FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES

# 2017 FINANCIAL REPORTS

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**

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# Independent Auditors' Report

To the Board of Directors and Shareholders
First Farmers and Merchants Corporation
Columbia, Tennessee

We have audited the accompanying consolidated financial statements of First Farmers and Merchants Corporation and Subsidiaries (the "Company"), which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the two-year period ended December 31, 2017, and the related notes to the consolidated financial statements.

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

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

### *Auditors' Responsibility*

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

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

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

### *Opinion*

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of First Farmers and Merchants Corporation and Subsidiaries as of December 31, 2017 and 2016, and the results of their operations and their cash flows for each of the years in the two-year period ended December 31, 2017 in accordance with accounting principles generally accepted in the United States of America.

### *Prior Period Financial Statements*

The consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows of First Farmers and Merchants Corporation for the year ended December 31, 2015 were audited by other auditors whose report dated March 1, 2016, expressed an unqualified opinion on these statements.

### *Audit of Internal Control Over Financial Reporting*

We also have audited in accordance with attestation standards established by the American Institute of Certified Public Accountants, the Company's internal control over financial reporting as of December 31, 2017, based on criteria established in *Internal Control — Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission, and our report dated March 6, 2018 expressed an unqualified opinion.

Dixon Hughes Goodman LLP

Atlanta, Georgia
March 6, 2018

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED BALANCE SHEETS**
**(Dollars in thousands)**

| | | December 31, 2017 | December 31, 2016 |
|---|---|---|---|
| **ASSETS** | Cash and due from banks | $ 26,878 | $ 22,703 |
| | Interest-bearing deposits | 26,371 | 9,214 |
| | Federal funds sold | 1,915 | 1,165 |
| | Total cash and cash equivalents | 55,164 | 33,082 |
| | Securities: | | |
| | Available-for-sale | 371,773 | 392,583 |
| | Held-to-maturity (fair market value $18,525 and $18,057 as of the periods presented) | 18,675 | 19,036 |
| | Total securities | 390,448 | 411,619 |
| | Loans, net of deferred fees | 854,033 | 812,219 |
| | Allowance for loan and lease losses | (9,122) | (9,348) |
| | Net loans | 844,911 | 812,219 |
| | Bank premises and equipment, net | 28,787 | 27,594 |
| | Bank-owned life insurance | 32,091 | 27,354 |
| | Goodwill | 9,018 | 9,018 |
| | Deferred tax assets | 2,445 | 4,771 |
| | Other assets | 12,955 | 12,110 |
| | **TOTAL ASSETS** | $ 1,375,819 | $ 1,337,767 |
| **LIABILITIES** | Deposits: | | |
| | Noninterest-bearing | $ 292,502 | $ 255,964 |
| | Interest-bearing | 914,047 | 907,859 |
| | Total deposits | 1,206,549 | 1,163,823 |
| | Securities sold under agreements to repurchase | 31,222 | 27,578 |
| | Accounts payable and accrued liabilities | 14,668 | 13,661 |
| | FHLB borrowings | - | 15,000 |
| | **TOTAL LIABILITIES** | 1,252,439 | 1,220,062 |
| | Commitments and contingencies (Note 11) | | |
| **SHAREHOLDERS' EQUITY** | Common stock - $10 par value per share, 8,000,000 shares authorized; 4,493,855 and 4,542,303 shares issued and outstanding as of the periods presented | 44,939 | 45,423 |
| | Retained earnings | 79,793 | 74,357 |
| | Accumulated other comprehensive loss | (1,447) | (2,170) |
| | Total shareholders' equity attributable to First Farmers and Merchants Corporation | 123,285 | 117,610 |
| | Noncontrolling interest – preferred stock of subsidiary | 95 | 95 |
| | **TOTAL SHAREHOLDERS' EQUITY** | 123,380 | 117,705 |
| | **TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY** | $ 1,375,819 | $ 1,337,767 |

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

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF INCOME**
**(Dollars in thousands, except per share data)**

| | | Years ended December 31, | | |
|---|---|---|---|---|
| | | **2017** | **2016** | **2015** |
| **INTEREST AND DIVIDEND INCOME** | Interest and fees on loans | $ 34,504 | $ 32,056 | $ 30,522 |
| | Income on investment securities | | | |
| | Taxable interest | 4,852 | 4,785 | 5,713 |
| | Exempt from federal income tax | 2,566 | 2,258 | 2,218 |
| | Dividends | 400 | 416 | 229 |
| | Total interest income | 42,322 | 39,515 | 38,682 |
| **INTEREST EXPENSE** | Interest on deposits | 2,892 | 2,384 | 2,131 |
| | Interest on other borrowings | 209 | 93 | 94 |
| | Total interest expense | 3,101 | 2,477 | 2,225 |
| | Net interest income | 39,221 | 37,038 | 36,457 |
| | (Provision credit) provision for loan and lease losses | (225) | 840 | 30 |
| | Net interest income after provision | 39,446 | 36,198 | 36,427 |
| **NON-INTEREST INCOME** | Mortgage banking activities | 583 | 498 | 304 |
| | Trust service fees | 3,122 | 2,673 | 2,530 |
| | Service fees on deposit accounts | 7,138 | 6,688 | 6,616 |
| | Brokerage fees | 423 | 289 | 540 |
| | Earnings on bank-owned life insurance | 504 | 411 | 376 |
| | Gain on sales of available-for-sale securities | 21 | 267 | 534 |
| | Gain on bank-owned life insurance | - | 123 | 34 |
| | Other non-interest income | 449 | 541 | 476 |
| | Total non-interest income | 12,240 | 11,490 | 11,410 |
| **NON-INTEREST EXPENSE** | Salaries and employee benefits | 20,762 | 18,373 | 18,897 |
| | Net occupancy expense | 3,045 | 2,152 | 2,192 |
| | Depreciation expense | 1,472 | 1,406 | 1,489 |
| | Data processing expense | 2,732 | 2,576 | 2,506 |
| | Legal and professional fees | 1,198 | 1,224 | 1,301 |
| | Stationery and office supplies | 285 | 314 | 289 |
| | Advertising and promotions | 1,056 | 1,368 | 1,163 |
| | FDIC insurance premium expense | 630 | 621 | 587 |
| | Other non-interest expense | 5,401 | 6,027 | 5,742 |
| | Total non-interest expenses | 36,581 | 34,061 | 34,166 |
| | Income before provision for income taxes | 15,105 | 13,627 | 13,671 |
| | Provision for income taxes | 4,727 | 3,301 | 3,349 |
| | Net income | 10,378 | 10,326 | 10,322 |
| | Noncontrolling interest – dividends on preferred stock of subsidiary | 16 | 16 | 16 |
| | Net income available to common shareholders | $ 10,362 | $ 10,310 | $ 10,306 |
| | Weighted average shares outstanding | 4,523,677 | 4,634,171 | 4,832,217 |
| | Earnings per share | $ 2.29 | $ 2.22 | $ 2.13 |

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

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**
**(Dollars in thousands)**

| | Years ended December 31, 2017 | 2016 | 2015 |
|---|---|---|---|
| Net income | $ 10,378 | $ 10,326 | $ 10,322 |
| Other comprehensive income (loss) | | | |
| Unrealized appreciation (depreciation) on available-for-sale securities, net of taxes of $426, ($400) and $685, respectively | 812 | (638) | 1,097 |
| Reclassification adjustment for realized gains included in net income, net of taxes of ($8), ($103) and ($206), respectively | (13) | (164) | (328) |
| Adjustment for amortization of net actuarial gains, net of taxes of ($47), ($67) and ($61), respectively | (135) | (107) | (99) |
| Adjustment for actuarial gain (loss) incurred in current year, net of taxes of $21, $15 and $110, respectively | 62 | 25 | 176 |
| Adjustment for amortization of prior year service costs, net of taxes of ($2) | (3) | (3) | (3) |
| Other comprehensive income (loss) | 723 | (887) | 843 |
| Total comprehensive income | $ 11,101 | $ 9,439 | $ 11,165 |

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

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
## (Dollars in thousands, except per share data)

| | Shares of stock | Noncontrolling interest - Preferred stock of subsidiary | Common stock | Retained earnings | Accumulated other comprehensive loss | Total |
|---|---|---|---|---|---|---|
| **Balance at December 31, 2014** | 4,900,576 | $ 95 | $ 49,006 | $ 67,609 | $ (2,126) | $ 114,584 |
| Net income | | | | 10,322 | | 10,322 |
| Other comprehensive income | | | | | 843 | 843 |
| Repurchase of common stock | (161,074) | | (1,611) | (2,797) | | (4,408) |
| Cash dividends declared, $0.74 per share | | | | (3,535) | | (3,535) |
| Preferred dividends paid | | | | (16) | | (16) |
| **Balance at December 31, 2015** | 4,739,502 | 95 | 47,395 | 71,583 | (1,283) | 117,790 |
| Net income | | | | 10,326 | | 10,326 |
| Other comprehensive loss | | | | | (887) | (887) |
| Repurchase under reorganization plan | (102,229) | | (1,022) | (2,040) | | (3,062) |
| Repurchase under stock repurchase plan | (94,970) | | (950) | (2,070) | | (3,020) |
| Cash dividends declared, $0.75 per share | | | | (3,426) | | (3,426) |
| Preferred dividends paid | | | | (16) | | (16) |
| **Balance at December 31, 2016** | 4,542,303 | 95 | 45,423 | 74,357 | (2,170) | 117,705 |
| Net income | | | | 10,378 | | 10,378 |
| Other comprehensive income | | | | | 723 | 723 |
| Repurchase under stock repurchase plan | (48,448) | | (484) | (1,406) | | (1,890) |
| Cash dividends declared, $0.78 per share | | | | (3,520) | | (3,520) |
| Preferred dividends paid | | | | (16) | | (16) |
| **Balance at December 31, 2017** | 4,493,855 | $ 95 | $ 44,939 | $ 79,793 | $ (1,447) | $ 123,380 |

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

## FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES
## CONSOLIDATED STATEMENTS OF CASH FLOWS
## (Dollars in thousands)

| | | Years ended December 31, | | |
|---|---|---|---|---|
| | | 2017 | 2016 | 2015 |
| **OPERATING ACTIVITIES** | Net income | $ 10,378 | $ 10,326 | $ 10,322 |
| | Adjustments to reconcile net income to net cash provided by operating activities | | | |
| | (Provision credit) provision for loan and lease losses | (225) | 840 | 30 |
| | Depreciation of premises and equipment | 1,472 | 1,406 | 1,489 |
| | Deferred tax benefit | 1,597 | (649) | 796 |
| | Net gains on sales of available-for-sale securities | (21) | (267) | (534) |
| | Net gains on sales of premises and equipment | (7) | - | - |
| | Gains on mortgage loans sold | (557) | (472) | (270) |
| | Proceeds from sale of mortgage loans held-for-sale | 18,268 | 17,422 | 15,455 |
| | Funding of mortgage loans held-for-sale | (17,444) | (16,950) | (14,831) |
| | Loss (gain) on foreclosed property | - | 5 | (33) |
| | Amortization of investment security premiums, net of accretion of discounts | 1,943 | 1,560 | 1,196 |
| | Increase in cash surrender value of life insurance contracts | (504) | (411) | (376) |
| | Changes in: | | | |
| | Other assets | (776) | (451) | 639 |
| | Other liabilities | 870 | (130) | (701) |
| | Net cash provided by operating activities | 14,994 | 12,229 | 13,182 |
| **INVESTING ACTIVITIES** | Proceeds from sales of available-for-sale securities | 20,269 | 51,055 | 79,119 |
| | Proceeds from maturities and calls of available-for-sale securities | 54,713 | 68,190 | 31,967 |
| | Proceeds from maturities and calls of held-to-maturity securities | 330 | 1,540 | 19,940 |
| | Purchases of available-for-sale investment securities | (54,846) | (119,390) | (107,655) |
| | Purchases of held-to-maturity investment securities | - | (16,534) | (1,991) |
| | Net increase in loans | (32,467) | (90,459) | (78,634) |
| | Proceeds from sale of other real estate owned | - | 89 | 66 |
| | Proceeds from sale of premises and equipment | 7 | - | - |
| | Purchases of premises and equipment | (2,665) | (3,484) | (1,234) |
| | Purchase of life insurance policies | (4,233) | (861) | - |
| | Proceeds from redemption of life insurance policy | - | 470 | - |
| | Net cash used in investing activities | (18,892) | (109,384) | (58,422) |
| **FINANCING ACTIVITIES** | Net increase in deposits | 42,726 | 60,022 | 83,846 |
| | Net increase in securities sold under agreements to repurchase | 3,644 | 3,401 | 1,343 |
| | (Decrease) increase in FHLB borrowings | (15,000) | 15,000 | - |
| | Repurchase of common stock under reorganization plan | - | (3,062) | - |
| | Repurchase of common stock under stock repurchase plan | (1,890) | (3,020) | (4,408) |
| | Cash dividends paid on common stock | (3,484) | (4,316) | (3,594) |
| | Cash dividends paid on preferred stock of subsidiary | (16) | (16) | (16) |
| | Net cash provided by financing activities | 25,980 | 68,009 | 77,171 |
| | Increase (decrease) in cash and cash equivalents | 22,082 | (29,146) | 31,931 |
| | Cash and cash equivalents at beginning of period | 33,082 | 62,228 | 30,297 |
| | Cash and cash equivalents at end of period | $ 55,164 | $ 33,082 | $ 62,228 |

**FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES**
**CONSOLIDATED STATEMENTS OF CASH FLOWS (Continued)**
**(Dollars in thousands)**

| | Years ended December 31, | | |
|---|---|---|---|
| **Supplemental disclosures of cash flow information:** | **2017** | **2016** | **2015** |
| Cash paid during the period for: | | | |
| Interest on deposits and borrowed funds | $ 2,891 | $ 2,413 | $ 2,335 |
| Income taxes | 2,662 | 3,352 | 3,241 |
| Real estate acquired in settlement of loans | $ - | $ 32 | $ 90 |
| Noncash investing activities: | | | |
| Change in fair value of securities available-for-sale, net of tax | $ (799) | $ (803) | $ 769 |
| Minimum pension liability adjustment, net of taxes | (73) | (85) | 74 |
| Common dividends declared | $ 3,520 | $ 3,426 | $ 3,535 |

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

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

### Accounting Policies

The accounting principles followed and the methods of applying those principles conform with accounting principles generally accepted in the United States ("GAAP") and to general practices in the banking industry. The significant accounting policies applicable to First Farmers and Merchants Corporation (the "Company") are summarized as follows.

### Nature of Operations

The Company is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, First Farmers and Merchants Bank (the "Bank"). The Bank is primarily engaged in providing a full range of banking and financial services, including lending, investing of funds, obtaining deposits, trust and wealth management operations, and other financing activities to individual and corporate customers in the Middle Tennessee area. The Bank is subject to competition from other financial institutions. The Company and the Bank are subject to the regulation of certain federal and state agencies and undergo periodic examinations by those regulatory authorities.

On April 19, 2016, the Company held its annual meeting of shareholders. At the annual meeting of shareholders, a corporate reorganization plan ("the Plan") was approved. Under the Plan, holders of fewer than 400 shares of Company common stock received cash in exchange for their shares in an amount determined by an independent third party valuation. Shareholders owning 400 or more shares were unaffected by the Plan. As a result of the reorganization, the Company had fewer than 1,200 holders of record of its common stock. Accordingly, the Company filed Form 15 with the Securities and Exchange Commission ("SEC") on April 22, 2016, which immediately suspended its duty to file periodic reports with the SEC pursuant to Section 13 of the Exchange Act, while also terminating the registration of its common stock under the Exchange Act. As of December 31, 2017, the Company had fewer than 1,100 holders of record of its common stock.

