



FIRST FARMERS AND MERCHANTS CORPORATION AND SUBSIDIARIES

2018 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, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in shareholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2018, 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. 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, 2018 and 2017, and the results of their operations and their cash flows for each of the years in the three-year period ended December 31, 2018 in accordance with accounting principles generally accepted in the United States of America.



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, 2018, 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, 2019 expressed an unqualified opinion.

Dixon Hughes Goodman LLP

Atlanta, Georgia
March 6, 2019

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

		December 31, 2018	December 31, 2017
ASSETS	Cash and due from banks	\$ 36,100	\$ 26,878
	Interest-bearing deposits	4,173	26,371
	Federal funds sold	246	1,915
	Total cash and cash equivalents	40,519	55,164
	Securities:		
	Available-for-sale	332,237	371,773
	Held-to-maturity (fair market value \$17,615 and \$18,525 as of the periods presented)	18,644	18,675
	Total securities	350,881	390,448
	Loans, net of deferred fees	895,191	855,632
	Allowance for loan and lease losses	(9,282)	(9,122)
	Net loans	885,909	846,510
	Bank premises and equipment, net	31,605	28,787
	Bank-owned life insurance	31,960	32,091
	Goodwill	9,018	9,018
LIABILITIES	Deferred tax assets	3,062	2,445
	Other assets	12,163	11,356
	TOTAL ASSETS	\$ 1,365,117	\$ 1,375,819
	Deposits:		
	Noninterest-bearing	\$ 302,345	\$ 292,502
	Interest-bearing	872,325	914,047
	Total deposits	1,174,670	1,206,549
	Securities sold under agreements to repurchase	40,579	31,222
	Accounts payable and accrued liabilities	15,885	14,668
	FHLB borrowings	4,000	-
	TOTAL LIABILITIES	1,235,134	1,252,439
	Commitments and contingencies (Note 11)		
SHAREHOLDERS' EQUITY	Common stock - \$10 par value per share, 8,000,000 shares authorized; 4,451,447 and 4,493,855 shares issued and outstanding as of the periods presented	44,514	44,939
	Retained earnings	89,299	79,793
	Accumulated other comprehensive loss	(3,925)	(1,447)
	Total shareholders' equity attributable to First Farmers and Merchants Corporation	129,888	123,285
	Noncontrolling interest – preferred stock of subsidiary	95	95
	TOTAL SHAREHOLDERS' EQUITY	129,983	123,380
	TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$ 1,365,117	\$ 1,375,819

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,		
		2018	2017	2016
INTEREST AND DIVIDEND INCOME	Interest and fees on loans	\$ 37,821	\$ 34,504	\$ 32,056
	Income on investment securities			
	Taxable interest	5,347	4,852	4,785
	Exempt from federal income tax	2,508	2,566	2,258
	Interest from federal funds sold and other	217	171	232
	Total interest income	45,893	42,093	39,331
INTEREST EXPENSE	Interest on deposits	3,715	2,892	2,384
	Interest on other borrowings	457	209	93
	Total interest expense	4,172	3,101	2,477
	Net interest income	41,721	38,992	36,854
	Provision (credit) for loan and lease losses	50	(225)	840
	Net interest income after provision	41,671	39,217	36,014
NON-INTEREST INCOME	Mortgage banking activities	849	583	498
	Trust service fees	3,650	3,122	2,673
	Service fees on deposit accounts	7,186	6,925	6,451
	Investment services fee income	584	423	289
	Earnings on bank-owned life insurance	487	504	411
	(Loss) gain on sales of available-for-sale securities	(205)	21	267
	Gain on redemption of bank-owned life insurance	542	-	123
	Other non-interest income	726	681	725
	Total non-interest income	13,819	12,259	11,437
NON-INTEREST EXPENSE	Salaries and employee benefits	22,883	20,868	18,460
	Net occupancy expense	2,929	3,045	2,152
	Depreciation expense	1,514	1,472	1,406
	Core provider expense	2,818	2,732	2,576
	Software support and other computer expense	1,999	1,745	1,444
	Legal and professional fees	1,102	1,198	1,224
	Audits and exams expense	692	451	723
	Advertising and promotions	1,223	1,056	1,368
	FDIC insurance premium expense	432	630	621
	Other non-interest expense	3,092	3,174	3,850
	Total non-interest expenses	38,684	36,371	33,824
	Income before provision for income taxes	16,806	15,105	13,627
	Provision for income taxes	2,593	4,727	3,301
	Net income	14,213	10,378	10,326
	Noncontrolling interest – dividends on preferred stock of subsidiary	16	16	16
	Net income available to common shareholders	\$ 14,197	\$ 10,362	\$ 10,310
	Weighted average shares outstanding	4,477,947	4,523,677	4,634,171
	Earnings per share	\$ 3.17	\$ 2.29	\$ 2.22

