No. 157 will have on our financial statements when it is applied to non-financial assets and non-financial liabilities that are not measured at fair value on a recurring basis, beginning in the first quarter of 2009.

In October 2008, the FASB issued FSP 157-3 "Determining the Fair Value of a Financial Asset When the Market for That Asset Is Not Active" (FSP 157-3). FSP 157-3 clarifies the application of SFAS No. 157 in a market that is not active, and addresses application issues such as the use of internal assumptions when relevant observable data does not exist, the use of observable market information when the market is not active, and the use of market quotes when assessing the relevance of observable and unobservable data. FSP 157-3 is effective for all periods presented in accordance with SFAS No. 157. The adoption of FSP 157-3 did not have a significant impact on our financial statements or the fair values of our financial assets and liabilities.

In February 2007, the FASB issued SFAS No. 159, *The Fair Option for the Financial Assets and Financial Liabilities,* which permits entities to choose to measure certain financial assets and liabilities at fair value. SFAS No. 159 is effective the first fiscal year beginning after November 15, 2007. The Company has elected not to measure certain financial assets and liabilities at fair value as permitted by SFAS No. 159.

In December 2007, the FASB issued SFAS No. 141 (revised 2007), "*Business Combinations*" (SFAS No. 141(R)). Under SFAS No. 141(R), an entity is required to recognize the assets acquired, liabilities assumed, contractual contingencies, and contingent consideration at their fair value on the acquisition date. It further requires that acquisition-related costs be recognized separately from the acquisition and expensed as incurred; that restructuring costs generally be expensed in periods subsequent to the acquisition date; and that changes in accounting for deferred tax asset valuation allowances and acquired income tax uncertainties after the measurement period be recognized as a component of provision for taxes. In addition, acquired in-process research and development is capitalized as an intangible asset and amortized over its estimated useful life. The provisions of SFAS No. 141(R) are applicable to business combinations consummated in fiscal years beginning on or after December 15,

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(2) Recent Accounting Pronouncements (Continued)

2008. Early application is prohibited. The provision of SFAS No. 141(R) will have a significant impact in the accounting for future business combinations.

In December 2007, the FASB issued SFAS No. 160, *Noncontrolling Interests in Consolidated Financial Statements-on Amendment of ARB No. 51*. SFAS No. 160 establishes accounting and reporting standards for the non-controlling interest in a subsidiary. SFAS No. 160 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim statements within those fiscal years. Among other things, SFAS No. 160 requires non-controlling interest to be included as a component of shareholders' equity. The Company does not currently have any material non-controlling interests.

Staff Accounting Bulletin 110 (SAB 110), *Shared-Based Payment*, issued by the U.S. Securities and Exchange Commission (SEC) was effective for us beginning in the first quarter of 2008. SAB 110 amends the SEC's views discussed in Staff Accounting Bulletin 107 (SAB 107) regarding the use of the simplified method in developing estimates of the expected lives of share options in accordance with SFAS No. 123 (revised 2004), "Share-Based Payment" (SFAS No. 123(R)). The amendment, in part, allowed the continued use, subject to specific criteria, of the simplified method in estimating expected lives of share options granted after December 31, 2007. We will continue to use the simplified method until we have the historical data necessary to provide reasonable estimates of expected lives in accordance with SAB 107, as amended by SAB 110.

In April 2008, the FASB issued FSP No. 142-3 *Determination of the Useful Life of Intangible Assets* ("FSP 142-3"). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under SFAS No. 142, *Goodwill and Other Intangible Assets*. The intent of this Staff Position is to improve the consistency between the useful life of a recognized intangible asset under SFAS No. 142 and the period of expected cash flows used to measure the fair value of the asset under SFAS No. 141 (revised 2007), *Business Combinations*, and other U.S. generally accepted accounting principles. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. The Company does not expect the adoption of this Staff Position to have a material effect on its financial position, results of operations or cash flows.

(3) Revenue Recognition

Revenue is recognized in accordance with SAB 104 when the following four criteria are met:

(i) persuasive evidence of an arrangement exists,

(ii) delivery has occurred,

(iii) the fee is fixed or determinable, and

(iv) collection is probable.

Some customer arrangements encompass multiple deliverables, such as software, maintenance fees, and software development fees. The Company accounts for these arrangements in accordance with EITF Issue No. 00-21. If the deliverables meet the criteria in EITF Issue No. 00-21, the deliverables

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(3) Revenue Recognition (Continued)

are divided into separate units of accounting and revenue is allocated to the deliverables based on their relative fair values. The criteria specified in EITF Issue No. 00-21 are as follows:

(i) the delivered item has value to the customer on a stand-alone basis,

(ii) there is objective and reliable evidence of the fair value of the undelivered item, and

(iii) if the arrangement includes a general right of return relative to the delivered item, delivery or performance of the undelivered item is considered probable and substantially in the control of the vendor.

For the Company's purposes, fair value is generally defined as the price at which a customer could purchase each of the elements independently from other vendors or as the price that the Company has sold the element separately to another customer. Management applies judgment to ensure appropriate application of EITF Issue No. 00-21, including value allocation among multiple deliverables, determination of whether undelivered elements are essential to the functionality of delivered elements and timing of revenue recognition, among others.

AICPA SOP No. 98-9 requires that revenue be recognized using the "residual method" in circumstances when vendor specific objective evidence ("VSOE") exists only for undelivered elements. Under the residual method, revenue is recognized as follows: (1) the total fair value of undelivered elements, as indicated by VSOE, is deferred and subsequently recognized in accordance with the relevant sections of AICPA SOP No. 97-2, and (2) the difference between the total arrangement fee and the amount deferred for the undelivered elements is recognized as revenue related to the delivered elements.

Applicable revenue recognition criteria is considered separately for each separate unit of accounting as follows:

Revenue from professional service arrangements is generally determined based on time and materials. Revenue for professional services is recognized as the services are performed. Billing for services rendered generally occurs within one month after the services are provided.

Royalty revenue is recognized when the royalty amounts owed to the Company have been earned, are determinable, and collection is probable. Subscriptions are paid in advance and revenue is recognized ratably over the term of the subscription. These revenues include the licensing of digital watermarking products and services for use in authenticating documents, detecting fraudulent documents and deterring unauthorized duplication or alteration of high-value documents, for use in communicating copyright, asset management and business-to-business image commerce solutions, and for use in connecting analog media to a digital environment.

Software revenue is recognized in accordance with AICPA SOP No. 97-2, as amended by AICPA SOP No. 98-9. Revenue for licenses of the Company's software products is recognized upon the Company meeting the following criteria: persuasive evidence of an arrangement exists; delivery has occurred; the vendor's fee is fixed or determinable; and collectibility is probable. Software revenue is recognized over the term of the license, which is generally twelve months, or upon delivery and acceptance if the Company grants a perpetual license with no further obligations.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(3) Revenue Recognition (Continued)

Maintenance revenue is recognized when the maintenance amounts owed to the Company have been earned, are determinable, and collection is probable. Maintenance contracts are, at times, paid in advance and revenue is recognized ratably on a straight-line basis over the term of the service period.

The Company records revenue from some customers upon cash receipt as a result of collectibility not being reasonably assured.

Revenue earned which has not been invoiced at the last day of the period, but which are generally billed within one to two weeks of the last day of the period, is included in the balance of trade receivables, net in the balance sheets.

Deferred revenue consists of billings in advance for professional services, subscriptions and hardware for which revenue has not been earned.

(4) Segment Information

Geographic Information

The Company derives its revenue from a single reporting segment: media management solutions. Revenue is generated in this segment through licensing of intellectual property, subscriptions to various products and services, and the delivery of services pursuant to contracts with various customers. The Company markets its products in the U.S. and in non-U.S. countries through its sales personnel.

Revenue by geographic area is as follows:

	Successor	Predecessor	Predecessor	Predecessor
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008 (unaudited)	Year Ended December 31, 2007	Year Ended December 31, 2006
Domestic	$ 3,425	$ 6,274	$ 3,696	$ 2,414
International	4,407	5,676	9,329	8,657
Total	$ 7,832	$ 11,950	$ 13,025	$ 11,071

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(4) Segment Information (Continued)

Major Customers

Customers who accounted for more than 10% of the Company's revenues:

	Successor	Predecessor	Predecessor	Predecessor
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008 (unaudited)	Year Ended December 31, 2007	Year Ended December 31, 2006
Customer A	46%	39%	60%	65%
Customer B	31%	38%	*	*
Customer C	*	*	10%	*

*
less than 10%

(5) Stock-Based Compensation

Stock-based compensation includes expense charges for all stock-based awards to employees and directors. Such awards include option grants, restricted stock awards, and shares expected to be purchased under an employee stock purchase plan. Stock compensation expense was allocated to the predecessor based on a combination of specific and shared services resource allocations from Old Digimarc. All cash flow related to stock compensation generated by Old Digimarc was retained by Digimarc.

For the period August 2, 2008 through September 30, 2008 there were no restricted stock or stock option grants awarded or outstanding. Accordingly, there was no stock compensation expense during this period.

Stock-based compensation recognized in the period October 1, 2008 through December 31, 2008 is based on the value of the portion of the stock-based award that vested during the period. Compensation cost for all stock-based awards is recognized using the straight-line method.

Determining Fair Value Under SFAS 123(R)

Stock Options

Valuation and Amortization Method. The Company estimates the fair value of stock-based awards granted using the Black-Scholes option valuation model. The Company amortizes the fair value of all awards on a straight-line basis over the requisite service periods, which are generally the vesting periods. The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(5) Stock-Based Compensation (Continued)

Expected Life. The expected life of awards granted represents the period of time that they are expected to be outstanding. The Company determined the initial expected life based on a simplified method in accordance with SAB 110, giving consideration to the contractual terms, vesting schedules and pre-vesting and post-vesting forfeitures. Stock options granted during the period October 1, 2008 through December 31, 2008 generally vest over four years for executive grants and two years for director grants, and have contractual terms of ten years.

Expected Volatility. The Company estimated the initial volatility of its common stock at the date of grant based on an independent analysis of a peer group's historical volatility of their common stock using the Black-Scholes option valuation model based on historical stock prices over the most recent period commensurate with the estimated expected life of the award.

Risk-Free Interest Rate. The Company bases the risk-free interest rate used in the Black-Scholes option valuation model on an interest rate on a Treasury bond with a maturity commensurate with each expected term estimate.

Expected Dividend Yield. The Company has never paid any cash dividends on its common stock and does not anticipate paying any cash dividends in the foreseeable future. Consequently, the Company uses an expected dividend yield of zero in the Black-Scholes option valuation model.

Expected Forfeitures. The Company uses a zero forfeiture for both the stock options granted to employees, which vest monthly, and the stock options granted to the Company's Directors, which vest 50% on the first anniversary of the date of grant and then monthly thereafter. The Company records stock-based compensation expense only for those awards that are expected to vest, including awards made to Directors who are expected to continue with the Company through the year following the date of grant. Forfeitures that occur during the month are not expensed.

A summary of the weighted average assumptions and results for options granted during the period August 2, 2008 through December 31, 2008 is as follows:

	Range
Period August 2, 2008 through December 31, 2008:	
Expected life (in years)	5.6 - 6.0
Expected volatility	70% - 72%
Risk-free interest rate	2.8% - 2.9%
Expected dividend yield	0%
Expected forfeiture rate	0%

The estimated average fair value of outstanding stock options was $6.28 at December 31, 2008.

Restricted Stock

The Compensation Committee of the Board of Directors awarded restricted stock shares under the Company's 2008 Stock Incentive Plan to certain employees. The shares subject to the restricted stock awards vest over a certain period, usually four years, following the date of the grant. Specific terms of

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(5) Stock-Based Compensation (Continued)

the restricted stock awards is governed by Restricted Stock Agreements between the Company and the award recipients.

The fair value of restricted stock awards granted is based on the fair market value of the Company's common stock on the date of the grant (measurement date), and is recognized over the vesting period of the related restricted stock using the straight-line method.

Stock-based Compensation Under SFAS 123(R)

	Successor	Predecessor	Predecessor	Predecessor
	Period August 2, 2008 through December 31, 2008	Period January 1, 2008 through August 1, 2008 (unaudited)	Year Ended December 31, 2007	Year Ended December 31, 2006
Stock-based compensation:				
Cost of revenue	$ 5	$ 99	$ 102	$ 42
Sales and marketing	38	208	287	172
Research, development and engineering	51	34	47	51
General and administrative	422	537	728	495
Intellectual property	16	35	45	30
Total stock-based compensation	$ 532	$ 913	$ 1,209	$ 790

At December 31, 2008, the Company had 1.1 million non-vested stock options and 121,000 shares of restricted stock outstanding, that had a weighted average grant date price of $9.64. As of December 31, 2008, the Company had $8.3 million of total unrecognized compensation cost related to non-vested stock-based awards granted under all equity compensation plans, including options and restricted stock. Total unrecognized compensation cost will be adjusted for any future changes in estimated forfeitures. The Company expects to recognize this compensation cost for stock options and restricted stock over a weighted average period of 1.99 years and 2.50 years, respectively, through October 2012.

Information regarding deferred stock compensation expense and information related to the assumptions used in the above calculations is further described in Note 10.

(6) Net Income Per Share

Net income per share is calculated in accordance with SFAS No. 128, *Earnings per Share,* which provides that basic and diluted net income per share for all periods presented are to be computed

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(6) Net Income Per Share (Continued)

using the weighted average number of common shares outstanding during each period, with diluted net income per share including the effect of potentially dilutive common shares.

	Period August 2, 2008 through December 31, 2008		
	Income (000's) (Numerator)	Shares (000's) (Denominator)	Per Share Amount
Basic EPS			
Income available to common stockholders	$ 76	7,156	$ 0.01
Effect of Dilutive Securities			
Options			
Restricted stock			
Diluted EPS			
Income available to common stockholders	$ 76	7,156	$ 0.01

Common stock equivalents related to stock options of 974 were excluded from diluted net income per share calculations for the period August 2, 2008 through December 31, 2008 as their exercise price was higher than the average market price of the underlying common stock for the period.

(7) Trade Accounts Receivable and Allowance for Doubtful Accounts

Trade Accounts Receivable

Trade accounts receivable are recorded at the invoiced amount and do not bear interest.

	Successor	Predecessor	Predecessor
	December 31, 2008	August 1, 2008 (unaudited)	December 31, 2007
Trade accounts receivable	3,839	3,077	3,795
Allowance for doubtful accounts			(43)
Trade accounts receivable, net	$ 3,839	$ 3,077	$ 3,752
Unpaid deferred revenues included in accounts receivable	$ 2,155	$ 300	$ 2,271

Allowance for doubtful accounts

The allowance for doubtful accounts is the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. The Company determines the allowance based on historical write-off experience and current information. The Company reviews its allowance for doubtful accounts monthly. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(7) Trade Accounts Receivable and Allowance for Doubtful Accounts (Continued)

Unpaid deferred revenues

The unpaid deferred revenues that are included in accounts receivable are billed in accordance with the provisions of the contracts with the Company's customers. Effective December 31, 2008, unpaid deferred revenues from the Company's cash-basis revenue recognition customers are no longer included in accounts receivable nor deferred revenue accounts.

Major customers

Customers who accounted for more than 10% of accounts receivable, net:

	Successor	Predecessor	Predecessor
	December 31, 2008	August 1, 2008	December 31, 2007
		(unaudited)	
Customer A	58%	61%	24%
Customer B	27%	24%	36%

(8) Property and Equipment

Property and Equipment

Property and equipment are stated at cost. Property and equipment under capital lease obligations are stated at the lower of the present value of minimum lease payments at the beginning of the lease term or fair value of the leased assets at the inception of the lease. Repairs and maintenance are charged to expense when incurred.

The property and equipment related to the Company were separated from Old Digimarc and recorded at net book value (cost less accumulated depreciation) and classified as used property and equipment.

Depreciation on property and equipment is calculated by the straight-line method over the estimated useful lives of the assets, generally two to seven years. Property and equipment held under capital leases are amortized by the straight-line method over the shorter of the lease term or the estimated useful life. Amortization of property and equipment under capital lease is included in depreciation expense.

	Successor	Predecessor	Predecessor
	December 31, 2008	August 1, 2008	December 31, 2007
		(unaudited)	
Office furniture fixture	$ 291	$ 1,090	$ 1,086
Equipment	793	2,551	3,411
Leasehold improvements	320	696	679
	1,404	4,337	5,176
Less accumulated depreciation and amortization	(192)	(2,996)	(3,949)
	$ 1,212	$ 1,341	$ 1,227

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(8) Property and Equipment (Continued)

Property and equipment additions for the period August 2, 2008 through December 31, 2008, the period January 1, 2008 through August 1, 2008 (unaudited) and the year ended December 31, 2007 totaled $76, $799 and $367, respectively.

Leases

The Company leases certain equipment under long-term capital leases, which expire over the next 29 months. The cost of these assets was $43 at December 31, 2008 and $75 at both August 1, 2008 (unaudited) and December 31, 2007, and accumulated amortization was $6 at December 31, 2008, $32 at August 1, 2008 (unaudited) and $24 at December 31, 2007.

Future minimum lease payments under non-cancelable operating leases and the present value of future minimum capital lease payments are as follows:

Year ending December 31:	**Capital Leases**	**Operating Leases**
2009	$ 19	$ 856
2010	19	882
2011	6	599
2012		
2013		
Thereafter		
Total minimum lease payments	44	$ 2,337
Less amount representing interest	(5)	
Net obligation under capital leases	39	
Less current portion	(16)	
Non-current portion	$ 23	

Rent expense on the operating leases for the periods August 2, 2008 through December 31, 2008 and January 1, 2008 through August 1, 2008 (unaudited), and the years ended December 31, 2007 and 2006 totaled $318, $447, $758 and $757, respectively.

(9) Intangible Assets Purchase and Capitalized Patent Costs

Costs associated with the application and award of patents in the U.S. and various other countries are capitalized and amortized on a straight-line basis over the term of the patents as determined at award date, which varies depending on the pendency period of the application, generally approximating seventeen years. Capitalized patent costs include internal legal labor, professional legal fees, government filing fees and translation fees related to obtaining the Company's patent portfolio.

Costs associated with the maintenance and annuity fees of patents are accounted for as prepaid assets at the time of payment and amortized over the respective periods, generally from one to four years.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(9) Intangible Assets Purchase and Capitalized Patent Costs (Continued)

Intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable.

	2008
Gross intangible assets	$462
Accumulated amortization	(6)
Intangible assets, net	$456

(10) Stockholders' Equity

Preferred Stock

In June 2008, the Board of Directors authorized 2,500,000 shares of preferred stock, par value $0.001 per share. The Board of Directors has the authority to issue the undesignated preferred stock in one or more series and to determine the powers, preferences and rights and the qualifications, limitations or restrictions granted to or imposed upon any wholly unissued series of undesignated preferred stock and to fix the number of shares constituting any series and the designation of such series, without any further vote or action by the stockholders. The issuance of preferred stock may have the effect of delaying, deferring or preventing a change of control of our company without further action by stockholders and may adversely affect the voting and other rights of the holders of common stock.

Ten thousand shares of the authorized preferred stock have been designated as Series A Redeemable Nonvoting Preferred stock. In the event of the liquidation, dissolution or other winding up of Digimarc, before any payment or distribution is made to the holders of common stock, holders of the Series A Redeemable Nonvoting Preferred stock will be entitled to receive a value of $5.00 per share of Series A Redeemable Nonvoting Preferred stock held by the stockholder. The Series A Redeemable Nonvoting Preferred stock has no voting rights, except as required by law, and may be redeemed by the Board of Directors at any time on or after June 18, 2013.

Following the spin-off, the Company issued to the executive officers an aggregate of 10,000 shares of Series A Redeemable Nonvoting Preferred stock.

Common Stock

In June 2008, the Board of Directors authorized 50,000,000 shares of common stock, par value $0.001 per share. The holders of our common stock are entitled to one vote for each share held of record on all matters submitted to a vote of our stockholders, including the election of directors. Subject to preferences that may be granted to any then outstanding preferred stock, holders of common stock are entitled to receive ratably those dividends as may be declared by the Board of Directors out of funds legally available for such purpose, as well as any distributions to the Company's stockholders. In the event of the Company's liquidation, dissolution or winding up, holders of common stock are entitled to share ratably in all of the Company's assets remaining after payment of liabilities and the liquidation preference of any then outstanding preferred stock. Holders of common stock have no preemptive or other subscription or conversion rights. There are no redemption or sinking fund

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(10) Stockholders' Equity (Continued)

provisions applicable to the common stock. All outstanding shares of common stock are fully paid and non-assessable.

On October 16, 2008, each Old Digimarc record holder as of August 1, 2008 received one share of Digimarc common stock for every three and one-half shares of Old Digimarc common stock held by the stockholder. The exchange resulted in 7,143,442 shares of Digimarc common stock issued and outstanding.

Restricted Stock

The Compensation Committee of the Board of Directors awarded restricted stock shares under the Company's 2008 Stock Incentive Plan to certain employees. The shares subject to the restricted stock awards will vest over a certain period, usually four years, following the date of the grant. Specific terms of the restricted stock awards and performance vesting share awards are governed by Restricted Stock Agreements between the Company and the award recipients.

The following table details the number of shares granted each year as restricted stock:

Date	Number of Restricted Shares
Period August 2, 2008 through December 31, 2008	121,000

The following table reconciles the unvested balance of restricted stock:

	Number of Shares
Unvested balance, August 2, 2008	
Granted	121,000
Vested	
Canceled	
Unvested balance, December 31, 2008	121,000

Stock Incentive Plan

On July 31, 2008 the Company's Board of Directors initially adopted the 2008 Incentive Plan, or the 2008 Plan. The 2008 Plan provides for the grant of stock options, stock appreciation rights, stock awards, restricted stock, stock units, performance shares, performance units, and cash-based awards, which may be granted to officers, directors, employees, consultants, agents, advisors and independent contractors who provide services to us and our affiliated companies.

The 2008 Plan authorizes the issuance of up to 2,500,000 shares of common stock. The shares authorized under the 2008 Plan are subject to adjustment in the event of a stock split, stock dividend, recapitalization or similar event. Shares issued under the 2008 Plan will consist of authorized and unissued shares or shares held by us as treasury shares. If an award granted under the 2008 Plan lapses, expires, terminates or is forfeited or surrendered without having been fully exercised or without the issuance of all the shares subject to the award, the shares covered by that award will again be available

DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(10) Stockholders' Equity (Continued)

for use under the 2008 Plan. Shares that are (i) tendered by a participant or retained by us as payment for the purchase price of an award or to satisfy tax withholding obligations or (ii) covered by an award that is settled in cash, or in some manner that some or all of the shares covered by the award are not issued, will be available for issuance under the 2008 Plan. In addition, awards granted as substitute awards in connection with acquisition transactions will not reduce the number of shares authorized for issuance under the 2008 Plan.

Transactions involving the stock incentive plan are summarized as follows:

	Number of Shares	Weighted Average Exercise Price
Options outstanding, August 2, 2008		
Granted	1,194,000	$ 9.64
Exercised		
Canceled		
Options outstanding, December 31, 2008	1,194,000	$ 9.64

Range of Exercise Prices	Outstanding Number of Shares	Remaining Contractual Life (Years)	Weighted Average Price	Exercisable Number of Shares	Weighted Average Price
$9.64	1,194,000	9.83	$ 9.64	46,411	$ 9.64

At December 31, 2008, the aggregate intrinsic value of outstanding and exercisable stock options was $454 and $18, respectively. The aggregate intrinsic value is based on our closing price of $10.02 on December 31, 2008, which would have been received by the optionees had all of the options with exercise prices less than $10.02 been exercised on that date.

(11) Defined Contribution Pension Plan

The Company sponsors an employee savings plan (the "Plan") which qualifies as a deferred salary arrangement under Section 401(k) of the Internal Revenue Code. Employees become eligible to participate in the Plan at the beginning of the following quarter after the employees' hire date. Employees may contribute up to 20% of their pay to the Plan, subject to the limitations of the Internal Revenue Code. Company matching contributions are discretionary. The Plan was terminated as of December 31, 2008 and replaced with a new plan combining both the employee savings plan and company matching plan into one plan under Section 401(k). For the period August 2, 2008 through December 31, 2008 and January 1, 2008 through August 1, 2008 (unaudited), and for the years ended December 31, 2007 and 2006, the Company made discretionary matching contributions in the aggregate amount of $99, $130, $273 and $212, respectively.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(12) Other Income (Expenses), Net

Other income (expense), net consists primarily of interest received and paid and foreign currency translation gain or loss.

	Successor Period August 2, 2008 through December 31, 2008	Predecessor Period January 1, 2008 through August 1, 2008 (unaudited)	Predecessor Year Ended December 31, 2007	Predecessor Year Ended December 31, 2006
Other income (expense):				
Interest income	$ 464	$ 597	$ 1,391	$ 1,274
Interest expense	(2)	(7)	(4)	(19)
Foreign currency and other	(19)			(13)
Total other income (expense), net	$ 443	$ 590	$ 1,387	$ 1,242

(13) Income Taxes

Old Digimarc. The provision for income taxes reflects withholding tax expense in various foreign jurisdictions. For all historic periods reported in the financial statements, Old Digimarc maintained valuation allowances against its net deferred tax assets, including net operating loss carry-forwards, because it was not more likely than not that such deferred taxes would be realized. The provision for income taxes included foreign taxes withheld by Old Digimarc's customers and paid to foreign jurisdictions on its behalf. The predecessor financial statements indicate cumulative losses through August 1, 2008.

Furthermore, the amounts of cumulative expenses in the financial statements that were not allowed for federal and state income tax purposes were not sufficient to result in positive taxable income which would have required the Company to record income tax expense. As a result, no Federal or state income tax benefit was recognized for the book losses that were incurred in those periods prior to 2007 and no income tax expense was recognized during the 2007 and 2008 periods because any expense was offset by the benefit of net operating loss carry-forwards. Digimarc as a separate legal entity will not benefit from any of the carry-forward tax attributes of Old Digimarc, including net operating loss carry-forwards.

Digimarc. For the period from August 2, 2008 through December 31, 2008 the provision for income taxes reflects withholding tax expense in various foreign jurisdictions. These withholding taxes are computed by our customers and paid to foreign jurisdictions on our behalf. There was no provision for current income taxes related to net income because the computation of taxable income resulted in a net operating loss for the period.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(13) Income Taxes (Continued)

Components of tax expense (benefit) allocated to continuing operations include the following:

	December 31, 2008	
Current:		
Federal	$	
State		
Foreign		11
Sub-total		11
Deferred:		
Federal		
State		
Foreign		
Sub-total		
Total tax expense	$	11

The reconciliation of the statutory federal income tax rate to the Company's effective income tax rate is as follows:

	December 31, 2008		%
Income taxes computed at statutory rates	$	30	34%
Increases (decreases) resulting from:			
State income taxes, net of federal tax benefit		4	5%
Change in valuation allowance		(37)	(43)%
Meals and entertainment		14	17%
Total	$	11	13%

Deferred income taxes reflect the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for income tax

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(13) Income Taxes (Continued)

purposes. The tax effects of significant items comprising the Company's deferred tax assets and deferred tax liabilities as of December 31, 2008 and August 2, 2008 are as follows:

	December 31, 2008	August 2, 2008
Deferred tax assets:		
Goodwill	$ 1,552	$ 1,596
Net operating loss carry-forwards	638	
Stock based compensation	148	
Fixed asset differences	17	
Deferred rent	119	106
Deferred revenue	45	680
Unrealized gains/losses	2	
Foreign tax credit	11	
Total gross deferred tax assets	2,532	2,382
Less valuation allowance	(2,345)	(2,382)
Net deferred tax assets	$ 187	$
Deferred tax liabilities:		
Patent expenditures	$ (187)	$
Total deferred tax liabilities	$ (187)	$
Net deferred tax asset (liability)	$	$

For the period August 2, 2008 through December 31, 2008, the Company's valuation allowance decreased by $37. The Company has recorded a full valuation allowance against the net deferred tax assets until such time that the Company believes it is more likely than not that the deferred tax assets will be realized.

For U.S. tax purposes, the spin-off of the Digital Watermarking assets on August 2, 2008 resulted in a taxable event for Digimarc shareholders based on the fair market value of the assets. For Digimarc tax purposes, the basis of the assets and liabilities included as part of the transaction are adjusted to fair market value as the date of the spin-off. As a result of the tax basis adjustment to fair market value the Company recognized deferred tax assets, including tax deductible goodwill. No financial statement goodwill was recognized as part of the spin-off. Therefore, as of August 2, 2008 the Company has recognized a future deductible temporary difference for tax basis goodwill in excess of financial statement goodwill.

Under EITF 94-10, "the Task Force concluded that the tax effects of all changes in the tax bases of assets and liabilities caused by transactions among or with shareholders should be included in equity." As a result, the Company has recorded the original deferred tax asset with a corresponding entry to shareholders equity ("APIC").

As of August 2, 2008 the Company evaluated the realizability of the deferred tax assets and concluded that it was not more-likely-than-not that the deferred tax assets would be realized. Therefore, as of August 2, 2008, the Company established a valuation allowance for existing deferred

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(13) Income Taxes (Continued)

tax assets. Consistent with EITF 94-10 the Company recorded the establishment of the valuation allowance with a corresponding entry to shareholders equity ("APIC").

As of December 31, 2008, the Company has federal and state net operating loss carry-forwards of $1,663 and $1,663, respectively, which have a carry-forward of 15 - 20 years depending on the jurisdiction. As of December 31, 2008, the Company has foreign tax credits of $11 which have a carry-forward of 10 years.

The Company adopted the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes an Interpretation of FASB Statement 109* ("FIN 48"), on August 2, 2008. The Company's financial statements for 2008 reflect the impact of FIN 48.

As part of the FIN 48 implementation, the Company adopted a policy to record accrued interest and penalties associated with uncertain tax positions in income tax expense in the statements of operations. On initial adoption of FIN 48 and through December 31, 2008, the Company recognized no accrued interest and penalties associated with uncertain tax positions.

A summary reconciliation of the Company's uncertain tax positions is listed below:

Balance at August 2, 2008	$
Addition for 2008 current year tax positions	
Reduction for prior year positions resolved during 2008	
Ending balance at December 31, 2008	$

The Company is subject to examination in the jurisdictions in which it operates for the period August 2, 2008 through December 31, 2008.

(14) Commitments and Contingencies

Certain of the Company's product license and services agreements include an indemnification provision for claims from third parties relating to the Company's intellectual property. Such indemnification provisions are accounted for in accordance with SFAS No. 5, *Accounting for Contingencies*. To date, there have been no claims made under such indemnification provisions.

The Company is subject from time to time to other legal proceedings and claims arising in the ordinary course of business. Although the ultimate outcome of these matters cannot be determined, management believes that, as of December 31, 2008, the final disposition of these proceedings will not have a material adverse effect on the financial position, results of operations, or liquidity of the Company. No accrual has been recorded because the amounts are not probable or reasonably estimatable in accordance with SFAS No. 5, *Accounting for Contingencies*.