### Basis of Presentation

The accompanying consolidated financial statements present the accounts of the Company and its wholly-owned subsidiary, the Bank. The Bank has the following direct and indirect subsidiaries: F&M West, Inc., Maury Tenn, Inc., and Maury Tenn Properties, Inc. Noncontrolling interests consist of preferred shares in Maury Tenn Properties, Inc. that are owned by third parties and Maury Tenn, Inc. The preferred shares in Maury Tenn Properties, Inc. receive dividends, which are included in the consolidated statements of income shown as income to non-controlling interest. Intercompany accounts and transactions have been eliminated in consolidation.

Certain items in prior financial statements have been reclassified to conform to the current presentation. These reclassifications had no effect on net income or shareholders' equity.

### Use of Estimates in the Preparation of Financial Statements

The preparation of financial statements in conformity with GAAP requires management of the Company and the Bank to make estimates and assumptions that affect the reported amounts of assets and liabilities. Those estimates and assumptions also affect disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near-term relate to the determination of the allowance for loan and lease losses, the fair value of financial instruments, the valuation of foreclosed real estate, valuation of goodwill, valuation of deferred tax assets, the liability related to post-retirement benefits, and reserves for claims incurred but not reported under the self-insured employee health benefits plan.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Concentrations of Credit Risk

The Company's banking activities include granting commercial, residential, and consumer loans to customers primarily located in Middle Tennessee and northern Alabama. The Company manages its portfolio and product mix in a manner to reduce economic risk. Concentrations of credit, as defined for regulatory purposes, are reviewed quarterly by management to ensure that internally established limits are not exceeded. At December 31, 2017, our concentrations of commercial real estate, rental and leasing loans were 167.5% of Tier 1 Capital plus the allowance for loan and lease losses. Health care and social assistance loans were 31.6%, construction loans were 74.1% and wholesale trade credits were 25.3% of Tier 1 Capital. These percentages are within our internally established limits regarding concentrations of credit.

Loans secured by non-farm, non-residential real estate comprised 22.3% of the loan portfolio at December 31, 2017.

### Cash and Due From Banks

Included in cash and due from banks are reserve amounts that are required to be maintained in the form of cash and/or balances due from the Federal Reserve Bank and other banks. At December 31, 2017, the Bank's required reserve was $4.7 million at the Federal Reserve. From time to time throughout the year, the Bank's balances due from other financial institutions exceeded Federal Deposit Insurance Corporation ("FDIC") insurance limits. The Bank had $1.9 million of federal funds sold as of December 31, 2017. Federal funds sold are essentially uncollateralized loans to other financial institutions.

### Cash Equivalents

The Company considers all liquid investments with original maturities of three months or less to be cash equivalents. Cash equivalents include cash on hand, cash due from banks, and federal funds sold. Federal funds are sold for one-day periods.

### Securities

Certain debt securities that management has the intent and ability to hold to maturity are classified as "held-to-maturity" and recorded at amortized cost. Securities not classified as held-to-maturity are classified as "available-for-sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income, net of tax. Purchase premiums and discounts are amortized or accreted to interest income over the expected lives of the securities using the interest method with a constant effective yield. In 2017, the Company adopted the provisions in ASU 2017-08 Receivables – Nonrefundable Fees and Other Costs (Topic 310). As such, callable debt securities held at a premium are amortized to the earliest call date instead of maturity. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

A decline in the fair value of any available-for-sale or held-to-maturity security below cost that is deemed to be other-than-temporary results in a reduction in the carrying amount of the security. To determine whether impairment is other-than-temporary, management considers whether the entity expects to recover the entire amortized cost basis of the security by reviewing the present value of the future cash flows associated with the security. The shortfall of the present value of the cash flows expected to be collected in relation to the amortized cost basis is referred to as a credit loss and is deemed to be other-than-temporary impairment. If a credit loss is identified, the credit loss is recognized as a charge to earnings and a new cost basis for the security is established. If management concludes that a decline in fair value of a security is temporary and, a full recovery of principal and interest is expected and it is not more-likely-than-not that it will be required to sell the security before recovery of their amortized cost basis, then the security is not other-than-temporarily impaired and the shortfall is recorded as a component of equity.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff is reported at their outstanding principal balances adjusted for unearned income, charge-offs, the allowance for loan and lease losses, any unamortized deferred fees or costs on originated loans, and unamortized premiums or discounts on purchased loans.

For loans amortized at cost, interest income is accrued based on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, as well as premiums and discounts, are deferred and amortized on a level yield basis over the respective term of the loan.

The accrual of interest on retail and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Past-due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current, the borrower has not missed a payment for six months, and future payments are reasonably assured.

Discounts and premiums on purchased commercial loans are amortized to income using the interest method over the remaining period to contractual maturity and adjusted for anticipated prepayments.

### Allowance for Loan and Lease Losses

The allowance for loan and lease losses is established through provisions for loan and lease losses charged against income. Loan losses are charged against the allowance when management determines that the uncollectibility of a loan has been confirmed. Subsequent recoveries, if any, are credited to the allowance in the period received.

The adequacy of the allowance for loan and lease losses is evaluated quarterly in conjunction with loan review reports and evaluations that are discussed in meetings with loan officers, credit administration, and the Bank’s Board of Directors. The Bank’s past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect a borrower’s ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors are considered in this evaluation. This process is inherently subjective as it requires material estimates that are susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans. The allowance for loan and lease losses is maintained at a level believed by management to be adequate to absorb estimated losses inherent in the loan portfolio.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

**Allowance for Loan and Lease Losses, (continued)**

A loan is considered impaired when it is probable that the Bank will be unable to collect all amounts due (principal and interest) according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for commercial and commercial real estate loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Groups of loans with similar risk characteristics are collectively evaluated for impairment based on the group's historical loss experience adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower where economic concessions have been granted.

When any collateral dependent commercial loan is considered uncollectable, whether past due or not, a current assessment of the value of the underlying collateral is made. The loan is placed on nonaccrual and the loan is charged down to the value of the collateral less estimated cost to sell or a specific reserve equal to the difference between book value of the loan and the fair value assigned to the collateral is created until such time as the loan is foreclosed. When the foreclosed collateral has been legally assigned to the Bank, a charge off is taken, if necessary, in order that the remaining balance reflects the fair value estimated less costs to sell the collateral then transferred to other real estate owned or other repossessed assets. When any unsecured commercial loan is considered uncollectable the loan is charged off no later than at 90 days past due.

All closed-end consumer loans (excluding conventional 1-4 family residential installment and revolving loans secured by real estate) are charged off upon reaching no later than 120 days (4 monthly payments) delinquent. If a loan is considered uncollectable, it is charged off earlier than 120 days delinquent. For conventional 1-4 family residential loans and installment and revolving loans secured by real estate, when a loan is 90 days past due, a current assessment of the value of the real estate is made. If the balance of the loan exceeds the fair value of the property, the loan is placed on nonaccrual and foreclosure proceedings are initiated. When the foreclosed property has been legally assigned to the Bank, a charge-off is taken with the remaining balance, reflecting the fair value less estimated costs to sell, transferred to other real estate owned.

**Loans Held-for-Sale**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value. Net unrealized losses, if any, are recognized through a valuation allowance by charges to non-interest income. Gains and losses on loan sales are recorded in non-interest income. The Company does not retain servicing rights on loans sold. Loans held-for-sale at December 31, 2017 and 2016 totaled $1.6 million and $218,000, respectively, and are recorded in other assets on the consolidated balance sheet.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Other Real Estate

Assets acquired through, or in lieu of, loan foreclosure are held-for-sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net income or expense from foreclosed assets.

When foreclosed properties are acquired current appraisals are obtained on the properties. Additionally, periodic updated appraisals are obtained on unsold foreclosed properties. When an updated appraisal reflects a market value below the current book value, a charge is booked to current earnings to reduce the property to its new market value less expected selling costs. Our policy for determining the frequency of periodic reviews is based upon consideration of the specific properties and the known or perceived market fluctuations in a particular market.

### Premises and Equipment

Premises, equipment, and leasehold improvements are stated at cost, less accumulated depreciation and amortization. The provision for depreciation is computed principally on an accelerated method over the estimated useful life of an asset, which ranges from 15 to 39 years for buildings, from three to 25 years for equipment, and the expected lease terms for leasehold improvements. Costs of major additions and improvements are capitalized. Expenditures for maintenance and repairs are charged to operations as incurred. Gains or losses from the disposition of property are reflected in operations, and the asset accounts and related allowances for depreciation are reduced.

### Federal Reserve and Federal Home Loan Bank Stock

Federal Reserve and Federal Home Loan Bank stock are required investments for institutions that are members of the Federal Reserve and Federal Home Loan Bank systems. The required investment in the common stock is based on a predetermined formula, carried at cost and evaluated for impairment. At December 31, 2017 and 2016 Federal Reserve and Federal Home Loan Bank stock totaled $3.9 million.

### Goodwill

Goodwill is evaluated annually for impairment. Quantitative and qualitative assessments are performed to determine whether the existence of events or circumstances leads to a determination that it is more-likely-than-not the fair value is less than the carrying amount, including goodwill. If, based on the evaluation, it is determined to be more-likely-than-not that the fair value is less than the carrying value, then goodwill is tested further for impairment. If the implied fair value of goodwill is lower than its carrying amount, a goodwill impairment is indicated and goodwill is written down to its implied fair value. Subsequent increases in goodwill value are not recognized in the financial statements.

### Transfers of Financial Assets

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company—put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity or the ability to unilaterally cause the holder to return specific assets.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Income Taxes

The Company files consolidated income tax returns with its subsidiaries. The Company accounts for income taxes in accordance with income tax accounting guidance (ASC 740, *Income Taxes*). The income tax accounting guidance requires two components of income tax expense which are current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more-likely-than-not that some portion or all of a deferred tax asset will not be realized.

Tax positions are recognized if it is more-likely-than-not, based on the technical merits that the tax position will be realized or sustained upon examination. The term more-likely-than-not means a likelihood of more than 50%; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50% likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances and information available at the reporting date and is subject to management's judgment. With a few exceptions, the Company is no longer subject to U.S. federal tax examinations and state and local tax examinations by tax authorities for years prior to 2014.

The Company recognizes interest and penalties on income taxes as a component of income tax expense. As of December 31, 2017, the Company has accrued no interest and no penalties related to uncertain tax positions.

On December 22, 2017, the United States Government enacted the Tax Cuts and Jobs Act (the "Tax Act"). The Tax Act amends the Internal Revenue Code of 1986 to reduce tax rates and modify policies, credits, and deductions for individuals and businesses. See Note 9 – Federal and State Income Taxes for more information on the impact of the new legislation to the Company.

### Securities Sold Under Agreements to Repurchase

Securities sold under agreements to repurchase, which are classified as secured borrowings, generally mature within one to four days from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction.

### Fair Value Measurements

ASC Topic 820, *Fair Value Measurements and Disclosures*, defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and requires certain disclosures about fair value measurements. In general, fair values of financial instruments are based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as input, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These adjustments may include amounts to reflect counterparty credit quality and the Company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. See Note 12 – Fair Value Measurement.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Earnings Per Share

Earnings per share represents income available to shareholders divided by the weighted average number of shares of Company common stock outstanding during the period. Fully diluted earnings per share is not presented as there are no common stock equivalents.

The following is a summary of the earnings per share calculation for the periods presented:

| | Years ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| | (dollars in thousands, expect per share data) | | |
| Earnings per share calculation: | | | |
| Numerator – Net income available to common shareholders | $ 10,362 | $ 10,310 | $ 10,306 |
| Denominator – Weighted average common shares outstanding | 4,523,677 | 4,634,171 | 4,832,217 |
| Net income per common share available to common shareholders | $ 2.29 | $ 2.22 | $ 2.13 |

In December 2016, the Company reauthorized a plan to repurchase up to 200,000 shares of its common stock during 2017. The Company repurchased 48,448, 94,970 and 161,074 shares in 2017, 2016, and 2015, respectively. During 2016, the Company also repurchased 102,229 shares related to the corporate reorganization plan approved on April 19, 2016 by the Company's shareholders.

### Accumulated Other Comprehensive Income (Loss)

Comprehensive income (loss) consists of net income and other comprehensive income (loss), net of applicable income tax expenses or benefits. Other comprehensive income (loss) includes unrealized appreciation or depreciation on available-for-sale securities and changes in the net actuarial gain or loss of the post-retirement benefit obligation.

The components of accumulated other comprehensive loss, included in shareholder's equity, are as follows:

| | Years ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| | (dollars in thousands) | | |
| Net unrealized losses on available-for-sale securities | $ (4,356) | $ (5,573) | $ (4,269) |
| Net actuarial gain on unfunded portion of post-retirement benefit obligation | 1,943 | 2,044 | 2,183 |
| | (2,413) | (3,529) | (2,086) |
| Tax benefit | 966 | 1,359 | 803 |
| Accumulated other comprehensive loss | $ (1,447) | $ (2,170) | $ (1,283) |

### Transfers Between Fair Value Hierarchy Levels

Transfers in and out of Level 1 (quoted market prices), Level 2 (other significant observable inputs) and Level 3 (significant unobservable inputs) are recognized on the period end date. There were no transfers between levels during 2017 or 2016.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Segment Reporting

Management analyzes the operations of the Company assuming one operating segment, community lending services.

### Recent Accounting Pronouncements

In May 2014, the Financial Accounting Standards Board ("FASB") issued *Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers (Topic 606)*. ASU 2014-09 states a company will recognize revenue when it transfers promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In doing so, companies will need to use more judgment and make more estimates than under existing guidance. These may include identifying performance obligations in the contract, estimating the amount of variable consideration to include in the transaction price and allocating the transaction price to each separate performance obligation. In August of 2015, the FASB issued *ASU 2015-14, Revenue from Contracts with Customers, (Topic 606): Deferral of the Effective Date*. ASU 2015-14 defers the effective date of Update 2014-09 for all entities by one year. As such, ASU 2014-09 is effective for public business entities for annual reporting periods beginning after December 15, 2017, including interim periods within that reporting period. The Company adopted the new standard under the modified retrospective approach on January 1, 2018. As a financial institution, the Company's revenue is more significantly weighted towards net interest income on its financial assets and liabilities, which is explicitly excluded from the scope of the new standard. In order to implement the new standard, the Company assessed its revenue streams from trust and wealth management services, deposit account service fees, mortgage banking activities and brokerage commissions. In addition, the Company reviewed its contracts with customers related to the aforementioned revenue streams. The Company's revenue recognition pattern for these revenue streams is not expected to change materially from current practice. The Company also continues to follow implementation issues specific to financial institutions which are still under discussion by the FASB's Transition Resource Group.