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,		
	<u>2018</u>	<u>2017</u>	<u>2016</u>
Net income	\$ 14,213	\$ 10,378	\$ 10,326
Other comprehensive income (loss)			
Unrealized (depreciation) appreciation on available-for-sale securities, net of taxes of (\$701), \$426 and (\$400), respectively	(2,139)	812	(638)
Reclassification adjustment for realized losses (gains) included in net income, net of taxes of \$55, (\$8) and (\$103), respectively	156	(13)	(164)
Adjustment for amortization of net actuarial gains, net of taxes of (\$50), (\$47) and (\$67), respectively	(140)	(135)	(107)
Adjustment for actuarial (losses) gains incurred in current year, net of taxes of (\$5), \$21 and \$15, respectively	(14)	62	25
Adjustment for amortization of prior year service costs, net of taxes of (\$1), (\$2) and (\$2), respectively	<u>(4)</u>	<u>(3)</u>	<u>(3)</u>
Other comprehensive (loss) income	(2,141)	723	(887)
Total comprehensive income	<u>\$ 12,072</u>	<u>\$ 11,101</u>	<u>\$ 9,439</u>

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, 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
Net income				14,213		14,213
Other comprehensive loss					(2,141)	(2,141)
Adoption of ASU 2018-02				313	(337)	(24)
Repurchase under stock repurchase plan	(42,408)		(425)	(1,384)		(1,809)
Cash dividends declared, \$0.81 per share				(3,620)		(3,620)
Preferred dividends paid				(16)		(16)
Balance at December 31, 2018	4,451,447	\$ 95	\$ 44,514	\$ 89,299	\$ (3,925)	\$ 129,983

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,		
		2018	2017	2016
OPERATING ACTIVITIES	Net income	\$ 14,213	\$ 10,378	\$ 10,326
	Adjustments to reconcile net income to net cash provided by operating activities			
	Provision (provision credit) for loan and lease losses	50	(225)	840
	Depreciation of premises and equipment	1,514	1,472	1,406
	Deferred tax benefit	140	1,597	(649)
	Net losses (gains) on sales of available-for-sale securities	205	(21)	(267)
	Net gains on sales of premises and equipment	-	(7)	-
	Gains on mortgage loans sold	(833)	(557)	(472)
	Proceeds from sale of mortgage loans held-for-sale	29,580	18,268	17,422
	Funding of mortgage loans held-for-sale	(27,654)	(17,444)	(16,950)
	Loss on foreclosed property	-	-	5
	Amortization of investment security premiums, net of accretion of discounts	1,524	1,943	1,560
	Increase in cash surrender value of life insurance Contracts	(487)	(504)	(411)
	Changes in:			
	Other assets	(313)	(776)	(451)
	Other liabilities	967	870	(130)
	Net cash provided by operating activities	18,906	14,994	12,229
INVESTING ACTIVITIES	Proceeds from sales of available-for-sale securities	11,633	20,269	51,055
	Proceeds from maturities and calls of available-for-sale securities	71,545	54,713	68,190
	Proceeds from maturities and calls of held-to-maturity securities	-	330	1,540
	Purchases of available-for-sale investment securities	(48,036)	(54,846)	(119,390)
	Purchases of held-to-maturity investment securities	-	-	(16,534)
	Net increase in loans	(41,048)	(32,467)	(90,459)
	Proceeds from sale of other real estate owned	-	-	89
	Proceeds from sale of premises and equipment	-	7	-
	Purchases of premises and equipment	(4,332)	(2,665)	(3,484)
	Purchase of life insurance policies	-	(4,233)	(861)
	Proceeds from redemption of life insurance policy	618	-	470
	Net cash used in investing activities	(9,620)	(18,892)	(109,384)
FINANCING ACTIVITIES	Net (decrease) increase in deposits	(31,879)	42,726	60,022
	Net increase in securities sold under agreements to repurchase	9,357	3,644	3,401
	Increase (decrease) in FHLB and other borrowings	4,000	(15,000)	15,000
	Repurchase of common stock under reorganization plan	-	-	(3,062)
	Repurchase of common stock under stock repurchase plan	(1,809)	(1,890)	(3,020)
	Cash dividends paid on common stock	(3,584)	(3,484)	(4,316)
	Cash dividends paid on preferred stock of subsidiary	(16)	(16)	(16)
	Net cash (used in) provided by financing activities	(23,931)	25,980	68,009
	(Decrease) increase in cash and cash equivalents	(14,645)	22,082	(29,146)
	Cash and cash equivalents at beginning of period	55,164	33,082	62,228
	Cash and cash equivalents at end of period	\$ 40,519	\$ 55,164	\$ 33,082