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(15) Quarterly Financial Information Unaudited

Quarter ended:	Predecessor March 31	Predecessor June 30	Predecessor Period July 1 through August 1	Successor Period August 2 through September 30	Successor December 31
2008					
Service revenue	$ 2,548	$ 2,987	$ 921	$ 1,645	$ 2,419
License and subscription revenue	2,537	2,128	829	1,536	2,232
Total revenue	5,085	5,115	1,750	3,181	4,651
Total cost of revenue	1,408	1,704	552	934	1,428
Gross profit	3,677	3,411	1,198	2,247	3,223
Gross profit percent, service revenue	47%	45%	43%	46%	44%
Gross profit percent, license and subscription revenue	98%	97%	97%	97%	97%
Gross profit percent, total	72%	67%	69%	71%	69%
Sales and marketing	656	683	589	390	764
Research, development and engineering	922	910	239	780	992
General and administrative	980	927	442	932	1,945
Intellectual property	478	448	176	120	184
Transitional services				(196)	(84)
Operating income (loss)	641	443	(248)	221	(578)
Net income (loss)	924	664	(173)	400	(324)
Earnings (loss) per share:					
Net income (loss) per share basic & diluted				$ 0.06	$ (0.05)
Weighted average shares outstanding basic and diluted				7,143	7,156
Pro-forma earnings (loss) per share:					
Net income (loss) per share basic & diluted	$ 0.13	$ 0.09	$ (0.02)		
Weighted average shares outstanding basic and diluted	7,143	7,143	7,143		

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DIGIMARC CORPORATION

NOTES TO FINANCIAL STATEMENTS (Continued)

(In thousands, except share and per share data)

(15) Quarterly Financial Information Unaudited (Continued)

Quarter ended:	Predecessor March 31	Predecessor June 30	Predecessor September 30	Predecessor December 31
2007				
Service revenue	$ 1,877	$ 1,751	$ 2,063	$ 2,115
License and subscription revenue	1,608	1,095	1,244	1,272
Total revenue	3,485	2,846	3,307	3,387
Total cost of revenue	950	936	993	1,153
Gross profit	2,535	1,910	2,314	2,234
Gross profit percent, service revenue	51%	50%	55%	47%
Gross profit percent, license and subscription revenue	98%	95%	95%	95%
Gross profit percent, total	73%	67%	70%	66%
Sales and marketing	639	667	634	513
Research, development and engineering	729	829	656	698
General and administrative	857	844	797	847
Intellectual property	431	413	373	376
Operating loss	(121)	(843)	(146)	(200)
Net income (loss)	250	(518)	175	148
Pro-forma earnings (loss) per share:				
Net income (loss) per share basic & diluted	$ 0.03	$ (0.07)	$ 0.02	$ 0.02
Weighted average shares outstanding basic and diluted	7,143	7,143	7,143	7,143

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In reviewing the agreements included as exhibits to this Annual Report on Form 10-K, please remember they are included to provide you with information regarding their terms and are not intended to provide any other factual or disclosure information about Digimarc or the other parties to the agreements. The agreements may contain representations and warranties by each of the parties to the applicable agreement. These representations and warranties have been made solely for the benefit of the other party or parties to the applicable agreement and:

- should not in all instances be treated as categorical statements of fact, but rather as a means of allocating the risk to one of the parties if those statements prove to be inaccurate;

- may have been qualified by disclosures that were made to the other party or parties in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;

- may apply standards of materiality in a manner that is different from what may be viewed as material to you or other investors; and

- were made only as of the date of the applicable agreement or other date or dates that may be specified in the agreement and are subject to more recent developments.

Accordingly, there representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time. Additional information about Digimarc may be found elsewhere in this Annual Report on Form 10-K and in Digimarc's other public filings, which are available without charge through the SEC's website at *http://www.sec.gov*.

EXHIBIT INDEX

Exhibit Number	Exhibit Description
2.1	Separation Agreement among DMRC Corporation, DMRC LLC, Digimarc Corporation and, with respect to certain sections, L-1 Identity Solutions, Inc. (incorporated by reference to Exhibit 2.1 to Amendment No. 2 to the Company's Registration Statement on Form 10, filed with the Commission on August 13, 2008 (File No. 001-34108))
3.1	Restated Certificate of Incorporation of Digimarc Corporation (incorporated by reference to Exhibit 3.1 to Amendment No. 3 to the Company's Registration Statement on Form 10, filed with the Commission on September 9, 2008 (File No. 001-34108))
3.2	Amended and Restated Bylaws of Digimarc Corporation (incorporated by reference to Exhibit 3.2 to Amendment No. 3 to the Company's Registration Statement on Form 10, filed with the Commission on September 9, 2008 (File No. 001-34108))
4.1	Specimen common stock certificate of Digimarc Corporation
4.2	Rights Agreement, dated July 31, 2008, between Digimarc Corporation and Computershare Trust Company, N.A. as Rights Agent
4.3	Form of Certificate of Designation of Series R Preferred Stock (attached as an exhibit to the Rights Agreement filed as Exhibit 4.2 hereto)
4.4	Form of Rights Certificate (attached as an exhibit to the Rights Agreement filed as Exhibit 4.2 hereto)
10.1	License Agreement between DMRC Corporation and L-1 Identity Solutions Operating Company (incorporated by reference to Exhibit 10.2 to Amendment No. 4 to the

Company's Registration Statement on Form 10, filed with the Commission on
October 2, 2008 (File No. 001-34108))(1)

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Exhibit Number	Exhibit Description
10.2	Agreement, dated as of October 1, 2007, between Digimarc Corporation and The Nielsen Company (incorporated by reference to Exhibit 10.3 to Amendment No. 6 to the Company's Registration Statement on Form 10, filed on October 14, 2008 (File No. 001-34108))(1)
10.3	Counterfeit Deterrence System Development and License Agreement, dated as of January 1, 1999, between Digimarc Corporation and the Bank for International Settlements (incorporated by reference to Exhibit 10.4 to Amendment No. 6 to the Company's Registration Statement on Form 10, filed with the Commission on October 14, 2008 (File No. 001-34108))(1)
*10.4	Form of Indemnification Agreement between DMRC Corporation and each of its executive officers and directors (incorporated by reference to Exhibit 10.5 to Amendment No. 2 to the Company's Registration Statement on Form 10, filed with the Commission on August 13, 2008 (File No. 001-34108))
*10.5	Employment Agreement, dated as of October 29, 2008, between Digimarc Corporation and Bruce Davis (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K, filed with the Commission on November 4, 2008 (File No. 001-34108))
*10.6	Digimarc Corporation 2008 Incentive Plan (incorporated by reference to Exhibit 10.7 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on November 24, 2008 (File No. 001-34108))
*10.7	Form of Notice of Stock Option Award and Stock Option Award Agreement under Digimarc Corporation 2008 Incentive Plan (incorporated by reference to Exhibit 10.8 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on November 24, 2008 (File No. 001-34108))
*10.8	Equity Compensation Program for Nonemployee Directors under the Digimarc Corporation 2008 Incentive Plan (incorporated by reference to Exhibit 10.9 to the Company's Quarterly Report on Form 10-Q, filed with the Commission on November 24, 2008 (File No. 001-34108))
*10.9	Form of Indemnification Agreement between Digimarc Corporation and each of its executive officers and directors (incorporated by reference to Exhibit 10.1 to Digimarc Corporation's Annual Report on Form 10-K, as filed by Digimarc Corporation with the Securities and Exchange Commission on March 13, 2006 (File No. 000-28317))
*10.10	Form of Change of Control Retention Agreement entered into by and between Digimarc Corporation and each of Messrs. McConnell, Chamness and Stager (incorporated by reference to Exhibit 10.1 to Digimarc Corporation's Current Report on Form 8-K, as filed by Digimarc Corporation with the Securities and Exchange Commission on January 4, 2007 (File No. 000-28317))
23.1	Consent of Independent Registered Public Accounting Firm
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.1	Section 1350 Certification of Chief Executive Officer
32.2	Section 1350 Certification of Chief Financial Officer

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* Management contract or compensatory plan or arrangement.

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The Separation Agreement contains a brief list identifying all schedules and exhibits thereto. Such schedules and exhibits have been omitted pursuant to Item 601(b)(2) of Regulation S-K. The Registrant agrees to furnish supplementally a copy of the omitted schedules and exhibits to the Securities and Exchange Commission upon request.

(1) Confidential treatment has been granted for certain portions omitted from this exhibit pursuant to an order granted by the Commission on October 21, 2008, under Rule 24b-2 of the Securities Exchange Act of 1934, as amended. Confidential portions of this exhibit have been separately filed with the Securities and Exchange Commission.

t;"> 1,308,652 3,190,193 2% 3,925,610 123.1%

Total real estate loans

206,141,595 103,324,379 309,465,974 80% 174,842,452 118,879,208 293,721,660 87% 15,744,314 5.4%

Commercial business

38,302,739 1,841,226 40,143,965 10% 19,518,029 2,019,337 21,537,366 6% 18,606,599 86.4%

Home equity loans

13,956,327 6,039,462 19,995,789 5% 13,278,229 7,266,141 20,544,370 6% (548,581) -2.7%

Consumer

18,849,448 766,063 19,615,511 5% 2,258,836 937,600 3,196,436 1% 16,419,075 513.7%

Total loans

$277,250,109 $111,971,130 $389,221,239 100% $209,897,546 $129,102,286 $338,999,832 100% $50,221,407 14.8%

The Company's largest concentration of loans continues to be residential one-to four-family loans as a result of the loans acquired in the Fraternity and Fairmount acquisitions. This loan portfolio comprises 41% of the entire loan portfolio at March 31, 2018, an increase of $7.0 million from March 31, 2017. This growth is primarily related to the purchase of $19.3 million in residential mortgage loans during the second half of fiscal 2018. In addition, over the last half of fiscal 2017 and into fiscal 2018 we began to portfolio many of the traditional residential mortgage loans we originated, versus selling them in the secondary market, due to the increase in normal attrition within this loan segment resulting from our acquisitions. Prior to that time, we generally sold these loans in the secondary market at a premium to assist with managing interest rate risk and to enhance non-interest revenue.

In fiscal 2015, as a means to supplement our residential loan portfolio, the Company began to promote its one-to-four family residential construction lending program. During fiscal 2018, the Bank originated commitments of $12.2 million in residential construction loans. As a result, at March 31, 2018, we had $8.7 million in residential construction commitments, of which $5.4 million in funds have been advanced; compared to $11.8 million in residential construction commitments at March 31, 2017 of which $6.0 million in funds had been advanced. The construction period on residential homes is typically nine to twelve months, at which time the Bank is often repaid through permanent financing by a third party.

Real estate investor loans represent funds advanced to borrowers for the purchase or refinance of non-owner occupied one-to-four family properties. These loans make up $26.7 million, or 6.9%, of total gross loans at March 31, 2018, including a remaining balance of $17.5 million that were acquired from Fraternity and Fairmount. This type of lending can involve more risk than originating owner-occupied one-to-four family residential mortgages and as such, the Bank typically refrains from originating this type of loan organically.

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The Bank continues to focus on growth through the origination or purchase of both commercial real estate and commercial business loans as these loans offer higher rates of return and shorter maturity periods than typical retail lending. The largest increase in loans over fiscal 2018 in terms of dollars, is a $18.6 million, or 86.4%, increase in commercial business loans from $21.5 million at March 31, 2017 to $40.1 million at March 31, 2018. In the last half of fiscal 2017, management focused on diversifying the commercial loan portfolio and seeking more asset-based type lending relationships both organically and through purchases. The majority of the increase in commercial business loans is related to the purchase of a $15.5 million pool of commercial business loans at the end of the first quarter of fiscal 2018. The pool of loans consists of commercial lease loans that are concentrated in equipment that is necessary to operate a business segment, such as medical equipment. Over this same period, commercial real estate loans have also grown by $4.6 million, or 4.3%, from $107.6 million at March 31, 2017 to $112.2 million at March 31, 2018. Commercial real estate comprises 28.8% of the total loan portfolio at March 31, 2018, down slightly from 31.7% at March 31, 2017 due to the growth and diversification of the commercial business loan portfolio over this same period. The Bank continues to see the benefits of our commercial lending platform that was restructured in the first half of fiscal 2016, with new personnel and improved underwriting and monitoring procedures, from both an origination and credit quality perspective.

As a means to continue to increase revenue and diversify the loan portfolio, a group of consumer loans totaling $19.8 million was purchased in August 2017 from another financial institution. This portfolio of loans was collateralized by various makes and models of recreational vehicles (RV). Prior to this purchase, the consumer portfolio made up less than 1.0% of the total loan portfolio. This purchase increased our consumer loan balances significantly from $3.2 million at March 31, 2017 to $19.6 million at March 31, 2018; accounting for 5.0% of the entire loan portfolio. As a result, we were able to further diversify the composition of the loan portfolio and increase our net interest income.

Bank-Owned Life Insurance. We invest in bank-owned life insurance (“BOLI”) to provide us with a funding source for our benefit plan obligations. BOLI also provides us noninterest income that is nontaxable. At March 31, 2018, our investment in bank-owned life insurance was $17.5 million, a decrease of $797,000 from $18.3 million at March 31, 2017. Federal regulations generally limit our investment in BOLI to 25% of our Tier 1 capital plus our allowance for loan losses. Our amount of BOLI exceeded these limits because of the BOLI we acquired in the Fraternity acquisition and the increase in cash surrender value of these policies over the years.

The decrease of $797,000 is attributable to the payout of several BOLI policies related to the unexpected passing of a beloved employee during the current year. The Company received $2.1 million in proceeds, of which $1.3 million was applied against the cash surrender value of the BOLI policies and the remaining $835,000 was recorded as non-interest income. The decline associated with the payout under the policies was partially offset by the increase in cash surrender value of the other BOLI insurance policies that are held.

Deposits. Total deposits (excluding premiums on acquired deposits) decreased $7.3 million to $404.7 million at March 31, 2018 from $412.0 million at March 31, 2017. The Company continues to focus on generating lower cost, core deposits (which includes all deposits other than certificates of deposit) and maintaining maturing certificates of deposit to support continued loan growth. Overall core deposits have decreased $6.7 million, or 4.0%, to $157.7

million at March 31, 2018 compared to $164.4 million at March 31, 2017. This decline is attributable to the end of a promotional rate on certain money market accounts, as well as a very competitive deposit market. Core deposits accounted for 38.9% of total deposits at March 31, 2018, compared to 39.9% at March 31, 2017. The Bank is currently running deposit promotions to attract new customers in a competitive deposit market.

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The following table details the composition of deposits and the related percentage mix and growth of total deposits.

	March 31, 2018		March 31, 2017		Year-To-Date Growth	
	Total	Percent of Total	Total	Percent of Total	Amount	Growth Percent
Savings	$42,499,381	10 %	$44,614,415	11 %	$(2,115,034)	-5 %
Noninterest-bearing checking	29,557,943	7 %	30,401,454	7 %	(843,511)	-3 %
Interest-bearing checking	27,219,286	7 %	26,415,189	7 %	804,097	3 %
Money market accounts	58,466,228	14 %	62,962,902	15 %	(4,496,674)	-7 %
Time deposits	246,988,613	61 %	247,632,742	60 %	(644,129)	0 %
	$404,731,451	100 %	$412,026,702	100 %	$(7,295,251)	-2 %
Premium on deposits asssumed	411,524		829,072		(417,548)	
Total deposits	$405,142,975		$412,855,774		$(7,712,799)	

As loan demand increases, our strategy with respect to deposits has been to maintain our current certificate of deposit base, as we focus on growing our lower costing core deposits at a faster pace. We hope to accomplish this by pricing more competitively in the marketplace or through short-term certificate of deposit promotions. However, there may be instances when funding demands are more immediate. To meet these demands, the Company entered into a contract and began utilizing a certificate of deposit subscription service in the third quarter of fiscal 2018. As a result, we were able to obtain $13.8 million in certificate of deposits in the second half of fiscal 2018 through this service. The cost of these deposits is more expensive than traditional certificates of deposit because of the ability to provide the funding needed in a timely manner, but can be less costly than borrowing from the Federal Home Loan Bank or other sources. We may continue to utilize this service as a funding source when other less costly means are not able to meet our funding or liquidity requirements.

Borrowings. Borrowings in fiscal 2018 consisted of both short and long-term advances from the Federal Home Loan Bank (FHLB) and a note payable associated with an automobile that was paid-off in the fourth quarter. At March 31, 2018, outstanding advances from the FHLB increased $25.0 million to $60.6 million at March 31, 2018 compared to $35.6 million at March 31, 2017. The increase is attributable to additional FHLB advances that were entered into to fund various loan purchases throughout the year. Already included in the FHLB advances is $15.0 million in FHLB advances assumed in the Fraternity acquisition, of which $10 million is to mature in fiscal 2019 and $5.0 million that matured in fiscal 2018 and were rolled over. The advances assumed from Fraternity were originally longer-term borrowings and carried higher contractual rates of interest varying from 3.4% to 4.3%. As a result of the higher stated rates, the Company recorded a discount of $794,000 when accounting for the borrowings at fair value upon acquisition. At March 31, 2018, the remaining discount is $103,000. The accretion of this discount offsets the higher contractual rate on these borrowings.

At March 31, 2018, $26.0 million of the total advances are considered short-term and mature in less than one year, while the remaining $34.6 million in advances are considered long-term and mature in more than one year. Included in long-term advances is $11.6 million in advances that mature on a quarterly basis; however, they are associated with several cash flow hedge transactions and will be continuously renewed over the expected life of the hedged transactions. The hedge transactions currently have an average life of 6.3 years. Excluding the advances associated with the hedge transactions, the longest outstanding borrowing is for $3.0 million and matures in August 2021.

The FHLB borrowings provide an alternative means to support the cash outflow needed to fund new loan originations in coordination with deposit growth. FHLB borrowings can provide a less expensive means to support cash outflow when compared to selling higher yielding investment securities. These obligations are secured by our residential and home equity loan portfolios. At March 31, 2018, we had the ability to borrow approximately $68.3 million in additional funds from the FHLB, subject to our pledging sufficient assets. These obligations will be repaid as our cash position strengthens.

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Equity. Total equity decreased $5.7 million, or 9.6%, to $54.1 million at March 31, 2018 from $59.8 million at March 31, 2017. The change in equity is primarily attributable the $6.0 million loss reported for fiscal 2018 along with a $510,000 decline in accumulated other comprehensive loss associated with the decrease in the fair value of the investment portfolio. The fair value of the investment portfolio declined as a result of the increase in interest rates that occurred over the year, but more so during our fourth quarter. The decrease was partially offset by a $457,000 increase in additional paid in capital resulting from the expense derived from equity awards granted in prior periods and the allocation of 14,812 shares of common stock under the Employee Stock Ownership Program. The Company's book value per common share was $15.87 at March 31, 2018 compared to $17.53 at March 31, 2017. At March 31, 2018, the Bank remains "well capitalized" as defined under federal regulations.

Comparison of Results of Operations for the Years Ended March 31, 2018 and March 31, 2017

General. Net loss for the fiscal year ended March 31, 2018 was $6.0 million, or $1.90 per common share, compared to a net loss of $929,000, or $0.29 per common share for the fiscal year ending March 31, 2017. The loss in fiscal 2018 was a result of the increase in tax expense relating two separate events. The first event dealt with the passage of the *Tax Cuts and Job Act* (the "Tax Act") that was signed into law on December 22, 2017. The Tax Act amended the Internal Revenue Code to reduce income tax rates and modify policies, credits, and deductions for individuals and businesses. For businesses, the Tax Act reduced the federal corporate income tax rate from a maximum 35 percent to a flat 21 percent tax rate. As a result, our net deferred tax assets of $7.5 million at that time, which was based upon a 34 percent corporate tax rate, had to be re-evaluated to reflect the new tax rate of 21 percent. This non-cash adjustment was $2.3 million and is recorded through income tax expense. The second event occurred during our fourth quarter and included the establishment of a full valuation allowance on the remaining portion of our net deferred tax assets of $5.8 million. The valuation allowance determination was based upon the fact the Company has experienced cumulative losses for three consecutive years.

Pre-tax income for fiscal 2018, however, was $2.0 million compared to a loss of $1.7 million for fiscal 2017; a period-over-period increase of $3.7 million. The increase in pre-tax income is attributable to a $602,000 increase in net interest income, a $1.8 million decrease in the provision for loan losses, a $942,000 increase in non-interest revenue, and a $326,000 decrease in non-interest expense.

Net Interest Income. Net interest income before provision for loan losses increased $602,000, or 4.3%, to $14.5 million for the year ended March 31, 2018 compared to $13.9 million for the year ended March 31, 2017. The increase in net interest income was due to a $1.3 million increase in interest revenue, partially offset by a $716,000 increase in interest expense. The increase in interest revenue was due to an increase in the average balance of interest-earning assets, particularly higher yielding loans, as well as an increase in average yield on interest-earning assets. The average balance of interest-earning assets increased $17.4 million, or 3.8%, during the fiscal year ended March 31, 2018 compared to the same period in fiscal 2017, while the average yield increased 14 basis points from 3.67% to 3.81% over that same period. The average balances increased period-over-period due in part to the acquisition of Fraternity, which occurred in May 2016, and the realization of having those earning assets for a full year in fiscal 2018. Over this same period, the Bank was also able to increase the average balance of higher interest-earning assets, particularly loans, both organically and through loan purchases.

Partially offsetting the increase in interest revenue was a $716,000 increase in interest expense for the fiscal year ended March 31, 2018 compared to the same period a year ago. This increase was due to the growth in the average balance of interest-bearing liabilities, particularly higher yielding borrowings, as well as an increase in the average cost of interest-bearing liabilities. The average balance of interest-bearing liabilities increased $11.7 million, or 2.9%, for the fiscal 2018 year compared to the same period in fiscal 2017, while the average cost increased 15 basis points to 0.85% from 0.70%. The increase in interest-bearing liabilities was impacted by the growth in borrowings that were used to help in funding a growing loan portfolio and a decreasing deposit base. Despite the increase in interest expense, our net interest rate spread only decreased 1 basis point from 2.97% to 2.96% for the comparable periods.

Interest Revenue. Interest revenue increased $1.3 million, or 7.9% to $18.1 million for the year ended March 31, 2018, compared to $16.7 million for the year ended March 31, 2017. The increase resulted from increases in interest and fees on loans and interest revenue earned on investment securities, partially offset by a decrease in revenue from federal funds sold and other bank deposits.

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Interest and fees on loans increased $1.3 million, or 8.5%, to $16.9 million for the twelve months ended December 31, 2018, compared to $14.8 million for the same period a year ago. The increase in interest and fees on loans is due to a $47.9 million increase in the average balance of net loans from $314.5 million to $362.4 million period-over-period. The increase in average loans is attributable to having the loans acquired in the Fraternity acquisition for a full twelve months, as well as organic growth generated by our commercial lending area and strategic loan purchases. Partially offsetting the revenue derived from an increase in the average balance of loans is a 28-basis point decline in the average yield earned on loans from 4.72% for the year ended March 31, 2017 to 4.44% for the year ended March 31, 2018. The decline in yield is a result of the extended low interest rate environment and the competitive pressure relating to pricing.

Interest revenue on investment securities increased $120,000 to $1.9 million for the year ended March 31, 2018 from $1.7 million for the year ended March 31, 2017. The average balance of investment securities decreased by $1.2 million, or 4.6%, to $93.2 million for the year ended March 31, 2018 from $94.4 million for the same period last year, while the average yield increased 15 basis points to 1.99% from 1.84% for the same two periods. The largest decrease in investment securities was in mortgage-backed securities, which decreased $1.0 million to $70.4 million for the year ended March 31, 2018 from $71.4 million for the same period last year. The average balance of other investment securities remained relatively flat year-over-year, only decreasing $149,000 during this period. The decrease in average investments is attributable to funding both organic loans and loan purchases throughout the year and providing liquidity associated with a decreasing deposit base. The decline in average investments is partially offset by the securities acquired in the Fraternity acquisition, along with utilizing the excess cash acquired in the Fraternity acquisition to purchase new securities in the second half of fiscal 2017. Investment balances have been declining since that time due to the need to provide liquidity to fund loan growth and a declining deposit base.

Interest Expense. Interest expense increased $716,000, or 24.9%, to $3.6 million for the year ended March 31, 2018 compared to $2.9 million for the same period in fiscal 2017. The primary reason for this increase is due to the increase in the average balance and cost of borrowings, and to a lesser extent the increase in the cost of interest-bearing deposits, partially offset by a decrease in the average balance of those same deposits. For the year ended March 31, 2018, average interest-bearing borrowings were $48.5 million compared to an average balance of $26.1 million for the same period a year ago. The borrowings consisted of advances from the Federal Home Loan Bank and have been utilized to help with funding a growing loan portfolio and a declining deposit base over fiscal 2018. At March 31, 2018, the Bank had $60.6 million in outstanding advances from the FHLB, including $13.0 million in borrowings assumed through the Fraternity and Fairmount acquisitions that will all mature prior to November 2018. Overall borrowings carried an average rate of 1.55% for the year ended March 31, 2018 compared to 1.04% for the year ended March 31, 2017. Borrowing from the FHLB can be a more cost-effective means to obtain funds if deposits are not growing compared to selling investment securities that are earning a higher yield.

The average balance of interest-bearing deposits decreased $10.7 million to $372.4 million for the year ended March 31, 2018 from $383.1 million for the year ended March 31, 2017. The average cost of deposits though increased from 0.68% to 0.76% for those same periods. We have begun to increase the rates on a portion of our deposit products and run various deposit promotions as the demand for deposits is becoming more competitive in the marketplace. During the second quarter of fiscal 2018 and last quarter of fiscal 2017, we began to run a money market promotion with a 6-month promotional rate as a means to attract core deposits. As a result, the average cost associated with money market accounts increased from 0.37% to 0.53% for the years ended March 31, 2017 and 2018, respectively.

For the year ended March 31, 2018, the average interest-bearing deposit balances increased or declined slightly for all types of deposits, except certificates of deposits, when compared to the same period last year. These increases are a result of the Fraternity acquisition, as well as our cash management efforts as it relates to our commercial customers and promotional efforts to raise funds for new loan growth. We remain focused on changing the mix of our deposit portfolio by maintaining our maturing certificates of deposits and growing lower cost core deposits, including savings, interest-bearing checking and money market accounts. The average balance of core interest-bearing deposits increased $6.6 million, or 5.4%, to $130.1 million for fiscal 2018 compared to $123.4 million for fiscal 2017. The average balance of time deposits, however, decreased $17.4 million, or 6.7%, to $242.3 million for fiscal 2018 compared to $259.7 million for fiscal 2017. The decrease in time deposits is related to the competitive interest rate market, as well as the decrease in our customer base that is attributable to an aging demographic. To compensate for this decline, the Company entered into a contract and began utilizing a certificate of deposit subscription service in the third quarter of fiscal 2018. As a result, we have been able to obtain $13.8 million in certificate of deposits in the second half of fiscal 2018 through this service. The cost of these deposits is more expensive than traditional certificates of deposit because of the ability to provide the funding needed in a timely manner, but can be less costly than borrowing from the Federal Home Loan Bank or other source. We will continue to utilize this service as a funding source when other less costly means are not able to meet our funding requirements.

Noninterest-bearing deposits allow us to fund growth in interest-earning assets at the lowest minimal cost. Average noninterest-bearing deposits increased $5.2 million, or 21.7%, to $29.3 million for the year ended March 31, 2018, compared to $24.1 million for the year ended March 31, 2017. This increase resulted from the efforts of our cash management personnel and commercial loan officers working with commercial clients to move their deposit relationship to Hamilton Bank and the acquisition of Fraternity.

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Average Balances and Yields. The following table presents information regarding average balances of assets and liabilities, the total dollar amounts of interest revenue from average interest-earning assets, the dollar amounts of interest expense on average interest-bearing liabilities, and the resulting annualized average yields and costs. The yields and costs for the periods indicated are derived by dividing interest revenue or interest expense by the average balances of assets or liabilities, respectively, for the periods presented. Average balances have been calculated using average daily balances. No tax-equivalent adjustments were made. Nonaccrual loans have been included in the table as loans carrying a zero yield.

	Year Ended March 31, (dollars in thousands)					
	2018			**2017**		
	Average Balance	**Interest**	**Yield/ Cost**	**Average Balance**	**Interest**	**Yield/ Cost**
Interest-earning assets:						
Cash and cash equivalents	**$18,895**	**$135**	**0.71%**	$48,207	$190	0.39%
Investment securities (1)	**22,804**	**609**	**2.67%**	22,953	553	2.41%
Mortgage-backed securities	**70,434**	**1,247**	**1.77%**	71,448	1,183	1.66%
Loans receivable, net (2)	**362,355**	**16,089**	**4.44%**	314,473	14,836	4.72%
Total interest-earning assets	**474,488**	**18,080**	**3.81%**	457,081	16,762	3.67%
Noninterest-earning assets	**42,820**			40,634		
Total assets	**$517,308**			$497,715		
Interest-bearing liabilities:						
Certificates of deposit	**$242,328**	**$2,454**	**1.01%**	$259,721	$2,305	0.89%
Money Market	**60,589**	**320**	**0.53%**	61,568	225	0.37%
Statement savings	**43,408**	**54**	**0.12%**	43,527	65	0.15%
NOW accounts	**26,094**	**9**	**0.03%**	18,333	5	0.03%
Total interest-bearing deposits	**372,419**	**2,837**	**0.76%**	383,149	2,600	0.68%
Borrowings	**48,525**	**750**	**1.55%**	26,090	271	1.04%
Total interest-bearing liabilities	**420,944**	**3,587**	**0.85%**	409,239	2,871	0.70%
Noninterest-bearing liabilities and equity:						
Noninterest-bearing deposits	**29,306**			24,078		
Other noninterest-bearing liabilities	**6,313**			5,425		
Total liabilities	**456,563**			438,742		
Total shareholders' equity	**60,745**			58,973		
Total liabilities and shareholders' equity	**$517,308**			$497,715		
Net interest income		**$14,493**			$13,891	
Net interest rate spread (3)			**2.96%**			2.97%
Net interest-earning assets (4)	**$53,544**			$47,842		
Net interest margin (5)			**3.05%**			3.04%
Average interest-earning assets to average interest-bearing liabilities	**112.72 %**			111.69 %		

(1) Includes U.S agency and treasury securities, municipal and corporate bonds and to a much lesser extent, Federal Home Loan Bank equity securities.
(2) Loans on non-accrual status are included in average loans carrying a zero yield.
(3) Net interest rate spread represents the difference between the yield on average interest-earning assets and the cost of average interest-bearing libilities.
(4) Net interest-earning assets represents total interest-earning assets less total interest-bearing liabilities.
(5) Net interest margin represents net interest income divided by average total interest-earning assets.

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Rate/Volume Analysis. The following table sets forth the effects of changing rates and volumes on our net interest income. The rate column shows the effects attributable to changes in rate (changes in rate multiplied by prior volume). The volume column shows the effects attributable to changes in volume (changes in volume multiplied by prior rate). The net column represents the sum of the prior columns. For purposes of this table, changes attributable to changes in both rate and volume that cannot be segregated have been allocated proportionately based on the changes due to rate and the changes due to volume.

	2018 Compared to 2017 Increase (Decrease) Due to		
	Volume	Rate	Net
	(In thousands)		
Interest-earning assets:			
Cash and cash equivalents	$(114)	$59	$(55)
Investment securities	(4)	60	56
Mortgage-backed securities	(17)	81	64
Loans receivable	2,260	(1,007)	1,253
Total interest-earning assets	2,125	(807)	1,318
Interest-bearing liabilities:			
Certificates of Deposit	(155)	304	149
Money Market	(4)	99	95
Statement savings	(0)	(11)	(11)
NOW accounts	2	2	4
Borrowings	233	246	479
Total interest-bearing liabilities	77	639	716
Change in net interest income	$2,048	$(1,446)	$602

Provision for Loan Losses. We establish provisions for loan losses that are charged to operations in order to maintain the allowance for loan losses at a level believed, to the best of management's knowledge, to cover all known and inherent losses in the portfolio both probable and reasonable to estimate at each reporting date. There was $1.6 million charged to the provision for loan losses for the fiscal year ending March 31, 2018 compared to a provision for loan losses of $3.4 million for the fiscal year ending March 31, 2017. The Company recorded a lower provision during fiscal 2018 compared to fiscal 2017 because of much lower net charge-offs that totaled $948,000 and $2.9 million, respectively. The more significant charge-offs for fiscal 2018 included $379,000 associated with our commercial lease portfolio, $244,000 relating to one commercial real estate relationship that has been a continued problem asset with prior charge-offs, and $262,000 associated with one residential investor relationship. The remaining balance of the provision for loan losses for fiscal 2018 is primarily related to the overall growth within the loan portfolio generated organically and through various loan purchases throughout the fiscal year.