In January 2016, the FASB issued *ASU 2016-01 Financial Instruments Overall (Topic 825)*. The amendments in ASU 2016-01: (a) require equity investments (except for those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplify the impairment assessment of equity securities without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminate the requirement for public business entities to disclose the method and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (d) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (e) require an entity to present separately in other comprehensive income, the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; (f) require separate presentation of financial assets and financial liabilities by measurement category and form of financial assets on the balance sheet or the notes to the financial statements; and (g) clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. The amendments in this ASU are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted the new standard on January 1, 2018. The adoption of the ASU did not have a material impact on the Company's financial position, results of operations or cash flows. The Company is currently evaluating the impact to financial statement disclosures for the year ended December 31, 2018.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Recent Accounting Pronouncements, (continued)

In February 2016, the FASB issued *ASU 2016-02 Leases (Topic 842).* ASU 2016-02 requires the recognition in the statement of financial position of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. The guidance requires that a lessee should recognize lease assets and lease liabilities as compared to previous GAAP that did not require lease assets and lease liabilities to be recognized for most leases. The guidance becomes effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. To prepare for implementation of this standard, the Company has evaluated its inventory of lease agreements, specifically those agreements in which the Company is the lessee party. Under current practice, the Company's leases are classified and accounted for as operating leases. Upon implementation, most of these lease agreements will be treated as a financing lease, thus the right-of-use asset will be recognized in premises and equipment and the total future commitment amount of the lease agreements will be recognized as a liability on the Company's balance sheet (currently disclosed in financial statement footnotes, See Note 8 – Leases). The impact to the Company's results of operations or cash flows is not expected to be material. The Company is currently evaluating the impact to the institution's capital ratios, as recognition of the right-of-use assets will be one-hundred percent risk rated. The Company plans to adopt the ASU on January 1, 2019, most likely under the modified retrospective approach.

In June 2016, the FASB issued *ASU 2016-13, Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments (Topic 326).* ASU 2016-13 introduces the current expected credit losses methodology. Among other things, the ASU requires the measurement of all expected credit losses for financial assets, including loans and available-for-sale debt securities, held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. The new model will require institutions to calculate all probable and estimable losses that are expected to be incurred through the loan's entire life. ASU 2016-13 also requires the allowance for credit losses for purchased financial assets with credit deterioration since origination to be determined in a manner similar to that of other financial assets measured at amortized cost; however, the initial allowance will be added to the purchase price rather than recorded as credit loss expense. The disclosure of credit quality indicators related to the amortized cost of financing receivables will be further disaggregated by year of origination (or vintage). Institutions are to apply the changes through a cumulative-effect adjustment to their retained earnings as of the beginning of the first reporting period in which the standard is effective. For public business entities that are not SEC filers, the ASU is effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. The Company is currently evaluating the impact on its consolidated financial statements.

In August 2016, the FASB issued *ASU 2016-15 Statement of Cash Flows (Topic 230).* ASU 2016-15 is intended to reduce the diversity in practice around how certain transactions are classified within the statement of cash flows. The guidance is effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Early adoption is permitted with retrospective application. The adoption of the ASU is not expected to have a material impact on the Company's financial position, results of operations or cash flows.

In March of 2017, the FASB issued *ASU 2017-08 Receivables – Nonrefundable Fees and Other Costs (Topic 310)*. ASU 2017-08 shortens the amortization period for certain callable debt securities held at a premium to require such premiums to be amortized to the earliest call date unless applicable guidance related to certain pools of securities is applied to consider estimated prepayments. Under prior guidance, entities were generally required to amortize premiums on individual, non-pooled callable debt securities as a yield adjustment over the contractual life of the security. ASU 2017-08 does not change the accounting for callable debt securities held at a discount. For public business entities, the ASU is effective for fiscal years beginning after December 15, 2018, with early adoption permitted. The Company elected to adopt the provisions of ASU 2017-08 in 2017 in advance of the required application date of January 1, 2019.

## NOTE 1 – GENERAL AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES, (CONTINUED)

### Recent Accounting Pronouncements, (continued)

In February of 2018, the FASB issued *ASU 2018-02 Income Statement – Reporting Comprehensive Income (Topic 220).* ASU 2018-02 allows a reclassification from accumulated comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. The guidance is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption of the guidance is permitted, including the adoption in any interim period, (1) for public business entities for reporting periods for which financial statements have not been issued and (2) for all other entities for reporting periods for which financial statements have not yet been made available for issuance. The adoption of the ASU is planned for the first interim period of 2018. The disproportionate tax effects lodged in other comprehensive income total approximately $337,000. Upon adoption of the standard, this amount will be reclassed, which will result in increasing retained earnings.

## NOTE 2 – RECLASSIFICATIONS FROM ACCUMULATED OTHER COMPREHENSIVE INCOME (“AOCI”)

Amounts reclassified from AOCI and the affected line items in the statements of income during the periods presented are as follows:

| | Amounts reclassified from AOCI | | | |
|---|---|---|---|---|
| | Years ended December 31, | | | |
| | 2017 | 2016 | 2015 | Affected line item in the Statements of income |
| Unrealized gains on available-for-sale securities | $ 21 | $ 267 | $ 534 | Gain on sale of available-for-sale securities |
| | (8) | (103) | (206) | Provision for income taxes |
| | $ 13 | $ 164 | $ 328 | Net reclassified amount |
| Amortization of defined benefit pension items | $ 179 | $ 174 | $ 160 | Salaries and employee benefits |
| | (47) | (67) | (62) | Provision for income taxes |
| | $ 132 | $ 107 | $ 98 | Net reclassified amount |
| Total reclassifications out of AOCI | $ 145 | $ 271 | $ 426 | |

## NOTE 3 – SECURITIES

The amortized cost and fair value of securities available-for-sale and held-to-maturity at December 31, 2017 and 2016 are summarized as follows:

| | Amortized cost | Gross unrealized gains | Gross unrealized losses | Fair value |
|---|---|---|---|---|
| **December 31, 2017** | | (dollars in thousands) | | |
| Available-for-sale securities: | | | | |
| U.S. government sponsored agencies | $ 68,067 | $ - | $ (590) | $ 67,477 |
| U.S. government sponsored agency mortgage backed securities | 207,338 | 5 | (4,685) | 202,658 |
| States and political subdivisions | 77,564 | 1,167 | (83) | 78,648 |
| Corporate bonds | 23,160 | 1 | (171) | 22,990 |
| | $ 376,129 | $ 1,173 | $ (5,529) | $ 371,773 |
| Held-to-maturity securities: | | | | |
| States and political subdivisions | $ 18,675 | $ 159 | $ (309) | $ 18,525 |
| | | | | |
| **December 31, 2016** | | | | |
| Available-for-sale securities: | | | | |
| U.S. government sponsored agencies | $ 87,089 | $ 112 | $ (566) | $ 86,635 |
| U.S. government sponsored agency mortgage backed securities | 215,718 | 26 | (5,097) | 210,647 |
| States and political subdivisions | 71,281 | 759 | (669) | 71,371 |
| Corporate bonds | 24,068 | 18 | (156) | 23,930 |
| | $ 398,156 | $ 915 | $ (6,488) | $ 392,583 |
| Held-to-maturity securities: | | | | |
| States and political subdivisions | $ 19,036 | $ 17 | $ (996) | $ 18,057 |

## NOTE 3 – SECURITIES, (CONTINUED)

Certain investments in debt securities are reported in the financial statements at an amount less than their historical cost. Total fair value of these investments at December 31, 2017 and 2016 was approximately $303.7 million and $304.8 million, which was approximately 82% and 78%, respectively, of the Company's investment portfolio. The Company evaluates its investment portfolio on a quarterly basis for impairment.

The analysis performed as of December 31, 2017 and 2016 indicated that all impairment was considered temporary, market driven due primarily to fluctuations in market interest rates and not credit-related.

The following table shows the Company's investments' gross unrealized losses and fair value of the Company's investments with unrealized losses that were not deemed to be other-than-temporarily impaired, aggregated by investment class and length of time that individual securities had been in a continuous unrealized loss position at December 31, 2017 and 2016:

| | Less than 12 months | | 12 months or more | | Total | |
|---|---|---|---|---|---|---|
| | Fair value | Unrealized losses | Fair value | Unrealized losses | Fair value | Unrealized losses |
| | | | (dollars in thousands) | | | |
| **December 31, 2017** | | | | | | |
| Available-for-sale securities: | | | | | | |
| U.S. government sponsored agencies | $ 40,267 | $ (254) | $ 27,210 | $ (336) | $ 67,477 | $ (590) |
| U.S. government sponsored agency mortgage backed securities | 55,567 | (414) | 144,233 | (4,271) | 199,800 | (4,685) |
| States and political subdivisions | 11,450 | (65) | 3,046 | (18) | 14,496 | (83) |
| Corporate bonds | 12,758 | (57) | 9,202 | (114) | 21,960 | (171) |
| | $ 120,042 | $ (790) | $ 183,691 | $ (4,739) | $ 303,733 | $ (5,529) |
| Held-to-maturity securities: | | | | | | |
| States and political subdivisions | $ 1,876 | $ (49) | $ 9,075 | $ (260) | $ 10,951 | $ (309) |
| **December 31, 2016** | | | | | | |
| Available-for-sale securities: | | | | | | |
| U.S. government sponsored agencies | $ 54,450 | $ (566) | $ - | $ - | $ 54,450 | $ (566) |
| U.S. government sponsored agency mortgage backed securities | 154,016 | (3,481) | 41,575 | (1,616) | 195,591 | (5,097) |
| States and political subdivisions | 37,714 | (669) | - | - | 37,714 | (669) |
| Corporate bonds | 15,525 | (151) | 1,523 | (5) | 17,048 | (156) |
| | $ 261,705 | $ (4,867) | $ 43,098 | $ (1,621) | $ 304,803 | $ (6,488) |
| Held-to-maturity securities: | | | | | | |
| States and political subdivisions | $ 17,596 | $ (996) | $ - | $ - | $ 17,596 | $ (996) |

## NOTE 3 – SECURITIES, (CONTINUED)

As shown in the tables above, at December 31, 2017, the Company had approximately $5.8 million in unrealized losses on $314.7 million of securities. The unrealized loss positions are most significant in two types of securities sectors which are U.S. government sponsored agencies and U.S. government sponsored agency mortgage backed securities. The unrealized losses associated with these investment securities are driven by changes in interest rates and the unrealized loss is recorded as a component of equity. These securities will continue to be monitored as a part of our ongoing impairment analysis, but are expected to perform even if the rating agencies reduce the credit rating of the bond issuers. Management evaluates the financial performance of the issuers on a quarterly basis to determine if it is probable that the issuers can make all contractual principal and interest payments. If a shortfall in future cash flows is identified, a credit loss will be deemed to have occurred and will be recognized as a change to earnings and a new cost basis for the security will be established.

The amortized cost and fair value of available-for-sale and held-to-maturity securities at December 31, 2017 and 2016, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Available-for-sale | | Held-to-maturity | |
|---|---|---|---|---|
| **December 31, 2017** | **Amortized cost** | **Fair value** | **Amortized cost** | **Fair value** |
| | (dollars in thousands) | | | |
| Within one year | $ 21,000 | $ 20,952 | $ - | $ - |
| One to five years | 80,065 | 79,423 | 200 | 200 |
| Five to ten years | 36,146 | 36,595 | 1,985 | 1,939 |
| After ten years | 31,580 | 32,145 | 16,490 | 16,386 |
| Mortgage-backed securities | 207,338 | 202,658 | - | - |
| | $ 376,129 | $ 371,773 | $ 18,675 | $ 18,525 |

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was $255.5 million at December 31, 2017 and $269.5 million at December 31, 2016.

The book value of securities sold under agreements to repurchase amounted to $37.5 million and $28.8 million at December 31, 2017 and 2016, respectively.

| | Years ended December 31, | | |
|---|---|---|---|
| | **2017** | **2016** | **2015** |
| | (dollars in thousands) | | |
| Gross gains recognized on sales of securities | **$** 24 | $ 286 | $ 579 |
| Gross losses recognized on sales of securities | (3) | (19) | (45) |
| Net realized gains on sales of securities available-for-sale | **$** 21 | $ 267 | $ 534 |

## NOTE 4 – LOANS

The following table presents the Bank's loans by category as of the periods presented:

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| **Commercial** | (dollars in thousands) | |
| Commercial and industrial | $ 117,742 | $ 137,684 |
| Non-farm, non-residential real estate | 190,590 | 159,646 |
| Construction and development | 60,116 | 80,049 |
| Commercial loans secured by real estate | 59,192 | 45,880 |
| Other commercial loans | 72,298 | 78,912 |
| Total commercial loans | 499,938 | 502,171 |
| **Retail** | | |
| Consumer loans | 7,740 | 8,044 |
| Single family residential | 320,784 | 281,399 |
| Other retail loans | 25,571 | 29,953 |
| Total retail loans | 354,095 | 319,396 |
| | $ 854,033 | $ 821,567 |
| Less: | | |
| Allowance for loan and lease losses | (9,122) | (9,348) |
| Total net loans | $ 844,911 | $ 812,219 |

The amount of capitalized fees, net calculated in accordance with accounting guidance included in the above loan totals were $1.1 million and $780,000 at December 31, 2017 and 2016, respectively.

*Loan Origination/Risk Management.* The Company has certain lending policies and procedures in place that are designed to maximize loan income within an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis. A reporting system supplements the review process by providing management with frequent reports related to loan production, loan quality, concentrations of credit, loan delinquencies, and non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower's ability to operate profitably and prudently expand its business. Underwriting standards are designed to promote relationship banking rather than transactional banking. Once it is determined that the borrower's management possesses sound ethics and solid business acumen, the Company's management examines current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial and industrial loans are secured by the assets being financed or other business assets such as accounts receivable or inventory and may incorporate a personal guarantee; however, some short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

## NOTE 4 – LOANS, (CONTINUED)

Commercial real estate loans are subject to underwriting standards and processes similar to commercial and industrial loans, in addition to those of real estate loans. These loans are viewed primarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts and the repayment of these loans is largely dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. Management monitors and evaluates commercial real estate loans based on collateral, geography, and risk grade criteria. As a general rule, the Company avoids financing single-purpose projects unless other underwriting factors are present to help mitigate the risk. The Company also utilizes third-party experts to provide insight and guidance about economic conditions and trends affecting market areas it serves. In addition, management tracks the level of owner-occupied commercial real estate loans versus non-owner occupied loans.

At December 31, 2017, approximately 44% of the outstanding principal balance of the Company's commercial real estate loans was secured by owner-occupied properties, compared to 43% at December 31, 2016. With respect to loans to developers and builders that are secured by non-owner occupied properties that the Company may originate from time to time, the Company generally requires the borrower to have had an existing relationship with the Company and have a proven record of success. Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews, sensitivity analysis of absorption, and lease rates and financial analysis of the developers and property owners. Construction loans are generally based upon estimates of costs and value associated with the complete project. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property, or an interim loan commitment from the company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions, and the availability of long-term financing.

The Company originates residential and consumer loans utilizing a computer-based credit scoring analysis to supplement the underwriting process. To monitor and manage consumer loan risk, policies and procedures are developed and modified, as needed, jointly by line and staff personnel. This activity, coupled with relatively small loan amounts that are spread across many individual borrowers, minimizes risk. Additionally, trend and outlook reports are reviewed by management on a regular basis. Underwriting standards for home equity loans are heavily influenced by statutory requirements, which include, but are not limited to, a maximum loan-to-value percentage of 80%, collection remedies, the number of such loans a borrower can have at one time and documentation requirements.

The Company engages a third party vendor to perform loan reviews. The Company reviews and validates the credit risk program on an annual basis. Results of these reviews are presented to management. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

The goal of the bank is to diversify loans to avoid a concentration of credit in a specific industry, person, entity, product, service, or any area vulnerable to a tax law change or an economic event. A concentration of credit occurs when obligations, direct or indirect, of the same or affiliated interests represent 25% or more of the Bank's capital structure. Commercial real estate rental and leasing represented the highest concentration at 120% of tier 1 capital. The Board of Directors recognizes that the Bank's geographic trade area imposes some limitations regarding loan diversification if the bank is to perform the function for which it has been chartered. Specifically, lending to qualified borrowers within the Bank's trade area will naturally cause concentrations of real estate loans in the primary communities served by the Bank and loans to employees of major employers in the area.