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

Supplemental disclosures of cash flow information:	Years ended December 31,		
	2018	2017	2016
Cash paid during the period for:			
Interest on deposits and borrowed funds	\$ 3,948	\$ 2,891	\$ 2,413
Income taxes	\$ 2,533	\$ 2,662	\$ 3,352
Real estate acquired in settlement of loans	\$ -	\$ -	\$ 32
Noncash investing activities:			
Change in fair value of securities			
available-for-sale, net of tax	\$ (1,983)	\$ (799)	\$ (803)
Minimum pension liability adjustment, net of taxes	\$ (74)	\$ (73)	\$ (85)
Common dividends declared	\$ 3,620	\$ 3,520	\$ 3,426

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

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO 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, 2018, the Company had 1,046 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018, our concentrations of commercial real estate loans were 178.9% of Tier 1 Capital plus the allowance for loan and lease losses while our construction loans were 69.3%. These percentages are within our internally established limits regarding concentrations of credit.

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, 2018, 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 \$246,000 of federal funds sold as of December 31, 2018. 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 Accounting Standard Update ("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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 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, 2018 and 2017 totaled \$506,000 and \$1.6 million, respectively, and are recorded as loans on the consolidated balance sheet.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018 and 2017 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 2015.

The Company recognizes interest and penalties on income taxes as a component of income tax expense. As of December 31, 2018, the Company has accrued any interest or 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

Fair value of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect these estimates. See Note 12 – Fair Value Measurement.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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,		
	2018	2017	2016
	(dollars in thousands, expect per share data)		
Earnings per share calculation:			
Numerator – Net income available to common shareholders	\$ 14,197	\$ 10,362	\$ 10,310
Denominator – Weighted average common shares outstanding	4,477,947	4,523,677	4,634,171
Net income per common share available to common shareholders	\$ 3.17	\$ 2.29	\$ 2.22

In December 2017, the Company reauthorized a plan to repurchase up to 200,000 shares of its common stock during 2018. The Company repurchased 42,408, 48,448 and 94,970 shares in 2018, 2017, and 2016, 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,		
	2018	2017	2016
	(dollars in thousands)		
Net unrealized losses			
on available-for-sale securities	\$ (7,040)	\$ (4,356)	\$ (5,573)
Net actuarial gain on unfunded portion			
of post-retirement benefit obligation	1,729	1,943	2,044
	(5,311)	(2,413)	(3,529)
Tax benefit	1,386	966	1,359
Accumulated other comprehensive loss	\$ (3,925)	\$ (1,447)	\$ (2,170)

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 2018 or 2017.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 February of 2018, the FASB issued *ASU 2018-02 Income Statement – Reporting Comprehensive Income (Topic 220)*. ASU 2018-02 allows a reclassification from accumulated other 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 Company adopted the ASU in the first interim period of 2018. Upon adoption of this standard, the disproportionate tax effects lodged in accumulated other comprehensive income were reclassified to retained earnings and totaled \$313,000.

In January of 2016, the FASB issued *ASU 2016-01 Financial Instruments Overall (Topic 825)*. The amendments in ASU 2016-01: (1) 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; (2) simplify the impairment assessment of equity securities without readily determinable fair values by requiring a qualitative assessment to identify impairment; (3) 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; (4) require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (5) 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; (6) 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 (7) 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 an impact on the Company's financial position, results of operations or cash flows. The adoption of the ASU impacted the Company's Fair Value Measurement footnote disclosure by requiring the Company to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes and eliminating the disclosure previously required that explains methods and significant assumptions used to estimate the fair value of the financial instruments measured at amortized cost on the balance sheet. See Note 12 – Fair Value Measurement for more information on the impact of the new accounting standard.

In August of 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 Company adopted the new standard on January 1, 2018 and the adoption of the ASU did not have a material impact on the Company's financial position, results of operations, cash flows, or disclosures.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Recent Accounting Pronouncements, (continued)

In March of 2017, the FASB issued *ASU 2017-07 Compensation – Retirement Benefits (Topic 715)*. The amendments in this update apply to all employers, including not-for-profit entities that offer to their employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715. The Update requires that employers report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net periodic benefit cost as defined in paragraphs 715-30-35-4 and 715-60-35-9 are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed. For public business entities, the ASU is effective for fiscal years beginning after December 15, 2017, with early adoption permitted. The Company adopted the new standard on January 1, 2018 and the adoption of the ASU resulted in the reclassification of certain net periodic benefit cost components, other than service cost, from salaries and employee benefits expense to other non-interest expense for each year the income statement is presented. Because the Company did not use a separate line item on the income statement to present the other components of net periodic benefit cost, an additional disclosure was made to explain that the other components are reported on the statements of income in other non-interest expense. See Note 17 – Post Retirement Benefit Plan for more information on the impact of the new accounting standard.