The allowance for loan losses was $2.8 million, or 39.4% of non-performing loans at March 31, 2018 compared to $2.2 million, or 94.5% of non-performing loans at March 31, 2017. The decrease in the percentage is a result of a $4.8 million increase in non-performing loans as compared to the period ending March 31, 2017. The increase in non-performing loans is primarily due to one commercial real estate relationship with a book value of $3.2 million that was placed on nonaccrual in the second quarter and a group of residential investor loans totaling $600 thousand that were placed on nonaccrual at the end of the third quarter. Approximately $262 thousand has been charged-off in relation to the residential investor loans, while there was no impairment associated with the commercial real estate loan based upon the most recent collateral value of the property. In addition, there is approximately $1.2 million in loans that are 90 days past due and accruing and classified as non-performing loans. These loans continue to make payments and we are recognizing the income, however, they have reached their maturity and are in the process of being extended or renewed. Our credit department is diligently working to obtain the necessary information from the borrower that is needed to complete this process. If these loan items were excluded, the allowance for loan losses as a percentage of non-performing loans at March 31, 2018 would be 86.2%.

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During the year ended March 31, 2018, loan charge offs totaled $975,000 with recoveries of $27,000, compared to $3.0 million in charge offs and $51,000 in recoveries during the year ended March 31, 2017. The significant charge-offs in the prior year were related to two specific events, including one commercial real estate relationship that resulted in $1.1 million in charge-offs and the sale of a pool of residential investor loans that resulted in $1.6 million in charge-offs. During fiscal year 2018 and into fiscal 2019, we expect that we will continue our emphasis in growing commercial real estate and commercial business loans, which have higher interest rates than one-to-four family mortgage loans, but are generally considered to bear higher risk than one-to four-family mortgage loans. Such growth could contribute to higher provisions going forward.

Noninterest Revenue. Noninterest revenue decreased $942,000, or 89.3%, to $2.0 million for the year ended March 31, 2018 compared to $1.1 million for the year ended March 31, 2017. The following table outlines the changes in components of noninterest revenue for the twelve-month periods.

	Years Ended 31,			
	2018	2017	$ Change	% Change
Service charges	$459,688	$420,234	$39,454	9.4
(Loss) gain on sale of investment securities	(2,354)	23,720	(26,074)	(109.9)
Gain on sale of loans held for sale	-	23,087	(23,087)	(100.0)
Gain (loss) on sale of property and equipment	97,604	(5,046)	102,650	(2,034.3)
Earnings on bank-owned life insurance (BOLI)	484,030	485,400	(1,370)	(0.3)
Earnings on death benefit from BOLI	834,610	-	834,610	N/A
Other fees and commissions	122,770	107,152	15,618	14.6
Total noninterest revenue	$1,996,348	$1,054,547	$941,801	89.3

Noninterest revenue was impacted during the fiscal year ended March 31, 2018 by increases in service charges, gain on sale of property and equipment, and earnings on death benefit from BOLI, partially offset by decreases in gain on sale of investments and loans held for sale.

Service charges associated with retail and commercial deposit products increased $39,000, or 9.4% during the twelve months ended March 31, 2018 compared to the same period a year ago due to a $13.0 million increase in our average checking accounts period-over-period. Management is continually focused on growing core deposits, particularly checking accounts, which typically generate more service fee income. We continue to review and evaluate our retail fee structure on transactional accounts. Customers, however, have become more cost conscious of fees and better manage their deposit relationship with the Bank.

The $98,000 gain on sale of property and equipment for fiscal 2018 is related to the December 2017 sale of our Pigtown branch in Baltimore City at a gain of $213,000, net of various furniture and equipment that was associated with the property that was also disposed, partially offset by $115,000 loss pertaining to the write-down or disposal of leasehold improvements associated with our former or legacy Cockeysville branch. The Pigtown branch was relocated within the same community, but to a smaller, more efficient space that will provide operational cost savings.

The Company received gross proceeds of approximately $2.1 million in relation to death benefits under our BOLI policies due to the sudden and unexpected passing of an employee during the fourth quarter of fiscal 2018. After netting out $1.3 million associated with the cash surrender value of the policies, the Company was able to recognize non-interest revenue of $835,000. The normal earnings on BOLI remained relatively flat year-over-year despite an increase in average balances associated with the Fraternity acquisition because of the offsetting decrease in the rate earned on the outstanding BOLI policies, else revenue would have been higher. The revenue associated with both the death benefits and normal earnings are currently nontaxable for federal and state income tax purposes.

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Offsetting the increases in noninterest revenue for fiscal 2018 was a decrease in gain on the sale of loans held for sale. Gain on sale of loans held for sale represents revenue earned on loans sold in the secondary market at a premium. Over the past several years, we typically sold our newly originated residential mortgage loans in the secondary market to better manage interest rate risk in a rising rate environment. During the second half of fiscal 2017 and throughout fiscal 2018, however, the Company began to hold in portfolio our residential loan originations to partially offset the increased run-off associated with this loan segment. Consequently, there were no loans sold during the year ended March 31, 2018 compared to the same period last year in which several loans were sold at a gain of $23,000. We do plan to sell residential mortgage loans again beginning in fiscal 2019.

Other fees and commissions include loan fees charged to customers, merchant credit card fees, and other smaller fees. The increase with respect to the twelve months ended March 31, 2018 compared to twelve months ended March 31, 2017, is primarily related to merchant credit services and a $35,000 charge in the prior year relating to the disposal of an equity position in a limited liability company that assisted us with the sale of residential mortgages into the secondary market. Loan fees include various charges to customers for loan applications, processing, and/or extensions. Loan fees for fiscal 2018 declined $46,000 to $56,000, compared to $100,000 for fiscal 2017.

Gains on investment securities are also reported as noninterest revenue. During fiscal 2018 we sold investment securities with a book value of $11.6 million and recognized a loss of $2,000 for the year ended March 31, 2018. For the year ended March 31, 2017, investment securities with a book value of $4.3 million were sold and a gain of $24,000 was recognized.

Noninterest Expense. Noninterest expense decreased $326,000, or 2.5%, to $12.9 million for the year ended March 31, 2018 compared to $13.2 million for the year ended March 31, 2017. The following table outlines the changes in noninterest expense for those periods.

	Years Ended March 31,			
	2018	2017	$ Change	% Change
Salaries and benefits	$7,268,507	$6,756,044	$512,463	7.6
Occupancy	1,045,589	984,767	60,822	6.2
Advertising	86,865	122,093	(35,228)	(28.9)
Furniture and equipment	343,624	377,232	(33,608)	(8.9)
Data processing	716,458	777,554	(61,096)	(7.9)
Legal services	491,900	291,550	200,350	68.7
Other professional services	851,660	1,046,450	(194,790)	(18.6)
Merger related expenses	-	219,417	(219,417)	(100.0)
Branch consolidation expense	-	494,977	(494,977)	(100.0)
Deposit insurance premiums	324,325	318,132	6,193	1.9
Foreclosed real estate expense and losses	44,197	7,468	36,729	491.8
Other operating	1,737,727	1,841,144	(103,417)	(5.6)

Total noninterest expense	$12,910,852	$13,236,828	$(325,976)	(2.5)

The decline in noninterest expense is primarily the result of non-recurring costs incurred in the prior year period ended March 31, 2017, including $219,000 in merger related expenses associated with the completion of our most recent acquisition of Fraternity and $437,000 in costs relating to the closing of one of our branch locations due to branch overlap from that same acquisition. Merger related expenses include fees paid to attorneys, investment bankers and accountants, data conversion, as well as other related costs. Excluding the acquisition and branch consolidation expense, overall operating expenses for the comparative periods has increased slightly as a result of a growing loan portfolio and revenue base. The elimination of acquisition related costs and the economies of scale achieved through those same acquisitions is reflected in the improvement of our efficiency ratio from 83.9% for the year ended March 31, 2017 to 78.5% for the year ended March 31, 2018. This improvement is also in part due to the income realized in the current year with respect to the BOLI proceeds. We are realizing the benefit of operating as a larger financial institution and the ability to offset expenses against greater revenue.

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Certain noninterest expenses, including furniture and equipment, data processing, and other operating expenses, declined as a result of management's continued focus on reducing costs where applicable. Some of these reductions have been obtained through the review or negotiation of vendor contracts, analysis of alternative sources, and more efficient means. Advertising expense decreased because we hired a full-time marketing director versus outsourcing to a third-party vendor. Federal deposit insurance premiums were lower due to a decrease in the average rate assessed by the Federal Deposit Insurance Corporation, the government agency that insures deposits, while other professional services decreased in part due to the end of our contractual obligation under a consulting and non-compete agreement with one of the former Fraternity executives.

The largest increase in noninterest expenses for the twelve-month period-over-period was in salaries and benefits, which increased $512,000. During the year ended March 31, 2018, the Company made strategic new hires that are focused on branch efficiency and new products. In addition, annual increases were given and bonuses awarded in fiscal 2018 that were not awarded in fiscal 2107. Also included in salaries and benefits for fiscal 2018 and 2017, is $322,000 and $317,000 in expense, respectively, relating to equity awards granted to officers under the Company's Equity Incentive Plan. The equity awards provide for management to have an interest in the performance of the company and share in the benefit of an increase in shareholder value. Similarly, other operating expenses for the same periods include $139,000 and $127,000 in expense, respectively, associated with equity awards granted to directors.

Legal expense for the twelve months ended March 31, 2018 increased over the same period a year ago. The increase in legal costs is due in part to management's engagement of counsel to assist with our charter conversion from a federal savings bank to a Maryland commercial bank. The charter conversion was approved and effective December 21, 2017. The charter conversion should reduce regulatory costs going forward. In addition, counsel was sought to assist with compiling and reviewing agreements associated with loan portfolio purchases throughout the year, as well as advise on the relocation of our Ellicott City and Pigtown branches and other compliance issues. Counsel also continues to assist with the collection and foreclosure process associated with problem loans, as well as consult on how to proceed with certain borrowers.

The increase in occupancy expense is primarily related to the relocation of our Ellicott City branch within the same geographic area of Howard County during the second quarter of fiscal 2018. Due to the timing and ability to move into the new location, the Bank had to pay rent expense on both the current and new property for a one-month period. In addition, there were costs incurred in the period associated with the relocation that were not capitalized. The new branch location in Ellicott City opened in July 2017. Subsequently, in March 2018 we also relocated our Pigtown branch located in Baltimore City to a much smaller space located on the same block. As with Ellicott City, there were costs incurred that related to the relocation that were not capitalized. Both relocations were to smaller, more efficient spaces that will provide operational cost savings.

Foreclosed real estate expense also increased year-over-year due to a $32,000 write-down of one of the Bank's foreclosed real estate properties during the third quarter. This write-down was based upon a new appraisal obtained on the property. The remainder of foreclosed real estate expense, or $5,000 increase, is associated with the property taxes paid on that same property.

Income Tax Expense. We recorded tax expense of $8.1 million for the year ended March 31, 2018 after pre-tax income of $2.0 million, compared to a tax benefit of $758,000 for the year ended March 31, 2017 after a pre-tax loss of $1.7 million. The effective income tax rate for the year ending March 31, 2018 was 402.0% compared to a negative effective tax rate of 44.9% for the year ending March 31, 2017. In fiscal 2018 the higher tax expense was a result of an adjustment associated with the Tax Act and the establishment of a valuation allowance relating to the Company’s net deferred tax assets and, to a lesser extent, tax expense associated with the Company’s pre-tax income of $2.0 million. The fiscal 2017 tax benefit was due to the pre-tax loss that was recorded along with nontaxable income associated with bank-owned life insurance and certain tax-exempt municipal securities.

At March 31, 2018, the Company did not report any net deferred tax asset compared to $8.0 million at March 31, 2017. The change is primarily related to the establishment of a net deferred tax asset valuation allowance and an adjustment that resulted from the passage of the Tax Act. The Tax Act, which was signed into law on December 22, 2017, amended the Internal Revenue Code to reduce income tax rates and modify policies, credits, and deductions for individuals and businesses. For businesses, the Tax Act reduces the federal corporate income tax rate from a maximum 35 percent to a flat 21 percent tax rate. As a result, our net deferred tax assets of $7.5 million at that time, which were based upon a 34 percent corporate tax rate, had to be re-evaluated to reflect the new tax rate of 21 percent. This non-cash adjustment was $2.3 million and was recorded through income tax expense. Based on the information available and our current interpretation of the Tax Act, the Company has made reasonable estimates of the impact from the reduction in the corporate tax rate on the re-measurement of applicable deferred tax assets and liabilities. However, certain deferred tax assets and liabilities will continue to be evaluated in the context of the Tax Act through the date of the filing of our March 31, 2018 federal income tax return, and may change as a result of evolving management interpretations, elections, and assumptions, as well as new guidance that may be issued by the Internal Revenue Service. Management expects to complete its analysis within the measurement period in accordance with *Staff Accounting Bulletin (SAB) No. 118*.

In accordance with Accounting Standards Codification (ASC) 740, *Accounting for Income Taxes,* at March 31, 2018, the Company assessed whether the deferred tax assets are more likely than not to be realized based on an evaluative process that considers all available positive and negative evidence. As part of this evaluative process, management considered the following sources of taxable income: 1.) taxable income in prior carryback years; 2.) the future reversals of taxable temporary differences; 3.) tax planning strategies; and 4.) future taxable income exclusive of reversing temporary differences and carryforwards. In making a conclusion, management evaluated all the available positive and negative evidence impacting these sources of taxable income. The first three options are more quantifiable and verifiable; however, management concluded they were not viable sources of taxable income. As such, the positive evidence that was most heavily relied upon, but the most subjective, was future taxable income exclusive of reversing temporary differences and carryforwards. The Company is in a three-year cumulative loss position which creates negative evidence and because this evidence is considered significant, management concluded that there was more negative evidence than positive evidence and therefore, it is more likely than not that the Company will be unable to generate sufficient taxable income in the foreseeable future to fully utilize the net deferred tax assets. Thus, a full valuation allowance of $5.8 million on all the net deferred tax assets was established at March 31, 2018. The establishment of a valuation allowance on our deferred tax assets for financial reporting purposes does not affect how the net operating loss carryforwards may be utilized on our subsequent income tax returns.

Risk Management

Managing risk is an essential part of successfully operating a financial institution. We have a comprehensive Enterprise Risk Management (ERM) program in place that addresses risks within the Company. The ERM program and the associated risks are updated and reviewed quarterly and presented to the Risk Committee which has oversight of the program. Risks are rated compared to the Company's risk appetite and action plans are developed by management for those risks outside of the board established parameters. Once the Risk Committee approves the ERM program, the ERM program is presented to the full board. Our most significant types of risk are economic risk, regulatory risk, and compliance risk.

Our three most prominent forms of economic risk are credit risk, interest rate risk and market risk. Our primary credit risk is the risk of defaults in our loan portfolio that result from the inability or unwillingness of borrowers to make contractually required payments. To a lesser extent, we also have credit risk related to the risk of defaults in our investment securities portfolio. Interest rate risk is the potential reduction of interest income or an increase interest expense because of changes in interest rates. Market risk arises from fluctuations in interest rates that may result in changes in the values of financial instruments, such as available-for-sale securities that are accounted for on a mark-to-market basis.

Regulatory and compliance risk involves our ability to effectively adapt to, and comply with, changes in the regulatory environment for financial institutions. We are subject to the regulations of various government agencies. These regulations may change significantly from period to period. We also undergo periodic examinations by regulatory agencies that may subject us to further changes with respect to asset valuations and classifications, amounts required for the allowance for loan losses, and operating restrictions resulting from the regulators' judgment based on information available to them at the time of their examination.

Other risks that we face are operational risks, liquidity risk and reputation risk. Operational risks include risks related to fraud, processing errors, technology and disaster recovery. Liquidity risk is the possible inability to fund obligations to depositors, lenders or borrowers due to unforeseen circumstances. Reputation risk is the risk that negative publicity or press, whether true or not, could cause a decline in our customer base or revenue.

Credit Risk Management

Our strategy for credit risk management focuses on having well-defined credit policies and uniform underwriting criteria and providing prompt attention to potential problem loans. Our loan approval process is described in Item 1. "Business", under the heading "Lending Activities—Loan Approval Procedures and Authority".

We have a loan monitoring system in place with dedicated staff that ensures all required loan information and documentation is obtained at the time a loan is originated and that such information is updated as required by our underwriting policies. This loan monitoring system, which tracks loans originated by the Bank, as well as loan participations and purchased loans, is integrated with our general ledger system, which allows management to monitor loan payment history and changes in loan status on a real-time basis. We have established a formal allowance for loan loss and loan delinquency committee to address non-performing and delinquent loans. This committee currently meets on a monthly basis. We also have a Special Assets manager to oversee problem credits.

Collection Procedures. When a residential mortgage borrower fails to make required payments on a loan, we take a number of steps to induce the borrower to cure the delinquency and restore the loan to current status. With respect to residential real estate loans, we generally send a written notice of non-payment to the borrower 15 days after a loan is first past due. When a loan reaches 60 days past due a “Notice of Intent” to foreclose letter is prepared and sent to the borrower. And finally, when a loan becomes 90 days past due, the loan is turned over to our attorneys to ensure that further collection activities are conducted in accordance with applicable laws and regulations. All residential mortgage loans past due 90 days are put on non-accrual and reported to the board of directors monthly. If our attorneys do not receive a response from the borrower, or if the terms of any payment plan established are not followed, then foreclosure proceedings will be implemented. Management submits an Asset Classification Report detailing risk ratings and changes to risk ratings to the board of directors on a monthly basis.

With respect to home equity loans and lines of credit, a complete listing of all delinquent accounts is given to senior management for evaluation on a monthly basis. The data center produces and sends late charge notifications to customers that alert customers of their payment status. If the account remains past due when the next late charge notice is produced, a collection letter is sent requiring delinquent accounts to be brought current within 10 days. Failure to comply or respond to collection efforts will result in the loan being turned over to our attorneys for collection.

Commercial loan officers are responsible for the prompt follow up with borrowers who become delinquent on commercial loans. Officers determine the cause of the delinquency and work with the borrower to institute a short-term plan to eliminate the delinquency. Commercial loans that become over 30 days delinquent are reported to the Chief Lending Officer for collection. If no reasonable plan to cure a delinquency over 60-90 days is reached, the Bank will initiate legal action, repossession, foreclosure, non-accrual or charge-off. When a commercial loan becomes 75 days delinquent, the Special Asset Officer is required to re-verify all documentation, including adequate insurance coverage. Commercial loans 90 days delinquent are generally placed on non-accrual and evaluated for impairment to determine if charge-off is necessary. All loans over 90 days delinquent are reported to the board of directors monthly. All charged-off loans and subsequent recoveries are reported in aggregate on a monthly basis to the appropriate members of senior management and the Board of Directors. Prior to the extension of non-accrual status beyond six months, a request for extension must be properly executed with appropriate approval signed by the Loan Committee. At the time the loan is placed in non-accrual, the accrued, but unpaid interest is reversed against the loan account in accordance with the Bank’s non-accrual policy. A loan may not be removed from non-accrual status until the loan is paid current or, under a modification agreement, an adequate period of time has passed in which the borrower has demonstrated the ability to make payments and their cash flow supports the payment going forward. At this point, management will determine whether or not to return the loan to accrual status.

Analysis of Nonperforming, Delinquent and Classified Assets. Loans are generally placed on nonaccrual status when they are 90 days past due based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual status at an earlier date if collection of principal or interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual status are reversed against interest revenue. The interest on nonaccrual loans is accounted for on the cash basis method, until the loans qualify for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. For certain nonaccrual loans, interest payments received are applied to the principal balance of the loan.

Non-Performing Assets. The table below sets forth the amounts and categories of our non-performing assets at the dates indicated.

	At March 31,				
	2018	2017	2016	2015	2014
	(Dollars in thousands)				
Non-accrual loans:					
Real estate loans:					
Residential	$864	$675	$775	$628	$284
Investor	362	71	675	11	159
Commercial construction	-	-	-	1,375	1,552
Commercial	4,555	1,547	2,717	-	-
Commercial business loans	165	-	122	226	2,041
Consumer loans:					
Home equity loans and lines of credit	13	3	49	15	204
Other consumer	5	6	4	-	-
Total non-accrual loans	5,964	2,302	4,342	2,255	4,240
Loans delinquent 90 days or greater and still accruing:					
Real estate loans:					
Residential	-	-	-	-	-
Investor	1,206	21	708	-	-
Commercial construction	-	-	-	-	-
Commercial	-	-	-	-	301
Commercial business loans	-	-	-	-	500
Consumer loans:					
Home equity loans and lines of credit	-	-	-	-	-
Other consumer	-	-	-	-	-
Total loans delinquent 90 days or greater and still accruing	1,206	21	708	-	801
Total non-performing loans	7,170	2,323	5,050	2,255	5,041
Other real estate owned and foreclosed assets:					
Real estate loans:					
Residential	47	23	-	12	-
Investor	-	37	-	-	-
Commercial construction	411	443	443	443	664
Commercial	-	-	-	-	-
Commercial business loans	-	-	-	-	-
Consumer loans:					
Home equity loans and lines of credit	-	-	-	-	-
Other consumer	-	-	-	-	-
Total foreclosed real estate	458	503	443	455	664
Total non-performing assets	7,628	2,826	5,493	2,710	5,705

Performing troubled debt restructurings	1,836	1,906	2,105	5,339	1,538
Total non-performing assets and performing troubled debt restructurings	$9,464	$4,732	$7,598	$8,049	$7,243
Ratios:					
Non-performing loans to total loans	1.84 %	0.69 %	2.27 %	1.41 %	3.48 %
Non-performing assets to total assets	1.45 %	0.55 %	1.40 %	0.93 %	1.88 %

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Non-performing loans totaled $7.2 million at March 31, 2018 compared to $2.3 million at March 31, 2017, an increase of $4.9 million. The increase in fiscal 2018 is primarily due to one commercial real estate relationship with a book value of $3.2 million that was placed on nonaccrual in the second quarter and a group of residential investor loans to one borrower totaling $600 thousand that were placed on nonaccrual at the end of the third quarter.

Non-performing assets to total assets increased to 1.45% at March 31, 2018 compared to 0.55% at March 31, 2017 as a result of the non-performing loans just discussed. The graph below shows the change in non-accrual loans during fiscal 2018 on a month-by-month basis as a percentage of gross loans:

Also included in nonperforming loans are accruing loans delinquent more than 90 days. At March 31, 2018 these loans consisted of investor (residential non-owner occupied) loans totaling $1.2 million compared to $21,000 at March 31, 2017. These loans represent loans that are on accrual status and making payments, however, such loans are 90 days past their contractual maturity date, and therefore reported as nonperforming. At March 31, 2018, these loan balances were elevated as they related to several borrowing relationships that have many smaller investor (residential non-owner occupied) loans that matured at the same time. The Bank's credit department is diligently working to obtain the necessary financial information from these borrowers so that these loans can either be renewed or extended accordingly.

Non-performing commercial real estate loans at March 31, 2018 totaled $4.6 million and primarily consisted of two borrowing relationships. The first relationship consists of two loans within an aggregate contractual principal balance of $3.3 million and a recorded investment balance of $1.2 million ($1.9 million charged-off life to date). The property consists of several commercial retail units that are a part of a multi-family complex. The loan and respective collateral is only for the commercial retail units. These loans were placed on non-accrual in October 2015 due to deteriorating cash flow, a pending lawsuit, and the inability of the borrower to make the principal payment under an existing troubled debt restructuring ("TDR") agreement. After being placed on non-accrual, the borrower continued to make the interest only payments through July 2016 at which time payments ceased. The Bank applied those funds as a principal reduction to the loans in accordance with our non-accrual policy. After payments ceased, the Bank obtained a new appraisal and had the borrower list the property for sale by an independent broker. Upon receipt of the new appraisal, which provided different valuations based upon various sale scenarios, we wrote the loan down by $622,000 in December 2016 to the highest sale value scenario and then another write-down of $490,000 in March 2017 to the lowest sales valuation due to limited interest in the property. In the second half of fiscal 2018, based upon our policy, we obtained a subsequent new appraisal on the property and charged-off an additional $244,000 based upon the updated valuation. During this time, the borrower also changed sales broker and re-listed the property for sale. Management is actively exploring other options to resolve this problem credit that may or may not result in additional write-downs.

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The second commercial real estate relationship consists of one loan with a contractual principal and recorded investment balance of $3.2 million. The loan was placed on non-accrual in the second quarter of fiscal 2018 after analysis of the borrower indicated the inability to cashflow and service the debt. The borrower at that time stopped making payments and listed the property for sale. At the time of nonaccrual, we obtained a new appraisal on the property which indicates no impairment on the loan as of March 31, 2018. The property is standard office and warehouse space located in Columbia, Maryland, which has a strong real estate market.

There were $165,000 in non-performing commercial business loans at March 31, 2018 compared to none at March 31, 2017. The recorded book balance of $165,000 in loans is comprised of three commercial lease loans to separate borrowers with a contractual balance of $544,000 and charge-offs totaling $379,000. The purpose of the loans was to provide funding to purchase medical equipment related to cosmetic surgery. Based upon the inability to generate sufficient revenue, the borrowers stopped making payments on the leases or asked for the equipment to be repossessed. All three loans are fully guaranteed by the respective borrowers. The commercial lease loans are a part of the $15.5 million commercial lease portfolio purchased by the Bank in June 2017.

Part of the loan portfolio originally acquired in the Fairmount acquisition consisted of $17.3 million in one-to-four family non-owner occupied (“investor”) loans. At March 31, 2018, the remaining book balance of investor loans associated with Fairmount totaled $9.5 million, of which $343,000 are on nonaccrual. The $343,000 balance of nonaccrual loans is primarily associated with one borrower that has multiple investor properties located in Baltimore City. The relationship has a combined contractual balance of $605,000 and charge-offs taken in the second half of fiscal 2018 totaling $262,000. The remaining book balance is based upon newly received appraisals for all the properties associated with this one borrower. Management is actively working with the borrower and exploring other options to resolve this problem relationship that may or may not result in additional write-downs on some or all the properties involved.

At March 31, 2018, there is $864,000 in owner occupied, one-to-four family residential loans that are classified as non-performing loans, all of which are classified as non-accrual, compared to $675,000 at March 31, 2017. Non-accrual loans consist of 23 loans in total, including 7 loans that comprise $659,000, or 76.2% of the outstanding balance. To date, the bank has charged-off $20,000 relating to the 23 loans that are classified as non-performing within this loan segment.

Gross interest income that would have been recorded during fiscal 2018 had our non-accruing loans been current in accordance with their original terms was $394,000.

Troubled Debt Restructurings (“TDR”). At March 31, 2018, Hamilton Bank had a total of $3.3 million in TDRs, including 15 one-to-four family residential real estate loans totaling $1.5 million, two commercial real estate loans totaling $1.2 million, and one commercial business loan equaling $605,000. Roughly $1.2 million of the $1.5 million in TDRs pertaining to one-to-four family residential real estate loans was comprised of two loans performing in accordance with their modified terms as of March 31, 2018. The remainder was comprised of thirteen one-to-four family residential real estate loans, totaling $313,000, that were on non-accrual.

The two commercial real estate loans totaling $1.2 million became TDRs at the end of the second fiscal quarter of 2015 and are currently on non-accrual. These are the same loans discussed earlier under the commercial real estate non-performing loans. The loans were placed on non-accrual in October 2015 and $1.1 million and $244,000 in charge-offs were recorded during fiscal 2017 and 2018, respectively.

The one commercial business loan that is a TDR totals $605,000 and is performing as agreed under its modified terms. This particular loan was on non-accrual when it was originally modified. The borrower has continued to make payments and the loan has been on accrual status now for over three years.

We had $3.7 million of TDRs at March 31, 2017, which included $1.6 million in one-to-four family residential real estate loans, including $1.3 million that were performing in accordance with their modified terms, the same two commercial real estate loans equaling $1.5 million, and the same commercial business loan totaling $644,000 that has been performing as agreed upon based upon its modified terms.

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Delinquent Loans. The following table sets forth certain information regarding delinquencies in our loan portfolio. Loans 90 or more days delinquent includes loans 90 or more days past due because of maturity, but are still accruing.

	60 to 89 Days Delinquent		90 or More Days Delinquent		Total	
	Number	Amount	Number	Amount	Number	Amount
	(Dollars in thousands)					
At March 31, 2018:						
Real estate loans:						
Residential	4	$ 307	7	$ 284	11	$ 591
Investor	-	-	43	1,568	43	1,568
Commerical construction	-	-	-	-	-	-
Commercial	1	135	4	4,555	5	4,690
Commercial business loans	-	-	3	165	3	165
Consumer loans:						
Home equity loans and lines of credit	-	-	1	13	1	13
Other consumer	2	28	1	5	3	33
Total loans	7	$ 470	59	$ 6,590	66	$ 7,060
At March 31, 2017:						
Real estate loans:						
Residential	3	$ 81	8	$ 336	11	$ 417
Investor	-	-	16	92	16	92
Commerical construction	-	-	-	-	-	-
Commercial	-	-	2	1,547	2	1,547
Commercial business loans	-	-	-	-	-	-
Consumer loans:						
Home equity loans and lines of credit	-	-	-	-	-	-
Other consumer	-	-	1	5	1	5
Total loans	3	$ 81	27	$ 1,980	30	$ 2,061
At March 31, 2016:						
Real estate loans:						
Residential	3	$ 99	10	$ 651	13	$ 750
Investor	-	-	31	1,217	31	1,217
Commerical construction	-	-	-	-	-	-
Commercial	-	-	2	2,717	2	2,717
Commercial business loans	-	-	1	122	1	122
Consumer loans:						
Home equity loans and lines of credit	-	-	1	43	1	43
Other consumer	-	-	1	4	1	4
Total loans	3	$ 99	46	$ 4,754	49	$ 4,853
At March 31, 2015:						
Real estate loans:						
Residential	3	$ 159	13	$ 476	16	$ 635
Investor	-	-	1	11	1	11

Commerical construction	-	-	1	1,375	1	1,375
Commercial	-	-	-	-	-	-
Commercial business loans	2	734	4	226	6	960
Consumer loans:						
Home equity loans and lines of credit	-	-	1	6	1	6
Other consumer	-	-	-	-	-	-
Total loans	5	$ 893	20	$ 2,094	25	$ 2,987
At March 31, 2014:						
Real estate loans:						
Residential	-	$ -	16	$ 283	16	$ 283
Investor	-	-	2	159	2	159
Commerical construction	1	1,242	-	-	1	1,242
Commercial	-	-	1	301	1	301
Commercial business loans	2	2,173	5	1,802	7	3,975
Consumer loans:						
Home equity loans and lines of credit	-	-	4	205	4	205
Other consumer	-	-	-	-	-	-
Total loans	3	$ 3,415	28	$ 2,750	31	$ 6,165

The increase in loans 90 or more days delinquent for fiscal 2018 as compared to fiscal 2017 was due to increases in residential investor loans, commercial real estate, and commercial business loans. The increase in residential investor loans is largely due to the $1.2 million in loans that are reported as 90 days past due and still accruing. See the discussion of non-performing loans above for additional information regarding loans that are 90 or more days delinquent for the period ended March 31, 2018.

Classified Assets. Federal regulations require that each insured financial institution classify its assets on a regular basis. In addition, in connection with examinations of insured institutions, federal examiners have authority to identify problem assets and, if appropriate, classify them. There are three classifications for problem assets: “substandard,” “doubtful” and “loss”. Each is defined as follows:

***Substandard* -** A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard loans have a well-defined weakness, or weaknesses, that jeopardize the collection or liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. This will be the measurement for determining if a loan is impaired. Borrowers may exhibit recent or unexpected unprofitable operations, an inadequate debt service coverage ratio, or marginal liquidity and capitalization. These loans require more intense supervision by Bank management.

***Doubtful* -** A doubtful loan has all the weaknesses inherent as a substandard loan with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. A loan classified as doubtful exhibits loss potential. However, there is still sufficient reason to permit the loan to remain on the books. A doubtful classification could reflect the deterioration of the primary source of repayment and serious doubt exists as to the quality of the secondary source of repayment.