## NOTE 4 – LOANS, (CONTINUED)

The following table provides details regarding the aging of the Bank's loan portfolio:

| December 31, 2017 | 30-59 days past due | 60-89 days past due | 90 days and greater past due | Total past due | Current | Total loans |
|---|---|---|---|---|---|---|
| | | | (dollars in thousands) | | | |
| **Commercial** | | | | | | |
| Commercial and industrial | $ 93 | $ 5 | $ 178 | $ 276 | $ 117,466 | $ 117,742 |
| Non-farm, non-residential real estate | - | - | 182 | 182 | 190,408 | 190,590 |
| Construction and development | - | - | - | - | 60,116 | 60,116 |
| Commercial loans secured by real estate | 79 | - | - | 79 | 59,113 | 59,192 |
| Other commercial loans | - | - | - | - | 72,298 | 72,298 |
| Total commercial loans | 172 | 5 | 360 | 537 | 499,401 | 499,938 |
| **Retail** | | | | | | |
| Consumer | 56 | 4 | 13 | 73 | 7,667 | 7,740 |
| Single family residential | 1,776 | 732 | 84 | 2,592 | 318,192 | 320,784 |
| Other retail loans | 276 | 14 | - | 290 | 25,281 | 25,571 |
| Total retail loans | 2,108 | 750 | 97 | 2,955 | 351,140 | 354,095 |
| **Total** | $ 2,280 | $ 755 | $ 457 | $ 3,492 | $ 850,541 | $ 854,033 |

| December 31, 2016 | 30-59 days past due | 60-89 days past due | 90 days and greater past due | Total past due | Current | Total loans |
|---|---|---|---|---|---|---|
| | | | (dollars in thousands) | | | |
| **Commercial** | | | | | | |
| Commercial and industrial | $ 19 | $ 13 | $ 193 | $ 225 | $ 137,459 | $ 137,684 |
| Non-farm, non-residential real estate | - | - | 202 | 202 | 159,444 | 159,646 |
| Construction and development | - | - | - | - | 80,049 | 80,049 |
| Commercial loans secured by real estate | - | - | 149 | 149 | 45,731 | 45,880 |
| Other commercial loans | - | - | - | - | 78,912 | 78,912 |
| Total commercial loans | 19 | 13 | 544 | 576 | 501,595 | 502,171 |
| **Retail** | | | | | | |
| Consumer | 50 | 14 | 3 | 67 | 7,977 | 8,044 |
| Single family residential | 1,456 | 79 | 211 | 1,746 | 279,653 | 281,399 |
| Other retail loans | 217 | 1 | 30 | 248 | 29,705 | 29,953 |
| Total retail loans | 1,723 | 94 | 244 | 2,061 | 317,335 | 319,396 |
| **Total** | $ 1,742 | $ 107 | $ 788 | $ 2,637 | $ 818,930 | $ 821,567 |

A loan is considered impaired, in accordance with the impairment accounting guidance, when based on current information and events, it is probable the Company will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include non-performing loans, but also include loans modified in troubled debt restructurings. The Company has one loan totaling $27,000 that was 90 days or more past due that was not included in nonaccrual loans as of December 31, 2017. The Company had two loans totaling $146,000 that were 90 days or more past due that were not included in nonaccrual loans as of December 31, 2016.

## NOTE 4 – LOANS, (CONTINUED)

The following table summarizes the impaired loans by loan type:

| December 31, 2017 | Unpaid contractual principal balance | Recorded investment with no allowance | Recorded investment with allowance | Total recorded investment | Related allowance | Average recorded investment year to date | Interest received | Interest accrued |
|---|---|---|---|---|---|---|---|---|
| | (dollars in thousands) | | | | | | | |
| **Commercial:** | | | | | | | | |
| Commercial and industrial | $ 282 | $ 37 | $ 191 | $ 228 | $ 11 | $ 243 | $ 13 | $ 1 |
| Non-farm, non-residential real estate | 1,811 | 1,554 | - | 1,554 | - | 1,655 | 109 | 11 |
| Commercial total | 2,093 | 1,591 | 191 | 1,782 | 11 | 1,898 | 122 | 12 |
| **Retail:** | | | | | | | | |
| Consumer loans | 15 | - | 13 | 13 | - | 16 | 1 | - |
| Single family residential | 1,934 | 336 | 1,208 | 1,544 | 1 | 1,513 | 90 | 9 |
| Other retail | 27 | - | 24 | 24 | 1 | 31 | 1 | - |
| Retail total | 1,976 | 336 | 1,245 | 1,581 | 2 | 1,560 | 92 | 9 |
| **Total** | $ 4,069 | $ 1,927 | $ 1,436 | $ 3,363 | $ 13 | $ 3,458 | $ 214 | $ 21 |

| December 31, 2016 | Unpaid contractual principal balance | Recorded investment with no allowance | Recorded investment with allowance | Total recorded investment | Related allowance | Average recorded investment year to date | Interest received | Interest accrued |
|---|---|---|---|---|---|---|---|---|
| | (dollars in thousands) | | | | | | | |
| **Commercial:** | | | | | | | | |
| Commercial and industrial | $ 359 | $ 30 | $ 229 | $ 259 | $ 48 | $ 260 | $ 16 | $ 14 |
| Non-farm, non-residential real estate | 2,180 | 39 | 1,930 | 1,969 | 1 | 2,315 | 162 | 137 |
| Commercial loans secured by real estate | 197 | 5 | 149 | 154 | 26 | 166 | 3 | 14 |
| Commercial total | 2,736 | 74 | 2,308 | 2,382 | 75 | 2,741 | 181 | 165 |
| **Retail:** | | | | | | | | |
| Single family residential | 1,539 | 799 | 492 | 1,291 | 58 | 1,335 | 78 | 79 |
| Other retail | 153 | 93 | - | 93 | - | 101 | 9 | 8 |
| Retail total | 1,692 | 892 | 492 | 1,384 | 58 | 1,436 | 87 | 87 |
| **Total** | $ 4,428 | $ 966 | $ 2,800 | $ 3,766 | $ 133 | $ 4,177 | $ 268 | $ 252 |

## NOTE 4 – LOANS, (CONTINUED)

Non-accrual loans, segregated by class of loans, were as follows:

| | December 31, 2017 | December 31, 2016 |
|---|---|---|
| | (dollars in thousands) | |
| **Commercial** | | |
| Commercial and industrial | $ 228 | $ 259 |
| Non-farm, non-residential real estate | 1,554 | 1,969 |
| Commercial loans secured by real estate | - | 154 |
| Total commercial loans | 1,782 | 2,382 |
| **Retail** | | |
| Consumer loans | 13 | 75 |
| Single family residential | 936 | 846 |
| Other retail | 17 | - |
| Total retail loans | 966 | 921 |
| **Total non-accrual loans** | $ 2,747 | $ 3,303 |

Included in certain loan categories of impaired loans are certain loans that have been modified in a troubled debt restructuring where economic concessions have been granted to borrowers who have experienced financial difficulties. These concessions typically result from our loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. Modifications of terms for our loans and their inclusion as troubled debt restructurings are based on individual facts and circumstances. Loan modifications that are included as troubled debt restructurings may involve either an increase or reduction of the interest rate, extension of the term of the loan, or deferral of principal and/or interest payments, regardless of the period of the modification. All of the loans identified as troubled debt restructurings were modified due to financial stress of the borrower. In order to determine if a borrower is experiencing financial difficulty, an evaluation is performed to determine the probability that the borrower will be in payment default on any of its debt in the foreseeable future with the modification. This evaluation is performed under the Company's internal underwriting policy.

When the Company modifies loans in a troubled debt restructuring, the Company evaluates any possible impairment similar to other impaired loans based on the present value of expected future cash flows, discounted at the contractual interest rate of the original loan or lease agreement, or the current fair value of the collateral, less selling costs for collateral dependent loans. If the Company determined that the value of the modified loan is less than the recorded investment in the loan, impairment is recognized through an allowance estimate or a charge-off to the allowance. In periods subsequent to modification, the Company evaluates all troubled debt restructurings, including those that have payment defaults, for possible impairment and recognize impairment through the allowance.

Outstanding principal balances of restructured loans were $425,000 and $820,000 at December 31, 2017 and 2016, respectively. As of December 31, 2017, the Company did not have any commitments to extend additional funds to borrowers with loans modified and included as a troubled debt restructuring. During 2017, certain loans were modified in troubled debt restructurings, where economic concessions were granted to borrowers consisting of reductions in the interest rates, payment extensions, forgiveness of principal, and forbearances.

## NOTE 4 – LOANS, (CONTINUED)

Presented below, segregated by class of loans, are troubled debt restructurings:

| | Twelve months ended December 31, 2017 | | |
|---|---|---|---|
| | Number of modifications | Post-modification outstanding balance | Net charge-offs resulting in modifications |
| | | (dollars in thousands) | |
| **Commercial** | | | |
| Commercial and industrial | 1 | $ 9 | $ - |
| **Retail** | | | |
| Consumer loans | 1 | 12 | - |
| Total | 2 | $ 21 | $ - |

| | Twelve months ended December 31, 2016 | | |
|---|---|---|---|
| | Number of modifications | Post-modification outstanding balance | Net charge-offs resulting in modifications |
| | | (dollars in thousands) | |
| **Commercial** | | | |
| Non-farm, non-residential | 1 | $ 35 | $ - |
| Commercial loans secured by real estate | 1 | 15 | - |
| Total | 2 | $ 50 | $ - |

The loan's accrual status is assessed at the time of its modification. As a result of the assessment, the accrual status may be modified. The Company had loans modified in troubled debt restructurings that are in accrual status with outstanding balances of $12,000 and $167,000, as of December 31, 2017 and 2016, respectively. Commercial and consumer loans modified in a troubled debt restructuring are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a troubled debt restructuring subsequently default, the Company evaluates the loan for possible further impairment. The allowance for loan and lease losses may be increased, adjustments may be made in the allocation of the allowance, or partial charge-offs may be taken to further write-down the carrying value of the loan. The Company considers a loan in default when it is 90 days or more past due or transferred to non-accrual.

As of December 31, 2017 and 2016, the Company did not have any loans that were modified in troubled debt restructurings during the past twelve months that have subsequently defaulted.

As of December 31, 2017 and 2016, the Company held no foreclosed real estate. In addition, the Company had no consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process according to location requirement of the applicable jurisdiction.

*Credit Quality Indicators.* As part of the on-going monitoring of the credit quality of the Company's loan portfolio, management tracks certain credit quality indicators including trends related to (i) the weighted-average risk grade of commercial loans, (ii) the level of classified commercial loans, (iii) net charge-offs, (iv) non-performing loans, and (v) the general economic conditions in the State of Tennessee.

## NOTE 4 – LOANS, (CONTINUED)

The Company uses a risk grading matrix to assign a risk grade to each of its commercial loans. Loans are graded on a scale of 1 through 8. A description of the general characteristics of the eight risk grades is as follows:

**Risk Rating 1 – Minimal Risk –** Loans in this category are secured by a cash deposit and are substantially risk free.

**Risk Rating 2 – Modest Risk –** Loans in this category have borrowers that show profitability, liquidity, and capitalization better than industry norms and a strong market position in the region. The borrower of these loans have a proven history of profitability and financial stability, along with an abundance of financeable assets available to protect the Bank's position.

**Risk Rating 3 – Average Risk –** Loans in this category have borrowers that show a stable earnings history and financial condition in line with industry norms. The borrower's liquidity and leverage are in line with industry norms. The credit extension is considered sound; however, elements may be present which suggest the borrower may not be free from temporary impairments in the future.

**Risk Rating 4 – Acceptable Risk –** Loans in this category have sound risk profiles, in which the borrower shows satisfactory asset quality and liquidity, good debt capacity and coverage, and good management in critical positions.

**Risk Rating 5 – Pass/Watch –** Loans in this category require a heightened level of supervision. The borrower may exhibit declining earnings, strained cash flow, increasing leverage, or weakening market positions that indicate a trend toward an unacceptable risk. The borrowers liquidity, leverage, and earnings performance is below or trending below industry norms.

**Risk Rating 6 – Special Mention –** Loans in this category are not currently adequate. These loans have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special mention loans are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

**Risk Rating 7 – Substandard –** Loans in this category are inadequately protected by the current sound worth and paying capacity of the obligor of the collateral pledged, if any. Loans so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

**Risk Rating 8 – Doubtful –** Loans in this category have all the weaknesses inherent in one classified substandard 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.

## NOTE 4 – LOANS, (CONTINUED)

The following table presents risk grades and classified loans by class:

| **December 31, 2017** Commercial loan portfolio: Credit risk profile by internally assigned grade | Commercial and industrial | Non-farm, non-residential real estate | Construction and development | Commercial loans secured by real estate | Other commercial | Commercial loan totals |
|---|---|---|---|---|---|---|
| | (dollars in thousands) | | | | | |
| Risk rating 1 - minimal risk | $ 1,319 | $ 211 | $ - | $ - | $ 187 | $ 1,717 |
| Risk rating 2 - modest risk | 5,294 | - | - | - | 61,020 | 66,314 |
| Risk rating 3 - average risk | 24,539 | 52,488 | 6,769 | 8,082 | 5,495 | 97,373 |
| Risk rating 4 - acceptable risk | 74,775 | 129,947 | 53,204 | 50,855 | 5,559 | 314,340 |
| Risk rating 5 - pass/watch | 4,520 | 6,365 | 143 | 30 | 30 | 11,088 |
| Risk rating 6 - special mention | 17 | - | - | 79 | - | 96 |
| Risk rating 7 - substandard | 7,278 | 1,579 | - | 146 | 7 | 9,010 |
| **TOTALS** | $ 117,742 | $ 190,590 | $ 60,116 | $ 59,192 | $ 72,298 | $ 499,938 |

| Retail loan portfolio: Credit risk profiles based on delinquency status classification | Consumer | Single family residential** | Other retail | Retail loan totals |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Performing - risk ratings 1 - 6 | $ 7,716 | $ 319,240 | $ 25,557 | $ 352,513 |
| Risk rated 7* | 24 | 1,544 | 14 | 1,582 |
| TOTALS | $ 7,740 | $ 320,784 | $ 25,571 | $ 354,095 |

*Loans are classified as nonperforming loans and are automatically placed on nonaccrual status once they reach 90 days past due. For the purposes of this table, the total includes all risk rated 7 loans, of which may be performing or non-performing.

**Single family residential loans includes first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit ("HELOCs").

## NOTE 4 – LOANS, (CONTINUED)

| **December 31, 2016** Commercial loan portfolio: Credit risk profile by internally assigned grade | Commercial and industrial | Non-farm, non-residential real estate | Construction and development | Commercial loans secured by real estate | Other commercial | Commercial loan totals |
|---|---|---|---|---|---|---|
| | | | (dollars in thousands) | | | |
| Risk rating 1 - minimal risk | $ 1,350 | $ 287 | $ - | $ 97 | $ 189 | $ 1,923 |
| Risk rating 2 - modest risk | 5,909 | 275 | - | - | 66,050 | 72,234 |
| Risk rating 3 - average risk | 36,709 | 57,814 | 10,718 | 2,827 | 5,977 | 114,045 |
| Risk rating 4 - acceptable risk | 78,423 | 96,665 | 69,331 | 42,717 | 6,674 | 293,810 |
| Risk rating 5 - pass/watch | 9,111 | 2,616 | - | 70 | 22 | 11,819 |
| Risk rating 6 - special mention | 26 | 102 | - | 89 | - | 217 |
| Risk rating 7 - substandard | 6,156 | 1,887 | - | 80 | - | 8,123 |
| TOTALS | $ 137,684 | $ 159,646 | $ 80,049 | $ 45,880 | $ 78,912 | $ 502,171 |

| Retail loan portfolio: Credit risk profiles based on delinquency status classification | Consumer | Single family residential** | Other retail | Retail loan totals |
|---|---|---|---|---|
| | | (dollars in thousands) | | |
| Risk ratings 1 - 6 | $ 8,023 | $ 280,108 | $ 29,881 | $ 318,012 |
| Nonperforming - risk rating 7* | 21 | 1,291 | 72 | 1,384 |
| TOTALS | $ 8,044 | $ 281,399 | $ 29,953 | $ 319,396 |

*Loans are classified as nonperforming loans and are automatically placed on nonaccrual status once they reach 90 days past due. For the purposes of this table, the total includes all risk rated 7 loans, of which may be performing or non-performing.