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. The adoption of the ASU did not have a material impact on the Company's financial position, results of operations, cash flows, or disclosures.

On January 1, 2018, the Company adopted *ASU 2014-09 Revenue from Contracts with Customers* and all subsequent amendments to the ASU (collectively, "ASC 606"), which (1) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (2) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Company's revenues come from interest income and other sources, including loans and securities that are outside the scope of ASC 606. The Company's services that fall within the scope of ASC 606 are presented within Non-Interest Income and are recognized as revenue as the Company satisfies its obligations to the customer. Services within the scope of Topic 606 are trust service fees, service fees on deposit accounts, and investment service fees income. This guidance is effective for fiscal years, and interim periods, within those fiscal years, beginning after December 15, 2017. The Company adopted the amendments in this ASU effective January 1, 2018 using the modified retrospective method. Since there was no material change to net income impact upon adoption of the new guidance, a cumulative effect adjustment to opening retained earnings was not necessary. The Company completed an evaluation under ASU 2014-09 for costs related to revenue streams within the scope of ASC 606 to determine whether such costs should be presented as expenses or contra-revenue (i.e., gross vs. net). Based on this evaluation, we determined that the classification of cardholder processing expenses should be netted against cardholder services income. We used the full retrospective method of adoption and restated the prior financial statements to net the cardholder processing expenses against related cardholder income. The reclassification changes resulted in changes to both non-interest income and non-interest expense, however, there was no change to previously reported net income. Cardholder processing expenses of \$222,000, \$210,000 and \$237,000 have been reclassified and reported as a component of service fees on deposit accounts for the years ended December 31, 2018, 2017 and 2016, respectively. Additionally, adoption of this standard did further expand disclosures of accounting policies for revenue sources within scope of ASC 606. See Note 19 – Revenue from Contracts with Customers for more information on the impact of the new accounting standard.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Recent Accounting Pronouncements, (continued)

In February of 2016, the FASB issued *ASU 2016-02 Leases (Topic 842)*. ASU 2016-02 replaces existing guidance (ASC Topic 840) that requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The new guidance also requires enhanced disclosure about an entity's leasing arrangements. In July of 2018, the FASB issued *ASU 2018-11, Leases (Topic 842): Targeted Improvements* which provides an optional transition method to adopt the new requirements of ASU 2016-02 as of the adoption date with no adjustment to the presentation or disclosure of comparative periods included in the financial statement in the period of adoption. The Company adopted ASU 2016-02 effective January 1, 2019 electing the optional transition method which will result in presentation of periods prior to adoption under the prior lease guidance of ASC Topic 840. The effect of adopting this standard resulted in an approximate \$5.0 million increase in assets, \$5.2 million increase in liabilities, and a \$200,000 cumulative effect adjustment to January 1, 2019 retained earnings. The cumulative effect adjustment to opening retained earnings was based on the calculated impact to net income as if Topic 842 had been adopted at the earliest comparative period that will be presented in the 2019 financial statements.

In June of 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 still reviewing the impact of the adoption of this guidance with oversight by a cross-functional implementation team. The Company has a working CECL model in which the calculation has been updated for parallel comparison for the prior four quarters. In preparation of adoption of the standard, the cross-functional implementation team is overseeing continued enhancements to the working CECL model, along with evaluating needed changes to current internal controls and policies. Any adjustment to the allowance for loan and lease losses upon adoption will result in a corresponding adjustment to retained earnings. The ultimate amount of the adjustment will depend on the portfolio composition, credit quality, economic conditions and reasonable and supportable forecasts at that time.

In August of 2018, FASB issued *ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. This Update is part of the FASB's ongoing disclosure framework project and modifies disclosure requirements of fair value measurements. The guidance removed the requirement to disclose (1) the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, (2) the policy for timing of transfers between levels and (3) the valuation processes for Level 3 fair value measurements. The guidance also added required disclosures of the change in unrealized gains and losses for recurring Level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. The ASU is effective for annual reporting periods including interim periods within those annual reporting periods, beginning after December 15, 2019. Early adoption is permitted, including adoption in any interim period.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Recent Accounting Pronouncements, (continued)

In August of 2018, FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes to the Disclosure Requirements for Fair Value Measurement*. This update is part of the FASB’s ongoing disclosure framework project and modifies disclosure requirements of fair value measurements. The guidance removed the requirement to disclose (1) the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, (2) the policy for timing of transfers between levels and (3) the valuation processes for Level 3 fair value measurements. The guidance also added required disclosures of the change in unrealized gains and losses for recurring Level 3 fair value measurements and the range and the weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. The ASU is effective for annual reporting periods including interim periods within those annual reporting periods, beginning after December 15, 2019. Early adoption is permitted, including adoption in any interim period. The guidance is not expected to have a significant impact on the Company’s financial position, results of operations, cash flows, or disclosures.