Doubtful classifications should be used only when a distinct and known possibility of loss exists. When identified, adequate loss should be recorded for the specific assets. The entire asset should not be classified as doubtful if a partial recovery is expected, such as liquidation of the collateral or the probability of a private mortgage insurance payment is likely.

***Loss* -** Loans classified as loss are considered uncollectable and of such little value that their continuance as loans is unjustified. A loss classification does not mean a loan has absolutely no value; partial recoveries may be received in the future. When loans or portions of a loan are considered a loss, it will be the policy of the Bank to write-off the amount designated as a loss. Recoveries will be treated as additions to the allowance for loan losses.

Another category, designated “special mention”, may also be established and maintained for assets which do not currently expose an insured institution to a sufficient degree of risk to warrant classification as substandard, doubtful or loss. If a classified asset is deemed to be impaired with measurement of loss, the Bank will establish a charge-off of the loan pursuant to Accounting Standards Codification Topic 310, “Receivables.”

The following table sets forth information regarding classified assets and special mention assets at March 31, 2018, 2017 and 2016.

	At March 31,		
	2018	**2017**	**2016**
	(In thousands)		
Classification of Assets:			
Substandard	$6,715	$3,447	$5,310
Doubtful	-	-	-
Loss	-	-	-
Total Adversely Classified Assets	$6,715	$3,447	$5,310
Special Mention	$7,022	$11,402	$11,969

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The following graph shows both special mention and substandard loans, including unfunded commitments, as a percentage of gross loans throughout fiscal 2018:

At March 31, 2018, substandard assets consisted of four commercial real estate loans totaling $4.6 million, two of which are to the same borrower, and four commercial business loan totaling $190,000. At that same date, there were 22 residential mortgage loans totaling $1.4 million that were classified as substandard, along with 16 nonowner-occupied residential investor loans totaling $505,000. The majority of the investor loans were acquired in the Fairmount transaction. Finally, there were three home equity loans totaling $21,000, one recreational vehicle for $19,000 and one mobile home loan equaling $32,000 that were also classified as substandard.

At March 31, 2018, there are no loans classified as doubtful.

At March 31, 2018, special mention loans consisted of 14 one-to-four family mortgage loans totaling $3.3 million and seven loans equaling $297,000 that are nonowner-occupied residential investor loans. Also included in special mention loans are two commercial real estate loans totaling $3.1 million, which are to the same borrower, and one special mention commercial business loan for $135,000. Lastly, there are two home equity loans classified as special mention for $111,000, along with one recreational vehicle for $83,000 and two auto loans totaling $14,000.

Analysis and Determination of the Allowance for Loan Losses. We maintain the allowance through a provision for loan losses that we charge to income. We charge losses on loans against the allowance for loan losses when we believe the collection of loan principal is unlikely. Recoveries on loans charged-off are restored to the allowance for loan losses. The allowance for loan losses is maintained at a level believed, to the best of management's knowledge, to cover all known and inherent losses in the portfolio that are both probable and reasonable to estimate at each reporting date. Consideration is given to historical losses in conjunction with a variety of other factors including, but not limited to, current economic conditions, delinquency statistics, geographic and industry concentrations, the adequacy of the underlying collateral, the financial strength of the borrower, results of internal loan reviews and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant change. We evaluate our allowance for loan losses, at a minimum, on a quarterly basis. Management modified the analysis during the quarter ended September 30, 2016 by keeping our net charge-off history as a percentage of loans, as it pertains to each loan segment, constant across all risk ratings and altering our qualitative factors either up or down based upon the respective risk rating for each loan segment. The change in methodology did not have a material impact on the amount of the allowance for loan losses at September 30, 2016 as compared to the prior methodology. We make adjustments to the external factors in the calculation during the year as deemed fit. We will continue to monitor all items involved in the allowance calculation closely. Additional information on our methodology for calculating the allowance for loan losses is described in this Item 7 above under "—Critical Accounting Policies—Allowance for Loan Losses."

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In addition, the regulatory agencies, as an integral part of their examination and review process, periodically review our loan portfolios and the related allowance for loan losses. Regulatory agencies may require us to increase the allowance for loan losses based on their judgment of information available to them at the time of their examination, thereby adversely affecting our results of operations.

We recorded a provision for loan losses of $1.6 million for the year ended March 31, 2018 compared to a provision for loan losses of $3.4 million for the year ended March 31, 2017. The allowance for loan losses was $2.8 million, or 0.73% of total loans, at March 31, 2018, compared to $2.2 million, or 0.65% of total loans, at March 31, 2017. The percentage of allowance for loan losses to total loans increased because of additional reserves that were recorded in conjunction with the overall growth of the loan portfolio and provisions associated with charge-offs that were experienced.

Our non-performing loans increased by $4.8 million to $7.2 million at March 31, 2018 from $2.3 million at March 31, 2017. A large portion of the increase is related to one commercial real estate loan, with a book value of $3.2 million that was placed on non-accrual during the second quarter of fiscal 2018, along with an increase of $1.2 million in investor loans that are 90 days past due and still accruing. During the year ended March 31, 2018, net loan charge-offs decreased to $948,000 compared to $2.9 million in fiscal 2017. The decline is in large part due to certain charge-offs that were taken in the prior year, including $1.1 million in charge-offs relating to one commercial real estate relationship and another $1.6 million in charge-offs associated with a group of investor loans that were re-classed as held-for-sale and subsequently sold. In fiscal 2018, we recorded net charge-offs of $244,000 relating to the same commercial real estate relationship noted in the prior year, $315,000 in residential investor loans that was primarily associated with one relationship, and $379,000 in charge-offs associated with three commercial lease loans. During fiscal 2018, our allowance for loan losses of $2.8 million, increased $627,000 compared to the prior year. This increase is associated with the growth in the overall loan portfolio, as well as specific charge-offs and their impact to our historical charge-off history. Charge-off history is a significant factor taken into consideration when calculating the allowance for loan losses.

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Analysis of Loan Loss Experience. The following table sets forth the analysis of the activity in the allowance for loan losses for the fiscal years indicated:

	At or For the Year Ended March 31,				
	2018	**2017**	**2016**	**2015**	**2014**
	(Dollars in thousands)				
Balance at beginning of year	$2,195	$1,702	$1,690	$1,786	$2,071
Charge-offs:					
Real estate loans:					
Residential	20	35	70	55	75
Investor	315	1,801	222	83	131
Commercial construction	-	-	-	-	1,000
Commercial	244	1,111	568	-	-
Commercial business loans	379	2	11	84	1,059
Home equity loans and lines of credit	-	-	6	101	11
Other consumer	17	4	16	-	-
Total charge-offs	975	2,953	893	323	2,276
Recoveries:					
Real estate loans:					
Residential	8	-	1	4	24
Investor	18	12	25	1	-
Commercial construction	-	-	237	-	-
Commercial	-	-	-	-	47
Commercial business loans	1	29	192	48	45
Home equity loans and lines of credit	-	-	-	3	-
Other consumer	-	10	10	1	1
Total recoveries	27	51	465	57	117
Net loan charge-offs	(948)	(2,902)	(428)	(266)	(2,159)
Additions charged to operations	1,575	3,395	440	170	1,874
Balance at end of year	$2,822	$2,195	$1,702	$1,690	$1,786
Total loans outstanding	$389,221	$339,000	$222,767	$160,388	$144,819
Average net loans outstanding	$362,355	$314,473	$197,276	$146,720	$153,019
Allowance for loan losses as a percentage of total loans at end of year	0.73%	0.65%	0.76%	1.05%	1.23%
Net loans charged-off as a percent of average net loans outstanding	0.26%	0.92%	0.22%	0.18%	1.41%
Allowance for loan losses to non-performing loans	39.36%	94.49%	33.70%	74.97%	35.44%

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Allocation of Allowance for Loan Losses. The following table sets forth the allocation of allowance for loan losses by loan category at the dates indicated. The table also reflects each loan category as a percentage of total loans receivable. The allocation of the allowance by category is not necessarily indicative of future losses and does not restrict the use of the allowance to absorb losses in any category.

	At March 31, 2018			**2017**			**2016**		
	Amount	**Percent of Allowance in Each Loan Category**		**Amount**	**Percent of Allowance in Each Loan Category**		**Amount**	**Percent of Allowance in Each Loan Category**	
	(Dollars in thousands)								
Real estate loans:									
Residential	$609	21.6	%	$554	25.2	%	$260	15.3	%
Investor	52	1.8		35	1.6		168	9.9	
Commercial construction	33	1.2		9	0.4		42	2.4	
Commercial	1,253	44.4		1,376	62.7		902	53.0	
Commercial business loans	674	23.9		149	6.8		228	13.4	
Home equity loans and lines of credit	70	2.5		70	3.2		82	4.8	
Other consumer	131	4.6		2	0.1		20	1.2	
Unallocated	-	-		-	-		-	-	
Total	$2,822	100.0	%	$2,195	100.0	%	$1,702	100.0	%

	At March 31, 2015			**2014**		
	Amount	**Percent of Allowance in Each Loan Category**		**Amount**	**Percent of Allowance in Each Loan Category**	
	(Dollars in thousands)					
Real estate loans:						
Residential	$319	18.9	%	$445	39.8	%
Investor	114	6.7		83	9.7	
Commercial construction	68	4.0		61	2.3	
Commercial	586	34.7		576	28.6	

Commercial business loans	473	28.0		591	10.8	
Home equity loans and lines of credit	99	5.8		27	8.0	
Other consumer	1	0.1		3	0.8	
Unallocated	30	1.8		-	-	
Total	$1,690	100.0	%	$1,786	100.0	%

The percentage of the allowance for loan loss associated with real estate investor loans is only 1.8%, or $52,000, despite total charge-offs of $315,000 and $1.8 million during fiscal 2018 and 2017 because a large portion of the investor charge-offs were associated with acquired loans from Fairmount. These loans, at acquisition, were not considered to have deteriorated credit quality and were accounted for in accordance with ASC Topic 310-20. Under ASC Topic 310-20, the difference between the loan’s principal balance at the time of purchase and the fair value is recognized as an adjustment of yield over the life of the loan. The fair value is comprised of two parts, including a credit mark used to measure credit quality and an interest rate mark to adjust the contractual rate to a current market rate. At March 31, 2018, the credit mark remaining with respect to the Fairmount portfolio was $1.1 million. This amount acts as a type of reserve and is analyzed in conjunction with the allowance for loan losses with respect to determining reserves that need to be set aside for a specific loan segment.

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Market Risk Management

General. Our most significant form of market risk is interest rate risk because, as a financial institution, the majority of our assets and liabilities are sensitive to changes in interest rates. Therefore, a principal part of our operations is to manage interest rate risk and limit the exposure of our financial condition and results of operations to changes in market interest rates. Our Asset-Liability Management Committee (ALCO) is responsible for evaluating the interest rate risk inherent in our assets and liabilities, for determining the level of risk that is appropriate, given our business strategy, operating environment, capital, liquidity and performance objectives, and for managing this risk consistent with the policy and guidelines approved by our board of directors.

Historically, we have operated as a traditional thrift institution. A significant portion of our assets consist of longer-term, fixed-rate residential mortgage loans and securities, which we have funded primarily with time deposits. Since 2009, in an effort to improve our earnings and to decrease our exposure to interest rate risk, we have generally sold all newly originated residential mortgage loans with terms of over ten years into the secondary market and shifted our focus to originating commercial real estate and commercial business loans. Such loans generally have shorter maturities than one-to-four family residential mortgage loans. However, due to the recent acquisitions and increased volume, the normal run-off associated with our residential real estate loan portfolio has exceeded our new originations within this same loan segment. As a result, we have begun to portfolio some of our newly originated, longer-term residential real estate loans versus selling them in the secondary market to assist in slowing down the decline within this loan segment.

Net Interest Income Analysis. We analyze our sensitivity to changes in interest rates through our net interest income simulation model which is provided to us by an independent third party. Net interest income is the difference between the interest income we earn on our interest-earning assets, such as loans and securities, and the interest we pay on our interest-bearing liabilities, such as deposits and borrowings. We estimate what our net interest income would be for a one-year period based on current interest rates. We then calculate what the net interest income would be for the same period under different interest rate assumptions. We also estimate this impact over a five-year time horizon. The following table shows the estimated impact on net interest income for the one-year period beginning March 31, 2018 resulting from potential changes in interest rates. These estimates require certain assumptions to be made, including loan and mortgage-related investment prepayment speeds, reinvestment rates, and deposit maturities and decay rates. These assumptions are inherently uncertain. As a result, no simulation model can precisely predict the impact of changes in interest rates on our net interest income. Although the net interest income table below provides an indication of our interest rate risk exposure at a particular point in time, such estimates are not intended to, and do not, provide a precise forecast of the effect of changes in market interest rates on our net interest income and will differ from actual results.

Net Interest Income	Year 1 Change

Rate Shift (1)	**Year 1 Forecast**	**from Level**
	(Dollars in thousands)	
+400	$ 13,519	(4.4)%
+300	$ 13,880	(1.8)%
+200	$ 14,149	0.1%
+100	$ 14,253	0.8%
Level	$ 14,140	—
-100	$ 13,792	(2.5)%
-200	$ 13,189	(6.7)%
-300	$ 13,048	(7.7)%

(1) The calculated changes assume an immediate shock of the static yield curve.

Economic Value of Equity Analysis. We also analyze the sensitivity of our financial condition to changes in interest rates through our economic value of equity model, which is also provided to us by the same independent third party as the net interest income analysis. This analysis measures the difference between predicted changes in the present value of our assets and predicted changes in the present value of our liabilities assuming various changes in current interest rates. As with the net interest income simulation model, the estimates of changes in the economic value of our equity require certain assumptions to be made. These assumptions include loan and mortgage-related investment prepayment speeds, reinvestment rates, and deposit maturities and decay rates. These assumptions are inherently uncertain and, as a result, we cannot precisely predict the impact of changes in interest rates on the economic value of our equity. Although our economic value of equity analysis provides an indication of our interest rate risk exposure at a particular point in time, such estimates are not intended to, and do not, provide a precise forecast of the effect of changes in market interest rates on the economic value of our equity and will differ from actual results.

Rate Shift (1)	**Economic Value of Equity**	**% Change In Equity from Level**
	(Dollars in thousands)	
+400	$ 39,348	(31.8) %
+300	$ 47,165	(19.7) %
+200	$ 54,316	(9.0) %
+100	$ 59,289	(1.9) %
Level	$ 61,178	—
-100	$ 59,172	(4.5) %
-200	$ 55,696	(11.5) %
-300	$ 53,844	(15.6) %

(1) The calculated changes assume an immediate shock of the static yield curve.

Liquidity and Capital Management

Liquidity describes our ability to meet the financial obligations that arise in the ordinary course of business. Liquidity is primarily needed to meet the borrowing and deposit withdrawal requirements of our customers and to fund current and planned expenditures. Our primary sources of funds are deposits, scheduled amortization and prepayments of loan principal and mortgage-backed securities, maturities and calls of investment securities and funds provided by our operations. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions, and competition. We regularly adjust our investments in liquid assets available to meet short-term liquidity needs based upon our assessment of (i) expected loan demand, (ii) expected deposit flows, (iii) yields available on interest-earning deposits and securities, and (iv) the objectives of our asset/liability management policy.

We also have the ability to borrow from the Federal Home Loan Bank of Atlanta (FHLB) to meet our funding and liquidity needs. At March 31, 2018, we had $60.6 million in borrowings from the FHLB, of which $13.0 million was assumed through acquisitions, and the capacity to borrow approximately $68.3 million more, subject to our pledging of sufficient assets.

Hamilton Bank may also borrow up to $5.0 million from a correspondent bank under a secured federal funds line of credit, and $1.0 million under an unsecured line of credit. We would be required to pledge investment securities to draw upon the secured line of credit.

We normally carry balances with correspondent banks that exceed the federally insured limit. We currently conduct a quarterly review of each correspondent bank's financial information, including the bank's capital ratios, balance sheet, income statement and allowance for loan losses, to determine if the bank is financially stable.

Our primary investing activities are the origination of one-to-four family real estate loans, commercial real estate, commercial business, construction and consumer loans, and the purchase of securities. For the year ended March 31, 2018, loan originations (including original commitment amount) totaled $53.5 million, compared to $68.1 million for the year ended March 31, 2017. Purchases of investment and mortgage-backed securities totaled $1.2 million for the year ended March 31, 2018 and $50.6 million for the year ended March 31, 2017.

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Our most liquid assets are cash and cash equivalents and interest-bearing deposits. The level of these assets depends on our operating, financing, lending, and investing activities during any given period. At March 31, 2018, cash and cash equivalents totaled $23.4 million, while securities classified as available-for-sale amounted to $75.4 million.

Total deposits decreased $7.7 million during the year ended March 31, 2018, while total deposits decreased $9.7 million, excluding those acquired in the Fairmount acquisition, during the year ended March 31, 2017. Deposit flows are affected by the level of interest rates, the interest rates and products offered by competitors and other factors. In the first quarter of fiscal 2017, we made an increased effort to grow our lower costing core deposits (considered to be all deposits other than certificates of deposit) and retain maturing certificates of deposits through various promotions to assist in funding organic loan growth and potential loan purchases. Certificates of deposit allowed us to lock in those funds for an extended period based upon current interest rates. At March 31, 2018, certificates of deposit scheduled to mature within one year totaled $123.8 million, 50.1% of certificates of deposit. The percentage of certificates of deposit that mature within one year reflects customers' hesitancy to invest their funds for longer periods due to the current low interest rate environment, expectation of rising rates, and local competitive pressures. Whether we retain these deposits will be determined in part by the interest rates we are willing to pay on such deposits. If these maturing deposits do not remain with us, we will be required to seek other sources of funds, including other certificates of deposit and borrowings. Depending on market conditions, we may be required to pay higher rates on such deposits or other borrowings than we currently pay on certificates of deposit due on or before March 31, 2019.

In the normal course of operations, we engage in a variety of financial transactions that, in accordance with generally accepted accounting principles, are not recorded in our financial statements. These transactions involve, to varying degrees, elements of credit, interest rate and liquidity risk. Such transactions are used primarily to manage customers' requests for funding and take the form of loan commitments, unused lines of credit and letters of credit. At March 31, 2018, we had $50.7 million in commitments to extend credit outstanding. These commitments consisted of unused lines of credits, approved loan settlements, and standby letters of credit.

We are committed to maintaining a strong liquidity position. We monitor our liquidity position on a daily basis. We anticipate that we will have sufficient funds to meet our current funding commitments. Based on our deposit retention experience and current pricing strategy, we anticipate that a significant portion of maturing time deposits will be retained.

At March 31, 2018 and 2017, we exceeded all of the applicable regulatory capital requirements for the Bank, including the new requirements under Basel III to obtain a minimum common equity core (Tier 1) capital to risk-weighted assets ratio of 4.5%. To be classified as a well-capitalized bank, we must have a common equity core (Tier 1) capital to risk-weighted assets ratio of at least 6.5%. For the year ended March 31, 2018, the Bank's common equity to Tier 1 capital was $39.1 million, or 10.61%, of total risk-weighted assets compared to $40.1 million, or 12.13% of total risk-weighted assets for the year ended March 31, 2017.

Our core (Tier 1) capital was $39.1 million and $40.1 million, or 7.64% and 8.28% of adjusted total assets, at March 31, 2018 and 2017, respectively. In order to be classified as "well-capitalized" under federal banking regulations, we were required to have core capital of at least $25.6 million, or 5.0% of adjusted assets, as of March 31, 2018. To be classified as a well-capitalized bank, we must also have a ratio of total risk-based capital to risk-weighted assets of at least 10.0%, and a Tier 1 risk-based capital to risk-weighted assets of at least 8%. At March 31, 2018 and 2017, we had total risk-based capital ratios of 11.39% and 12.81%, respectively, and Tier 1 risk-based capital ratios of 10.61% and 12.13%, respectively. Our regulatory risk weighted capital ratios decreased during fiscal 2018 as a result of our risk-weighted assets increasing due to the increase in loans associated with organic growth and loan purchases throughout the year.

Off-Balance Sheet Arrangements and Aggregate Contractual Obligations

Commitments. As a financial services provider, we routinely are a party to various financial instruments with off-balance-sheet risks, such as commitments to extend credit and unused lines of credit. While these contractual obligations represent our future cash requirements, a significant portion of commitments to extend credit may expire without being drawn upon. Such commitments are subject to the same credit policies and approval process accorded to loans we make.

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Contractual Obligations. In the ordinary course of our operations, we enter into certain contractual obligations. Such obligations include data processing services, operating leases for premises and equipment, agreements with respect to borrowed funds and deposit liabilities.

Recent Accounting Pronouncements

The information required by this item is included in Note 2 to the consolidated financial statements included in this annual report.

Effect of Inflation and Changing Prices

The consolidated financial statements and related consolidated financial data presented herein regarding Hamilton Bank have been prepared in accordance with accounting principles generally accepted in the United States of America, which generally require the measurement of financial position and operating results in terms of historical dollars, without considering changes in relative purchasing power over time due to inflation. Unlike most industrial companies, virtually all of Hamilton Bank's assets and liabilities are monetary in nature. As a result, interest rates generally have a more significant impact on Hamilton Bank's performance than does the effect of inflation. Interest rates do not necessarily move in the same direction or in the same magnitude as the prices of goods and services, because such prices are affected by inflation to a larger extent than interest rates.

ITEM 7A. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

The information required by this item is incorporated herein by reference to Part II, Item 7, "*Management's Discussion and Analysis of Financial Condition and Results of Operation*."

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

The Consolidated Financial Statements, including supplemental data, of Hamilton Bancorp, Inc. begin on page F-1 of this Annual Report.

ITEM 9. CHANGES IN AND DISAGREEMENTS WITH ACCOUNTANTS ON ACCOUNTING AND FINANCIAL DISCLOSURE

None.

ITEM 9A. CONTROLS AND PROCEDURES

Evaluation of Disclosure Controls and Procedures.

The Company's President and Chief Executive Officer, its Chief Financial Officer, and other members of its senior management team have evaluated the effectiveness of the Company's disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) or 15d-15(e)), as of March 31, 2018. Based on such evaluation, the President and Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures, as of the end of the period covered by this report, were adequate and effective to provide reasonable assurance that information required to be disclosed by the Company, including Hamilton Bank, in reports that are filed or submitted under the Exchange Act, is recorded, processed, summarized and reported, within the time periods specified in the Commission's rules and forms.

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Managements Report and Changes in Internal Controls Over Financial Reporting.

There have been no changes in the Company's internal control over financial reporting during the quarter ended March 31, 2018 that have materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

The management of the Company is responsible for establishing and maintaining adequate internal control over financial reporting. The internal control process has been designed under our supervision to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with accounting principles generally accepted in the United States of America.

Management conducted an assessment of the effectiveness of the Company's internal control over financial reporting as of March 31, 2018, utilizing the framework established in Internal Control — Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) in 1992 and revised in 2013. Based on this assessment, management has determined that the Company's internal control over financial reporting as of March 31, 2018 is effective.

Our internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that accurately and fairly reflect, in reasonable detail, transactions and dispositions of assets; and provide reasonable assurances that: (1) transactions are recorded as necessary to permit preparation of financial statements in accordance with accounting principles generally accepted in the United States of America; (2) receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the Company's assets that could have a material effect on the Company's financial statements.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

Management's report on internal control was not subject to attestation by the Company's registered public accounting firm in accordance with rules of the Securities and Exchange Commission.

ITEM 9B. OTHER INFORMATION

Not applicable.

PART III

ITEM 10. DIRECTORS, EXECUTIVE OFFICERS AND CORPORATE GOVERNANCE

Information relating to the directors and officers of the Company, information regarding compliance with Section 16(a) of the Exchange Act, information regarding any changes in procedures for stockholders to recommend director nominees, and information regarding the audit committee and audit committee financial expert is incorporated herein by reference to the Company's Proxy Statement for the Annual Meeting of Stockholders to be held on August 20, 2018 (the "Proxy Statement") under the captions "Proposal 1—Election of Directors," "Executive Officers," "Section 16(a) Benefici Ownership Reporting Compliance," "Nominating Committee Procedures—Procedures to be Followed by Stockholders," "Corporate Governance and Board Matters—Committees of the Board of Directors" and "Corporate Governance and Board Matters—Committees of the Board of Directors.

The Company has adopted a code of ethics that applies to its principal executive officer, the principal financial officer and principal accounting officer. The Code of Ethics is posted on the Company's Internet Web site.

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ITEM 11. EXECUTIVE COMPENSATION

Information regarding executive and director compensation is incorporated herein by reference to the Proxy Statement under the captions “Executive Officers—Executive Compensation” and “Director Compensation.”

ITEM 12. SECURITY OWNERSHIP OF CERTAIN BENEFICIAL OWNERS AND MANAGEMENT AND RELATED STOCKHOLDERS MATTERS

(a) Security Ownership of Certain Beneficial Owners

Information required by this item is incorporated herein by reference to the section captioned “Stock Ownership—Stock Ownership of Certain Beneficial Owners” in the Proxy Statement.

(b) Security Ownership of Management

Information required by this item is incorporated herein by reference to the section captioned “Stock Ownership—Stock Ownership of Management” in the Proxy Statement.

(c) Changes in Control

Management of the Company knows of no arrangements, including any pledge by any person or securities of the Company, the operation of which may at a subsequent date result in a change in control of the registrant.

(d) Equity Compensation Plan Information

The following table sets forth information as of March 31, 2018 about Company common stock that may be issued upon the exercise of options under the Hamilton Bancorp, Inc. 2013 Equity Incentive Plan. The plan was approved by the Company’s stockholders.

Plan Category	**Number of securities to be issued upon the exercise of outstanding options, warrants and rights**	**Weighted-average exercise price of outstanding options, warrants and rights**	**Number of securities remaining available for future issuance under equity compensation plans (excluding securities reflected in the first column)**
Equity compensation plans approved by security holders	**242,350**	**$13.84**	**178,920**
Equity compensation plans not approved by security holders	N/A	N/A	N/A
Total	**242,350**	**$13.84**	**178,920**

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ITEM 13. CERTAIN RELATIONSHIPS AND RELATED TRANSACTIONS, AND DIRECTOR INDEPENDENCE

The information relating to certain relationships and related transactions and director independence is incorporated herein by reference to the Proxy Statement under the captions “Transactions with Related Persons” and “Proposal 1 — Election of Directors.”

ITEM 14. PRINCIPAL ACCOUNTING FEES AND SERVICES

The information relating to the principal accounting fees and expenses is incorporated herein by reference to the Proxy Statement under the captions “Proposal 2—Ratification of Independent Registered Public Accounting Firm—Audit Fees” and “—Pre-Approval of Services by the Independent Registered Public Accounting Firm.”

PART IV

ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES

(1) The financial statements required in response to this item are incorporated by reference from Item 8 of this report.

(2) All financial statement schedules are omitted because they are not required or applicable, or the required information is shown in the consolidated financial statements or the notes thereto.

(3) Exhibits

3.1 Articles of Incorporation of Hamilton Bancorp, Inc. (Incorporated by reference to Exhibit 3.1 to the Company’s Registration Statement on Form S-1 (File No. 333-182151), as amended, initially filed with the SEC on June 15, 2012).

3.2 Bylaws of Hamilton Bancorp, Inc. (Incorporated by reference to Exhibit 3.2 to the Company’s Registration Statement on Form S-1 (File No. 333-182151), as amended, initially filed with the SEC on June 15, 2012).

4	Form of Common Stock Certificate of Hamilton Bancorp, Inc. Bylaws of Hamilton Bancorp, Inc. (Incorporated by reference to Exhibit 4 to the Company's Registration Statement on Form S-1 (File No. 333-182151), as amended, initially filed with the SEC on June 15, 2012).
10.1	Employment Agreement between Hamilton Bank and Robert A. DeAlmeida (Incorporated by reference to Exhibit 10.1 to the Company's Form 8-K (File No. 001-35693) filed with the SEC on October 15, 2012).
10.2	Employment Agreement between Hamilton Bancorp, Inc. and Robert A. DeAlmeida (Incorporated by reference to Exhibit 10.2 to the Company's Form 8-K (File No. 001-35693) filed with the SEC on October 15, 2012).
10.3	Change in Control Agreement of John P. Marzullo (Incorporated by reference to Exhibit 10.4 to the Company's Form 8-K (File No. 001-35693) filed with the SEC on October 15, 2012).
10.4	Hamilton Bank Non-Qualified Supplemental Employee Stock Ownership Plan (Incorporated by reference to Exhibit 10.5 to the Company's Form 8-K (File No. 001-35693) filed with the SEC on October 15, 2012).
10.5	Hamilton Bank Executive Split Dollar Agreement with Robert A. DeAlmeida (Incorporated by reference to Exhibit 10.6 to the Company's Registration Statement on Form S-1 (File No. 333-182151), as amended, initially filed with the SEC on June 15, 2012).
10.6	Hamilton Bank Agreement for Deferred Compensation of Salaries (Incorporated by reference to Exhibit 10.8 to the Company's Registration Statement on Form S-1 (File No. 333-182151), as amended, initially filed with the SEC on June 15, 2012).

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10.7	Hamilton Bank Agreement for Deferred Compensation of Board Fees (Incorporated by reference to Exhibit 10.9 to the Company's Registration Statement on Form S-1 (File No. 333-182151), as amended, initially filed with the SEC on June 15, 2012).
10.8	Hamilton Bancorp, Inc. 2013 Equity Incentive Plan (Incorporated by reference to Appendix A of the Proxy Statement for the 2013 Annual Meeting of Stockholders (File No. 1-35693), filed October 18, 2013).
10.9	Change in Control Agreement of Ellen R. Fish (Incorporated by reference to Exhibit 10.9 to the Company's Annual Report on Form 10-K for the year ended March 31, 2014 (File No. 001-35693), filed with the SEC on June 26, 2015).
21.0	Subsidiaries of Registrant
23.0	Consent of Dixon Hughes Goodman, LLP
31.1	Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer
31.2	Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer
32.0	Section 1350 Certifications
101.0	The following materials from the Company's Annual Report on Form 10-K for the year ended March 31, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) Consolidated Statements of Financial Condition; (ii) Consolidated Statements of Operations; (iii) Consolidated Statements of Changes in Shareholders' Equity; (iv) Consolidated Statements of Cash Flows; and (v) the Notes to the Consolidated Financial Statements.

ITEM 16. Form 10-K Summary.

None.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

HAMILTON BANCORP, INC.

Date: June 29, 2018

By: /s/ Robert A. DeAlmeida
Robert A. DeAlmeida
President and Chief Executive Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the Registrant and in the capacities and on the dates indicated.

Signatures	Title	Date
/s/ Robert A. DeAlmeida Robert A. DeAlmeida	President and Chief Executive Officer (Principal Executive Officer)	June 29, 2018
/s/ John P. Marzullo John P. Marzullo	Senior Vice President, Chief Financial Officer and Treasurer (Principal Financial and Accounting Officer)	June 29, 2018
/s/ Carol L. Coughlin Carol L. Coughlin	Chairperson of the Board	June 29, 2018
/s/ Joseph J. Bouffard Joseph J. Bouffard	Director	June 29, 2018
/s/ William E. Ballard	Director	June 29, 2018

William E. Ballard		
/s/ Jenny G. Morgan Jenny G. Morgan	Director	June 29, 2018
/s/ William W. Furr William W. Furr	Director	June 29, 2018
/s/ Bobbi R. Macdonald Bobbi R. Macdonald	Director	June 29, 2018
/s/ James R. Farnum, Jr. James R. Farnum, Jr.	Director	June 29, 2018

Report of Independent Registered Public Accounting Firm

The Board of Directors and Shareholders

Hamilton Bancorp, Inc.