**Single family residential loans includes first mortgages, closed-end second mortgages, residential construction loans, and home equity lines of credit ("HELOCs").

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES

The allowance for loan and lease losses ("ALLL") is a reserve established through a provision for possible loan and lease losses charged to expense, which represents management's best estimate of probable losses that have been incurred within the existing portfolio of loans. The allowance, in the judgment of management, is necessary to reserve for estimated loan losses and risks inherent in the loan portfolio. The Company's allowance for possible loan and lease loss methodology includes allowance allocations calculated in accordance with ASC Topic 310, "Receivables" and allowance allocations calculated in accordance with ASC Topic 450, "Contingencies." Accordingly, the methodology is based on historical loss experience by type of credit and internal risk grade, specific homogeneous risk pools and specific loss allocations, with adjustments for current events and conditions. The Company's process for determining the appropriate level of the allowance for possible loan losses is designed to account for credit deterioration as it occurs. The provision for loan and lease losses reflects loan quality trends, including the levels of and trends related to nonaccrual loans, past due loans, potential problem loans, criticized loans, and net charge-offs or recoveries, among other factors. The provision for loan and lease losses also reflects the totality of actions taken on all loans for a particular period. In other words, the amount of the provision reflects not only the necessary increases in the allowance for possible loan losses related to newly identified criticized loans, but it also reflects actions taken related to other loans including, among other things, any necessary increases or decreases in required allowances for specific loans or loan pools.

The level of the allowance reflects management's continuing evaluation of industry concentrations, specific credit risks, loan loss experience, current loan portfolio quality, present economic, political and regulatory conditions, and unidentified losses inherent in the current loan portfolio. Portions of the allowance may be allocated for specific credits; however, the entire allowance is available for any credit that, in management's judgment, should be charged off. While management utilizes its best judgment and information available, the ultimate adequacy of the allowance is dependent upon a variety of factors beyond the Company's control, including, among other things, the performance of the Company's loan portfolio, the economy, changes in interest rates, and the view of the regulatory authorities toward loan classifications.

The Company's allowance for loan losses consists of three elements: (i) specific valuation allowances determined in accordance with ASC Topic 310 based on probable losses on specific loans; (ii) historical valuation allowances determined in accordance with ASC Topic 450 based on historical loan loss experience for similar loans with similar characteristics and trends, adjusted, as necessary, to reflect the impact of current conditions; and (iii) general valuation allowances determined in accordance with ASC Topic 450 based on general economic conditions and other qualitative risk factors both internal and external to the Company.

The allowances established for probable losses on specific loans are based on a regular analysis and evaluation of problem loans. Commercial loans are classified based on an internal credit risk grading process that evaluates, among other things: (i) the obligor's ability to repay; (ii) the underlying collateral, if any; and (iii) the economic environment and industry in which the borrower operates. This analysis is performed at the relationship manager level for all commercial loans. When a loan has a calculated grade of seven or higher, a special assets officer analyzes the loan to determine whether the loan is impaired and, if impaired, the need to specifically allocate a portion of the allowance for possible loan losses to the loan. Specific valuation allowances are determined by analyzing the borrower's ability to repay amounts owed, collateral deficiencies, the relative risk grade of the loan and economic conditions affecting the borrower's industry, among other things.

Historical valuation allowances are calculated based on the historical loss experience of specific types of loans and the internal risk grade of such loans at the time they were charged-off. The Company calculates historical loss ratios for pools of similar loans with similar characteristics based on the proportion of actual charge-offs experienced to the total population of loans in the pool. The historical loss ratios are periodically updated based on actual charge-off experience. A historical valuation allowance is established for each pool of similar loans based upon the product of the historical loss ratio and the total dollar amount of the loans in the pool. The Company's pools of similar loans include similarly risk-graded groups of commercial and industrial loans, commercial real estate loans, consumer real estate loans, and consumer and other loans.

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES, (CONTINUED)

The components of the general valuation allowance include: (i) the additional reserves allocated to specific loan portfolio segments as a result of applying an environmental risk adjustment factor to the base historical loss allocation and (ii) the additional reserves that are not allocated to specific loan portfolio segments including allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

The allowance for loan and lease losses is maintained at a level considered adequate to provide for the losses that can be reasonably anticipated. Management's periodic evaluation of the adequacy of the allowance is based on the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to change. The Company uses a rolling twenty quarters historic loss period for all segments when estimating the historical charge-off rates calculated in accordance with ASC Topic 450.

General valuation allowances are based on general economic conditions and other qualitative risk factors both internal and external to the Company. In general, such valuation allowances are determined by evaluating, among other things: (i) current delinquency trends; (ii) the impact of economic events on portfolio risks; (iii) the experience, ability and effectiveness of the Bank's lending management and staff; (iv) the effectiveness of the Company's loan policies, procedures and internal controls; (iii) changes in asset quality; (iv) new volume loan growth trends; (v) the composition and concentrations of credit; (vi) the impact of competition on loan structuring and pricing; (vii) the effectiveness of the internal loan review function; and (viii) the impact of environmental events on portfolio risks. Management evaluates the degree of risk that each one of these components has on the quality of the loan portfolio on a quarterly basis. Each component is determined to have either a high, moderate, or low degree of risk. The results are then input into a "general allocation matrix" to determine an appropriate general valuation allowance.

Included in the general valuation allowances are allocations for groups of similar loans with risk characteristics that exceed certain concentration limits established by management. Concentration risk limits have been established, among other things, for certain industry concentrations, large balance and highly leveraged credit relationships that exceed specified risk grades, and loans originated with policy exceptions that exceed specified risk grades.

Loans identified as losses by management and internal loan review are charged off. Furthermore, consumer loan accounts are charged off automatically based on regulatory requirements.

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES, (CONTINUED)

The following tables summarize the allocation in the ALLL by loan segment:

| December 31, 2017 | Beginning balance | Charge-offs | Recoveries | (Provision Credit) Provision | Ending balance |
|---|---|---|---|---|---|
| **Commercial** | | | | | |
| Commercial and industrial | $ 2,302 | $ (114) | $ 98 | $ (64) | $ 2,222 |
| Non-farm, non-residential real estate | 1,824 | - | - | 546 | 2,370 |
| Construction and development | 1,250 | - | - | (186) | 1,064 |
| Commercial loans secured by real estate | 1,179 | - | 3 | 257 | 1,439 |
| Other commercial | 917 | - | 2 | (214) | 705 |
| Total commercial | 7,472 | (114) | 103 | 339 | 7,800 |
| **Retail** | | | | | |
| Consumer loans | 26 | (10) | 7 | 85 | 108 |
| Single family residential | 909 | (23) | 4 | (481) | 409 |
| Other retail | 941 | - | 32 | (168) | 805 |
| Total retail | 1,876 | (33) | 43 | (564) | 1,322 |
| Total | $ 9,348 | $ (147) | $ 146 | $ (225) | $ 9,122 |

| December 31, 2016 | Beginning balance | Charge-offs | Recoveries | (Provision Credit) Provision | Ending balance |
|---|---|---|---|---|---|
| **Commercial** | | | | | |
| Commercial and industrial | $ 2,140 | $ (22) | $ 71 | $ 113 | $ 2,302 |
| Non-farm, non-residential real estate | 1,836 | - | - | (12) | 1,824 |
| Construction and development | 975 | - | - | 275 | 1,250 |
| Commercial loans secured by real estate | 1,011 | - | - | 168 | 1,179 |
| Other commercial | 736 | - | 3 | 178 | 917 |
| Total commercial | 6,698 | (22) | 74 | 722 | 7,472 |
| **Retail** | | | | | |
| Consumer loans | 243 | (161) | 4 | (60) | 26 |
| Single family residential | 730 | (29) | 6 | 202 | 909 |
| Other retail | 963 | (2) | 4 | (24) | 941 |
| Total retail | 1,936 | (192) | 14 | 118 | 1,876 |
| Total | $ 8,634 | $ (214) | $ 88 | $ 840 | $ 9,348 |

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES, (CONTINUED)

| December 31, 2015 | Beginning balance | Charge-offs | Recoveries | (Provision Credit) Provision | Ending balance |
|---|---|---|---|---|---|
| **Commercial** | | | | | |
| Commercial and industrial | $ 1,608 | $ - | $ 521 | $ 11 | $ 2,140 |
| Non-farm, non-residential real estate | 1,757 | - | 80 | (1) | 1,836 |
| Construction and development | 975 | - | - | - | 975 |
| Commercial loans secured by real estate | 932 | - | 79 | - | 1,011 |
| Other commercial | 728 | - | 3 | 5 | 736 |
| Total commercial | 6,000 | - | 683 | 15 | 6,698 |
| **Retail** | | | | | |
| Consumer loans | 237 | (11) | 17 | - | 243 |
| Single family residential | 738 | (36) | 14 | 14 | 730 |
| Other retail | 959 | - | 3 | 1 | 963 |
| Total retail | 1,934 | (47) | 34 | 15 | 1,936 |
| Total | $ 7,934 | $ (47) | $ 717 | $ 30 | $ 8,634 |

The following tables detail the amount of the ALLL allocated to each portfolio segment as of December 31, 2017, 2016 and 2015, disaggregated on the basis of the Company's impairment methodology:

| December 31, 2017 | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Ending balance |
|---|---|---|---|
| **Commercial** | | | |
| Commercial and industrial | $ 11 | $ 2,211 | $ 2,222 |
| Non-farm, non-residential real estate | - | 2,370 | 2,370 |
| Construction and development | - | 1,064 | 1,064 |
| Commercial loans secured by real estate | - | 1,439 | 1,439 |
| Other commercial | - | 705 | 705 |
| Total commercial | 11 | 7,789 | 7,800 |
| **Retail** | | | |
| Consumer loans | - | 108 | 108 |
| Single family residential | 1 | 408 | 409 |
| Other retail | 1 | 804 | 805 |
| Total retail | 2 | 1,320 | 1,322 |
| Total | $ 13 | $ 9,109 | $ 9,122 |

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES, (CONTINUED)

| December 31, 2016 | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Ending balance |
|---|---|---|---|
| **Commercial** | | | |
| Commercial and industrial | $ 48 | $ 2,254 | $ 2,302 |
| Non-farm, non-residential real estate | 1 | 1,823 | 1,824 |
| Construction and development | - | 1,250 | 1,250 |
| Commercial loans secured by real estate | 26 | 1,153 | 1,179 |
| Other commercial | - | 917 | 917 |
| Total commercial | 75 | 7,397 | 7,472 |
| **Retail** | | | |
| Consumer loans | - | 26 | 26 |
| Single family residential | 58 | 851 | 909 |
| Other retail | - | 941 | 941 |
| Total retail | 58 | 1,818 | 1,876 |
| Total | $ 133 | $ 9,215 | $ 9,348 |

| December 31, 2015 | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Ending balance |
|---|---|---|---|
| **Commercial** | | | |
| Commercial and industrial | $ 28 | $ 2,112 | $ 2,140 |
| Non-farm, non-residential real estate | - | 1,836 | 1,836 |
| Construction and development | - | 975 | 975 |
| Commercial loans secured by real estate | 29 | 982 | 1,011 |
| Other commercial | - | 736 | 736 |
| Total commercial | 57 | 6,641 | 6,698 |
| **Retail** | | | |
| Consumer loans | - | 243 | 243 |
| Single family residential | 102 | 628 | 730 |
| Other retail | - | 963 | 963 |
| Total retail | 102 | 1,834 | 1,936 |
| Total | $ 159 | $ 8,475 | $ 8,634 |

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES, (CONTINUED)

The following tables show loans as of December 31, 2017, 2016 and 2015 related to each balance in the allowance for possible loan and lease losses by portfolio segment and disaggregated on the basis of the Company's impairment methodology:

| December 31, 2017 | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Ending balance |
|---|---|---|---|
| **Commercial** | | | |
| Commercial and industrial | $ 228 | $ 117,514 | $ 117,742 |
| Non-farm, non-residential real estate | 1,554 | 189,036 | 190,590 |
| Construction and development | - | 60,116 | 60,116 |
| Commercial loans secured by real estate | - | 59,192 | 59,192 |
| Other commercial loans | - | 72,298 | 72,298 |
| Total commercial loans | 1,782 | 498,156 | 499,938 |
| **Retail** | | | |
| Consumer loans | 13 | 7,727 | 7,740 |
| Single family residential | 1,544 | 319,240 | 320,784 |
| Other retail loans | 24 | 25,547 | 25,571 |
| Total retail loans | 1,581 | 352,514 | 354,095 |
| Total loans | $ 3,363 | $ 850,670 | $ 854,033 |

| December 31, 2016 | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Ending balance |
|---|---|---|---|
| **Commercial** | | | |
| Commercial and industrial | $ 259 | $ 137,425 | $ 137,684 |
| Non-farm, non-residential real estate | 1,969 | 157,677 | 159,646 |
| Construction and development | - | 80,049 | 80,049 |
| Commercial loans secured by real estate | 154 | 45,726 | 45,880 |
| Other commercial loans | - | 78,912 | 78,912 |
| Total commercial loans | 2,382 | 499,789 | 502,171 |
| **Retail** | | | |
| Consumer loans | 21 | 8,023 | 8,044 |
| Single family residential | 1,291 | 280,108 | 281,399 |
| Other retail loans | 72 | 29,881 | 29,953 |
| Total retail loans | 1,384 | 318,012 | 319,396 |
| Total loans | $ 3,766 | $ 817,801 | $ 821,567 |

## NOTE 5 – ALLOWANCE FOR LOAN AND LEASE LOSSES, (CONTINUED)

| December 31, 2015 | Loans individually evaluated for impairment | Loans collectively evaluated for impairment | Ending balance |
|---|---|---|---|
| **Commercial** | | | |
| Commercial and industrial | $ 322 | $ 127,577 | $ 127,899 |
| Non-farm, non-residential real estate | 401 | 160,608 | 161,009 |
| Construction and development | - | 51,330 | 51,330 |
| Commercial loans secured by real estate | 163 | 27,928 | 28,091 |
| Other commercial loans | - | 60,325 | 60,325 |
| Total commercial loans | 886 | 427,768 | 428,654 |
| **Retail** | | | |
| Consumer loans | - | 9,914 | 9,914 |
| Single family residential | 1,340 | 258,914 | 260,254 |
| Other retail loans | 74 | 32,370 | 32,444 |
| Total retail loans | 1,414 | 301,198 | 302,612 |
| Total loans | $ 2,300 | $ 728,966 | $ 731,266 |

## NOTE 6 – PREMISES AND EQUIPMENT

The following table presents the Company's fixed assets by category:

| | 2017 | 2016 |
|---|---|---|
| | (dollars in thousands) | |
| Land | $ 10,248 | $ 10,248 |
| Premises | 26,098 | 24,296 |
| Furniture and equipment | 11,263 | 11,305 |
| Leasehold improvements | 2,024 | 1,846 |
| Construction in progress | 150 | 231 |
| | 49,783 | 47,926 |
| Less accumulated depreciation | (20,996) | (20,332) |
| | $ 28,787 | $ 27,594 |

## NOTE 7 – RELATED PARTY TRANSACTIONS

Certain related parties (active directors and executive officers of the Company or the Bank, including their affiliates, families and companies in which they hold 10% or more ownership) were customers of, and had loans and other transactions with, the Bank in the ordinary course of business. An analysis of the activity with respect to such loans are shown in the table below. These totals exclude loans made in the ordinary course of business to other companies with which neither the Company nor the Bank had a relationship other than the association of one of its directors in the capacity of officer or director.