In January of 2017, FASB issues ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU simplifies the subsequent measurement of goodwill and eliminates Step two from the goodwill impairment test. The Company should perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit’s fair value. The impairment charge is limited to the amount of goodwill allocated to that reporting unit. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017. The guidance is not expected to have a significant impact on the Company’s financial position, results of operations, or disclosures.

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,			Affected line item in the
	2018	2017	2016	Statements of income
Unrealized (losses) gains on available-for-sale securities	\$ (211)	\$ 21	\$ 267	(Loss) gain on sale of available-for-sale securities
	56	(8)	(103)	Benefit (provision) for income taxes
	<u>\$ (155)</u>	<u>\$ 13</u>	<u>\$ 164</u>	Net reclassified amount
Amortization of defined benefit pension items	\$ 190	\$ 179	\$ 174	Salaries and employee benefits
	(50)	(47)	(67)	Provision for income taxes
	<u>\$ 140</u>	<u>\$ 132</u>	<u>\$ 107</u>	Net reclassified amount
Total reclassifications out of AOCI	\$ (15)	\$ 145	\$ 271	

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 – SECURITIES

The amortized cost and fair value of securities available-for-sale and held-to-maturity at December 31, 2018 and 2017 are summarized as follows:

	<u>Amortized cost</u>	<u>Gross unrealized gains</u>	<u>Gross unrealized losses</u>	<u>Fair value</u>
December 31, 2018	(dollars in thousands)			
Available-for-sale securities:				
U.S. government sponsored agencies	\$ 58,704	\$ 5	\$ (716)	\$ 57,993
U.S. government sponsored agency mortgage backed securities	195,629	20	(5,751)	189,898
States and political subdivisions	64,440	217	(576)	64,081
Corporate bonds	20,504	-	(239)	20,265
	<u>\$ 339,277</u>	<u>\$ 242</u>	<u>\$ (7,282)</u>	<u>\$ 332,237</u>
Held-to-maturity securities:				
States and political subdivisions	<u>\$ 18,644</u>	<u>\$ 14</u>	<u>\$ (1,043)</u>	<u>\$ 17,615</u>
December 31, 2017				
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
	<u>\$ 376,129</u>	<u>\$ 1,173</u>	<u>\$ (5,529)</u>	<u>\$ 371,773</u>
Held-to-maturity securities:				
States and political subdivisions	<u>\$ 18,675</u>	<u>\$ 159</u>	<u>\$ (309)</u>	<u>\$ 18,525</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018 and 2017 was approximately \$294.0 million and \$303.7 million, which was approximately 86% and 82%, 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, 2018 and 2017 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, 2018 and 2017:

	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, 2018						
Available-for-sale securities:						
U.S. government sponsored agencies	\$ 5,996	\$ (13)	\$ 49,004	\$ (703)	\$ 55,000	\$ (716)
U.S. government sponsored agency mortgage backed securities	26,320	(99)	156,489	(5,652)	182,809	(5,751)
States and political subdivisions	27,006	(402)	8,906	(174)	35,912	(576)
Corporate bonds	4,471	(29)	15,795	(210)	20,266	(239)
	<u>\$ 63,793</u>	<u>\$ (543)</u>	<u>\$ 230,194</u>	<u>\$ (6,739)</u>	<u>\$ 293,987</u>	<u>\$ (7,282)</u>
Held-to-maturity securities:						
States and political subdivisions	<u>\$ 5,621</u>	<u>\$ (265)</u>	<u>\$ 10,451</u>	<u>\$ (778)</u>	<u>\$ 16,072</u>	<u>\$ (1,043)</u>
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)
	<u>\$ 120,042</u>	<u>\$ (790)</u>	<u>\$ 183,691</u>	<u>\$ (4,739)</u>	<u>\$ 303,733</u>	<u>\$ (5,529)</u>
Held-to-maturity securities:						
States and political subdivisions	\$ 1,876	\$ (49)	\$ 9,075	\$ (260)	\$ 10,951	\$ (309)

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3 – SECURITIES, (CONTINUED)

As shown in the tables above, at December 31, 2018, the Company had approximately \$8.3 million in unrealized losses on \$310.1 million of securities. The level of unrealized loss positions impacted all types of securities owned by the Company with the largest balance of unrealized losses recorded in 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 charge 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, 2018 and 2017, 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	
	Amortized Cost	Fair value	Amortized cost	Fair value
December 31, 2018				
	(dollars in thousands)			
Within one year	\$ 25,433	\$ 25,276	\$ 200	\$ 200
One to five years	65,324	64,565	-	-
Five to ten years	27,707	27,517	2,747	2,612
After ten years	25,184	24,981	15,697	14,803
Mortgage-backed securities	195,629	189,898	-	-
	<u>\$ 339,277</u>	<u>\$ 332,237</u>	<u>\$ 18,644</u>	<u>\$ 17,615</u>
December 31, 2017				
	(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	-	-
	<u>\$ 376,129</u>	<u>\$ 371,773</u>	<u>\$ 18,675</u>	<u>\$ 18,525</u>

The carrying value of securities pledged as collateral to secure public deposits and for other purposes was \$239.5 million and \$255.5 million at December 31, 2018 and 2017, respectively.