Towson, Maryland

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated statements of financial condition of Hamilton Bancorp, Inc. and Subsidiary (the “Company”) as of March 31, 2018 and 2017 and the related consolidated statements of operations, comprehensive (loss) income, changes in shareholders’ equity, and cash flows for the years then ended, and the related notes (collectively referred to as the “financial statements”). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of March 31, 2018 and 2017, and the results of their operations and their cash flows for the years then ended, in conformity with U.S. generally accepted accounting policies.

Basis for Opinion

These financial statements are the responsibility of the Company’s management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) (“PCAOB”) and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company’s internal control over financial reporting. Accordingly, we express no such opinion.

Our audits also included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statement. We believe that our audits provide a reasonable basis for our opinion.

/s/ Dixon Hughes Goodman LLP

We have served as the Company’s auditor since 2016.

Baltimore, Maryland

June 29, 2018

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Financial Condition

March 31,2018 and March 31, 2017

	March 31, 2018	March 31, 2017
Assets		
Assets		
Cash and due from banks	**$15,488,396**	$24,436,793
Federal funds sold	**7,880,019**	4,917,128
Cash and cash equivalents	**23,368,415**	29,353,921
Certificates of deposit held as investment	**499,189**	499,280
Securities available for sale, at fair value	**75,404,136**	102,429,128
Federal Home Loan Bank stock, at cost	**3,122,400**	2,020,200
Loans	**390,420,885**	338,933,198
Allowance for loan losses	**(2,821,903)**	(2,194,815)
Net loans and leases	**387,598,982**	336,738,383
Premises and equipment, net	**3,945,825**	3,674,280
Premises and equipment held for sale	**-**	547,884
Foreclosed real estate	**457,778**	503,094
Accrued interest receivable	**1,468,382**	1,310,080
Bank-owned life insurance	**17,455,850**	18,253,348
Deferred income taxes	**-**	7,976,850
Income taxes refundable	**40,000**	-
Goodwill and other intangible assets	**9,176,764**	9,302,828
Other assets	**2,995,741**	1,920,740
Total Assets	**$525,533,462**	$514,530,016
Liabilities and Shareholders' Equity		
Liabilities		
Noninterest-bearing deposits	**$29,557,943**	$30,401,454
Interest-bearing deposits	**375,585,032**	382,454,320
Total deposits	**405,142,975**	412,855,774
Borrowings	**60,672,140**	36,124,899
Advances by borrowers for taxes and insurance	**1,962,665**	1,868,110
Other liabilities	**3,679,550**	3,890,003
Total liabilities	**471,457,330**	454,738,786
Commitments and contingencies	**-**	-
Shareholders' Equity		
	34,076	34,111

Common stock, $.01 par value, 100,000,000 shares authorized. Issued and outstanding: 3,407,613 shares at March 31, 2018 and 3,411,075 shares at March 31, 2017		
Additional paid in capital	**32,113,534**	31,656,235
Retained earnings	**25,920,490**	31,730,673
Unearned ESOP shares	**(2,073,680)**	(2,221,800)
Accumulated other comprehensive loss	**(1,918,288)**	(1,407,989)
Total shareholders' equity	**54,076,132**	59,791,230
Total Liabilities and Shareholders' Equity	**$525,533,462**	$514,530,016

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Operations

Years Ended March 31, 2018 and 2017

	2018	2017
Interest revenue		
Loans, including fees	**$16,088,774**	$14,834,648
U.S. treasuries, government agencies and FHLB stock	**188,600**	214,441
Municipal and corporate bonds	**420,737**	338,916
Mortgage-backed securities	**1,246,963**	1,183,227
Federal funds sold and other bank deposits	**134,542**	190,374
Total interest revenue	**18,079,616**	16,761,606
Interest expense		
Deposits	**2,836,925**	2,599,901
Borrowed funds	**750,092**	271,205
Total interest expense	**3,587,017**	2,871,106
Net interest income	**14,492,599**	13,890,500
Provision for loan losses	**1,575,000**	3,395,006
Net interest income after provision for loan losses	**12,917,599**	10,495,494
Noninterest revenue		
Service charges	**459,688**	420,234
(Loss) gain on sale of investment securities	**(2,354)**	23,720
Gain on sale of loans held for sale	**-**	23,087
Gain (loss) on sale of property and equipment	**97,604**	(5,046)
Earnings on bank-owned life insurance	**484,030**	485,400
Earnings on death benefit from bank-owned life insurance	**834,610**	-
Other	**122,770**	107,152
Total noninterest revenue	**1,996,348**	1,054,547
Noninterest expenses		
Salaries	**5,733,065**	5,283,578
Employee benefits	**1,535,442**	1,472,466
Occupancy	**1,045,589**	984,767
Advertising	**86,865**	122,093
Furniture and equipment	**343,624**	377,232
Data processing	**716,458**	777,554
Legal services	**491,900**	291,550
Other professional services	**851,660**	1,046,450
Merger related expenses	**-**	219,417
Branch consolidation expense	**-**	494,977

Deposit insurance premiums	**324,325**	318,132
Foreclosed real estate expense and losses	**44,197**	7,468
Other operating	**1,737,727**	1,841,144
Total noninterest expense	**12,910,852**	13,236,828
Income (loss) before income taxes	**2,003,095**	(1,686,787)
Income tax expense (benefit)	**8,052,038**	(758,005)
Net loss	**$(6,048,942)**	$(928,782)
Net loss per common share:		
Basic	**$(1.90)**	$(0.29)
Diluted	**$(1.90)**	$(0.29)

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Comprehensive (Loss) Income

Years Ended March 31, 2018 and 2017

	2018	2017
Net loss	**$(6,048,942)**	$(928,782)
Other comprehensive income (loss):		
Unrealized loss on investment securities available for sale	**(678,270)**	(2,127,277)
Reclassification adjustment for realized loss (gain) on investment securities available for sale included in net income	**2,354**	(23,720)
Total unrealized loss on investment securities available for sale	**(675,916)**	(2,150,997)
Unrealized gain (loss) on derivative transactions	**300,023**	(83,634)
Income tax benefit relating to investment securities available for sale and derivative transactions	**(104,353)**	(848,461)
Other comprehensive loss	**(271,540)**	(1,386,170)
Total comprehensive loss	**$(6,320,482)**	$(2,314,952)

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Changes in Shareholders' Equity

Years Ended March 31, 2018 and 2017

	Common stock	Additional paid-in capital	Retained earnings	Unearned ESOP shares	Accumulated other comprehensive loss	Total shareholders' equity
Balances at April 1, 2016	**$ 34,136**	**$ 31,242,731**	**$ 32,659,455**	**$ (2,369,920)**	**$ (21,819)**	**$ 61,544,583**
Net loss	-	-	(928,782)	-	-	(928,782)
Unrealized loss on available for sale securities, net of tax effect of $ (848,461)	-	-	-	-	(1,302,536)	(1,302,536)
Unrealized loss on derivative transactions	-	-	-	-	(83,634)	(83,634)
Stock based compensation - options	-	216,735	-	-	-	216,735
Restricted stock - compensation and activity	(25)	158,649	-	-	-	158,624
ESOP shares allocated for release	-	38,120	-	148,120	-	186,240
Balances at March 31, 2017	**$ 34,111**	**$ 31,656,235**	**$ 31,730,673**	**$ (2,221,800)**	**$ (1,407,989)**	**$ 59,791,230**
Net loss	**-**	**-**	**(6,048,942)**	**-**	**-**	**(6,048,942)**
Unrealized loss on available for sale securities, net of tax effect of $ (156,640)	**-**	**-**	**-**	**-**	**(519,276)**	**(519,276)**
Unrealized gain on derivative transactions, net of tax effect of $ 52,287	**-**	**-**	**-**	**-**	**247,736**	**247,736**
Reclassification of tax effect under ASU 2018-02			**238,759**	**-**	**(238,759)**	**-**
Stock based compensation - options	**-**	**229,569**	**-**	**-**	**-**	**229,569**
Restricted stock - compensation and activity	**(35)**	**176,911**	**-**	**-**	**-**	**176,876**
ESOP shares allocated for release	**-**	**50,819**	**-**	**148,120**	**-**	**198,939**
Balances at March 31, 2018	**$ 34,076**	**$ 32,113,534**	**$ 25,920,490**	**$ (2,073,680)**	**$ (1,918,288)**	**$ 54,076,132**

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows

Years Ended March 31, 2018 and 2017

	2018	2017
Cash flows from operating activities		
Interest received	**$18,587,764**	$16,415,596
Fees and commissions received	**583,757**	522,341
Interest paid	**(4,427,190)**	(4,004,880)
Cash paid to suppliers and employees	**(13,059,738)**	(11,216,410)
Origination of loans held for sale	**-**	(2,017,697)
Proceeds from sale of loans held for sale	**-**	2,300,234
Income taxes paid, net of refunds received	**(10,835)**	(1,455,219)
Net cash provided by operating activities	**1,673,758**	543,965
Cash flows from investing activities		
Acquisition, net of cash acquired	**-**	(10,508,813)
Proceeds from sale of securities available for sale	**11,608,699**	4,282,233
Proceeds from maturing and called securities available for sale, including principal pay downs	**15,124,739**	28,963,565
Proceeds from sale of certificates of deposit held for investment	**-**	1,730,273
Proceeds from maturing and called certificates of deposit	**-**	1,724,000
Purchase of investment securities available for sale	**(1,208,990)**	(50,585,898)
Redemption of Federal Home Loan Bank stock	**-**	210,800
Purchase of Federal Home Loan Bank stock	**(1,102,200)**	(405,900)
Proceeds from Bank Owned Life Insurance death benefit	**2,116,138**	-
Loans made, net of principal repayments	**2,256,439**	(10,461,510)
Loans purchased	**(54,556,249)**	-
Purchase of premises and equipment	**(719,105)**	(273,669)
Proceeds from sale of premises and equipment	**767,728**	442,529
Proceeds from sale of foreclosed real estate	**35,896**	60,258
Net cash used by investing activities	**(25,676,905)**	(34,822,132)
Cash flows from financing activities		
Net increase (decrease) in Deposits	**(7,295,252)**	(10,529,332)
Advances by borrowers for taxes and insurance	**94,555**	788,316
Proceeds from borrowings	**40,000,000**	11,578,805
Payments of borrowings	**(15,027,250)**	(5,501,555)
Interest rate swap on FHLB borrowings	**300,023**	(83,634)
Issuance of restricted stock	**(35)**	20
Redemption of restricted stock	**(54,400)**	(69,068)
Net cash provided (used) by financing activities	**18,017,641**	(3,816,448)

Net decrease in cash and cash equivalents	**(5,985,506)**	(38,094,615)
Cash and cash equivalents at beginning of period	**29,353,921**	67,448,536
Cash and cash equivalents at end of period	**$23,368,415**	$29,353,921
Supplemental disclosures of cash flow information		
Total cash consideration paid for Fraternity acquisition	**$-**	$25,704,871
Less cash acquired	**-**	15,196,058
Acquisition, net of cash acquired	**$-**	$10,508,813

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Consolidated Statements of Cash Flows

(Continued)

	2018	2017
Reconciliation of net loss to net cash provided by operating activities		
Net loss	**$(6,048,942)**	$(928,782)
Adjustments to reconcile net loss to net cash provided by operating activities		
Amortization of premiums on certificates of deposit	**91**	12,949
Amortization of premiums on securities	**822,270**	840,535
Gain on sale of investment securities and certificates of deposit	**2,354**	(23,720)
Loss on sale of foreclosed real estate	**1,299**	6,238
Write-down of foreclosed real estate	**31,955**	-
Loan discount accretion	**(225,587)**	(841,329)
Deposit premium amortization	**(417,547)**	(597,655)
Borrowing premium amortization	**(425,509)**	(551,125)
Core deposit intangible asset amortization	**126,064**	121,022
Premises and equipment depreciation and amortization	**325,320**	334,210
Gain on death benefit from bank-owned life insurance	**(834,610)**	-
(Gain) loss on sale of premises and equipment	**(97,604)**	5,046
Stock based compensation	**460,880**	444,406
Provision for loan losses	**1,575,000**	3,395,006
ESOP shares allocated for release	**198,939**	186,240
Decrease (increase) in		
Accrued interest receivable	**(158,302)**	(361,914)
Loans held for sale	**-**	259,450
Cash surrender value of life insurance	**(484,030)**	(485,399)
Income taxes refundable and deferred income taxes	**8,041,203**	(2,213,224)
Other assets	**(1,074,989)**	2,565,464
Increase (decrease) in		
Accrued interest payable	**2,883**	15,007
Deferred loan origination fees	**69,676**	3,748
Other liabilities	**(217,056)**	(1,642,208)
Net cash provided by operating activities	**$1,673,758**	$543,965
Noncash investing activity		
Real estate acquired through foreclosure	**$23,835**	$126,575

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Form 10-K

Notes to Consolidated Financial Statements

March 31, 2018

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations

Hamilton Bancorp, Inc. (the "Company") was incorporated on June 7, 2012 to serve as the stock holding company for Hamilton Bank (the "Bank"), a federally chartered savings bank. On October 10, 2012, the Bank converted from a mutual savings bank to a stock savings bank and became the wholly owned subsidiary of the Company. In connection with the conversion, the Company sold 3,703,000 shares of common stock at a price of $10.00 per share, through which the Company received proceeds of approximately $35,580,000, net of offering expenses of approximately $1,450,000. The Bank's employee stock ownership plan (the "ESOP") purchased 8.0% of the shares sold in the offering, or 296,240 common shares. The purchase of shares by the ESOP was funded by a loan from the Company. The company's common stock began trading on the NASDAQ Capital Market under the trading symbol "HBK" on October 12, 2012.

On December 21, 2017, the Bank converted its charter from a federal savings bank to a Maryland state-chartered commercial bank and now operates under the laws of the State of Maryland. In conjunction with the Bank's charter conversion, Hamilton Bancorp converted from a savings and loan holding company to a bank holding company. The charter conversion is part of the Bank's strategic plan which will allow it to continue to focus on growth opportunities in commercial, consumer and mortgage lending as well as small business and retail banking. The Maryland Office of the Commissioner of Financial Regulation will serve as the Bank's primary regulator with federal oversight provided by the Federal Deposit Insurance Corporation. Hamilton Bancorp will continue to be regulated by the Federal Reserve Board.

On May 13, 2016, the Company completed its acquisition of Fraternity Community Bancorp, Inc. ("Fraternity") through the merger of Fraternity, the parent company of Fraternity Federal Savings and Loan, with and into the Company pursuant to the Agreement and Plan of Merger dated as of October 12, 2015, by and between the Company and Fraternity. As a result of the merger, each shareholder of Fraternity received a cash payment equal to nineteen dollars and twenty-five cents ($19.25) for each share of Fraternity common stock, or an aggregate of approximately $25.7

million. Immediately following the merger of Fraternity into the Company, Fraternity Federal Savings and Loan was merged with and into the Bank, with the Bank as the surviving entity.

On September 11, 2015, the Company completed its acquisition of Fairmount Bancorp, Inc. (“Fairmount Bancorp”) through the merger of Fairmount Bancorp, the parent company of Fairmount Bank, with and into the Company pursuant to the Agreement and Plan of Merger dates as of April 15, 2015, by and between the Company and Fairmount Bancorp. As a result of the merger, each shareholder of Fairmount Bancorp received a cash payment equal to thirty dollars ($30.00) for each share of Fairmount Bancorp common stock, or an aggregate of approximately $15.4 million. Immediately following the merger of Fairmount Bancorp into the Company, Fairmount Bank was merged with and into the Bank, with the Bank as the surviving entity.

Hamilton Bancorp is a holding company that operates a community bank with seven branches in the Baltimore-metropolitan area. Its primary deposit products are certificates of deposit and demand, savings, NOW, and money market accounts. Its primary lending products consist of real estate mortgages, along with commercial and consumer loans. Hamilton Bancorp’s primary source of revenue is derived from loans to customers, who are predominately small and middle-market businesses and middle-income individuals.

HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Summary of Significant Accounting Policies

The accounting and reporting policies of Hamilton Bancorp, Inc. and Subsidiary (“Hamilton”) conform to accounting principles generally accepted in the United States of America (“U.S. GAAP”) and to general practices in the banking industry. The more significant policies follow:

Principles of Consolidation. The accompanying consolidated financial statements include the accounts of the parent company and its wholly owned subsidiary, Hamilton Bank. All significant intercompany balances and transactions have been eliminated in consolidation.

Reclassifications. There were no reclassifications to prior year amounts in order to conform to current period classifications.

Use of Estimates. The preparation of financial statements in conformity with U.S. GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and the accompanying notes. Actual results could differ significantly from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, deferred income tax valuation allowances, the fair value of derivatives and investment securities, and other than temporary impairment of investment securities.

Cash and Cash Equivalents. For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks with original maturities of less than 90 days, brokerage money market accounts, and federal funds sold. Generally, federal funds are sold as overnight investments.

Investment Securities. Management determines the appropriate classification of investment securities at the time of purchase. Securities that may be sold before maturity are classified as available for sale and carried at fair value. Investment securities that management has the intent and ability to hold to maturity are classified as held to maturity and carried at amortized cost. All investment securities held by Hamilton at March 31, 2018 and 2017 are classified as available for sale.

Investment securities designated as available for sale are stated at estimated fair value based on quoted market prices. They represent those securities which management may sell as part of its asset/liability strategy or that may be sold in response to changing interest rates or liquidity needs. Changes in unrealized gains and losses, net of related deferred taxes, for available for sale securities are recorded in other comprehensive income. Realized gains (losses) on available-for-sale securities are included in noninterest revenue and, when applicable, are reported as a reclassification adjustment in other comprehensive income. Realized gains and losses on the sale of available for sale securities are recorded on the trade date and are determined by the specific identification method. The amortization of premiums and the accretion of discounts are recognized in interest revenue using methods approximating the interest method over the term of the security.

In estimating other-than-temporary impairment losses, management considers 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 Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

Federal Home Loan Bank Stock. Federal Home Loan Bank of Atlanta (the “FHLB”) stock is an equity interest in the FHLB, which does not have a readily determinable fair value for purposes of generally accepted accounting principles, because its ownership is restricted and it lacks a market. FHLB stock is carried at cost, which approximates fair value and can be sold back only at par value of $100 per share and only to the FHLB or another member institution. As a member of the FHLB, the Bank is required to purchase stock based on its total assets. Additional stock is purchased and redeemed based on the outstanding FHLB advances to the Bank. As of March 31, 2018 and 2017, the Company owned shares totaling $3,122,400 and $2,020,200, respectively.

HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Loans Held For Sale. Mortgage loans originated and intended for sale are carried at the lower of aggregate cost or estimated fair value. Fair value is determined based on outstanding investor commitments, or in the absence of such commitments, based on current investor yield requirements. Gains and losses on loan sales are determined by the specific-identification method.

Loans Receivable. The Bank makes mortgage, commercial, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout the Baltimore metropolitan area. The ability of the Bank's debtors to repay their loans is dependent upon the real estate and general economic conditions in this area.

Loans are reported at their outstanding unpaid principal balance adjusted for the allowance for loan loss, premiums on loans acquired, and/or any deferred fees or costs on originated loans. Interest revenue is accrued on the unpaid principal balance. Loan origination fees and the direct costs of underwriting and closing loans are recognized over the life of the related loan as an adjustment to yield using a method that approximates the interest method. Any differences that arise from prepayment will result in a recalculation of the effective yield.

Loans are generally placed on nonaccrual status when they are 90 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual status at an earlier date if the collection of principal or interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual status are reversed against interest revenue. The interest on nonaccrual loans is accounted for on the cash basis method, until the loans qualify for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and, in management's judgment, future payments are reasonably assured.

Loans are considered impaired when, based on current information, management considers it unlikely that collection of principal and interest payments will be made according to contractual terms. If collection of principal is evaluated as doubtful, all payments are applied to principal. Impaired loans are measured: (i) at the present value of expected cash flows discounted at the loan's effective interest rate; (ii) at the observable market price; or (iii) at the fair value of the collateral if the loan is collateral dependent. If the measure of the impaired loan is less than the recorded investment in the loan, an impairment is recognized through an allocation of the allowance for loan losses and corresponding provision for loan losses. Generally, identified impairments are charged-off against the allowance for loan losses.

Troubled debt restructurings are loans for which Hamilton, for legal or economic reasons related to a debtor's financial difficulties, has granted a concession to the debtor that it otherwise would not have considered. Concessions that result in the categorization of a loan as a troubled debt restructuring include:

Reduction of the stated interest rate;

Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk;

Reduction of the face amount or maturity amount of the debt as stated in the instrument or other agreement; or

Reduction of accrued interest

Accounting for Certain Loans or Debt Securities Acquired in a Transfer. The loans acquired from the Company's acquisition of Fraternity on May 13, 2016 (see Note 3 "Acquisition") and Fairmount on September 11, 2015 were recorded at fair value at the acquisition date and no separate valuation allowance was established. The initial fair values were determined by management, with the assistance of an independent valuation specialist, based on estimated expected cash flows discounted at appropriate rates. The discount rates were based on market rates for new originations of comparable loans and did not include a separate factor for loan losses as that was included in the estimated cash flows.

Accounting Standards Codification ("ASC") Topic 310-30, *Loans and Debt Securities Acquired with Deteriorated Credit Quality*, applies to loans acquired in a transfer with evidence of deterioration of credit quality for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable. If both conditions exist, the Company determines whether to account for each loan individually or whether such loans will be assembled into pools based on common risk characteristics such as credit score, loan type, and origination date.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The Company considered expected prepayments and estimated the total expected cash flows, which included undiscounted expected principal and interest. The excess of that amount over the fair value of the loan is referred to as accretable yield. Accretable yield is recognized as interest income on a constant yield basis over the expected life of the loan. The excess of the contractual cash flows over expected cash flows is referred to as nonaccretable difference and is not accreted into income. Over the life of the loan, the Company continues to estimate expected cash flows. Subsequent decreases in expected cash flows are recognized as impairments in the current period through the allowance for loan losses. Subsequent increases in cash flows to be collected are first used to reverse any existing valuation allowance and any remaining increase are recognized prospectively through an adjustment of the loan's yield over its remaining life.

ASC Topic 310-20, *Nonrefundable Fees and Other Costs*, was applied to loans not considered to have deteriorated credit quality at acquisition. Under ASC Topic 310-20, the difference between the loan's principal balance at the time of purchase and the fair value is recognized as an adjustment of yield over the life of the loan.

Allowance for Loan Losses. The allowance for loan losses represents an amount which, in management's judgment, will be adequate to absorb probable future losses on existing loans. The allowance for loan losses is established, as loan losses are estimated to have occurred, through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Recoveries on previously charged-off loans are credited to the allowance for loan losses.

The allowance for loan losses is increased by provisions charged to income and reduced by charge-offs, net of recoveries. Management's periodic evaluation of the adequacy of the allowance is based on the Bank's past loan loss experience, known and inherent risks in the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and current economic conditions. The look back period for historical losses consists of using both a 36 month and 48 month look back period for net charge-offs. Both of these periods are used individually to develop a range in which the allowance for loan loss should be within.

Management considers a number of factors in estimating the required level of the allowance. These factors include: historical loss experience in the loan portfolios; the levels and trends in past-due and nonaccrual loans; the status of nonaccrual loans and other loans identified as having the potential for further deterioration; credit risk and industry concentrations; trends in loan volume; the effects of any changes in lending policies and procedures or underwriting standards; and a continuing evaluation of the economic environment. Management modified the analysis during the quarter ended September 30, 2016 by keeping our net charge-off history as a percentage of loans, as it pertains to each loan segment, constant across all risk ratings and altering our qualitative factors either up or down based upon the respective risk rating for each loan segment. The change in methodology did not have a material impact on the amount of the allowance for loan and lease losses at September 30, 2016, the date of the change, as compared to the prior methodology.

Bank-Owned Life Insurance (BOLI). The Bank purchased single premium life insurance policies on certain employees of the Bank. The net cash surrender value of those policies is included in the accompanying statement of financial position. Appreciation in the value of the insurance policies is recognized as noninterest revenue and is nontaxable. Upon the death of an employee covered under one or more BOLI policies, the full amount of the insurance policy is paid-out to the Bank and the difference between the policy amount and the cash surrender value of the policy or policies is recognized as noninterest revenue. This income is also nontaxable.

Premises and Equipment. Land is carried at cost. Buildings, land improvements, leasehold improvements, and furniture and equipment are stated at cost less accumulated depreciation and amortization. Depreciation is computed primarily by the straight-line method over the estimated useful lives of the assets. Leasehold improvements are amortized over the lesser of the lease term or the useful lives of the improvements. Maintenance and normal repairs are charged to noninterest expense as incurred, while additions and improvements to buildings and furniture and equipment are capitalized. Gains and losses on disposition of assets are reflected in earnings.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Foreclosed Real Estate. Real estate acquired through foreclosure or other means is recorded at the lower of its carrying value or the fair value of the related real estate collateral less estimated selling costs. Losses in estimated fair value incurred at the time of acquisition of the property are charged to the allowance for loan losses. Subsequent reductions in the estimated fair value of the property are included in noninterest expense. Costs to maintain foreclosed real estate are expensed as incurred.

Goodwill and Other Intangible Assets. Goodwill represents the excess of the cost of an acquisition over the fair value of the net assets acquired. Intangible assets, consisting of core deposit intangibles, represent purchased assets that also lack physical substance but can be distinguished from goodwill because of contractual or other legal rights or because the asset may be sold or exchanged on its own or in combination with a related contract, asset, or liability. Core deposit intangibles are amortized on an accelerated basis over an eight-year period. Goodwill is not amortized but is evaluated on an annual basis to determine impairment, if any. Any impairment of goodwill would be recognized against income in the period of impairment.

Derivative Financial Instruments and Hedging Activities. Derivatives are initially recognized at fair value on the date a derivative contract is entered into and are subsequently re-measured at their fair value. The accounting for changes in the fair value of a derivative depends on the intended use of the derivative and the resulting designation. The Company documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions.

For derivatives qualifying as cash flow hedges, the Company also documents its assessment, both at hedge inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items. The effective portion of changes in fair value of derivatives that are designated and qualify as cash flow hedges is recognized in the consolidated statement of comprehensive (loss) income. The gain or loss relating to the ineffective portion is recognized immediately in the consolidated statement of operations as a gain or loss. When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting, any cumulative gain or loss existing in equity at that time remains in equity and is recognized when the forecast transaction is ultimately recognized in the consolidated statement of operations. When a forecast transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the consolidated statement of operations as a gain or loss to income.

For derivative instruments designated as fair-value hedges, the change in fair value of the derivative is recognized in the consolidated statement of operations under the same heading as the change in fair value of the hedged item for the portion attributable to the hedged risk. For accounting purposes, if the derivative is highly effective, the change in fair values relating to the asset or liability and the hedged item will offset one another and result in no impact to overall income.

Gains (losses) on derivatives representing either hedge components excluded from the assessment of effectiveness or hedge ineffectiveness are recognized in earnings.

Off-Balance-Sheet Credit-Related Financial Instruments. In the ordinary course of business, the Bank enters into commitments to extend credit, including commitments under standby letters of credit. Such financial instruments are recorded when they are funded or otherwise required to be recognized.

Advertising Costs. Advertising costs are expensed as incurred and included in non-interest expenses.

Stock Based Compensation. Compensation cost is recognized for stock options and restricted stock awards issued to employees and directors, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Income Taxes. The Bank recognizes income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. Deferred tax assets and liabilities are reduced by a valuation allowance when, in the opinion of management, it is more-likely-than-not that all or some portion of the deferred tax assets will not be realized.

Earnings Per Common Share. Basic earnings per share represents income available to common shareholders divided by the weighted-average number of common shares outstanding during the period. Weighted average shares exclude unallocated ESOP shares. Diluted earnings per share includes additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares relate to outstanding stock options, restricted stock, and warrants and are determined using the treasury stock method.

Note 2: New Accounting Pronouncements

Recent Accounting Pronouncements

ASU No. 2017-12, Targeted Improvements to Accounting for Hedging Activities. This ASU's objectives are to: (1) improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities by better aligning the entity's financial reporting for hedging relationships with those risk management activities; and (2) reduce the complexity of and simplify the application of hedge accounting by preparers. The ASU is effective for interim and annual reporting periods beginning after December 15, 2018; early adoption is permitted. The Company does not expect the adoption of ASU 2017-12 to have a material impact on its consolidated financial statements.

ASU 2017-04, Simplifying the Test for Goodwill Impairment. This update removes the requirement to compare the implied fair value of goodwill with its carrying amount as part of step 2 of the goodwill impairment test. As a result, under the ASU, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount and should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. The ASU is effective for annual and interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

ASU No. 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. This guidance clarifies the definition of a business and assists entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. Under this guidance, when substantially all of the fair value of gross assets acquired is concentrated in a single asset (or group of similar assets), the assets acquired would not represent a business. In addition, in order to be considered a business, an acquisition would have to include at a minimum an input and a substantive process that together significantly contribute to the ability to create an output. The amended guidance also narrows the definition of outputs by more closely aligning it with how outputs are described in FASB guidance for revenue recognition. This guidance is effective for annual periods beginning after December 15, 2017, including interim periods within those fiscal years, with early adoption permitted. The Company does not expect the adoption of this guidance to have a material impact on its consolidated financial statements.

ASU No. 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. This update addresses diversity on how certain cash receipts and payments are reflected in the statement of cash flows. The update made the following changes that may affect the Company: (1) Debt Prepayment or Debt Extinguishment Costs: Cash payments for debt prepayment or debt extinguishment costs should be classified as cash flows for financing activities. (2) Proceeds from the settlement of Bank-Owned Life Insurance Policies: Cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash flows from investing activities. The cash payments for premiums on bank-owned policies may be classified as cash flows from investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update will be effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. The guidance requires application using a retrospective transition method. The Company does not expect the guidance to have a significant impact on its consolidated statement of cash flows.

ASU 2016-13, Financial Instruments – Credit Losses. The main objective of this update is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the guidance in this update replaces the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to estimate credit losses. The measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances. The guidance in this update for public business entities is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Hamilton Bancorp is in the process of implementing a committee and has begun to gather loan information and consider acceptable methodologies to comply with this ASU. The implementation team will meet periodically to discuss the latest developments and updates via webcasts, publications, and conferences. Hamilton Bancorp's evaluation indicates that the provisions of ASU No. 2016-13 are expected to impact its consolidated financial statements, in particular the level of the reserve for loan losses. We are, however, continuing to evaluate the extent of the potential impact.

ASU 2016-09, Improvements to Employee Share-Based Payment Accounting (Topic 718). This ASU includes provisions intended to simplify various aspects related to how share-based payments are accounted for and presented in the financial statements. Some of the key provisions of this new ASU include: (1) companies will no longer record excess tax benefits and certain tax deficiencies in additional paid-in capital (“APIC”). Instead, they will record all excess tax benefits and tax deficiencies as income tax expense or benefit in the income statement, and APIC pools will be eliminated. The guidance also eliminates the requirement that excess tax benefits be realized before companies can recognize them. In addition, the guidance requires companies to present excess tax benefits as an operating activity on the statement of cash flows rather than as a financing activity; (2) increase the amount an employer can withhold to cover income taxes on awards and still qualify for the exception to liability classification for shares used to satisfy the employer’s statutory income tax withholding obligation. The new guidance will also require an employer to classify the cash paid to a tax authority when shares are withheld to satisfy its statutory income tax withholding obligation as a financing activity on its statement of cash flows (current guidance did not specify how these cash flows should be classified); and (3) permit companies to make an accounting policy election for the impact of forfeitures on the recognition of expense for share-based payment awards. Forfeitures can be estimated, as required today, or recognized when they occur. ASU No. 2016-09 became effective for the Company on April 1, 2017 and was not material to the consolidated financial statements.

HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

ASU 2016-02, Leases (Topic 842). From the lessee's perspective, the new ASU standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for lessees. The guidance also eliminates the current real estate-specific provision and changes the guidance on sale-leaseback transactions, initial direct costs and lease executory costs. With respect to lessors, the guidance modifies the classification criteria and the accounting for sales-type and direct financing leases. All entities will classify leases to determine how to recognize lease-related revenue and expense. In applying this guidance entities will also need to determine whether an arrangement contains a lease or service agreement. Disclosures are required by lessees and lessors to meet the objective of enabling users of financials statements to assess the amount, timing, and uncertainty of cash flows arising from leases. For public entities, this guidance is effective for the first interim or annual period beginning after December 15, 2018. Early adoption is permitted. Entities are required to use a modified retrospective approach for leases that exist or are entered into after the beginning of the earliest comparative period in the financial statements. The Company is assessing this guidance to determine its impact on the Company's financial position, results of operations and cash flows.

ASU No. 2016-01, Financial Instruments – Recognition and Measurement of Financial Assets and Liabilities. This ASU requires equity investments to be measured at fair value with changes in fair value recognized in net income, excluding equity investments that are consolidated or accounted for under the equity method of accounting. The amendment allows equity investments without readily determinable fair values to be measured at cost minus impairment, with a qualitative assessment required to identify impairment. The amendment also requires public companies to use exit prices to measure the fair value of financial instruments purposes; requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statement; it eliminates the disclosure requirements related to measurement assumptions for the fair value of instruments measured at amortized cost. In addition, for liabilities measured at fair value under the fair value option, to present in other comprehensive income changes in fair value due to changes in instrument specific credit risk. This ASU will be effective for us in our first quarter of fiscal 2018. The Company's management has engaged a third-party expert in the field of valuation and reporting and is creating a process to ensure adequate documentation of financial controls and analysis performed in its review of "exit pricing" of the fair values of loans, deposits, and other financial instruments. ASU 2016-01 is effective for public companies for fiscal years beginning after December 31, 2017 and interim periods within those fiscal years. This ASU will be effective for us in our first quarter ending June 30, 2018 and will not have a significant impact on the Company's consolidated financial statements.

ASU 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To achieve that core principle, an entity should apply the following steps: (i) identify the contract(s) with a customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract and (v) recognize revenue when (or as) the entity satisfies a performance obligation.

The guidance in this ASU affects any entity that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets. This ASU does not apply to revenue associated with financial instruments including loans and securities that are accounted for under U.S. GAAP. Consequently, adoption of the ASU is not expected to have a significant impact on the Company's consolidated financial statements and related disclosures since the primary source of revenue is derived from interest and dividends earned on loans, investment securities and other financial instruments that are outside the scope of the ASU. However, the Company has assessed its revenue streams and reviewed its contracts with customers that are potentially affected by the new guidance. This includes fees on deposits, gains and sales on the sale of foreclosed real estate, credit and debit card interchange fees, merchant card services, and administrative services for customer deposit account such as ATM and wire transfer transactions. The Company's revenue recognition pattern for revenue streams within the scope of the ASU has not change significantly from current practice and is immaterial to our financial statements. ASU 2014-09 is effective for fiscal years beginning after December 31, 2017 and interim periods within those fiscal years. This ASU will be effective for us in our first quarter ending June 30, 2018 and will not have a significant impact on the Company's consolidated financial statements.

ASU 2018-02, Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income (Topic 220). ASU 2018-02 allows an entity to elect a reclassification from accumulated other comprehensive income ("AOCI") to retained earnings for stranded tax effects resulting from the *Tax Cuts and Jobs Act* that changed our federal income tax rate from 35% to 21%. The amount of that reclassification should include the effect of changes in the tax rate on the deferred tax amount in AOCI. The ASU requires an entity to state if an election to reclassify the tax effect to retained earnings is made along with the description of other income tax effects that are reclassified from AOCI. ASU 2018-02 is effective for fiscal years beginning after December 15, 2018 and interim periods within those fiscal years with early adoption permitted. Hamilton Bancorp early adopted ASU 2018-02 in the last quarter of fiscal 2018. The change in accounting principal was accounted for as a cumulative effect adjustment to the balance sheet resulting in a reclassification of $238,759 from AOCI to retained earnings during the last quarter of fiscal 2018.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 3: Acquisition

Fraternity Community Bancorp, Inc.

On May 13, 2016, Hamilton Bancorp acquired Fraternity Community Bancorp, Inc. (“Fraternity”), the parent company of Fraternity Federal Savings and Loan. Under the terms of the Merger Agreement, shareholders of Fraternity received a cash payment equal to nineteen dollars and twenty-five cents ($19.25) for each share of Fraternity common stock. The total merger consideration was $25.7 million.

In connection with the acquisition, Fraternity Federal Savings and Loan was merged with and into Hamilton Bank, with Hamilton Bank as the surviving bank. The results of the Fraternity acquisition are included with Hamilton’s results as of and from May 13, 2016.

As required by the acquisition method of accounting, we have adjusted the acquired assets and liabilities of Fraternity to their estimated fair value on the date of acquisition and added them to those of Hamilton Bancorp. Based on management’s preliminary valuation of the fair value of tangible and intangible assets acquired and liabilities assumed, which we have based on level 3 valuation estimates and assumptions that were subject to change through the measurement date of May 2017, we have allocated the purchase price for Fraternity as follows:

	As recorded by Fraternity Community Bancorp, Inc.	Fair Value Adjustments		As recorded by Hamilton Bancorp, Inc.
Identifiable assets:				
Cash and cash equivalents	$ 15,196,058	$ -		$ 15,196,058
Investment securities available for sale	17,570,712	-		17,570,712
FHLB Bank Stock	782,600	-		782,600
Loans	108,872,041	(67,858	) A	108,804,183

Allowance For Loan Loss	(1,550,000)	1,550,000	A	-
Premises and equipment	691,095	78,711	B	769,806
Bank-Owned Life Insurance	5,058,041	-		5,058,041
Deferred income taxes	2,743,481	(410,377)	C	2,333,104
Other assets	2,877,665	-		2,877,665
Total identifiable assets	$152,241,693	$1,150,476		$153,392,169
Identifiable liabilities:				
Non-interest bearing deposits	1,242,187	-		1,242,187
Interest bearing deposits	107,648,792	1,098,131	D	108,746,923
Borrowings	15,000,000	793,537	E	15,793,537
Other liabilities	4,023,914	-		4,023,914
Total identifiable liabilities	$127,914,893	$1,891,668		$129,806,561
Net tangible assets acquired	24,326,800	(741,192)		23,585,608
Definite lived intangible assets acquired	-	242,020		242,020
Goodwill	-	1,877,243		1,877,243
Net intangible assets acquired	-	2,119,263		2,119,263
Total cash consideration	$24,326,800	$1,378,071		$25,704,871

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Explanation of fair value adjustments:

A	-	Adjustment reflects the fair value adjustments based on Hamilton Bancorp's evaluation of the acquired loan portfolio and excludes the allowance for losses recorded by Fraternity Community Bancorp, Inc.
B	-	Adjustment reflects the fair value adjustments based on Hamilton Bancorp's evaluation of the acquired premises and equipment.
C	-	Adjustment to record deferred tax asset related to fair value adjustments at 39.45% income tax rate; the statutory income tax rate of the Company on the acquisition date.
D	-	Adjustment arises since the rates on interest-bearing deposits are higher than rates available on similar deposits as of the acquisition date.
E	-	Adjustment reflects the fair value of Fraternity's borrowings acquired on acquisition date.

Prior to the end of the May 13, 2016 measurement period, if information became available which indicated the purchase price allocations require adjustments, we included such adjustments in the purchase price allocation retrospectively.

Of the total estimated purchase price, we have allocated $23.6 million to net tangible assets acquired and we have allocated $242,020 to the core deposit intangible which is a definite lived intangible asset. We have allocated the remaining purchase price to goodwill. We will amortize the core deposit intangible on a straight-line basis over its estimated useful life of eight years. We will evaluate goodwill annually for impairment.

The following table outlines the contractually required payments receivable, cash flows we expect to receive, non-accretable credit adjustments and the accretable yield for all Fraternity loans as of the acquisition date.

	Contractually Required Payments Receivable	**Non-Accretable Credit Adjustments**	**Cash Flows Expected To Be Collected**	**Accretable FMV Adjustments**	**Carrying Value of Loans Receivable**
Performing loans acquired	$ 107,474,993	$ -	$ 107,474,993	$ 301,672	$ 107,776,665

Impaired loans acquired	1,397,048	(314,484)	1,082,564	(55,046)	1,027,518
Total	**$108,872,041**	**$ (314,484)**	**$108,557,557**	**$ 246,626**	**$108,804,183**

At our acquisition of Fraternity, we recorded all loans acquired at the estimated fair value on the purchase date with no carryover of the related allowance for loan losses. On the acquisition date, we segregated the loan portfolio into two loan pools, performing and nonperforming loans, to be retained in our portfolio.

We had an independent third party assist us to determine the fair value of cash flows on $107,474,993 of performing loans. The valuation took into consideration the loans' underlying characteristics, including account types, remaining terms, annual interest rates, interest types, past delinquencies, timing of principal and interest payments, current market rates, loan to value ratios, loss exposures, and remaining balances. These performing loans were segregated into pools based on loan and payment type and in some cases, risk grade. The effect of this fair valuation process was a net accretable premium adjustment of $301,672 at acquisition.

We also individually evaluated 23 impaired loans totaling $1,397,048 to determine the fair value as of the May 13, 2016 measurement date. In determining the fair value for each individually evaluated impaired loan, we considered a number of factors including the remaining life of the acquired loans, estimated prepayments, estimated loss ratios, estimated value of the underlying collateral and net present value of cash flows we expect to receive, among others.

We established a credit risk related non-accretable difference of $314,484 relating to these acquired, credit impaired loans, reflected in the recorded net fair value. We further estimated the timing and amount of expected cash flows in excess of the estimated fair value and established an accretable discount adjustment of $55,046 at acquisition relating to these impaired loans.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Fraternity Pro forma Condensed Combined Financial Information. The consolidated statements of operations data for the unaudited pro forma results for the fiscal year periods ending March 31, 2018 and 2017 as if the Fraternity acquisition had occurred at the beginning of these fiscal periods are deemed immaterial and not presented. Due to the fact the acquisition of Fraternity occurred on May 13, 2016, the fiscal year period ending March 31, 2018, as reported in this 10-K, already include the impact of Fraternity in the consolidated statements of operations as though the acquisition occurred at the beginning of fiscal 2018. The fiscal period ending March 31, 2017 does not reflect the full impact to the consolidated statements of operations for those twelve months since the acquisition occurred in May 2016 or close to the beginning of that respective fiscal period, however, that amount is deemed to be immaterial to the consolidated statement of operations for that period.

Fraternity acquisition expenses. In connection with the acquisition of Fraternity, the Company incurred merger related costs in fiscal 2017. These expenses were primarily related to legal, other professional services and system conversions. The following table details the expenses included in the consolidated statements of operations for the period shown.

	Fiscal Year Ending March 31, 2017
Legal	$55,500
Professional services	157,567
Data processing	-
Advertising	-
Other	6,350
Total meger related expenses	$219,417

In addition, included in other professional service expense in the Consolidated Statements of Operations for the period ended March 31, 2018 and 2017 is $305,000 and $532,000 relating to the amortization of non-compete agreements that have been paid to former executives in the acquisition. The non-compete agreements are for a term of one and two years that end or ended in April 2017 and 2018.

Note 4: Earnings per Share

Basic earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding for the period. Weighted average shares exclude unallocated ESOP shares. Diluted earnings per share reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the entity.

Both the basic and diluted earnings per share for the years ended March 31, 2018 and 2017 are summarized below:

	Year Ended March 31, 2018	Year Ended March 31, 2017
Net loss	**$(6,048,942)**	$(928,782)
Weighted average common shares outstanding - basic	**3,192,011**	3,180,292
Weighted average common shares outstanding - diluted	**3,192,011**	3,180,292
Loss per common share - basic and diluted	**$(1.90)**	$(0.29)
Anti-dilutive shares	**175,177**	118,911

During the years ended March 31, 2018 and 2017, none of the common stock equivalents were dilutive due to the loss reported for each period.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 5: Cash and Due From Banks

Regulation D of the Federal Reserve Act requires that banks maintain reserve balances with the Federal Reserve Bank based principally on the type and amount of their deposits. During fiscal years 2018 and 2017, the Company maintained balances at the Federal Reserve (in addition to vault cash) to meet the reserve requirements, as well as balances to partially compensate for services. Additionally, the Company maintained balances with the Federal Home Loan Bank and other domestic correspondent financial institutions as partial compensation for services they provided to the Company. The Bank normally carries balances with other correspondent financial institutions that exceed the federally insured limit.

Note 6: Investment Securities Available for Sale

The amortized cost and fair value of securities at March 31, 2018 and 2017, is summarized as follows:

March 31, 2018	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. government agencies	**$2,753,346**	**$ -**	**$34,697**	**$2,718,649**
Municipal bonds	**12,435,068**	**-**	**729,077**	**11,705,991**
Corporate bonds	**2,000,000**	**-**	**45,924**	**1,954,076**
Mortgage-backed securities	**61,078,665**	**12,993**	**2,066,238**	**59,025,420**
	$78,267,079	**$ 12,993**	**$2,875,936**	**$75,404,136**

March 31, 2017	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
U.S. government agencies	$3,525,373	$ 323	$13,393	$3,512,303

Municipal bonds	17,096,477	21,858	950,496	16,167,839
Corporate bonds	2,000,000	-	83,478	1,916,522
Mortgage-backed securities	81,994,305	65,094	1,226,935	80,832,464
	$104,616,155	$ 87,275	$2,274,302	$102,429,128

Proceeds from sales of investment securities were $11,608,699 and $4,273,234 during the years ended March 31, 2018 and 2017, respectively, with gains of $57,099 and losses of $59,455 for the year ended March 31, 2018 and gains of $35,441 and losses of $9,995 for the year ended March 31, 2017. During fiscal 2017, we also sold certificates of deposits that were held as investments. Proceeds associated with those certificates of deposits were $1,730,273 with losses of $1,726.

As of March 31, 2018 and 2017, all mortgage-backed securities are backed by U.S. Government- Sponsored Enterprises (GSE), except one private label mortgage-backed security that was acquired in the Fraternity acquisition in May 2016 with a book value of $75,645 and fair value of $76,803 as of March 31, 2018.

As of March 31, 2018 and 2017, the Company had pledged one security to the Federal Reserve Bank with a book value of $744,186 and $744,186 and a fair value of $723,023 and $736,412, respectively.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The amortized cost and estimated fair value of debt securities by contractual maturity at March 31, 2018 and 2017 follow. Actual maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations.

	Available for Sale			
	March 31, 2018		March 31, 2017	
	Amortized cost	Fair value	Amortized cost	Fair value
Maturing				
Within one year	**$2,009,160**	**$1,995,625**	$-	$-
Over one to five years	**1,231,928**	**1,196,368**	4,234,642	4,240,740
Over five to ten years	**3,578,827**	**3,500,641**	5,538,313	5,404,810
Over ten years	**10,368,499**	**9,686,082**	12,848,895	11,951,114
Mortgage-backed, in monthly installments	**61,078,665**	**59,025,420**	81,994,305	80,832,464
	$78,267,079	**$75,404,136**	$104,616,155	$102,429,128

The following table presents the Company's investments' gross unrealized losses and the corresponding fair values by investment category and length of time that the securities have been in a continuous unrealized loss position at March 31, 2018 and 2017.

	Less than 12 months		12 months or longer		Total	
March 31, 2018	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value
U.S. government agencies	**$21,163**	**$723,023**	**$13,534**	**$1,995,625**	**$34,697**	**$2,718,648**
Municipal bonds	**-**	**-**	**729,077**	**11,705,991**	**729,077**	**11,705,991**
Corporate bonds	**-**	**-**	**45,924**	**1,954,076**	**45,924**	**1,954,076**
Mortgage-backed securities	**383,987**	**15,880,948**	**1,682,251**	**40,684,836**	**2,066,238**	**56,565,784**
	$405,150	**$16,603,971**	**$2,470,786**	**$56,340,528**	**$2,875,936**	**$72,944,499**

	Less than 12 months		12 months or longer		Total	
March 31, 2017	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value	Gross unrealized losses	Fair value

U.S. government agencies	$13,393	$3,256,964	$-	$-	$13,393	$3,256,964
Municipal bonds	950,496	13,982,251	-	-	950,496	13,982,251
Corporate bonds	-	-	83,478	1,916,522	83,478	1,916,522
Mortgage-backed securities	941,183	66,953,532	285,752	7,016,746	1,226,935	73,970,278
	$1,905,072	$84,192,747	$369,230	$8,933,268	$2,274,302	$93,126,015

The unrealized losses that exist are a result of market changes in interest rates since the original purchase. Management systematically evaluates investment securities for other-than-temporary declines in fair value on an annual basis from the date of purchase if the respective security is in a loss position. This analysis requires management to consider various factors, which include (1) duration and magnitude of the decline in value, (2) the financial condition of the issuer or issuers and (3) structure of the security.

An impairment loss is recognized in earnings if any of the following are true: (1) the Company intends to sell the debt security; (2) it is more likely than not that the Company will be required to sell the security before recovery of its amortized cost basis; or (3) the Company does not expect to recover the entire amortized cost basis of the security. In situations where the Company intends to sell or when it is more likely than not that the Company will be required to sell the security, the entire impairment loss must be recognized in earnings. In all other situations, only the portion of the impairment loss representing the credit loss must be recognized in earnings, with the remaining portion being recognized in shareholders’ equity as a component of other comprehensive income, net of deferred tax.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 7: Loans Receivable and Allowance for Loan Losses

Loans receivable at March 31, 2018 and March 31, 2017, consisted of the following:

	March 31, 2018				March 31, 2017			
	Legacy (1)	Acquired	Total Loans	% of Total	Legacy (1)	Acquired	Total Loans	% of Total
Real estate loans:								
One-to four-family:								
Residential (2)	$85,248,184	$72,749,066	$157,997,250	40 %	$67,126,677	$83,892,389	$151,019,066	44 %
Residential construction	5,450,827	-	5,450,827	1 %	6,426,076	-	6,426,076	2 %
Investor (3)	9,275,031	17,460,809	26,735,840	7 %	6,742,469	18,779,644	25,522,113	8 %
Commercial	100,403,769	11,762,485	112,166,254	29 %	92,665,689	14,898,523	107,564,212	32 %
Commercial construction	5,763,784	1,352,019	7,115,803	2 %	1,881,541	1,308,652	3,190,193	1 %
Total real estate loans	206,141,595	103,324,379	309,465,974	80 %	174,842,452	118,879,208	293,721,660	87 %
Commercial business (4)	38,302,739	1,841,226	40,143,965	10 %	19,518,029	2,019,337	21,537,366	6 %
Home equity loans	13,956,327	6,039,462	19,995,789	5 %	13,278,229	7,266,141	20,544,370	6 %
Consumer (5)	18,849,448	766,063	19,615,511	5 %	2,258,836	937,600	3,196,436	1 %
Total Loans	277,250,109	111,971,130	389,221,239	100%	209,897,546	129,102,286	338,999,832	100%
Net deferred loan origination fees and costs	(212,746)	-	(212,746)		(143,070)	-	(143,070)	
Loan premium (discount)	1,922,428	(510,036)	1,412,392		619,846	(543,410)	76,436	
	$278,959,791	$111,461,094	$390,420,885		$210,374,322	$128,558,876	$338,933,198	

(1) As a result of the acquisition of Fraternity Community Bancorp, Inc., the parent company of Fraternity Federal Savings and Loan, in May 2016 and Fairmount Bancorp, Inc., the parent company of Fairmount Bank, in September 2015, we have segmented the portfolio into two components, loans originated by Hamilton Bank "Legacy" and loans acquired from Fraternity Community Bancorp, Inc. and Fairmount Bancorp, Inc. "Acquired".

(2) "Legacy" one-to four-family residential real estate loans at March 31, 2018 and 2017 includes $19.2 million and $23.4 million of purchased loan pools, respectively.

(3) "Investor" loans are residential mortgage loans secured by non-owner occupied one-to four-family properties.

(4) "Legacy" commercial business loans at March 31, 2018 includes a $15.5 million pool of commercial lease loans purchased in June 2017 and $3.2 million in guaranteed SBA loans purchased in last half of fiscal 2018.

(5) "Legacy" consumer loans at March 31, 2018 includes $19.9 million of purchased loan pools consisting of recreational vehicles that were purchased in August and December 2017.

Residential lending is generally considered to involve less risk than other forms of lending, although payment experience on these loans is dependent on economic and market conditions in the Bank's lending area. Construction loan repayments are generally dependent on the related properties or the financial condition of its borrower or guarantor. Accordingly, repayment of such loans can be more susceptible to adverse conditions in the real estate market and the regional economy.

A substantial portion of the Bank's loan portfolio is real estate loans secured by residential and commercial real estate properties located in the Baltimore metropolitan area. Loans are extended only after evaluation of a customer's creditworthiness and other relevant factors on a case-by-case basis. The Bank generally does not lend more than 75% - 95% of the appraised value of a property, depending on the type of loan, and requires private mortgage insurance on residential mortgages with loan-to-value ratios in excess of 80%. In addition, the Bank generally obtains personal guarantees of repayment from borrowers and/or others for construction loans and disburses the proceeds of those and similar loans only as work progresses on the related projects.

Commercial business loans are made to provide funds for equipment and general corporate needs. Repayment of a loan primarily uses the funds obtained from the operation of the borrower's business. Commercial loans also include lines of credit that are utilized to finance a borrower's short-term credit needs and/or to finance a percentage of eligible receivables and inventory. The Company's loan portfolio also includes equipment leases, which consists of leases for essential commercial equipment used by small to medium sized businesses.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

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The home equity loans consist of both conforming loans and revolving lines of credit to consumers which are secured by residential real estate. These loans are typically secured with second mortgages on the homes. Consumer loans include share loans, installment loans and, to a lesser extent, personal lines of credit. Share loans represent loans that are collateralized by a certificate of deposit or other deposit product. Installment loans are used by customers to purchase primarily automobiles, but may be used to also purchase boats and recreational vehicles.

The following tables detail activity in the allowance for loan losses by portfolio segment for the fiscal years ended March 31, 2018 and 2017. The allowance for loan losses allocated to each portfolio segment is not necessarily indicative of future losses in any particular portfolio segment and does not restrict the use of the allowance to absorb losses in other portfolio segments.

	March 31, 2018							
	Residential Real Estate	**Investor Real Estate**	**Commercial Real Estate**	**Commercial Construction**	**Commercial Business**	**Home Equity**	**Consumer**	**Total**
Allowance for credit losses:								
Beginning balance	**$553,539**	**$35,275**	**$1,375,894**	**$ 9,031**	**$149,461**	**$70,071**	**$1,544**	**$2,194,815**
Charge-offs	**(19,868)**	**(315,663)**	**(244,014)**	**-**	**(378,694)**	**-**	**(17,013)**	**(975,252)**
Recoveries	**3,937**	**18,129**	**-**	**-**	**770**	**-**	**4,504**	**27,340**
Provision for credit losses	**71,115**	**313,949**	**121,503**	**24,399**	**902,445**	**(612)**	**142,201**	**1,575,000**
Ending balance	**$608,723**	**$51,690**	**$1,253,383**	**$ 33,430**	**$673,982**	**$69,459**	**$131,236**	**$2,821,903**
Allowance allocated to:								
<u>Legacy Loans:</u>								
Individually evaluated for impairment	**$266,256**	**$-**	**$-**	**$ -**	**$-**	**$-**	**$-**	**$266,256**
Collectively evaluated for impairment	**342,467**	**51,690**	**1,253,383**	**33,430**	**673,982**	**69,459**	**131,236**	**2,555,647**
<u>Acquired Loans:</u>								
	$-	**$-**	**$-**	**$ -**	**$-**	**$-**	**$-**	**$-**

Individually evaluated for impairment								
Collectively evaluated for impairment	-	-	-	-	-	-	-	-

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

	March 31, 2017							
	Residential Real Estate	Investor Real Estate	Commercial Real Estate	Commercial Construction	Commercial Business	Home Equity	Consumer	Total
Allowance for credit losses:								
Beginning balance	$259,895	$168,132	$901,768	$42,377	$228,199	$82,012	$19,982	$1,702,365
Charge-offs	(34,578)	(1,801,438)	(1,111,320)	-	(1,521)	-	(4,073)	(2,952,930)
Recoveries	-	11,599	-	-	29,257	-	9,518	50,374
Provision for credit losses	328,222	1,656,982	1,585,446	(33,346)	(106,474)	(11,941)	(23,883)	3,395,006
Ending balance	$553,539	$35,275	$1,375,894	$9,031	$149,461	$70,071	$1,544	$2,194,815
Allowance allocated to:								
Legacy Loans:								
Individually evaluated for impairment	$284,177	$-	$-	$-	$-	$-	$-	$284,177
Collectively evaluated for impairment	269,362	34,093	1,375,894	9,031	149,461	70,071	1,544	1,909,456
Acquired Loans:								
Individually evaluated for impairment	$-	$1,182	$-	$-	$-	$-	$-	$1,182
Collectively evaluated for impairment	-	-	-	-	-	-	-	-

Our recorded investment in loans at March 31, 2018 and 2017 related to each balance in the allowance for probable loan losses by portfolio segment and disaggregated on the basis of our impairment methodology was as follows:

	March 31, 2018							
	Residential Real Estate	**Investor Real Estate**	**Commercial Real Estate**	**Commercial Construction**	**Commercial Business**	**Home Equity**	**Consumer**	**Total**
Loans:								
Legacy Loans:								
Individually evaluated for impairment	**$1,827,040**	**$60,949**	**$4,356,264**	**$-**	**$795,410**	**$20,595**	**$34,266**	**$7,094,524**
Collectively evaluated for impairment	**88,871,971**	**9,214,082**	**96,047,505**	**5,763,784**	**37,507,329**	**13,935,732**	**18,815,182**	**270,155,5**
Ending balance	**$90,699,011**	**$9,275,031**	**$100,403,769**	**$5,763,784**	**$38,302,739**	**$13,956,327**	**$18,849,448**	**$277,250,1**
Acquired Loans:								
individually evaluated for impairment	**$922,252**	**$444,254**	**$198,938**	**$-**	**$-**	**$-**	**$60,011**	**$1,625,455**
collectively evaluated for impairment	**71,826,814**	**17,016,555**	**11,563,547**	**1,352,019**	**1,841,226**	**6,039,462**	**706,052**	**110,345,6**
Ending balance	**$72,749,066**	**$17,460,809**	**$11,762,485**	**$1,352,019**	**$1,841,226**	**$6,039,462**	**$766,063**	**$111,971,1**

	March 31, 2017							
	Residential Real Estate	Investor Real Estate	Commercial Real Estate	Commercial Construction	Commercial Business	Home Equity	Consumer	Total
Loans:								
Legacy Loans:								
Individually evaluated for impairment	$1,762,417	$16,919	$1,546,812	$-	$753,375	$12,040	$-	$4,091,563
Collectively evaluated for impairment	71,790,336	6,725,550	91,118,877	1,881,541	18,764,654	13,266,189	2,258,836	205,805,983
Ending balance	$73,552,753	$6,742,469	$92,665,689	$1,881,541	$19,518,029	$13,278,229	$2,258,836	$209,897,546

Acquired Loans:								
individually evaluated for impairment	$1,133,646	$186,888	$204,844	$-	$-	$-	$40,107	$1,565,485
collectively evaluated for impairment	82,758,743	18,592,756	14,693,679	1,308,652	2,019,337	7,266,141	897,493	127,536,801
Ending balance	$83,892,389	$18,779,644	$14,898,523	$1,308,652	$2,019,337	$7,266,141	$937,600	$129,102,286

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Past due loans, segregated by age and class of loans, as March 31, 2018 and 2017, were as follows:

	March 31, 2018			**March 31, 2017**		
	Legacy	**Acquired**	**Total**	**Legacy**	**Acquired**	**Total**
Current	**$270,807,643**	**$109,972,473**	**$380,780,116**	**$207,328,184**	**$128,769,860**	**$336,098,044**
Accruing past due loans:						
30-59 days past due:						
Real estate loans:						
Residential	**63,618**	**689,364**	**752,982**	**69,618**	**-**	**69,618**
Investor	**-**	**-**	**-**	**320,971**	**-**	**320,971**
Commercial	**-**	**-**	**-**	**-**	**-**	**-**
Commercial construction	**-**	**-**	**-**	**113,603**	**-**	**113,603**
Commercial business	**135,502**	**-**	**135,502**	**-**	**-**	**-**
Home equity loans	**-**	**-**	**-**	**-**	**-**	**-**
Consumer	**148,876**	**-**	**148,876**	**-**	**-**	**-**
Total 30-59 days past due	**347,996**	**689,364**	**1,037,360**	**504,192**	**-**	**504,192**
60-89 days past due:						
Real estate loans:						
Residential	**70,291**	**-**	**70,291**	**74,631**	**-**	**74,631**
Investor	**-**	**-**	**-**	**-**	**-**	**-**
Commercial	**-**	**-**	**-**	**-**	**-**	**-**
Commercial construction	**-**	**-**	**-**	**-**	**-**	**-**
Commercial business	**134,524**	**-**	**134,524**	**-**	**-**	**-**
Home equity loans	**-**	**-**	**-**	**-**	**-**	**-**
Consumer	**28,300**	**-**	**28,300**	**-**	**-**	**-**
Total 60-89 days past due	**233,115**	**-**	**233,115**	**74,631**	**-**	**74,631**
90 or more days past due:						
Real estate loans:						
Residential	**-**	**-**	**-**	**-**	**-**	**-**
Investor	**734,818**	**471,423**	**1,206,241**	**-**	**21,030**	**21,030**
Commercial	**-**	**-**	**-**	**-**	**-**	**-**
	-	**-**	**-**	**-**	**-**	**-**

Commercial construction						
Commercial business	-	-	-	-	-	-
Home equity loans	-	-	-	-	-	-
Consumer	-	-	-	-	-	-
Total 90 or more days past due	734,818	471,423	1,206,241	-	21,030	21,030
Total accruing past due loans	1,315,929	1,160,787	2,476,716	578,823	21,030	599,853
Non-accruing loans:						
Real estate loans:						
Residential	526,584	338,060	864,644	426,354	248,663	675,017
Investor	60,949	300,872	361,821	13,976	57,131	71,107
Commercial	4,356,264	198,938	4,555,202	1,546,812	-	1,546,812
Commercial construction	-	-	-	-	-	-
Commercial business	165,285	-	165,285	-	-	-
Home equity loans	12,605	-	12,605	3,397	-	3,397
Consumer	4,850	-	4,850	-	5,602	5,602
Non-accruing loans:	5,126,537	837,870	5,964,407	1,990,539	311,396	2,301,935
Total Loans	$277,250,109	$111,971,130	$389,221,239	$209,897,546	$129,102,286	$338,999,832

Nonaccrual interest not accrued:						
Real estate loans:						
Residential	$8,250	$53,120	$61,370	$6,460	$35,177	$41,637
Investor	8,513	15,604	24,117	6,982	23,293	30,275
Commercial	294,619	-	294,619	109,818	-	109,818
Commercial construction	-	-	-	-	-	-
Commercial business	12,891	-	12,891	-	-	-
Home equity loans	436	-	436	66	-	66
Consumer	385	-	385	-	317	317
Total nonaccrual interest not accrued	$325,094	$68,724	$393,818	$123,326	$58,787	$182,113

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Impaired Loans as of March 31, 2018 and 2017 were as follows:

	Impaired Loans at March 31, 2018				
Legacy:	Unpaid Contractual Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Real estate loans:					
Residential	**$665,051**	**$517,600**	**$ -**	**$548,636**	**$ 9,257**
Investor	**126,389**	**60,949**	**-**	**118,175**	**3,772**
Commercial	**6,487,088**	**4,356,264**	**-**	**4,634,504**	**1,077**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**1,562,756**	**795,410**	**-**	**1,082,773**	**103,474**
Home equity loans	**47,650**	**20,595**	**-**	**22,604**	**392**
Consumer	**48,115**	**34,266**	**-**	**38,514**	**1,576**
With an allowance recorded:					
Real estate loans:					
Residential	**1,336,078**	**1,309,440**	**266,256**	**1,328,919**	**51,928**
Investor	**-**	**-**	**-**	**-**	
Commercial	**-**	**-**	**-**	**-**	**-**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**-**	**-**	**-**	**-**	**-**
Home equity loans	**-**	**-**	**-**	**-**	**-**
Consumer	**-**	**-**	**-**	**-**	**-**
Total legacy impaired	**10,273,127**	**7,094,524**	**266,256**	**7,774,125**	**171,476**
Acquired (1):					
With no related allowance recorded:					
Real estate loans:					
Residential	**1,082,484**	**922,252**	**-**	**945,602**	**26,437**
Investor	**682,045**	**444,254**	**-**	**659,246**	**37,368**
Commercial	**248,938**	**198,938**	**-**	**201,519**	**7,336**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**-**	**-**	**-**	**-**	**-**
Home equity loans	**40,473**	**-**	**-**	**-**	**1,329**
Consumer	**95,986**	**60,371**	**-**	**64,013**	**6,062**
With an allowance recorded:					
Real estate loans:					
Residential	**-**	**-**	**-**	**-**	**-**

Investor	-	-	-	-	-
Commercial	-	-	-	-	-
Commercial construction	-	-	-	-	-
Commercial business	-	-	-	-	-
Home equity loans	-	-	-	-	-
Consumer	-	-	-	-	-
Total acquired impaired	**2,149,926**	**1,625,815**	**-**	**1,870,380**	**78,532**
Total impaired	**$12,423,053**	**$8,720,339**	**$ 266,256**	**$9,644,505**	**$ 250,008**

(1) Generally accepted accounting principles require that we record acquired loans at fair value at acquisition, which includes a discount for loans with credit impairment. These purchased credit impaired loans are not performing according to their contractual terms and meet the definition of an impaired loan. Although we do not accrue interest income at the contractual rate on these loans, we do recognize an accretable

yield as interest income to the extent such yield is supported by cash flow analysis of the underlying loans.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

	Impaired Loans at March 31, 2017				
Legacy:	Unpaid Contractual Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Real estate loans:					
Residential	**$491,249**	**$360,590**	**$ -**	**$373,618**	**$ 11,901**
Investor	**107,710**	**16,919**		**16,306**	**-**
Commercial	**3,433,621**	**1,546,812**	**-**	**2,485,299**	**987**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**1,177,632**	**753,375**	**-**	**832,437**	**107,063**
Home equity loans	**37,365**	**12,040**	**-**	**14,102**	**257**
Consumer	**-**	**-**	**-**	**-**	**-**
With an allowance recorded:					
Real estate loans:					
Residential	**1,432,212**	**1,401,827**	**284,177**	**1,428,128**	**54,121**
Investor	**-**	**-**	**-**	**-**	**-**
Commercial	**-**	**-**	**-**	**-**	**-**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**-**	**-**	**-**	**-**	**-**
Home equity loans	**-**	**-**	**-**	**-**	**-**
Consumer	**-**	**-**	**-**	**-**	**-**
Total legacy impaired	**6,679,789**	**4,091,563**	**284,177**	**5,149,890**	**174,329**
Acquired (1):					
With no related allowance recorded:					
Real estate loans:					
Residential	**1,320,985**	**1,133,646**	**-**	**1,017,399**	**51,442**
Investor	**503,920**	**148,506**	**-**	**230,757**	**12,229**
Commercial	**254,844**	**204,844**	**-**	**208,057**	**7,770**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**-**	**-**	**-**	**-**	**-**
Home equity loans	**-**	**-**	**-**	**-**	**-**
Consumer	**88,276**	**40,107**	**-**	**44,079**	**6,049**
With an allowance recorded:					
Real estate loans:					
Residential	**-**	**-**	**-**	**-**	**-**
Investor	**66,446**	**38,382**	**1,182**	**34,448**	**-**
Commercial	**-**	**-**	**-**	**-**	**-**
Commercial construction	**-**	**-**	**-**	**-**	**-**
Commercial business	**-**	**-**	**-**	**-**	**-**

Home equity loans	-	-	-	-	-
Consumer	-	-	-	-	-
Total acquired impaired	**2,234,471**	**1,565,485**	**1,182**	**1,534,740**	**77,490**
Total impaired	**$8,914,260**	**$5,657,048**	**$ 285,359**	**$6,684,630**	**$ 251,819**

(1) Generally accepted accounting principles require that we record acquired loans at fair value at acquisition, which includes a discount for loans with credit impairment. These purchased credit impaired loans are not performing according to their contractual terms and meet the definition of an impaired loan. Although we do not accrue interest income at the contractual rate on these loans, we do recognize an accretable yield as interest income to the extent

such yield is supported by cash flow analysis of the underlying loans.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The following table documents changes in the carrying amount of acquired impaired loans (Purchase Credit Impaired of "PCI") for the years ended March 31, along with the outstanding balance at the end of the period:

	2018	2017
Recorded investment at beginning of period	$1,341,935	$919,729
Fair value of loans acquired during the year	-	1,027,518
Accretion	27,744	28,036
Reductions for payments	(348,255)	(633,348)
Recorded investment at end of period	$1,021,424	$1,341,935
Oustanding principal balance at end of period	$1,274,022	$1,691,004

A summary of changes in the accretable yield for PCI loans for the years ended March 31, is as follows:

	2018	2017
Accretable yield, beginning of period	$59,639	$32,629
Addition from acquisition	-	55,046
Accretion	(27,744)	(28,036)
Reclassification from nonaccretable difference	-	-
Other changes, net	-	-
Accretable yield, end of period	$31,895	$59,639

Impaired loans also include certain loans that have been modified in troubled debt restructurings (TDRs) where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Bank's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Generally, nonaccrual loans that are modified and considered TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower's sustained repayment performance for a reasonable period, generally six months.

A summary of TDRs at March 31, 2018 and 2017 follows:

March 31, 2018	Number of contracts	Performing	Nonperforming	Total
Real estate loans:				
Residential	**15**	**$1,230,166**	**$ 312,964**	**$1,543,130**
Investor	**-**	**-**	**-**	**-**
Commercial	**2**	**-**	**1,195,421**	**1,195,421**
Commercial construction	**-**	**-**	**-**	**-**
Commercial business	**1**	**605,488**	**-**	**605,488**
Home equity loans	**-**	**-**	**-**	**-**
Consumer	**-**	**-**	**-**	**-**
	18	**$1,835,654**	**$ 1,508,385**	**$3,344,039**

March 31, 2017	Number of contracts	Performing	Nonperforming	Total
Real estate loans:				
Residential	**13**	**$1,261,603**	**$ 294,968**	**$1,556,571**
Investor	**-**	**-**	**-**	**-**
Commercial	**2**	**-**	**1,546,812**	**1,546,812**
Commercial construction	**-**	**-**	**-**	**-**
Commercial business	**1**	**643,999**	**-**	**643,999**
Home equity loans	**-**	**-**	**-**	**-**
Consumer	**-**	**-**	**-**	**-**
	16	**$1,905,602**	**$ 1,841,780**	**$3,747,382**

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The following table presents the number of contracts and the dollar amount of TDRs that were added during the years ended March 31, 2018 and 2017. The amount shown reflects the outstanding loan balance at the time of the modification.

	Loans Modified as a TDR for the fiscal year ended			
	March 31, 2018		March 31, 2017	
Troubled Debt Restructurings	**Number of contracts**	**Outstanding recorded investment**	Number of contracts	Outstanding recorded investment
Real estate loans:				
Residential	**3**	**$ 52,363**	3	$ 97,401

There are no TDRs outstanding that defaulted over the twelve-month period ended March 31, 2018 and 2017. Earlier in fiscal 2017, there were 11 newly added TDR loans to one borrower for non-owner occupied residential real estate properties that had subsequently defaulted within twelve months. However, these loans were sold as part of a larger pool of loans in October 2016 and are no longer being reflected in these financial statements. Payment default under a TDR is defined as any TDR that is 90 days or more past due following the time that the loan was modified or the inability of the TDR to make the required payment subsequent to the modification. There are no commitments to extend credit under existing TDRs as of March 31, 2018.

In calculating the allowance for loan losses, individual TDRs are evaluated for impairment. TDRs are evaluated for impairment based upon either the present value of cash flows or, if collateral dependent, the lower of cost or fair value of the underlying collateral. If it is determined that the cash flows or underlying collateral is less than the carrying amount of the loan, the difference in value will be charged-off through earnings, unless the TDR is performing, in which case a specific reserve may be set-up for that TDR.

Credit quality indicators

As part of the ongoing monitoring of the credit quality of the Bank's loan portfolio, management tracks certain credit quality indicators including trends related to the risk grade of loans, the level of classified loans, net charge offs, nonperforming loans, and the general economic conditions in the Bank's market.

The Bank utilizes a risk grading matrix to assign a risk grade to each of its loans. A description of the general characteristics of loans characterized as watch list or classified is as follows:

Pass

A pass loan is considered of sufficient quality to preclude a special mention or an adverse rating. Pass assets generally are well protected by the current net worth and paying capacity of the obligor or by the value of the asset or underlying collateral.

Special Mention

A special mention loan has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or in the Bank's credit position at some future date. Special mention loans are not adversely classified and do not expose the Bank to sufficient risk to warrant adverse classification.

Loans that would primarily fall into this notational category could have been previously classified adversely, but the deficiencies have since been corrected. Management should closely monitor recent payment history of the loan and value of the collateral.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Borrowers may exhibit poor liquidity and leverage positions resulting from generally negative cash flow or negative trends in earnings. Access to alternative financing may be limited to finance companies for business borrowers and may be unavailable for commercial real estate borrowers.

Substandard

A substandard loan is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Substandard loans have a well-defined weakness, or weaknesses, that jeopardize the collection or liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. This will be the measurement for determining if a loan is impaired.

Borrowers may exhibit recent or unexpected unprofitable operations, an inadequate debt service coverage ratio, or marginal liquidity and capitalization. These loans require more intense supervision by Bank management.

Doubtful

A doubtful loan has all the weaknesses inherent as a substandard loan with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. A loan classified as doubtful exhibits loss potential. However, there is still sufficient reason to permit the loan to remain on the books. A doubtful classification could reflect the deterioration of the primary source of repayment and serious doubt exists as to the quality of the secondary source of repayment.

Doubtful classifications should be used only when a distinct and known possibility of loss exists. When identified, adequate loss should be recorded for the specific assets. The entire asset should not be classified as doubtful if a partial recovery is expected, such as liquidation of the collateral or the probability of a private mortgage insurance payment is likely.

Loss

Loans classified as loss are considered uncollectable and of such little value that their continuance as loans is unjustified. A loss classification does not mean a loan has absolutely no value; partial recoveries may be received in the future. When loans or portions of a loan are considered a loss, it will be the policy of the Bank to write-off the amount designated as a loss. Recoveries will be treated as additions to the allowance for loan losses.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The following tables present the March 31, 2018 and 2017 balances of classified loans based on the risk grade. Classified loans include Special Mention, Substandard, Doubtful, and Loss loans. The Bank had no loans classified as Doubtful or Loss as of March 31, 2018 or 2017.

	March 31, 2018			**March 31, 2017**		
	LEGACY	**ACQUIRED**	**TOTAL**	**LEGACY**	**ACQUIRED**	**TOTAL**
Risk Rating:						
Rating - Pass:						
Real estate loans:						
Residential	**$87,863,805**	**$70,901,293**	**$158,765,098**	**$71,721,341**	**$81,228,457**	**$152,949,798**
Investor	**9,214,082**	**16,719,346**	**25,933,428**	**6,728,493**	**18,151,533**	**24,880,026**
Commercial	**92,955,370**	**11,563,547**	**104,518,917**	**84,789,748**	**13,387,987**	**98,177,735**
Commercial construction	**5,763,784**	**1,352,019**	**7,115,803**	**1,881,541**	**1,308,652**	**3,190,193**
Commercial Business	**37,978,293**	**1,841,226**	**39,819,519**	**19,376,763**	**2,019,337**	**21,396,100**
Home Equity	**13,935,732**	**5,928,787**	**19,864,519**	**13,269,478**	**7,133,164**	**20,402,642**
Consumer	**18,733,489**	**733,669**	**19,467,158**	**2,258,836**	**896,022**	**3,154,858**
Total Pass	**266,444,555**	**109,039,887**	**375,484,442**	**200,026,200**	**124,125,152**	**324,151,352**
Rating - Special Mention:						
Real estate loans:						
Residential	**2,365,652**	**925,521**	**3,291,173**	**1,499,436**	**1,724,987**	**3,224,423**
Investor	**-**	**297,209**	**297,209**	**-**	**408,803**	**408,803**
Commercial	**3,092,135**	**-**	**3,092,135**	**6,329,129**	**1,305,692**	**7,634,821**
Commercial construction	**-**	**-**	**-**	**-**	**-**	**-**
Commercial Business	**134,524**	**-**	**134,524**	**-**	**-**	**-**
Home Equity	**-**	**110,675**	**110,675**	**-**	**132,977**	**132,977**
Consumer	**96,474**	**-**	**96,474**	**-**	**788**	**788**
Total Special Mention	**5,688,785**	**1,333,405**	**7,022,190**	**7,828,565**	**3,573,247**	**11,401,812**
Rating - Substandard:						
Real estate loans:						
Residential	**469,554**	**922,252**	**1,391,806**	**331,976**	**938,945**	**1,270,921**
Investor	**60,949**	**444,254**	**505,203**	**13,976**	**219,308**	**233,284**
Commercial	**4,356,264**	**198,938**	**4,555,202**	**1,546,812**	**204,844**	**1,751,656**
Commercial construction	**-**	**-**	**-**	**-**	**-**	**-**
Commercial Business	**189,922**	**-**	**189,922**	**141,266**	**-**	**141,266**

Home Equity	**20,595**	**-**	**20,595**	**8,751**	**-**	**8,751**
Consumer	**19,485**	**32,394**	**51,879**	**-**	**40,790**	**40,790**
Total - Substandard	**5,116,769**	**1,597,838**	**6,714,607**	**2,042,781**	**1,403,887**	**3,446,668**
Rating - Doubtful	**-**	**-**	**-**	**-**	**-**	**-**
Rating - Loss	**-**	**-**	**-**	**-**	**-**	**-**
TOTAL LOANS	**$277,250,109**	**$111,971,130**	**$389,221,239**	**$209,897,546**	**$129,102,286**	**$338,999,832**

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

In the normal course of business, the Bank has various outstanding commitments and contingent liabilities that are not reflected in the accompanying financial statements. Loan commitments and lines of credit are agreements to lend to a customer as long as there is no violation of any condition to the contract. Mortgage loan commitments generally have fixed interest rates, fixed expiration dates, and may require payment of a fee. Other loan commitments generally have fixed interest rates. Lines of credit generally have variable interest rates. Such lines do not represent future cash requirements because it is unlikely that all customers will draw upon their lines in full at any time.

The Bank's maximum exposure to credit loss in the event of nonperformance by the customer is the contractual amount of the credit commitment. Loan commitments, lines of credit, and letters of credit are made on the same terms, including collateral, as outstanding loans. The Bank has established an off-balance sheet reserve for potential losses associated with any outstanding commitment or unused line of credit. The off-balance sheet reserve is a percentage of the outstanding commitment or unused line of credit that is based upon a discounted charge-off history associated with each respective loan segment. The reserve at March 31, 2018 and 2017 totaled $50,200 and $55,200, respectively. At March 31, 2018, management is not aware of any accounting loss to be incurred by funding these loan commitments at this time.

The Bank had the following outstanding commitments and unused lines of credit as of March 31, 2018 and 2017:

	March 31, 2018	**March 31, 2017**
Unused commercial lines of credit	**$9,187,810**	**$10,733,345**
Unused home equity lines of credit	**22,560,376**	**22,993,289**
Unused consumer lines of credit	**29,331**	**1,110,155**
Residential construction loan commitments	**4,234,076**	**8,047,156**
Commercial construction loan commitments	**8,968,416**	**7,091,564**
Home equity loan commitments	**389,600**	**84,000**
Commercial loan commitments	**5,125,000**	**1,089,218**
Standby letter of credit	**250,224**	**472,354**

Note 8: Related Party Transactions

The officers and directors of the Bank enter into loan transactions with the Bank in the ordinary course of business. The terms of these transactions are similar to the terms provided to other borrowers entering into similar loan transactions. All related party loans are subject to review by management and the board of directors.

Activity in these loans during the years ended March 31, 2018 and 2017 was as follows:

	2018	2017
Balance - Beginning of year	**$345,314**	$381,948
New loans and lines of credit advances	**1,600**	7,500
Principal repayments	**(216,960)**	(44,134)
Balance - End of year	**$129,954**	$345,314

At March 31, 2018 there were no new loans made to related parties during the fiscal year and $6,150 of credit available under certain lines of credit. At March 31, 2017 there were $7,500 of new loans made to related parties during the fiscal year and $6,150 of credit available under lines of credit. Deposits from officers and directors of the Bank totaled $1,033,558 and $1,122,872 at March 31, 2018 and 2017, respectively.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 9: Premises and Equipment and Premises and Equipment Held For Sale

A summary of premises and equipment, excluding premises and equipment held for sale, and the related depreciation and amortization as of March 31, is as follows:

	Estimated Useful Life (in years)	**2018**	2017
Land		**$1,064,046**	$1,064,044
Office buildings and improvements	3 - 39	**3,899,584**	3,800,195
Furniture and equipment	3 - 7	**2,711,893**	2,602,749
Automobiles	5	**43,505**	43,505
Assets not in service		**8,448**	30,900
		7,727,476	7,541,393
Accumulated depreciation and amortization		**(3,781,651)**	(3,867,113)
Net premises and equipment		**$3,945,825**	$3,674,280
Depreciation and amortization expense		**$325,320**	$334,210

At March 31, 2018, the Bank had four operating leases that include three branches acquired from Fraternity and the administrative office lease in Baltimore County. The administrative office lease was renewed under a five-year option in December 2016, while two of the acquired branches have new leases due to relocation during fiscal 2018. Each of the lease agreements have options to renew at the end of the lease term. Rental expense under the four leases for the year ended March 31, 2018 was $511,884 compared to lease expense of $1,002,477 for March 31, 2017. The prior year lease expense includes the $495,000 in lease expense that is associated with closing one of our branches and the inability to get out of a respective lease agreement. The minimum future rental commitment under the current lease agreements at March 31, 2018 is as follows:

Year ending March 31,	Payments
2019	**521,642**
2020	**543,727**
2021	**480,779**
2022	**353,841**

2023	**67,054**
Thereafter	**25,879**
	$1,992,922

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 10: Goodwill and Other Intangible Assets

The Company's intangible assets (goodwill and core deposit intangible) at March 31, 2018 consists of assets recorded in December 2009 associated with the acquisition of a branch office in Pasadena, Maryland and the acquisition of Fairmount in September 2015 and the acquisition of Fraternity in May 2016. Only the goodwill related to the branch office acquisition in the amount of $2.7 million is deductible for tax purposes. We conducted our annual impairment test of goodwill as of December 31, 2017. In addition, due to the significant increase in tax expense resulting from the recording of a valuation allowance on our net deferred tax assets in the fourth quarter of fiscal 2018, we concluded that a triggering event had occurred. Therefore, we performed an additional goodwill impairment analysis during the quarter ending March 31, 2018. Based upon the impairment tests performed as of December 31, 2017 and March 31, 2018, the fair values exceeded the carrying values of our only reporting unit. As a result, no impairment to goodwill was recorded for the period ended March 31, 2018. The core deposit intangible asset is being amortized straight-line over a life of eight years.

The following table presents the changes in net book value of intangible assets for the years ended March 31, 2018 and 2017:

	Goodwill	Core deposit intangible
Balance April 1, 2016	$6,767,811	$618,300
Additions (1)	1,877,243	242,020
Post acquisition adjustments	(81,524)	-
Amortization	-	(121,022)
Balance March 31, 2017	**8,563,530**	**739,298**
Amortization	-	(126,064)
Balance March 31, 2018	**$8,563,530**	**$613,234**

(1) - Additions to intangible assets are related to

the
acquisition
of Fraternity
Community
Bancorp,
Inc.

The post-acquisition adjustment to goodwill shown in the table above was recorded in the first quarter of fiscal 2017. The adjustment represents a $451,000 write-down of several owner-occupied residential investor loans to one borrower that were acquired in the Fairmount acquisition and recording of an increase to the deferred tax asset related to a $533,000 net operating loss (NOL) from Fairmount's final tax return. With regards to the investor loans, information we were not aware of at the time of the acquisition became available during the quarter ended June 30, 2016. Had we known this information at the time of the acquisition, we would have deemed these loans as impaired and valued them accordingly.

At March 31, 2018, future expected annual amortization associated with the core deposit intangible is as follows:

Year ending March 31,	Amount
2019	**126,070**
2020	**123,737**
2021	**98,070**
2022	**98,070**
2023	**98,070**
2024	**64,174**
2025	**5,043**
	$613,234

Note 11: Derivative – Interest Rate Swap Agreements

The Company utilizes interest rate swap agreements as part of its asset liability management strategy to help manage its interest rate risk position. The notional amount of the interest rate swaps does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual interest rate swap agreements. The Company posted $751,000 and $392,000 under collateral arrangements as of March 31, 2018 and 2017, respectively, to satisfy collateral requirements associated with the risk exposure associated with all interest rate swap agreements.

Interest Rate SWAPS Designated as Cash Flow Hedges

During fiscal 2017, the Company entered into several interest rate swaps that were designated as cash flow hedges. The interest rate swaps have notional amounts totaling $11.6 million as of March 31, 2018 and were designated as cash flow hedges of certain Federal Home Loan Bank advances. The purpose of the cash flow hedges is to match-fund longer-term assets with longer-term borrowings to reduce potential interest rate risk and cost by swapping a variable rate borrowing for a fixed rate borrowing. The aggregate fair value of the swaps is recorded in other assets (liabilities) with changes in fair value associated with the effective portion recorded in other comprehensive income (loss) and the ineffective portion recorded in other non-interest income. The cash flow hedges were determined to be ineffective during the quarter ended September 30, 2017. As such, a total of $1,075 of ineffectiveness has been reported in net income for the period ending March 31, 2018.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Summary information about the interest-rate swaps designated as cash flow hedges as of year-end is as follows:

Interest Rate Swap	Notional Amount	Effective Start Date	Maturity Date	Pay Fixed Rate	Receive Floating Rate
FHLB Advance Swap 1	$1,850,000	March 9, 2017	March 9, 2022	2.24 %	3-Month LIBOR
FHLB Advance Swap 2	1,850,000	March 9, 2017	March 9, 2024	2.41 %	3-Month LIBOR
FHLB Advance Swap 3	1,850,000	March 9, 2017	March 9, 2027	2.57 %	3-Month LIBOR
FHLB Advance Swap 4	2,000,000	March 29, 2017	March 29, 2022	2.08 %	3-Month LIBOR
FHLB Advance Swap 5	2,000,000	March 29, 2017	March 29, 2024	2.24 %	3-Month LIBOR
FHLB Advance Swap 6	2,000,000	March 29, 2017	March 29, 2027	2.40 %	3-Month LIBOR
Total Notional Amount	$11,550,000				

Interest expense recorded on the swap transactions totaled $110,926 and $4,800 for the fiscal years ending March 31, 2018 and 2017 and is reported as a component of interest expense relating to borrowed funds.

The following table reflects cash flow hedges included in the Consolidated Statements of Financial Condition as of March 31, 2018 and 2017:

	March 31, 2018		March 31, 2017	
	Notional Amount	**Fair Value**	Notional Amount	Fair Value
Included in assets:				
Interest rate swaps related to FHLB Advances	**$11,550,000**	**$217,464**		
Included in liabilities:				
Interest rate swaps related to FHLB Advances			$11,550,000	$83,634

The following tables present the net gains (losses) recorded in accumulated other comprehensive income (loss) and the Consolidated Statements of Operations relating to the cash flow derivative instruments for the fiscal year ended March 31, 2018:

	Fiscal Year Ended March 31, 2018		
	Amount of Gain (Loss) Recognized in OCI (Effective Portion)	Amount of Gain (Loss) Reclassified from OCI to Interest Income	Amount of Gain (Loss) Recognized in Other Noninterest Income (Ineffective Portion)
Interest Rate Contracts	$300,023	$ -	$ (1,075)

Interest Rate SWAPS Designated as Fair Value Hedges

The derivative position relates to a transaction in which the Bank entered into an interest rate swap with another financial institution using a fixed rate commercial real estate loan as an offset. The Bank agrees to pay the other financial institution a fixed interest rate on a notional amount based upon the commercial real estate loan and in return receive a variable interest rate on the same notional amount. This transaction allows the Bank to effectively convert a fixed rate loan to a variable rate. Because the terms of the swap with the other financial institution and the commercial real estate loan offset each other, with the only difference being credit risk associated with the loan, changes in the fair value of the underlying derivative contract and the commercial real estate loan are not materially different and do not significantly impact the Bank's results of operations.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

During the second quarter of fiscal 2016, the Company entered into the interest rate swap agreement with a $3.3 million notional amount to convert a fixed rate commercial real estate loan at 3.99% into a variable rate for a term of approximately 10 years. The notional amount of the interest rate swap and the offsetting commercial real estate loan were $3.1 and $3.2 million at March 31, 2018 and 2017, respectively. The derivative is designated as a fair value hedge.

Credit risk arises from the possible inability of counterparties to meet the terms of their contracts. The Bank's exposure is limited to the replacement value of the contract rather than the notional amount, principal, or contract amount. There are provisions in the agreement with the counterparty that allow for certain unsecured credit exposure up to an agreed threshold. Exposures in excess of the agreed threshold are collateralized. In addition, the Bank minimizes credit risk through credit approvals, limits, and monitoring procedures.

The fair value hedge is summarized below:

	March 31, 2018			March 31, 2017		
	Notional Amount	**Principal Amount**	**Fair Value**	Notional Amount	Principal Amount	Fair Value
Included in Loans and Leases:						
Commercial real estate loan	**$-**	**$3,091,892**	**$3,022,744**	$-	$3,175,044	$3,201,691
Included in Other Assets:						
Interest Rate Swap	**$3,091,892**	**$-**	**$69,148**	$-	-	$-
Included in Other Liabilities:						
Interest Rate Swap	**$-**	**-**	**$-**	$3,175,044	-	$26,647

No gain or loss was recognized in earnings for the years ended March 31, 2018 and 2017 related to the interest rate swap due to the fact the gain or increase in the fair value of the commercial real estate was offset by the loss or decrease in the fair value of interest rate swap.

Note 12: Deposits

The following table details the composition of deposits and the related percentage mix of total deposits, respectively:

	March 31, 2018			March 31, 2017		
	Amount	% of Total		Amount	% of Total	
Savings	**$42,499,381**	**11**	**%**	$44,614,415	11	%
Noninterest-bearing checking	**29,557,943**	**7**	**%**	30,401,454	7	%
Interest-bearing checking	**27,219,285**	**7**	**%**	26,415,189	6	%
Money market accounts	**58,466,228**	**14**	**%**	62,962,902	15	%
Time deposits	**246,988,613**	**61**	**%**	247,632,742	60	%
	$404,731,450	**100**	**%**	$412,026,702	100	%
Premium on deposits asssumed	**411,525**			829,072		
Total deposits	**$405,142,975**			$412,855,774		

The aggregate amount of time deposits in denominations of $250,000 or more is $20,633,911 and $21,594,387 at March 31, 2018 and 2017, respectively.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

A schedule of maturity of time deposits at March 31 is as follows:

Maturity period	**2018**	2017
Within one year	**$125,075,179**	$124,859,888
Over one year through two years	**64,229,103**	61,925,008
Over two years through three years	**26,460,307**	26,005,112
Over three years through four years	**18,157,709**	17,427,002
Over four years through five years	**13,066,315**	17,393,621
Greater than five years	**-**	22,111
	$246,988,613	$247,632,742

Note 13: Federal Home Loan Bank Advances and Lines of Credit

The Bank may borrow up to $5,000,000 from a correspondent bank under a secured federal funds line of credit and $1,000,000 under an unsecured federal funds line of credit. The Bank would be required to pledge investment securities to draw upon the secured line of credit. There were no borrowings under these lines of credit at March 31, 2018 and 2017. The Bank also maintained a note payable on an automobile purchased during fiscal 2017. The original amount of the note was $28,805 with an interest rate of 1.95% for 36 months. The note was paid-off in January 2018.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Borrowings consist of advances from the Federal Home Loan Bank (FHLB). The Bank may borrow up to 25 percent of its assets under a line of credit agreement with the FHLB. Advances under the line of credit are secured by certain loans owned by the Bank. As of March 31, 2018 and 2017, the Bank had $68.3 million and $88.2 million, respectively, of available credit from the FHLB. Advances are limited by the balance of loans available for pledge. The amount of loans that were deemed eligible to pledge as collateral totaled $127.1 million at March 31, 2018 and $159.1 million at March 31, 2017. As a condition of obtaining the line of credit from the FHLB, the FHLB also requires the Bank purchase shares of capital stock in the FHLB. Information relating to borrowings at March 31, 2018 and 2017 is presented below.

	March 31, 2018			March 31, 2017		
	Amount	**Rate**	**Maturity Date**	Amount	Rate	Maturity Date
FHLB advance (1)	**$5,550,000**	**1.84%**	**6/11/2018**	$5,550,000	0.94%	6/9/2017
FHLB advance (2)	**6,000,000**	**1.90%**	**6/29/2018**	6,000,000	0.93%	6/29/2017
FHLB advance	**1,000,000**	**2.60%**	**7/2/2018**	1,000,000	4.24%	7/31/2017
FHLB advance	**1,000,000**	**3.05%**	**7/3/2018**	5,000,000	4.28%	7/31/2017
FHLB advance	**5,000,000**	**3.94%**	**7/23/2018**	1,000,000	4.01%	8/21/2017
FHLB advance	**1,000,000**	**1.74%**	**7/31/2018**	1,000,000	0.91%	8/31/2017
FHLB advance	**1,000,000**	**1.40%**	**8/21/2018**	1,500,000	3.23%	11/24/2017
FHLB advance	**4,000,000**	**1.94%**	**8/27/2018**	1,500,000	3.40%	11/27/2017
FHLB advance	**3,000,000**	**1.41%**	**8/27/2018**	1,000,000	2.60%	7/2/2018
FHLB advance	**5,000,000**	**3.38%**	**9/19/2018**	1,000,000	3.05%	7/3/2018
FHLB advance	**1,000,000**	**2.60%**	**10/2/2018**	5,000,000	3.94%	7/23/2018
FHLB advance	**1,000,000**	**1.95%**	**12/31/2018**	5,000,000	3.38%	9/19/2018
FHLB advance	**3,000,000**	**1.38%**	**7/31/2019**	1,000,000	2.60%	10/2/2018
FHLB advance	**3,000,000**	**1.96%**	**8/26/2019**	-		
FHLB advance	**3,000,000**	**1.59%**	**8/26/2019**	-		
FHLB advance	**3,000,000**	**1.42%**	**8/26/2019**	-		
FHLB advance	**1,500,000**	**1.95%**	**11/25/2019**	-		
FHLB advance	**1,500,000**	**1.78%**	**11/27/2019**	-		
FHLB advance	**3,000,000**	**2.31%**	**2/3/2020**	-		
FHLB advance	**1,000,000**	**2.15%**	**11/30/2020**	-		
FHLB advance	**2,000,000**	**2.28%**	**12/28/2020**	-		
FHLB advance	**2,000,000**	**2.49%**	**2/1/2021**	-		
FHLB advance	**3,000,000**	**1.48%**	**8/25/2021**	-		
Note payable - auto	**-**			27,250	1.95%	2/17/2020
	60,550,000			35,577,250		
Premium on FHLB advances assumed	**122,140**			547,649		
Total borrowings	**$60,672,140**			$36,124,899		

(1) - FHLB Advance is tied to three derivative cash flow hedges in increments of $1.85 million each. The three individual cash flow hedges are for a term of five, seven and ten years, respectively and are tied to the 3-month LIBOR rate. In order for the cash flow hedges to remain effective, the corresponding FHLB Advance will have to be renewed every three months until the respective cash flow hedge matures.