The Bank has granted loans to certain related parties including directors, executive officers, and their related interests. These loan transactions were made in the ordinary course of business on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable loans to persons not related to the Bank and did not involve more than the normal risk of collectability or present other unfavorable features. None of these loans to directors, executive officers, and their related interests are impaired at December 31, 2017 and 2016. Changes in related party loans for the years ended December 31, 2017 and 2016 are as follows:

| | 2017 | 2016 |
|---|---|---|
| | (dollars in thousands) | |
| Related party extensions of credit, beginning of period | $ 2,906 | $ 4,260 |
| New loans | 15 | 517 |
| Repayments or reductions | (430) | (1,871) |
| Related party extension of credit, end of period | $ 2,491 | $ 2,906 |

The aggregate balances of related party deposits at December 31, 2017 and 2016 were $42.2 million and $33.4 million, respectively.

The aggregate balances of related party repurchase agreements at December 31, 2017 and 2016 were $21.7 million and $10.0 million, respectively.

The Company and Bank utilize various services and purchased goods provided by certain related parties. Payments to directors and their related interests for services provided during 2017, 2016 and 2015 totaled $260,000, $235,000 and $151,000, respectively.

## NOTE 8 – LEASES

Real property for four of the Bank's office locations and certain equipment are leased under noncancelable operating leases expiring at various times through 2034. In most cases, the leases provide for one or more renewal options of five to ten years under the same or similar terms. In addition, various items of office equipment are leased under cancelable operating leases. Total rental expense incurred under all operating leases, including short-term leases with terms of less than one month, amounted to approximately $14,000, $26,000 and $30,000 for equipment leases and approximately $665,000, $417,000 and $380,000 for building leases in 2017, 2016 and 2015, respectively. Future minimum lease commitments as of December 31, 2017 under all noncancelable operating leases with initial terms of one year or more are shown in the following table:

| Year | Lease payments |
|---|---|
| (dollars in thousands) | |
| 2018 | $ 580 |
| 2019 | 586 |
| 2020 | 581 |
| 2021 | 558 |
| 2022 | 520 |
| Thereafter | 2,675 |
| Total | $ 5,500 |

## NOTE 9 – FEDERAL AND STATE INCOME TAXES

The following table presents components of income tax expense attributable to continuing operations:

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| | | (dollars in thousands) | |
| Current | $ 3,130 | $ 3,950 | $ 2,553 |
| Deferred | 571 | (649) | 796 |
| Revalution of net deferred tax asset | 1,026 | - | - |
| Total provision for income taxes | 4,727 | $ 3,301 | $ 3,349 |

A reconciliation between reported income tax expense and the amounts computed by applying the U.S. federal statutory income tax rate of 34% to income before income taxes is presented in the following table:

| | 2017 | 2016 | 2015 |
|---|---|---|---|
| | | (dollars in thousands) | |
| Tax expense at statutory rate | $ 5,130 | $ 4,628 | $ 4,643 |
| Increase (decrease) in taxes resulting from: | | | |
| Tax-exempt interest | (1,408) | (1,298) | (1,226) |
| Nondeductible interest expense | 25 | 19 | 19 |
| Employee benefits | (137) | (192) | (80) |
| Revaluation of net deferred tax asset | 1,026 | - | - |
| Other nondeductible expenses (nontaxable income) - net | 28 | 76 | 28 |
| State income taxes net of federal tax benefit | 76 | - | 106 |
| Other | (13) | 68 | (141) |
| Total provision for income taxes | $ 4,727 | $ 3,301 | $ 3,349 |
| Effective tax rate | 31.3% | 24.3% | 24.4% |

Income tax expense for 2017 was impacted by the adjustment of our deferred tax assets and liabilities related to the reduction in the U.S. federal statutory income tax rate to 21% under the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. Deferred tax assets and liabilities expected to be realized in future periods were re-measured as a result of the new law, which is more fully discussed below. As such, the Company recognized tax expense totaling $1.0 million, as detailed in the table above.

## NOTE 9 – FEDERAL AND STATE INCOME TAXES, (CONTINUED)

Year-end deferred taxes are presented in the table below. As a result of the Tax Cuts and Jobs Act enacted on December 22, 2017 (discussed below), deferred taxes as of December 31, 2017 are based on the newly enacted U.S. statutory federal income tax rate of 21%. Deferred taxes as of December 31, 2016 are based on the previously enacted U.S. statutory federal income tax rate of 34%.

| | (dollars in thousands) | |
|---|---|---|
| Deferred tax effects of principal temporary differences | **2017** | **2016** |
| Allowance for possible loan and lease losses | $ 2,384 | $ 3,579 |
| Deferred compensation | 1,881 | 2,587 |
| Amortization of intangibles | (2,100) | (3,067) |
| Recognition of nonaccrual loan income | 36 | 64 |
| Unrealized losses on available-for-sale securities | 1,137 | 2,145 |
| Post-retirement benefit obligation | 534 | 826 |
| Accelerated depreciation | (626) | (590) |
| Prepaid expenses | (66) | (86) |
| REIT dividends | (641) | (486) |
| Loan fees | 292 | 315 |
| FHLB stock dividends | (428) | (627) |
| Other | 42 | 111 |
| Net deferred tax asset | $ 2,445 | $ 4,771 |

No valuation allowance for deferred tax assets was recorded at December 31, 2017 and 2016 as management believes it is more likely than not that all of the deferred tax assets will be realized against deferred tax liabilities and projected future taxable income. There were no unrecognized tax benefits during any of the reported periods.

The Company and its subsidiaries file income tax returns with the Internal Revenue Service, State of Tennessee and State of Alabama. The Company is not subject to U.S. federal, state and local, or non-U.S. income tax examinations by tax authorities for years prior to 2014.

### Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act was enacted on December 22, 2017. Among other things the new law (i) establishes a new, flat corporate federal statutory income tax rate of 21%, (ii) eliminates the corporate alternative minimum tax and allows the use of any such carryforwards to offset regular tax liability for any taxable year, (iii) limits the deduction for net interest expense incurred by U.S. corporations, (iv) allows businesses to immediately expense, for tax purposes, the cost of new investments in certain qualified depreciable assets, (v) eliminated or reduces certain deductions related to meals and entertainment expenses, (vi) modified the limitation on excessive employee remuneration to eliminate the exception for performance-based compensation and clarifies the definition of a covered employee, (vii) limits the deductibility of deposit insurance premiums and (viii) removed the 20 year carry-forward limitation on Company's net operating losses. The Tax Cuts and jobs Act also significantly changes U.S. tax law related to foreign operations, however, such changes do not currently impact us.

As stated above, as a result of the enactment of the Tax Cuts and Jobs Act on December 22, 2017, the Company revalued its deferred tax assets and liabilities based upon the newly enacted U.S. statutory federal income tax rate of 21%, which is the tax rate at which these assets and liabilities are expected to reverse in the future. Notwithstanding the foregoing, management is still analyzing certain aspects of the new law and refining our calculations, which could affect the measurement of these assets and liabilities or give rise to the new deferred tax amounts. Nonetheless, the Company recognized expense related to the revaluation of our deferred tax assets and liabilities totaling $1.0 million.

## NOTE 10 – BORROWED FUNDS

The Bank is a party to the Blanket Agreement for Advances and Security Agreement (the “Blanket Agreement”) with the Federal Home Loan Bank of Cincinnati (the “FHLB”). Advances made to the Bank under the Blanket Agreement are collateralized by the FHLB stock and qualifying residential mortgage loans totaling 150% of the outstanding amount borrowed. These collateralization matters are outlined in the Blanket Agreement dated June 20, 2006 between the Bank and the FHLB. There were no outstanding advances at December 31, 2017. As of December 31, 2016, there was an outstanding overnight advance of $15 million.

Stock held in the FHLB totaling $3.0 million at December 31, 2017 and 2016 is carried at cost. The stock is restricted and can only be sold back to the FHLB at par.

The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these repurchase agreements are accounted for as secured borrowings and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Company’s consolidated statements of condition, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. As a result, there is no offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Company does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of offset for a repurchase agreement resembles a secured borrowing, whereby the collateral pledged by the Company would be used to settle the fair value of the repurchase agreement should the Company be in default (e.g., fails to make an interest payment to the counterparty). For private institution repurchase agreements, if the private institution counterparty were to default (e.g., declare bankruptcy), the Company could cancel the repurchase agreement (i.e., cease payment of principal and interest), and attempt collection on the amount of collateral value in excess of the repurchase agreement fair value. The collateral is held by a third party financial institution in the counterparty's custodial account. The Company has the right to sell or repledge the investment securities. The Company is required by the counterparty to maintain adequate collateral levels. In the event the collateral fair value falls below stipulated levels, the Company will pledge additional securities. The Company closely monitors collateral levels to ensure adequate levels are maintained, while mitigating the potential risk of over-collateralization in the event of counterparty default.

The following table presents the remaining contractual maturities of the Company’s repurchase agreements as of December 31, 2017 and 2016, disaggregated by the class of collateral pledged.

| **December 31, 2017** | **Overnight and Continuous** |
|---|---|
| | (dollars in thousands) |
| **Class of collateral pledged:** | |
| U.S. government agencies | $ 31,222 |

| **December 31, 2016** | **Overnight and Continuous** |
|---|---|
| | (dollars in thousands) |
| **Class of collateral pledged:** | |
| U.S. government agencies | $ 27,578 |

## NOTE 10 – BORROWED FUNDS, (CONTINUED)

Securities sold under agreements to repurchase consist of obligations of the Bank to other parties. The obligations are secured by investment securities and such collateral is held in safekeeping by a third party. The maximum amount of outstanding agreements at any month end during 2017 and 2016 totaled $34.2 million and $29.5 million, respectively, and the monthly average of such agreements totaled $30.0 million and $26.1 million for 2017 and 2016, respectively. The agreements at December 31, 2017, mature January 2, 2018.

## NOTE 11 – SIGNIFICANT ESTIMATES, COMMITMENTS, AND CONTINGENCIES

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Estimates related to the ALLL are reflected in the Note 5 – Allowance for Loan and Lease Losses. Other significant estimates and concentrations not discussed in those footnotes include:

### General Litigation

The Company is subject to claims and lawsuits that arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the consolidated financial position, results of operations, and cash flows of the Company.

### Pension and Other Post-Retirement Benefit Obligations

The Company has a noncontributory defined benefit post-retirement health care plan whereby it agrees to provide certain post-retirement benefits to eligible employees. The benefit obligation is the actuarial present value of all benefits attributed to service rendered prior to the valuation date based on the projected unit credit cost method. It is reasonably possible that events could occur that would change the estimated amount of this liability materially in the near term.

### Self-Insurance Reserves

The Company is self-insured for its employees' health benefit programs, which include medical, dental, and prescription drug benefits. The costs of the Company's employee health insurance benefits, including paid claims, an estimate of incurred but not reported ("IBNR") claims, stop loss premiums and administrative fees are included in salaries and employee benefits on the consolidated statements of income.

The accrual for employee health insurance benefits is based on analysis performed internally by management. The liability for employee health insurance benefits at December 31, 2017 and 2016 was approximately $251,000 and $339,000, respectively. The Company regularly analyzes the liability for incurred but not reported claims and believes our reserves are adequate. However, significant judgement is involved in assessing these reserves, such as assessing historical claims paid, average lag times between claims incurred dates, reported dates and paid dates, and the frequency and severity of claims. There may be differences between actual settlement amounts and recorded reserves and any resulting adjustment is included in expense once a probable amount is known. Any significant increase in the number of employee health insurance claims or costs of those claims above our recorded reserve could have a material impact to our financial results. The Company mitigates the risk of potential claims for both individual participants and in the aggregate by carrying stop loss insurance coverage.

## NOTE 11 – SIGNIFICANT ESTIMATES, COMMITMENTS, AND CONTINGENCIES, (CONTINUED)

**Current Economic Conditions**

The current economic climate continues to present financial institutions with circumstances and challenges which in some cases have resulted in large and unanticipated declines in the fair values of investments and other assets, constraints on liquidity and capital and significant credit quality problems, including volatility in the valuation of real estate and other collateral supporting loans.

The accompanying financial statements have been prepared using values and information currently available to the Company.

Given the potential for volatility of economic conditions, the values of assets and liabilities recorded in the financial statements could change rapidly, resulting in material future adjustments in asset values, the ALLL and capital that could negatively impact the Company's ability to meet regulatory capital requirements and maintain sufficient liquidity. Furthermore, the Company's regulators could require material adjustments to asset values or the allowance for loan and lease losses for regulatory capital purposes that could affect the Company's measurement of regulatory capital and compliance with the capital adequacy guidelines under the regulatory framework for prompt corrective action.

**Commitments and Credit Risk**

The Company grants commercial, consumer, and residential loans to customers primarily throughout the States of Tennessee and Alabama. The Bank is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the balance sheet. The contract or notional amounts of those instruments reflect the extent of involvement the Bank has in those particular financial instruments.

**Commitments to Originate Loans**

Commitments to originate loans are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since a portion of the commitments may expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation of the counterparty. Collateral held varies, but may include accounts receivable, inventory, property, plant and equipment, commercial real estate, and residential real estate.

Mortgage loans in the process of origination represent amounts that the Company plans to fund within a normal period of 30 to 90 days, and which are intended for sale to investors in the secondary market. Total mortgage loans in process of origination were $3.1 million and $1.7 million, at December 31, 2017 and 2016, respectively. Total mortgage loans held-for-sale amounted to $1.6 million and $218,000, at December 31, 2017 and 2016, respectively.

## NOTE 11 – SIGNIFICANT ESTIMATES, COMMITMENTS, AND CONTINGENCIES, (CONTINUED)

### Standby Letters of Credit

Standby letters of credit are irrevocable conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Financial standby letters of credit are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. Performance standby letters of credit are issued to guarantee performance of certain customers under nonfinancial contractual obligations. The credit risk involved in issuing standby letters of credit is essentially the same as that involved in extending loans to customers. Should the Company be obligated to perform under the standby letters of credit, the Company may seek recourse from the customer for reimbursement of amounts paid. The Company had total outstanding standby letters of credit amounting to $31.6 million and $14.2 million, at December 31, 2017 and 2016, respectively, with terms ranging from seven days to 24 months.

### Lines of Credit

Lines of credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Lines of credit generally have fixed expiration dates. Since a portion of the line may expire without being drawn upon, the total unused lines do not necessarily represent future cash requirements. Each customer's creditworthiness is evaluated on a case-by-case basis. The amount of collateral obtained, if deemed necessary, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable, inventory, property, plant and equipment, commercial real estate, and residential real estate. Management uses the same credit policies in granting lines of credit as it does for on-balance-sheet instruments.

At December 31, 2017, the Company had granted unused lines of credit to borrowers for commercial lines and open-end consumer lines aggregating $121.5 million and $57.0 million, respectively. At December 31, 2016, unused lines of credit to borrowers for commercial lines and open-end consumer lines aggregated $143.5 million and $49.8 million, respectively.