The book value of securities sold under agreements to repurchase amounted to \$40.6 million and \$37.5 million at December 31, 2018 and 2017, respectively.

	Years ended December 31,		
	2018	2017	2016
	(dollars in thousands)		
Gross gains recognized on sales of securities	\$ -	\$ 24	\$ 286
Gross losses recognized on sales of securities	(211)	(3)	(19)
Net realized gains on sales of securities available-for-sale	<u>\$ (211)</u>	<u>\$ 21</u>	<u>\$ 267</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – LOANS

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

	December 31, 2018	December 31, 2017
	(dollars in thousands)	
<u>Commercial</u>		
Commercial and industrial	\$ 105,550	\$ 117,742
Non-farm, non-residential real estate	212,305	190,590
Construction and development	82,633	60,116
Commercial loans secured by real estate	59,813	59,192
Other commercial loans	70,723	72,298
Total commercial loans	<u>531,024</u>	<u>499,938</u>
<u>Retail</u>		
Consumer loans	7,161	7,740
Single family residential	335,177	322,383
Other retail loans	21,829	25,571
Total retail loans	<u>364,167</u>	<u>355,694</u>
	\$ 895,191	\$ 855,632
Less:		
Allowance for loan and lease losses	(9,282)	(9,122)
Total net loans	<u>\$ 885,909</u>	<u>\$ 846,510</u>

The amount of capitalized fees, net calculated in accordance with accounting guidance included in the above loan totals were \$1.4 million and \$1.1 million at December 31, 2018 and 2017, 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, 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018, 41% of the outstanding principal balance of the Company's commercial real estate loans was secured by owner-occupied properties, compared to 44% at December 31, 2017. 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 196% 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – LOANS, (CONTINUED)

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

December 31, 2018	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	\$ 96	\$ 122	\$ 157	\$ 375	\$ 105,175	\$ 105,550
Non-farm, non-residential real estate	-	-	-	-	212,305	212,305
Construction and development	-	-	-	-	82,633	82,633
Commercial loans secured by real estate	-	913	163	1,076	58,737	59,813
Other commercial loans	-	-	-	-	70,723	70,723
Total commercial loans	96	1,035	320	1,451	529,573	531,024
Retail						
Consumer	11	1	22	34	7,127	7,161
Single family residential	2,678	592	203	3,473	331,704	335,177
Other retail loans	17	10	15	42	21,787	21,829
Total retail loans	2,706	603	240	3,549	360,618	364,167
Total	\$ 2,802	\$ 1,638	\$ 560	\$ 5,000	\$ 890,191	\$ 895,191

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	319,791	322,383
Other retail loans	276	14	-	290	25,281	25,571
Total retail loans	2,108	750	97	2,955	352,739	355,694
Total	\$ 2,280	\$ 755	\$ 457	\$ 3,492	\$ 852,140	\$ 855,632

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 had no loans that were 90 days or more past due that were not included in nonaccrual loans as of December 31, 2018. The Company had 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – LOANS, (CONTINUED)

The following table summarizes the impaired loans by loan type:

December 31, 2018	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	\$ 206	\$ 176	\$ 24	\$ 200	\$ -	\$ 225	\$ 14	\$ 12
Non-farm, non-residential real estate	192	192	-	192	-	211	13	12
Commercial total	<u>398</u>	<u>368</u>	<u>24</u>	<u>392</u>	<u>-</u>	<u>436</u>	<u>27</u>	<u>24</u>
Retail:								
Consumer loans	33	7	23	30	5	28	1	1
Single family residential	1,878	583	1,010	1,593	1	1,928	110	110
Other retail	26	25	-	25	-	27	1	1
Retail total	<u>1,937</u>	<u>615</u>	<u>1,033</u>	<u>1,648</u>	<u>6</u>	<u>1,983</u>	<u>112</u>	<u>112</u>
Total	<u>\$ 2,335</u>	<u>\$ 983</u>	<u>\$ 1,057</u>	<u>\$ 2,040</u>	<u>\$ 6</u>	<u>\$ 2,419</u>	<u>\$ 139</u>	<u>\$ 136</u>