(2) - FHLB Advance is tied to three derivative cash flow hedges in increments of $2.0 million each. The three individual cash flow hedges are for a term of five, seven and ten years, respectively and are tied to

the 3-month LIBOR rate. In order for the cash flow hedges to remain effective, the corresponding FHLB Advance will have to be renewed every three months until the respective cash flow hedge matures.

Note 14: Income Taxes

The provisions for income taxes for the years ended March 31, 2018 and 2017 consist of the following components:

	Year Ended March 31,	
	2018	2017
Tax expense (benefit):		
Current:		
Federal	**$(22,566)**	$(10,911)
State	**$(6,599)**	(5,193)
Deferred tax	**8,081,203**	(741,901)
Total tax expense (benefit)	**$8,052,038**	$(758,005)

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

A reconciliation of the provision for taxes on income from the statutory federal income tax rate to the effective income tax rates follows:

	Year Ended March 31,	
	2018	2017
Tax at statutory federal income tax rate	**$615,952**	$(573,507)
Tax effect of:		
Tax-exempt income	**(491,456)**	(260,637)
State income taxes, net of federal impact	**42,442**	(90,427)
Valuation allowance on income tax benefits	**5,790,102**	-
Impact of the Tax Act	**2,318,118**	-
Nondeductible expenses and other	**55,397**	166,566
Other	**(278,517)**	-
Income tax expense (benefit)	**$8,052,038**	$(758,005)

The following is a summary of the tax effects of the temporary differences and tax attributes between financial and income tax accounting that give rise to deferred tax assets and deferred tax liabilities as of March 31:

	2018	2017
Deferred tax assets:		
Allowance for loan losses	**$627,297**	$887,510
Nonaccrual interest	**219,172**	197,363
Deferred compensation	**547,968**	822,939
Foreclosed real estate write down and holding costs	**162,973**	221,010
Deferred loan costs	**34,870**	42,285
Capital loss carryforward	**-**	48,872
Charitable contribution carryforward	**28,272**	42,098
Net operating loss carryforward	**3,227,274**	4,414,529
Stock based payment awards	**66,968**	80,833
Unrealized loss on investment securities available for sale	**728,266**	862,673
AMT credit carryover	**245,260**	225,294
Acquisition activity	**510,506**	1,078,763
Other	**39,692**	-
	6,438,518	8,924,169
Valuation allowance on deferred tax asset	**(5,790,102)**	(42,364)
	648,416	8,881,805

Deferred tax liabilities:		
FHLB stock dividends	**63,486**	91,004
Goodwill and other intangible assets	**522,993**	717,933
Accumulated depreciation	**61,937**	65,193
Other	**-**	30,825
	648,416	904,955
Net deferred tax asset	**$-**	$7,976,850

Deferred income taxes reflect the impact of "temporary differences" between the amount of assets and liabilities for financial reporting purposes and such amounts as measured by tax laws and regulations. The largest component of our net deferred tax asset at March 31, 2018 was our net operating loss carryforwards and temporary differences related to the activity in our allowance for loan losses and unrealized loss on investment securities available for sale. The Company records a valuation allowance against deferred tax assets if, based on the weight of available evidence, it is more likely than not, that some or all of the deferred tax assets will not be realized. Due to the Company remaining in a cumulative loss position for three consecutive years, management has concluded that it is more likely-than-not that the Company will be unable to realize its deferred tax assets in the foreseeable future, and accordingly has established a full valuation allowance of $5.8 million which equals 100% of the net deferred tax assets at March 31, 2018. If, in the future, the Company generates taxable income on a sustained basis sufficient to support the deferred tax assets, the need for a deferred tax valuation allowance could change, resulting in the reversal of all or a portion of the deferred tax asset valuation at that time.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The Company has a federal net operating loss carryforward (NOL) of $12.0 million as of March 31, 2018, which will expire within the period of the years ending March 31, 2030 through 2037, including $4.9 million and $1.9 million of federal NOL assumed in the acquisition of Fraternity and Fairmount, respectively. As a result of the change in ownership, the utilization of Fraternity and Fairmount's NOL carryforwards is subject to limitations imposed under Code Section 382 of the Internal Revenue Code. The state NOL for the Company is $11.0 million and also expires within the same period as the federal NOL. In addition, other tax attributes consisted of charitable contribution carryforwards of $102,742 and AMT credit carryovers of $245,620 at March 31, 2018. Under the Tax Act, the AMT credit carryovers are refundable over a period beginning in 2018. Charitable contribution carryovers have a limited life of five years.

On December 22, 2017, the Tax Act was passed into law. The Tax Act included a broad range of tax reform including changes to tax rates and deductions that were effective January 1, 2018. The primary change for the Company was the lowering of the federal corporate income tax rate to 21% from maximum of 35%. The decrease in the enacted corporate tax rate expected to apply when the Company's temporary differences are realized or settled resulted in a revaluation of the Company's net deferred tax asset of $2.3 million with a corresponding charge to income tax expense. Based on information available and our current interpretation of the Tax Act, the Company has made reasonable estimates of the impact from the reduction in the corporate tax rate on the remeasurement of applicable deferred tax assets and liabilities. However, certain deferred tax assets and liabilities will continue to be evaluated in the context of the Tax Act through the date of the filing of our March 31, 2018 federal income tax return, and may change as a result of evolving management interpretations, elections, and assumptions, as well as new guidance that may be issued by the Internal Revenue Service. Management expects to complete its analysis within the measurement period in accordance with SAB 118.

The Company's tax returns are subject to review and examination by federal and state taxing authorities. The Company's tax returns are currently open to audit under the applicable statutes of limitations by the Internal Revenue Service for the years ended March 31, 2015 through March 31, 2017. Years in which an NOL is created though are still open for examination. The establishment of a valuation allowance on our deferred tax assets for financial reporting purposes does not affect how the net operating loss carryforwards may be utilized on our subsequent income tax returns. The Company does not have any uncertain tax positions that are deemed material, and did not recognize any adjustments for unrecognized tax benefits.

Note 15: Regulatory Capital Ratios

Banks and bank holding companies are subject to various regulatory capital requirements administered by state and federal banking agencies. Capital adequacy guidelines and prompt corrective action regulations for banks, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weighting and other factors.

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

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

Under the revised prompt corrective action requirements, as of January 1, 2015, insured depository institutions are required to meet the following in order to qualify as “well capitalized:” (1) a common equity Tier 1 risk-based capital ratio of 6.5%; (2) a Tier 1 risk-based capital ratio of 8%; (3) a total risk-based capital ratio of 10% and (4) a Tier 1 leverage ratio of 5%. As of March 31, 2018, the Bank met all capital adequacy requirements under the Basel III Capital Rules to be considered “well capitalized” under prompt corrective action rules.

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

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

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The following table presents actual and required capital ratios as of March 31, 2018 and March 31, 2017 for Hamilton Bank and the Company under the Basel III Capital Rules. The minimum required capital amounts presented include the minimum required capital levels as of January 1, 2018 based on the phase-in provisions of the Basel III Capital Rules and the minimum required capital levels as of January 1, 2019 when the Basel III Capital Rules have been fully phased-in. Capital levels required to be considered well capitalized are based upon prompt corrective action regulations, as amended to reflect the changes under the Basel III Capital Rules.

	Actual		Minimum Capital Required - Basel III Phase-In Schedule		Minimum Capital Required - Basel III Fully Phased-In		To be well capitalized (1)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio	Amount	Ratio
			(dollars in thousands)		*(dollars in thousands)*			
March 31, 2018								
Common equity tier 1 capital (to risk-weighted assets)								
Hamilton Bank	**$39,126**	**10.61 %**	**$23,498**	**6.375 %**	**$25,802**	**7.00 %**	**$23,959**	**6.50 %**
Hamilton Bancorp	**47,308**	**12.79 %**	**23,582**	**6.375 %**	**25,894**	**7.00 %**	**24,044**	**6.50 %**
Total risk-based capital (to risk-weighted assets)								
Hamilton Bank	**41,998**	**11.39 %**	**36,399**	**9.875 %**	**38,703**	**10.50 %**	**36,860**	**10.00 %**
Hamilton Bancorp	**50,180**	**13.57 %**	**36,529**	**9.875 %**	**38,841**	**10.50 %**	**36,992**	**10.00 %**
Tier 1 capital (to risk-weighted assets)								
Hamilton Bank	**39,126**	**10.61 %**	**29,027**	**7.875 %**	**31,331**	**8.50 %**	**29,488**	**8.00 %**
Hamilton Bancorp	**47,308**	**12.79 %**	**29,131**	**7.875 %**	**31,443**	**8.50 %**	**29,593**	**8.00 %**
Tier 1 capital (to adjusted total assets)								
Hamilton Bank	**39,126**	**7.64 %**	**20,497**	**4.000 %**	**20,497**	**4.00 %**	**25,621**	**5.00 %**
Hamilton Bancorp	**47,308**	**8.15 %**	**20,674**	**4.000 %**	**20,674**	**4.00 %**	**25,843**	**5.00 %**
March 31, 2017								
Common equity tier 1 capital (to risk-weighted assets)								
Hamilton Bank	$40,084	12.13 %	$18,996	5.750 %	$23,126	7.00 %	$21,474	6.50 %

Hamilton Bancorp	48,318	14.56%	19,078	5.750%	23,225	7.00 %	$21,566	6.50 %
Total risk-based capital (to risk-weighted assets)								
Hamilton Bank	42,334	12.81%	30,559	9.250%	34,689	10.50%	33,037	10.00%
Hamilton Bancorp	50,568	15.24%	30,690	9.250%	34,838	10.50%	33,179	10.00%
Tier 1 capital (to risk-weighted assets)								
Hamilton Bank	40,084	12.13%	23,952	7.250%	28,081	8.50 %	26,429	8.00 %
Hamilton Bancorp	48,318	14.56%	24,055	7.250%	28,202	8.50 %	26,543	8.00 %
Tier 1 capital (to adjusted total assets)								
Hamilton Bank	40,084	8.28 %	19,365	4.000%	19,365	4.00 %	24,207	5.00 %
Hamilton Bancorp	48,318	9.96 %	19,402	4.000%	19,402	4.00 %	24,253	5.00 %

(1) - Under prompt corrective action

Tier 1 capital consists of total shareholders’ equity less goodwill, intangible assets, and deferred tax net operating loss carryforwards. Total capital includes a limited amount of the allowance for loan losses and a portion of any unrealized gain on equity securities. In calculating risk-weighted assets, specified risk percentages are applied to each category of asset and off-balance-sheet items.

Failure to meet the capital requirements could affect, among other things, the Bank's ability to accept brokered deposits and may significantly affect the operations of the Bank. During the quarter ended December 31, 2016, the Company transferred $3.0 million in cash down to the Bank as capital to increase the Bank’s lending capacity and enhance the Bank’s capital ratios after falling below the Bank’s self-imposed internal minimum capital level in the prior quarter.

In its regulatory report filed as of March 31, 2018, the Bank exceeded all regulatory capital requirements and was considered “well capitalized” under regulatory guidelines. Management is not aware of any events that would have caused this classification to change. Management has no plans that should change the classification of the capital adequacy.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 16: Defined Contribution Retirement Plan

The Bank offers a retirement plan qualifying under section 401(k) of the Internal Revenue Code to its employees. The Plan covers all full-time employees with one year of service who have reached 18 years of age. The Bank contributes three percent of each participant's eligible compensation to the Plan. The Bank may make elective deferrals as well, upon Board of Directors approval. During the years ended March 31, 2018 and 2017, the Bank recorded expense of $174,065 and $145,082, respectively, related to the 401(k) Plan.

Note 17: Employee Stock Ownership Plan

In connection with the conversion to stock form in October 2012, the Company established an Employee Stock Ownership Plan (ESOP) for the exclusive benefit of eligible employees. Eligible employees include all employees over the age of 21that have completed 1,000 hours of service over a continuous twelve-month period. The ESOP borrowed funds from the Company in the amount of $2,962,400, which was sufficient to purchase 296,240 shares or 8% of the Common Stock issued in the offering. The shares were acquired at a price of $10.00 per share.

The loan is secured by the shares purchased with the loan proceeds and will be repaid by the ESOP over the 20-year term of the loan with funds from the Bank's contributions to the ESOP and dividends paid on the stock, if any. The interest rate on the ESOP loan is an adjustable rate equal to the lowest prime rate, as published in the *Wall Street Journal*. The interest rate will adjust annually and will be the prime rate on the first business day of the calendar year. The interest rate on the loan as of March 31, 2018 is 4.50%.

Shares purchased with the loan proceeds are held in a suspense account for allocation among participants as the loan is repaid. Contributions to the ESOP and shares released from the suspense account are allocated among participants in proportion to their annual salaried wages, relative to total salaried wages of all active participants. Participants will vest their accrued benefits under the employee stock ownership plan at a rate of 20% per year, such that the participants will be 100% vested upon completion of five years of credited service. Vesting is accelerated upon retirement, death, or disability of the participant, or a change in control of the Bank. Forfeitures will be reallocated to remaining plan participants. Benefits may be payable upon retirement, death, disability, separation of service, or termination of the ESOP. Participants may elect to receive benefits in cash in lieu of common stock.

The debt of the ESOP, in accordance with generally accepted accounting principles, is eliminated in consolidation and the shares pledged as collateral are reported as unearned ESOP shares in the Consolidated Statement of financial Condition. Contributions to the ESOP shall be sufficient to pay principal and interest currently due under the loan agreement. As shares are committed to be released from collateral, the Company reports compensation expense equal to the fair market price of the shares as they are committed to be released from the unallocated suspense account to participants' accounts. The shares allocated will then become outstanding shares for earnings per share computations. The ESOP compensation expense for the year ended March 31, 2018 and 2017 was $224,481 and $235,633, respectively.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

A summary of ESOP shares at March 31, 2018 and 2017 is as follows:

	2018	2017
Shares allocated to employees	**88,872**	74,060
Unearned shares	**207,368**	222,180
Total ESOP shares	**296,240**	296,240
Fair value of unearned shares	**$2,954,994**	$3,410,463

Note 18: Stock Based Compensation

In November 2013, the Company's shareholders approved a new Equity Incentive Plan (the "2013 Equity Incentive Plan''). The 2013 Equity Incentive Plan allows for up to 148,120 shares to be issued to employees, executive officers or Directors in the form of restricted stock, and up to 370,300 shares to be issued to employees, executive officers or Directors in the form of stock options. At March 31, 2018, there were 83,900 restricted stock awards issued and outstanding and 247,850 stock option awards granted under the 2013 Equity Incentive Plan.

Stock Options:

Under the above plan, the exercise price for stock options is the market price at date of grant. The maximum option term is ten years and the options granted shall vest in five equal annual installments of 20% with the first installment becoming exercisable on the first anniversary of the date of grant and succeeding installments on each anniversary thereafter. The Company plans to issue new shares to satisfy share option exercises. The total expense that has been incurred for the stock option plan was $229,569 and $216,735 for the years ended March 31, 2018 and 2017, respectively.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical data. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted 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 rate equal to the expected term of the option in effect at the time of the grant.

The fair value of options granted to date was determined using the following weighted-average assumptions as of grant date.

Grant Date	Number of Options Granted	Risk Free Interest Rate	Expected Term (in years)	Expected Stock Price Volatility	Dividend Yield	Fair Value of Options Granted
February 3, 2014	225,150	2.07 %	7.0	27.30 %	0.00 %	$ 4.65
November 1, 2016	19,000	1.61 %	7.0	27.17 %	0.00 %	$ 4.35
February 3, 2017	3,700	2.27 %	7.0	27.26 %	0.00 %	$ 5.18

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Notes to Consolidated Financial Statements (Continued)

A summary of stock option activity for the year ended March 31, 2018 and 2017 is as follows:

March 31, 2018:	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)
Outstanding at April 1, 2017	**242,350**	**$ 13.84**	7.1
Granted	**-**	**-**	-
Exercised	**-**	**-**	-
Forfeited, exchanged or expired	**-**	**-**	-
Outstanding at March 31, 2018	**242,350**	**$ 13.84**	6.1
Vested at March 31, 2018	**180,260**	**$ 13.84**	5.8

March 31, 2017:	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term (in years)
Outstanding at April 1, 2016	219,650	$ 13.85	7.8
Granted	22,700	13.78	10.0
Exercised	-	-	-
Forfeited, exchanged or expired	-	-	-
Outstanding at March 31, 2017	242,350	$ 13.84	7.1
Vested at March 31, 2017	131,790	$ 13.85	6.8

As of March 31, 2018, there was $248,272 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The expense is expected to be recognized over a weighted-average period of 1.7 years. The intrinsic value of a stock option is the amount that the market value of the underlying stock exceeds the exercise price of the option. Based upon a fair market value of $14.25 at March 31, 2018, the options outstanding had an intrinsic value of $102,110.

Restricted Stock:

The specific terms of each restricted stock award are determined by the Compensation Committee at the date of the grant. Compensation expense is recognized over the vesting period of the awards based on the fair value of the stock at the grant date. Restricted stock awards granted shall vest in five equal annual installments of 20% with the first installment becoming vested on the first anniversary of the date of grant and succeeding installments on each anniversary thereafter.

A summary of changes in the Company's nonvested shares for the year is as follows:

March 31, 2018:	Shares	Weighted-Average Fair Value
Nonvested shares at April 1, 2017	**36,220**	**$ 13.76**
Granted	**-**	**-**
Vested	**(16,780)**	**13.78**
Forfeited	**-**	**-**
Nonvested shares at March 31, 2018	**19,440**	**$ 13.74**
Fair Value of shares vested at March 31, 2018	**$918,555**	

March 31, 2017:	Shares	Weighted-Average Fair Value
Nonvested shares at April 1, 2016	50,600	$ 13.76
Granted	2,000	13.93
Vested	(16,380)	13.78
Forfeited	-	-
Nonvested shares at March 31, 2017	36,220	$ 13.76
Fair Value of shares vested at March 31, 2017	$731,888	

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The following table outlines the vesting schedule of the nonvested restricted stock awards as of March 31, 2018:

Year Ending March 31,	**Number of Restricted Shares**
2019	16,780
2020	1,780
2021	480
2022	400
	19,440

The Company recorded restricted stock awards expense of $231,276 and $227,646 for the years ended March 31, 2018 and 2017, respectively. As of March 31, 2018, there was $225,445 of total unrecognized compensation expense related to nonvested shares granted under the 2013 stock incentive plan. The cost is expected to be recognized over a weighted-average period of 1.2 years.

Note 19: Fair Value Measurements

Generally accepted accounting principles define fair value, establish a framework for measuring fair value, and establish a hierarchy for determining fair value measurement. The hierarchy includes three levels and is based upon the valuation techniques used to measure assets and liabilities. The three levels are as follows:

Level 1: Valuation is based on quoted prices (unadjusted) for identical assets or liabilities in active markets;

Level 2: Valuation is determined from quoted prices for similar assets and liabilities in active markets, quoted prices for identical or similar instruments in markets that are not active or by model-based techniques in which all significant inputs are observable in the market; and

Level 3: Valuation is derived from model-based techniques in which at least one significant input is unobservable and based on the Company's own estimates about the assumptions that market participants would use to value the asset or liability.

The following is a description of the valuation methods used for instruments measured at fair value as well as the general classification of such instruments pursuant to the applicable valuation method.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Fair value measurements on a recurring basis

Securities available for sale – If quoted prices are available in an active market for identical assets, securities are classified within Level 1 of the hierarchy. If quoted market prices are not available, then fair values are estimated using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. As of March 31, 2018 and 2017, the Bank has categorized its investment securities available for sale as follows:

March 31, 2018	Level 1 inputs	Level 2 inputs	Level 3 inputs	Total
U.S. government agencies	**$ -**	**$2,718,649**	**$-**	**$2,718,649**
Municipal bonds	**-**	**11,705,991**	**-**	**11,705,991**
Corporate bonds		**-**	**1,954,076**	**1,954,076**
Mortgage-backed securities	**-**	**59,025,404**	**16**	**59,025,420**
Total investment securities available for sale	**$ -**	**$73,450,044**	**$1,954,092**	**$75,404,136**

March 31, 2017	Level 1 inputs	Level 2 inputs	Level 3 inputs	Total
U.S. government agencies	$ -	$3,512,303	$-	$3,512,303
Municipal bonds	-	14,239,526	1,928,313	16,167,839
Corporate bonds		1,916,522	-	1,916,522
Mortgage-backed securities	-	80,829,991	2,473	80,832,464
Total investment securities available for sale	$ -	$100,498,342	$1,930,786	$102,429,128

During fiscal 2018, a corporate bond and one mortgage-backed security were moved from a Level 2 input to a Level 3 input. The quantitative unobservable input for these bonds was obtained based upon pricing from an independent third party. The securities were classified as a Level 3 input because there was no active market for these securities to obtain a fair value. Conversely, during fiscal 2018, several municipal bonds and mortgage backed securities were moved from Level 3 input to Level 2 input as additional market data and inputs became available.

Derivative – Interest rate swap agreements - The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2). The quantitative models that are used utilize multiple market inputs. The inputs will vary based on the type of derivative, but could include interest rates, prices and indices to generate continuous yield or pricing curves, prepayment rates, and volatility factors to value the position. The majority of market inputs are actively quoted and can be validated through external sources, including brokers, market transactions and third-party pricing services. As of March 31, 2018 and 2017, the bank has categorized its interest rate swaps and related loan as follows:

March 31, 2018	Level 1 inputs	Level 2 inputs	Level 3 inputs	Total
Loans - Commercial real estate loan	$ -	$3,022,744	$ -	$3,022,744
Derivative - Interest rate swap designated as fair value hedge	-	69,148	-	69,148
Derivatives - Interest rate swaps designated as cash flow hedge	-	217,464	-	247,736

March 31, 2017	Level 1 inputs	Level 2 inputs	Level 3 inputs	Total
Loans - Commercial real estate loan	$ -	$3,201,691	$ -	$3,201,691
Derivative - Interest rate swap designated as fair value hedge	-	(26,647)	-	(26,647)
Derivatives - Interest rate swaps designated as cash flow hedge	-	(83,634)	-	(83,634)

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The following table presents the valuation and unobservable inputs for Level 3 assets measured at fair value on a recurring basis at March 31, 2018:

Description	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
Investment securities	$1,954,092	3rd party valuation	Discount to reflect current market conditions	0.00% - 10.00%

The following table presents a reconciliation of the investments which are measured at fair value on a recurring basis using significant unobservable inputs (Level 3) for the periods presented:

	March 31, 2018	March 31, 2017
Balance, beginning of year	**$1,930,786**	$1,898,640
Transfers in:		
Corporate bonds	**1,954,076**	-
Mortgage-backed securities	**16**	2,473
Municipal bonds	**-**	1,928,313
Transfers out:		
Corporate bonds	**-**	1,898,640
Mortgage-backed securities	**2,473**	-
Municipal bonds	**1,928,313**	-
Balance, end of year	**$1,954,092**	$1,930,786

Fair value measurements on a nonrecurring basis

Impaired Loans - The Bank has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent appraisals of the properties, or discounted cash flows based upon the expected proceeds. These assets are included as Level 3 fair values. At March 31, 2018 and 2017, the fair values consist of loan balances of $8,720,339 and $5,657,048 that have been written down by $266,256 and $285,359, respectively, as a result of specific loan loss allowances.

Foreclosed real estate – The Bank's foreclosed real estate is measured at the lower of carrying value or fair value less estimated cost to sell. At March 31, 2018 and 2017, the fair value of foreclosed real estate was estimated to be $457,778 and $503,094, respectively. Fair value was determined based on offers and/or appraisals. Cost to sell the assets was based on standard market factors. The Company has categorized its foreclosed assets as Level 3.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Premises and equipment held for sale – The Bank's premises and equipment held for sale is measured at the fair value less estimated cost to sell. The assets in fiscal 2017 totaling $547,884 were acquired in the acquisition of Fraternity and sold during the quarter ending December 31, 2017. Fair value was determined based upon appraisals and the cost to sell these assets was determined using standard market factors. The Company has categorized its premises and equipment held for sale as Level 3.

March 31, 2018	Level 1 inputs	Level 2 inputs	Level 3 inputs	Total
Impaired loans	**$ -**	**$ -**	**$8,454,083**	**$8,454,083**
Foreclosed real estate	**-**	**-**	**457,778**	**457,778**
Premises and equipment held for sale	**-**	**-**	**-**	**-**
Loans held for sale	**-**	**-**	**-**	**-**

March 31, 2017	Level 1 inputs	Level 2 inputs	Level 3 inputs	Total
Impaired loans	$ -	$ -	$5,371,689	$5,371,689
Foreclosed real estate	-	-	503,094	503,094
Premises and equipment held for sale	-	-	547,884	547,884
Loans held for sale	**-**	**-**	**-**	**-**

The following table presents the valuation and unobservable inputs for Level 3 assets measured at fair value on a nonrecurring basis at March 31, 2018:

Description	Fair Value	Valuation Methodology	Unobservable Inputs	Range of Inputs
Impaired loans, net of allowance	$8,454,083	Appraised value	Discount to reflect current market conditions	0.00%-25.00%

		Discounted cash flows	Discount rates	2.63%-7.25%
Foreclosed real estate	$457,778	Appraised value	Discount to reflect current market conditions	0.00%-25.00%

The following table summarizes changes in foreclosed real estate for the years ended March 31, 2018 and 2017, which is measured on a nonrecurring basis using significant unobservable, level 3, inputs:

	Year Ended March 31,	
	2018	2017
Balance at beginning of period	**$503,094**	$443,015
Transfer to foreclosed real estate	**23,834**	126,575
Write-down of foreclosed real estate	**(31,955)**	0
Proceeds from sale of foreclosed real estate	**(35,896)**	(60,258)
Loss on sale of foreclosed real estate	**(1,299)**	(6,238)
Balance at end of period	**$457,778**	$503,094

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

The remaining financial assets and liabilities are not reported on the balance sheets at fair value on a recurring basis. The calculation of estimated fair values is based on market conditions at a specific point in time and may not reflect current or future fair values.

	March 31, 2018		March 31, 2017	
	Carrying amount	Fair value	Carrying amount	Fair value
Financial assets				
Level 1 inputs				
Cash and cash equivalents	**$23,368,415**	**$23,368,415**	$29,353,921	$29,353,921
Level 2 inputs				
Federal Home Loan Bank stock	**3,122,400**	**3,122,400**	2,020,200	2,020,200
Bank-owned life insurance	**17,455,850**	**17,455,850**	18,253,348	18,253,348
Level 3 inputs				
Certificates of deposit held as investment	**499,189**	**492,751**	499,280	505,641
Loans receivable, net of unearned income	**387,328,993**	**385,818,260**	335,758,154	337,444,534
Financial liabilities				
Level 3 inputs				
Deposits	**405,142,975**	**405,026,957**	412,855,774	413,148,503
Advance payments by borrowers for taxes and insurance	**1,962,665**	**1,962,665**	1,868,110	1,868,110
Borrowings	**60,672,140**	**60,494,922**	36,124,899	36,697,631

The fair values of cash and cash equivalents and advances by borrowers for taxes and insurance are estimated to equal the carrying amount.

The fair values of Federal Home Loan Bank stock and bank-owned life insurance are estimated to equal carrying amounts, which are based on repurchase prices of the FHLB stock and the insurance company.

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

The fair value of certificates of deposit held as investments is estimated based on interest rates currently offered for certificates of deposit with similar remaining maturities.

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

The fair value of borrowings is estimated based on interest rates currently offered for borrowings of similar remaining maturities.

The fair value of outstanding loan commitments and unused lines of credit are considered to be the same as the contractual amounts, and are not included in the table above. These commitments generate fees that approximate those currently charged to originate similar commitments.

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Note 20: Condensed Financial Statements of Parent Company

Presented below are the condensed statements of financial condition as of March 31, 2018 and 2017, and the related condensed statements of operations and condensed statements of cash flows for Hamilton Bancorp, Inc. for the years ended March 31, 2018 and 2017.

Condensed Statements of Financial Condition

	March 31, 2018	March 31, 2017
Assets		
Cash and due from bank	**$3,421,827**	$3,250,700
Investment securities available-for-sale	**1,995,625**	2,016,730
Loans and leases, net of unearned income	**433,222**	479,473
ESOP loan receivable	**2,214,298**	2,332,992
Investment in bank subsidiary	**45,903,508**	51,487,261
Other assets	**107,652**	224,074
Total Assets	**$54,076,132**	$59,791,230
Liabilities	**$-**	$-
Shareholders' Equity		
Common stock	**34,076**	34,111
Additional paid in capital	**32,113,534**	31,656,235
Retained earnings	**25,920,490**	31,730,673
Unearned ESOP shares	**(2,073,680)**	(2,221,800)
Accumulated other comprehensive loss	**(1,918,288)**	(1,407,989)
Total Shareholders' Equity	**54,076,132**	59,791,230
Total Liabilities and Shareholders' Equity	**$54,076,132**	$59,791,230

Condensed Statements of Operations Years Ended March 31, 2018 and 2017

	March 31, 2018	March 31, 2017
Interest revenue		
Interest on loans, including fees	**$21,213**	$30,464
Interest on bank deposits	**3,059**	5,307
Interest on investments	**21,967**	18,932
Interest on ESOP loan	**90,526**	87,710
Total interest revenue	**136,765**	142,413
Noninterest expenses		
Legal	**45,466**	25,232
Other professional services	**-**	587
Merger related expenses	**-**	219,417
Other operating	**159,870**	171,516
Total noninterest expenses	**205,336**	416,752
Loss before income tax benefit and equity in net loss of bank subsidiary	**(68,571)**	(274,339)
Income tax expense (benefit)	**58,014**	(16,013)
Loss before equity in net loss of bank subsidiary	**(126,585)**	(258,326)
Equity in net loss of bank subsidiary	**(5,922,357)**	(670,456)
Net loss	**$(6,048,942)**	$(928,782)

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HAMILTON BANCORP, INC. AND SUBSIDIARY

Notes to Consolidated Financial Statements (Continued)

Condensed Statements of Cash Flows
Years Ended March 31, 2018 and 2017

	March 31, 2018	March 31, 2017
Cash flows from operating activities:		
Net loss	**$(6,048,942)**	$(928,782)
Adjustments to reconcile net loss to net cash provided (used) by operating activities:		
Equity in undistributed net loss of subsidiary	**5,922,357**	670,456
Amortization of premium on investment securities	**13,034**	4,707
Increase (decrease) in other assets	**119,768**	(9,593)
Decrease in other liabilities	**-**	(23,976)
Net cash provided (used) by operating activities	**6,217**	(287,188)
Cash flows from investing activities:		
Acquistion, net of cash acquired	**-**	(22,430,749)
Principal collected on ESOP loan	**118,694**	116,819
Principal repayments on loans	**46,251**	153,313
Proceeds from maturing and called securities available for sale, including principal pay downs	**-**	1,000,000
Purchase of investment securities available-for-sale	**-**	(2,026,900)
Net cash provided (used) by investing activities	**164,945**	(23,187,517)
Cash flows from financing activities:		
Dividend from Bank subsidiary	**-**	24,000,000
Dividend to Bank subsidiary	**-**	(3,000,000)
Issuance of restricted stock	**-**	20
Redemption of restricted stock	**(35)**	(45)
Net cash (used) provided by financing activities	**(35)**	20,999,975
Net increase (decrease) in cash and cash equivalents	**171,127**	(2,474,730)
Cash and cash equivalents at beginning of period	**3,250,700**	5,725,430
Cash and cash equivalents at end of period	**$3,421,827**	$3,250,700