## NOTE 12 – FAIR VALUE MEASUREMENT

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

- *Level 1 Inputs* - Unadjusted quoted prices in active markets for identical assets or liabilities.

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

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

## NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and/or quarterly valuation process. There were no transfers between levels during 2017 or 2016.

### Recurring Measurements

The following table summarizes financial assets measured at fair value on a recurring basis by the level within the fair value hierarchy utilized to measure fair value:

| | Recurring fair value measurements at December 31, 2017 | | | |
|---|---|---|---|---|
| | Total carrying value | Level 1 | Level 2 | Level 3 |
| | (dollars in thousands) | | | |
| **Assets** | | | | |
| Available-for-sale investment securities: | | | | |
| U.S. government sponsored agencies | $ 67,477 | $ - | $ 67,477 | $ - |
| U.S. government sponsored agency mortgage backed securities | 202,658 | - | 202,658 | - |
| State and political subdivision | 78,648 | - | 78,648 | - |
| Corporate bonds | 22,990 | - | 22,990 | - |
| Total assets at fair value | $ 371,773 | $ - | $ 371,773 | $ - |

| | Recurring fair value measurements at December 31, 2016 | | | |
|---|---|---|---|---|
| | Total carrying value | Level 1 | Level 2 | Level 3 |
| | (dollars in thousands) | | | |
| **Assets** | | | | |
| Available-for-sale investment securities: | | | | |
| U.S. government sponsored agencies | $ 86,635 | $ - | $ 86,635 | $ - |
| U.S. government sponsored agency mortgage backed securities | 210,647 | - | 210,647 | - |
| State and political subdivision | 71,371 | - | 71,371 | - |
| Corporate bonds | 23,930 | - | 23,930 | - |
| Total assets at fair value | $ 392,583 | $ - | $ 392,583 | $ - |

The following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis and recognized in the accompanying balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the year ended December 31, 2017.

## NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

### Available-for-Sale Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, the Company obtains fair value measurements from an independent pricing service, such as Interactive Data Corporation, which utilizes pricing models to determine fair value measurement. The Company reviews the pricing quarterly to verify the reasonableness of the pricing. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other factors. U.S. government agencies, state and political subdivisions, U.S. government sponsored agency mortgage-backed securities and corporate bonds are classified as Level 2 inputs.

### Nonrecurring Measurements

The following table summarizes financial assets measured at fair value on a nonrecurring basis as of December 31, 2017 and 2016, by the level within the fair value hierarchy utilized to measure fair value:

| **December 31, 2017** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| | | (dollars in thousands) | | |
| Impaired loans (collateral-dependent) | $ - | $ - | $ 2,083 | $ 2,083 |

| **December 31, 2016** | **Level 1** | **Level 2** | **Level 3** | **Total** |
|---|---|---|---|---|
| | | (dollars in thousands) | | |
| Impaired loans (collateral-dependent) | $ - | $ - | $ 2,670 | $ 2,670 |

### Impaired Loans (Collateral-Dependent)

The estimated fair value of collateral-dependent impaired loans is based on the appraised fair value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy.

The Company considers the appraisal or evaluation as the starting point for determining fair value and then considers other factors and events in the environment that may affect the fair value. Appraisals of the collateral underlying collateral-dependent loans are obtained when the loan is determined to be collateral-dependent and subsequently as deemed necessary by the Chief Credit Officer. Appraisals are reviewed for accuracy and consistency by the Chief Credit Officer. Appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by discounts to consider lack of marketability and estimated cost to sell if repayment or satisfaction of the loan is dependent on the sale of the collateral. These discounts and estimates are developed by the Chief Credit Officer by comparison to historical results. Fair value adjustments were $11,000 at December 31, 2017 and $130,000 at December 31, 2016.

Loans considered impaired under ASC 310-35, "Impairment of a Loan," are loans for which, based on current information and events, it is probable that the creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. Impaired loans are subject to nonrecurring fair value adjustments to reflect (1) subsequent partial write-downs that are based on the observable market price or current appraised value of the collateral or (2) the full charge-off of the loan carrying value.

## NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

### Other Real Estate Owned

Other real estate owned ("OREO") is initially recorded at fair value at the time of acquisition, as determined by independent appraisal or evaluation by the Company, less costs to sell when the real estate is acquired in settlement of loans. Quarterly evaluations of OREO are performed to determine if there have been any subsequent decline in the value of OREO properties. OREO is classified within Level 3 of the fair value hierarchy. OREO assets are subject to nonrecurring fair value adjustments to reflect subsequent partial write-downs that are based on the observable market price or current appraised value of the collateral less selling costs. There was not any OREO held by the Company at December 31, 2017 or December 31, 2016, and thus no fair value adjustments during either period.

Appraisals of OREO are obtained when the real estate is acquired and subsequently as deemed necessary by the Chief Credit Officer. Appraisals are required annually and reviewed for accuracy and consistency by the Chief Credit Officer. The appraised values are reduced by discounts to consider lack of marketability and estimated costs to sell. Appraisers are selected from the list of approved appraisers maintained by management.

### Unobservable (Level 3) Inputs

The following table presents quantitative information about unobservable inputs used in nonrecurring Level 3 fair value measurements:

| | Quantitative information about Level 3 fair value measurements | | | | |
|---|---|---|---|---|---|
| **December 31, 2017** | | **Fair value** | **Valuation technique(s)** | **Unobservable input** | **Range (weighted average)** |
| | | | (dollars in thousands) | | |
| Impaired loans (collateral-dependent) | $ | 2,083 | Market comparable properties | Marketability discount | 9.0% -10.0% (9.6%) |

| | Quantitative Information about Level 3 fair value measurements | | | | |
|---|---|---|---|---|---|
| **December 31, 2016** | | **Fair value** | **Valuation technique(s)** | **Unobservable input** | **Range (weighted average)** |
| | | | (dollars in thousands) | | |
| Impaired loans (collateral-dependent) | $ | 2,670 | Market comparable properties | Marketability discount | 26.0% - 55.0% (36.0%) |

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

The following methods and assumptions were used to estimate the fair value of each class of financial instruments for which it is practicable to estimate that value:

*Cash and due from banks* – The carrying amount approximates fair value.

*Interest bearing deposits in other banks* – The carrying amount approximates fair value.

*Federal funds sold* – The carrying amount approximates fair value.

## NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

*Securities held-to-maturity* – Fair values are based on quoted market prices, if available. If a quoted price is not available, fair value is estimated using quoted prices for similar securities. The fair value estimate is provided to management from a third party using modeling assumptions specific to each type of security that are reviewed and approved by management. Quarterly sampling of fair values provided by additional third parties supplement the fair value review process.

*Loans held-for-sale* – Loans are committed to be delivered to investors on a "best efforts delivery" basis within 30 – 90 days of mitigation. Due to this short turnaround time, the carrying amounts of the Company's agreements approximate their fair values.

*Loans (net of the allowance for loan and lease losses)* – The fair value of fixed rate loans and variable rate mortgage loans is estimated by discounting the future cash flows using current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. For other variable rate loans, the carrying amount approximates fair value.

*FHLB stock* – The carrying value of FHLB stock approximates fair value based on the redemption provisions of the FHLB.

*Federal Reserve Bank stock* – The carrying value of Federal Reserve Bank stock approximates fair value based on the redemption provisions of the Federal Reserve Bank.

*Accrued interest receivable* – The carrying amount approximates fair value.

*Deposits* – The fair value of fixed maturity time deposits is estimated by discounting the future cash flows using the rates currently offered for deposits of similar remaining maturities. For deposits including demand deposits, savings accounts, NOW accounts, and certain money market accounts, the carrying value approximates fair value.

*Repurchase agreements* – The fair value is estimated by discounting future cash flows using current rates.

*Accrued interest payable* – The carrying amount approximates fair value.

*Federal Funds Purchased and other borrowings* – For federal funds purchased and overnight borrowings from the FHLB, the carrying amount approximates fair value, as these borrowings are settled on a short-term basis (typically daily).

*Commitments to extend credit and letters of credit* – The fair value of commitments to originate loans is estimated using the fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the present creditworthiness of the counterparties. For fixed-rate loan commitments, fair value also considers the difference between current levels of interest rates and the committed rates. The fair values of letters of credit and lines of credit are based on fees currently charged for similar agreements or on the estimated cost to terminate or otherwise settle the obligations with the counterparties at the reporting date. The fair values of these commitments are not material.

## NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

The following tables present the assets and liabilities that are measured at fair value on a non-recurring basis by level within the fair value hierarchy as reported on the consolidated statements of financial position:

**Fair value measurements at December 31, 2017**

| | Carrying amount | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Financial assets | | | | |
| Cash and due from banks | $ 26,878 | $ 26,878 | $ - | $ - |
| Interest-bearing deposits in other banks | 26,371 | 26,371 | - | - |
| Federal funds sold | 1,915 | 1,915 | - | - |
| Securities available-for-sale | 371,773 | - | 371,773 | - |
| Securities held-to-maturity | 18,675 | - | 18,525 | - |
| Loans held-for-sale | 1,599 | - | 1,599 | - |
| Loans, net | 844,911 | - | - | 843,290 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,879 | - | 3,879 | - |
| Accrued interest receivable | 4,377 | - | 4,377 | - |
| Financial liabilities | | | | |
| Non-interest bearing deposits | 292,502 | 292,502 | - | - |
| Interest-bearing deposits | 914,047 | - | 913,766 | - |
| Repurchase agreements | 31,222 | - | 31,222 | - |
| Accrued interest payable | 777 | - | 777 | - |
| Off-balance sheet credit related instruments: | | | | |
| Commitments to extend credit and letters of credit | - | - | - | - |

## NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

**Fair value measurements at December 31, 2016**

| | Carrying amount | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant unobservable inputs (Level 3) |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Financial assets | | | | |
| Cash and due from banks | $ 22,703 | $ 22,703 | $ - | $ - |
| Interest-bearing deposits in other banks | 9,214 | 9,214 | - | - |
| Federal funds sold | 1,165 | 1,165 | - | - |
| Securities available-for-sale | 392,583 | - | 392,583 | - |
| Securities held-to-maturity | 19,036 | - | 18,057 | - |
| Loans held-for-sale | 218 | - | 218 | - |
| Loans, net | 812,219 | - | - | 819,413 |
| Federal Home Loan Bank and Federal Reserve Bank stock | 3,879 | - | 3,879 | - |
| Accrued interest receivable | 4,625 | - | 4,625 | - |
| Financial liabilities | | | | |
| Non-interest bearing deposits | 255,964 | 255,964 | - | - |
| Interest-bearing deposits | 907,859 | - | 908,437 | - |
| Repurchase agreements | 27,578 | - | 27,578 | - |
| Accrued interest payable | 567 | - | 567 | - |
| FHLB borrowings | 15,000 | - | 15,000 | - |
| Off-balance sheet credit related instruments: | | | | |
| Commitments to extend credit and letters of credit | - | - | - | - |

## NOTE 13 – QUARTERLY RESULTS OF OPERATIONS (Unaudited)

The following tables present unaudited quarterly interim financial information for the Company for the periods presented:

| | March 31, 2017 | June 30, 2017 | September 30, 2017 | December 31, 2017 | Total |
|---|---|---|---|---|---|
| | | | (dollars in thousands) | | |
| Interest income | $ 10,206 | $ 10,546 | $ 10,716 | $ 10,854 | $ 42,322 |
| Interest expense | 700 | 780 | 803 | 818 | 3,101 |
| Net interest income | 9,506 | 9,766 | 9,913 | 10,036 | 39,221 |
| (Provision credit) provision for loan and lease losses | - | - | - | (225) | (225) |
| Non-interest income | 2,758 | 3,036 | 3,291 | 3,155 | 12,240 |
| Non-interest expenses | 9,328 | 8,994 | 9,235 | 9,040 | 36,597 |
| Income before income taxes | 2,936 | 3,808 | 3,969 | 4,376 | 15,089 |
| Income taxes | 555 | 971 | 986 | 2,215 | 4,727 |
| Net income available to common shareholders | $ 2,381 | $ 2,837 | $ 2,983 | $ 2,161 | $ 10,362 |
| Basic earnings per share | $ 0.52 | $ 0.63 | $ 0.66 | $ 0.48 | $ 2.29 |
| Weighted average shares outstanding | 4,541,043 | 4,521,045 | 4,519,030 | 4,507,351 | 4,523,677 |

| | March 31, 2016 | June 30, 2016 | September 30, 2016 | December 31, 2016 | Total |
|---|---|---|---|---|---|
| | | | (dollars in thousands) | | |
| Interest income | $ 9,665 | $ 9,683 | $ 10,045 | $ 10,122 | $ 39,515 |
| Interest expense | 558 | 605 | 642 | 672 | 2,477 |
| Net interest income | 9,107 | 9,078 | 9,403 | 9,450 | 37,038 |
| Provision for loan and lease losses | 75 | 380 | 385 | - | 840 |
| Non-interest income | 2,626 | 2,918 | 3,077 | 2,864 | 11,485 |
| Non-interest expenses | 8,227 | 8,254 | 8,570 | 9,021 | 34,072 |
| Income before income taxes | 3,431 | 3,362 | 3,525 | 3,293 | 13,611 |
| Income taxes | 842 | 815 | 912 | 732 | 3,301 |
| Net income available to common shareholders | $ 2,589 | $ 2,547 | $ 2,613 | $ 2,561 | $ 10,310 |
| Basic earnings per share | $ 0.55 | $ 0.55 | $ 0.57 | $ 0.56 | $ 2.22 |
| Weighted average shares outstanding | 4,739,502 | 4,658,005 | 4,584,146 | 4,556,029 | 4,634,171 |

## NOTE 14 – DEPOSITS

The Bank does not have any foreign offices and all deposits are serviced in its 22 domestic offices. Maturities of time deposits of $250,000 or more at December 31, 2017 and 2016 are as follows:

| | 2017 | 2016 |
|---|---|---|
| | (dollars in thousands) | |
| Under 3 months | $ 2,675 | $ 6,956 |
| 3 to 12 months | 19,457 | 26,735 |
| Over 12 months | 5,085 | 6,478 |
| Total | $ 27,217 | $ 40,169 |

At December 31, 2017 and 2016, the Bank had $356,000 and $78,000, respectively, of deposit accounts in overdraft status and thus have been reclassified to loans in the accompanying consolidated balance sheets.