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	<u>2,093</u>	<u>1,591</u>	<u>191</u>	<u>1,782</u>	<u>11</u>	<u>1,898</u>	<u>122</u>	<u>12</u>
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	<u>1,976</u>	<u>336</u>	<u>1,245</u>	<u>1,581</u>	<u>2</u>	<u>1,560</u>	<u>92</u>	<u>9</u>
Total	<u>\$ 4,069</u>	<u>\$ 1,927</u>	<u>\$ 1,436</u>	<u>\$ 3,363</u>	<u>\$ 13</u>	<u>\$ 3,458</u>	<u>\$ 214</u>	<u>\$ 21</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – LOANS, (CONTINUED)

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

	<u>December 31, 2018</u>	<u>December 31, 2017</u>
	(dollars in thousands)	
<u>Commercial</u>		
Commercial and industrial	\$ 200	\$ 228
Non-farm, non-residential real estate	192	1,554
Commercial loans secured by real estate	60	-
Total commercial loans	<u>452</u>	<u>1,782</u>
<u>Retail</u>		
Consumer loans	22	13
Single family residential	1,175	936
Other retail	25	17
Total retail loans	<u>1,222</u>	<u>966</u>
Total non-accrual loans	<u>\$ 1,674</u>	<u>\$ 2,747</u>

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 \$447,000 and \$425,000 at December 31, 2018 and 2017, respectively. As of December 31, 2018, the Company did not have any commitments to extend additional funds to borrowers with loans modified and included as a troubled debt restructuring. During 2018, 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – LOANS, (CONTINUED)

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

Twelve months ended December 31, 2018			
	Number of modifications	Post- modification outstanding balance	Net charge-offs resulting in modifications
		(dollars in thousands)	
<u>Retail</u>			
Consumer loans	3	\$ 11	\$ -
Total	3	\$ 11	\$ -
Twelve months ended December 31, 2017			
	Number of modifications	Post- modification outstanding balance	Net charge-offs resulting in modifications
		(dollars in thousands)	
<u>Commercial</u>			
Commercial and industrial	1	\$ 9	\$ -
<u>Retail</u>			
Consumer loans	1	12	-
Total	2	\$ 21	\$ -

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 \$8,000 and \$12,000, as of December 31, 2018 and 2017, 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, 2018 and 2017, 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, 2018 and 2017, 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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. These loans 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 current existing facts, conditions, and values, highly questionable and improbable.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4 – LOANS, (CONTINUED)

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

December 31, 2018

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	\$ 1,272	\$ 168	\$ -	\$ -	\$ 124	\$ 1,564
Risk rating 2 – modest risk	8,456	-	-	-	57,711	66,167
Risk rating 3 – average risk	13,593	56,882	9,809	7,295	767	88,346
Risk rating 4 – acceptable risk	74,139	144,782	72,229	51,957	12,118	355,225
Risk rating 5 – pass/watch	478	7,050	595	353	-	8,476
Risk rating 6 – special mention	2,625	-	-	133	3	2,761
Risk rating 7 – substandard	4,987	3,423	-	75	-	8,485
Totals	<u>\$ 105,550</u>	<u>\$ 212,305</u>	<u>\$ 82,633</u>	<u>\$ 59,813</u>	<u>\$ 70,723</u>	<u>\$ 531,024</u>

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	\$ 7,116	\$ 333,371	\$ 21,643	\$ 362,130
Risk rated 7*	45	1,806	186	2,037
Totals	<u>\$ 7,161</u>	<u>\$ 335,177</u>	<u>\$ 21,829</u>	<u>\$ 364,167</u>

*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 nonperforming.

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

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	<u>\$ 117,742</u>	<u>\$ 190,590</u>	<u>\$ 60,116</u>	<u>\$ 59,192</u>	<u>\$ 72,298</u>	<u>\$ 499,938</u>

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	<u>\$ 7,740</u>	<u>\$ 320,784</u>	<u>\$ 25,571</u>	<u>\$ 354,095</u>

*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 nonperforming.

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

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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; (v) changes in asset quality; (vi) new volume loan growth trends; (vii) the composition and concentrations of credit; (viii) the impact of competition on loan structuring and pricing; (ix) the effectiveness of the internal loan review function; and (x) 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

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

	Beginning balance	Charge-offs	Recoveries	Provision (provision credit)	Ending balance
December 31, 2018					
Commercial:					
Commercial and industrial	\$ 2,222	\$ -	\$ 61	\$ (15)	\$ 2,268
Non-farm, non-residential real estate	2,370	-	-	27	2,397
Construction and development	1,064	-	-	28	1,092
Commercial loans secured by real estate	1,439	-	-	1	1,440
Other commercial	705	-	21	(2)	724
Total commercial	<u>7,800</u>	<u>-</u>	<u>82</u>	<u>39</u>	<u>7,921</u>
Retail:					
Consumer loans	108	(5)	37	(1)	139
Single family residential	409	-	1	17	427
Other retail	805	(6)	1	(5)	795
Total retail	<u>1,322</u>	<u>(11)</u>	<u>39</u>	<u>11</u>	<u>1,361</u>
Totals	<u>\$ 9,122</u>	<u>\$ (11)</u>	<u>\$ 121</u>	<u>\$ 50</u>	<u>\$ 9,282</u>