The following table presents maturities of interest-bearing time deposits as of December 31, 2017:

| | (dollars in thousands) |
|---|---|
| 2018 | $ 147,454 |
| 2019 | 15,713 |
| 2020 | 7,803 |
| 2021 | 8,539 |
| 2022 | 12,934 |
| Thereafter | - |
| Total | $ 192,443 |

## NOTE 15 – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY

The following tables present the condensed balance sheet, statements of income, comprehensive income (loss), and cash flows of the Parent Company:

### CONDENSED BALANCE SHEET

| | As of December 31, | |
|---|---|---|
| | 2017 | 2016 |
| | (dollars in thousands) | |
| Cash | $ 594 | $ 563 |
| Investment in bank subsidiary | 124,671 | 114,036 |
| Investment in credit life insurance company | 54 | 54 |
| Investment in other securities | 17 | 17 |
| Dividends receivable from bank subsidiary | 1,029 | 863 |
| Cash surrender value - life insurance | - | 4,903 |
| Total assets | $ 126,365 | $ 120,436 |
| Liabilities | | |
| Accrued liabilities | $ 2,181 | $ 1,963 |
| Dividends payable | 899 | 863 |
| Total liabilities | 3,080 | 2,826 |
| Shareholders' equity | | |
| Common stock - $10 par value, 8,000,000 shares authorized; 4,493,855 and 4,542,303 shares issued and outstanding as of the periods presented | 44,939 | 45,423 |
| Retained earnings | 79,793 | 74,357 |
| Accumulated other comprehensive loss | (1,447) | (2,170) |
| Total shareholders' equity | 123,285 | 117,610 |
| Total liabilities and shareholders' equity | $ 126,365 | $ 120,436 |

## NOTE 15 – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY, (CONTINUED)

### CONDENSED STATEMENTS OF INCOME

| | Years ended December 31, | | |
|---|---|---|---|
| | **2017** | **2016** | **2015** |
| | | (dollars in thousands) | |
| Operating income | | | |
| Dividends from bank subsidiary | $ 6,674 | $ 11,178 | $ 8,002 |
| Other dividend income | - | 5 | - |
| Other | 95 | 77 | 72 |
| Operating expenses | (360) | (1,092) | (292) |
| Income before equity in undistributed net income of bank subsidiary | 6,409 | 10,168 | 7,782 |
| Equity in undistributed net income of bank subsidiary | 3,969 | 158 | 2,540 |
| Net income | $ 10,378 | $ 10,326 | $ 10,322 |
| Noncontrolling interest – dividends on preferred stock | (16) | (16) | (16) |
| Net income available to common shareholders | $ 10,362 | $ 10,310 | $ 10,306 |

## NOTE 15 – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY, (CONTINUED)

### CONDENSED STATEMENTS OF CASH FLOWS

| | Years ended December 31, | | |
|---|---|---|---|
| | 2017 | 2016 | 2015 |
| | | (dollars in thousands) | |
| Operating activities | | | |
| Net income | $ 10,378 | $ 10,326 | $ 10,322 |
| Adjustments to reconcile net income to net cash provided by operating activities | | | |
| Equity in undistributed net income of bank subsidiary | (3,969) | (158) | (2,540) |
| Increase in cash surrender value of life insurance contracts | (77) | (357) | (72) |
| (Increase) decrease in other assets | (166) | 892 | 59 |
| Increase (decrease) in payables | 217 | (36) | 288 |
| Total adjustments | (3,995) | 341 | (2,265) |
| Net cash provided by operating activities | 6,383 | 10,667 | 8,057 |
| Investing activities | | | |
| Purchase of single premium life insurance policies | (962) | - | - |
| Net cash used by investing activities | (962) | - | - |
| Financing activities | | | |
| Payment to repurchase common stock | (1,890) | (6,082) | (4,408) |
| Common stock dividends paid | (3,484) | (4,316) | (3,594) |
| Preferred stock of subsidiary dividends paid | (16) | (16) | (16) |
| Net cash used by financing activities | (5,390) | (10,414) | (8,018) |
| Increase in cash | 31 | 253 | 39 |
| Cash at beginning of year | 563 | 310 | 271 |
| Cash at end of year | $ 594 | $ 563 | $ 310 |

## NOTE 16 – EMPLOYEE BENEFIT PLANS

The Bank contributes to a qualified profit-sharing plan covering employees who meet participation requirements. To be eligible to participate, employees must complete 1,000 hours of service within the twelve-month time period following their date of hire. Employees must be age 20 or older. The amount of the contribution is at the discretion of the Bank's Board of Directors, up to the maximum deduction allowed for federal income tax purposes. Contributions to the plan, which amounted to $712,000, $791,000, and $885,000 in 2017, 2016 and 2015, respectively, are included in salaries and employee benefits expense.

On November 15, 2016, the Bank formalized a supplemental executive retirement plan ("SERP") for a key officer. The principal cost of this agreement is accrued over the anticipated remaining period of active employment, based on the present value of the expected retirement benefit. The related liability of approximately $332,000 and $33,000 was included in other liabilities as of December 31, 2017 and December 31, 2016, respectively.

The Company and Bank implemented a deferred compensation plan that permits directors to defer their director's fees and earn interest on the deferred amount at the wall street journal prime rate plus three percent. The agreements provide for a lump sum payment or 120 monthly payments of deferred fees plus accrued interest after retirement, separation from service, or death. The liability accrued for this plan totaled $6.8 million at December 31, 2017 and 2016. The charge to expense for the agreements was $837,000, $737,000 and $738,000 for the years ended December 31, 2017, 2016 and 2015, respectively.

## NOTE 17 – POST-RETIREMENT BENEFIT PLAN

Effective July 1, 2013, the Company revised its retiree medical benefit plan for employees who were hired before March 20, 2007. Newly retiring employees will no longer be offered medical, dental or life insurance coverage. Instead, qualified retirees will receive a post-retirement bonus. The Company will pay a post-retirement bonus equal to $20,000 to employees who: (i) were hired prior to March 20, 2007; (ii) retire on or after July 1, 2013; (iii) are at least age 59 ½ at the time of retirement; and (iv) have at least 25 years of service to the Company as of retirement. The bonus will be paid in a lump sum cash payment (subject to applicable tax withholding requirements) within 60 days after the employee's retirement, provided such retirement constitutes a "separation from service" under section 409A of the Internal Revenue Code. The Company still sponsors a defined benefit post-retirement health care plan for retirees who retired prior to July 1, 2007. Under this plan, premiums paid by retirees and spouses depend on date of retirement, age and coverage election.

The Company funding policy is to make the minimal annual contribution that is required by applicable regulations, plus such amounts as the Company may determine to be appropriate from time to time. The Company expects to contribute $143,000 to the plan in 2018.

The following table provides further information about the plan:

| | Post-retirement benefits | |
|---|---|---|
| | **2017** | **2016** |
| | (dollars in thousands) | |
| **Change in benefit obligation** | | |
| Benefit obligation at beginning of year | $ 2,170 | $ 2,241 |
| Service cost | 38 | 38 |
| Interest cost | 78 | 92 |
| Expected benefits paid | (159) | (161) |
| Actuarial gain | (83) | (40) |
| Benefit obligation at end of year | $ 2,044 | $ 2,170 |
| **Change in fair value of assets** | | |
| Fair value of plans assets at beginning of year | $ - | $ - |
| Employer contribution | 159 | 161 |
| Benefits paid | (159) | (161) |
| Fair value of plan assets at end of year | $ - | $ - |
| **Reconciliation of funded status to benefit costs recognized** | | |
| Projected benefit obligation, end of year | $ (2,044) | $ (2,170) |
| Fair value of assets, end of year | - | - |
| Funded status, end of year | $ (2,044) | $ (2,170) |

## NOTE 17 – POST-RETIREMENT BENEFIT PLAN, (CONTINUED)

Amounts recognized in accumulated other comprehensive income not yet recognized as components of net periodic benefit cost consist of:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Unrecognized net actuarial gain | $ | (1,912) | $ | (2,008) |
| Unrecognized prior service cost | | (31) | | (36) |
| | $ | (1,943) | $ | (2,044) |

Amounts recognized in statement of financial position are as follows:

| | 2017 | | 2016 | |
|---|---|---|---|---|
| | (dollars in thousands) | | | |
| Accounts payable and accrued liabilities | $ | 2,044 | $ | 2,170 |

A reconciliation of other comprehensive income (loss) is as follows:

| | Post-retirement benefits | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| | (dollars in thousands) | | | |
| Accumulated other comprehensive income (loss) beginning of year | $ | (2,044) | $ | (2,183) |
| Amortization of net actuarial gain | | 179 | | 174 |
| Gain incurred in current year | | (83) | | (40) |
| Prior service cost established in current year | | 5 | | 5 |
| Other comprehensive income (loss) | | 101 | | 139 |
| Ending balance (before tax effects) | $ | (1,943) | $ | (2,044) |

| | Post-retirement benefits | | | |
|---|---|---|---|---|
| | 2017 | | 2016 | |
| Components of net periodic benefit cost | (dollars in thousands) | | | |
| Service cost | $ | 38 | $ | 38 |
| Interest cost | | 78 | | 92 |
| Amortization of prior service cost | | (5) | | (5) |
| Recognized net actuarial gain | | (179) | | (174) |
| Net periodic benefit cost | $ | (68) | $ | (49) |

The estimated net gain for the defined benefits post-retirement plan that will be amortized from accumulated other comprehensive income into net periodic benefit cost over the next fiscal year is $190,000.

## NOTE 17 – POST-RETIREMENT BENEFIT PLAN, (CONTINUED)

| | Post-retirement benefits | |
|---|---|---|
| Weighted-average assumption used to determine benefit obligation: | **2017** | **2016** |
| Discount rate | 3.75% | 3.75% |
| Rate of compensation increase | NA | NA |

| | Post-retirement benefits | |
|---|---|---|
| Weighted-average assumptions used to determine benefit costs: | **2017** | **2016** |
| Discount rate | 3.75% | 4.25% |

The following table gives the Health Care Cost Trend, which is applied to gross charges, net claims and retiree paid premiums to reflect the Company's past practice and stated ongoing intention to maintain relatively constant cost sharing between the Company and retirees:

| Health care trend rate | **2017** | **2016** |
|---|---|---|
| Initial | | |
| Pre-65 | 9% | 9% |
| Post-65 | 8% | 8% |
| Ultimate (pre and post-65) | 5% | 5% |
| Years to ultimate | | |
| Pre-65 | 8 | 8 |
| Post-65 | 6 | 6 |

The following benefit payments, which reflect expected future service, as appropriate, are expected to be paid, net of participant contributions:

| **FYE** | **Company benefits** (dollars in thousands) |
|---|---|
| 2018 | $ 143 |
| 2019 | 143 |
| 2020 | 143 |
| 2021 | 180 |
| 2022 | 177 |
| 2023-2027 | 938 |
| | $ 1,724 |

Assumed health care cost trend rates have a significant effect on the amounts reported for the health care plans. A one-percentage-point change in assumed health care cost trend rates would have the following effects:

| | **1-percentage-point increase** | **1-percentage-point decrease** |
|---|---|---|
| | (dollars in thousands) | |
| Effect on total of service and interest cost | $ 8 | $ (4) |
| Effect on post-retirement benefit obligation | 163 | (93) |

## NOTE 18 – REGULATORY CAPITAL

The Company and the Bank are subject to various regulatory capital requirements administered by federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions, by regulators that, if undertaken, could have a direct material effect on the financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific guidelines that involve quantitative measure of the assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices.

The minimum capital level requirements applicable to bank holding companies and banks are:

(1) a common equity Tier 1 capital ratio of 4.5%;
(2) a Tier 1 risk-based capital ratio of 6%;
(3) a total risk-based capital ratio of 8%; and
(4) a Tier 1 leverage ratio of 4% for all institutions.

The capital level requirements also establish a "capital conservation buffer" of 2.5% (to be phased in over three years) above the regulatory minimum risk-based capital ratios, and result in the following required minimum ratios once the capital conservation buffer is fully phased in:

(1) a common equity Tier 1 risk-based capital ratio of 7%;
(2) a Tier 1 risk-based capital ratio of 8.5%; and
(3) a total risk-based capital ratio of 10.5%.

As of January 1, 2016, compliance with the capital conservation buffer is determined by increasing the capital ratio minimum by 0.625% for the capital ratio with the least spread between regulatory minimum and calculated ratios. The buffer will increase each year until fully implemented in January 2019. An institution will be subject to limitations on paying dividends, engaging in share repurchases and paying discretionary bonuses if capital levels fall below minimum levels plus the buffer amounts. These limitations establish a maximum percentage of eligible retained income that could be utilized for such actions. Management believes that, as of December 31, 2017, the Company and the Bank would meet all capital adequacy requirements on a fully implemented basis as if such requirements had been in effect.

To be considered well capitalized under applicable banking regulations, the Company and the Bank must maintain the following minimum capital ratios and not be subject to a written agreement, order or directive to maintain a higher capital level:

(1) a common equity Tier 1 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%.

Under capital level requirements, common equity Tier 1 capital generally consists of common stock (plus related surplus) and retained earnings plus limited amounts of minority interest in the form of common stock, less goodwill and other specified intangible assets and other regulatory deductions. Tier 1 capital generally consists of common stock (plus related surplus) and retained earnings, limited amounts of minority interest in the form of additional Tier 1 capital instruments, and non-cumulative preferred stock and related surplus, subject to certain eligibility standards, less goodwill and other specified intangible assets and other regulatory deductions. Tier 2 capital generally consists of subordinated debt (including that portion of subordinated debentures associated with trust preferred securities in excess of the amount that is treated as Tier 1 capital), types of preferred stock that don't qualify as Tier 1 capital and a limited amount of loan loss reserves, subject to certain eligibility criteria.

## NOTE 18 – REGULATORY CAPITAL, (CONTINUED)

The current capital level requirements allow banks and their holding companies with less than $250 billion in assets a one-time opportunity to opt out of a requirement to include unrealized gains and losses in accumulated other comprehensive income in their capital calculation. Both the Company and the Bank have opted out of this requirement.

Actual capital amounts and ratios are presented in the table below. Management believes, as of December 31, 2017, that the Company and the Bank met the guidelines to which they were subject.

| (Dollars in thousands) | Actual | | Minimum capital requirement | | Minimum to be well capitalized | |
|---|---|---|---|---|---|---|
| **As of December 31, 2017** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| Common equity Tier 1 (to Risk weighted assets) Consolidated | $ 115,714 | 12.8% | $ 40,688 | 4.5% | $ - | - |
| Bank | 117,099 | 12.9% | 40,694 | 4.5% | 58,780 | 6.5% |
| Total capital (to Risk weighted Assets) Consolidated | 124,836 | 13.8% | 72,334 | 8.0% | - | - |
| Bank | 126,221 | 14.0% | 72,345 | 8.0% | 90,431 | 10.0% |
| Tier 1 capital (to Risk weighted assets) Consolidated | 115,714 | 12.8% | 54,251 | 6.0% | - | - |
| Bank | 117,099 | 12.9% | 54,259 | 6.0% | 72,345 | 8.0% |
| Tier 1 capital (to average assets) Consolidated | 115,714 | 8.6% | 53,974 | 4.0% | - | - |
| Bank | 117,099 | 8.7% | 53,748 | 4.0% | 67,185 | 5.0% |

| (Dollars in thousands) | Actual | | Minimum capital requirement | | Minimum to be well capitalized | |
|---|---|---|---|---|---|---|
| **As of December 31, 2016** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| Common equity Tier 1 (to Risk weighted assets) Consolidated | $ 110,762 | 12.5% | $ 39,966 | 4.5% | $ - | - |
| Bank | 107,187 | 12.1% | 39,742 | 4.5% | 57,405 | 6.5% |
| Total capital (to Risk weighted Assets) Consolidated | 120,110 | 13.5% | 71,050 | 8.0% | - | - |
| Bank | 116,535 | 13.2% | 70,652 | 8.0% | 88,315 | 10.0% |
| Tier 1 capital (to Risk weighted assets) Consolidated | 110,762 | 12.5% | 53,287 | 6.0% | - | - |
| Bank | 107,187 | 12.1% | 52,989 | 6.0% | 70,652 | 8.0% |
| Tier 1 capital (to average assets) Consolidated | 110,762 | 8.4% | 52,708 | 4.0% | - | - |
| Bank | 107,187 | 8.2% | 52,513 | 4.0% | 65,641 | 5.0% |

The Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval. At December 31, 2017, approximately $7,982 of retained earnings were available for dividend declaration without prior approval.

## NOTE 19 – SUBSEQUENT EVENTS

FASB ASC Topic 855, "Subsequent Events", established general standards of accounting for a disclosure of events that occur after the balance sheet date but before financial statements are issued. The Company evaluated all events or transactions that occurred after December 31, 2017, through March 6, 2018. During this period there were no material recognizable subsequent events that required recognition or disclosures in the December 31, 2017 financial statements.