	Beginning balance	Charge-offs	Recoveries	Provision (provision credit)	Ending balance
December 31, 2017					
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	<u>7,472</u>	<u>(114)</u>	<u>103</u>	<u>339</u>	<u>7,800</u>
Retail:					
Consumer loans	26	(10)	7	85	108
Single family residential	909	(23)	4	(481)	409
Other retail	941	-	32	(168)	805
Total retail	<u>1,876</u>	<u>(33)</u>	<u>43</u>	<u>(564)</u>	<u>1,322</u>
Totals	<u>\$ 9,348</u>	<u>\$ (147)</u>	<u>\$ 146</u>	<u>\$ (225)</u>	<u>\$ 9,122</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

The following tables detail the amount of the ALLL allocated to each portfolio segment as of December 31, 2018 and 2017, disaggregated on the basis of the Company's impairment methodology:

	Loans individually evaluated for impairment	Loans collectively evaluated for impairment	Ending balance
December 31, 2018			
Commercial:			
Commercial and industrial	\$ -	\$ 2,268	\$ 2,268
Non-farm, non-residential real estate	-	2,397	2,397
Construction and development	-	1,092	1,092
Commercial loans secured by real estate	-	1,440	1,440
Other commercial	-	724	724
Total commercial	-	7,921	7,921
Retail:			
Consumer loans	5	134	139
Single family residential	1	426	427
Other retail	-	795	795
Total retail	6	1,355	1,361
Totals	\$ 6	\$ 9,276	\$ 9,282

	Loans individually evaluated for impairment	Loans collectively evaluated for impairment	Ending balance
December 31, 2017			
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
Totals	\$ 13	\$ 9,109	\$ 9,122

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

The following tables show loans as of December 31, 2018 and 2017 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:

	Loans individually evaluated for impairment	Loans collectively evaluated for impairment	Ending balance
December 31, 2018			
Commercial:			
Commercial and industrial	\$ 200	\$ 105,350	\$ 105,550
Non-farm, non-residential real estate	192	212,113	212,305
Construction and development	-	82,633	82,633
Commercial loans secured by real estate	-	59,813	59,813
Other commercial	-	70,723	70,723
Total commercial	392	530,632	531,024
Retail:			
Consumer loans	30	7,131	7,161
Single family residential	1,593	333,584	335,177
Other retail	25	21,804	21,829
Total retail	1,648	362,519	364,167
Totals	\$ 2,040	\$ 893,151	\$ 895,191

	Loans individually evaluated for impairment	Loans collectively evaluated for impairment	Ending balance
December 31, 2017			
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	-	72,298	72,298
Total commercial	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	24	25,547	25,571
Total retail	1,581	352,514	351,095
Totals	\$ 3,363	\$ 850,670	\$ 854,033

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6 – PREMISES AND EQUIPMENT

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

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Land	\$ 13,053	\$ 10,248
Premises	26,607	26,098
Furniture and equipment	12,060	11,263
Leasehold improvements	2,120	2,024
Construction in progress	213	150
	<u>54,053</u>	<u>49,783</u>
Less accumulated depreciation	(22,448)	(20,996)
	<u>\$ 31,605</u>	<u>\$ 28,787</u>

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 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 and their related interests are impaired at December 31, 2018 and 2017. Changes in related party loans for the years ended December 31, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Related party extensions of credit, beginning of period	\$ 2,491	\$ 2,906
New loans	775	15
Repayments or reductions	(930)	(430)
Related party extension of credit, end of period	<u>\$ 2,336</u>	<u>\$ 2,491</u>

The aggregate balances of related party deposits at December 31, 2018 and 2017 were \$35.8 million and \$42.2 million, respectively.

The aggregate balances of related party repurchase agreements at December 31, 2018 and 2017 were \$27.0 million and \$21.7 million, respectively.

The Company and Bank utilize various services and purchased goods provided by certain related parties, in which some are governed by contractual agreements. Payments to directors and their related interests for services provided during 2018, 2017 and 2016 totaled \$221,000, \$260,000 and \$235,000, respectively.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 operating leases, including short-term leases with terms of less than one month, amounted to approximately \$14,000, \$14,000 and \$26,000 for small equipment leases and approximately \$578,000, \$569,000 and \$331,000 for building leases in 2018, 2017 and 2016, respectively. Additionally, the Bank leases certain IT hardware, which is accounted for as an operating lease. Lease expense for the IT hardware amounted to approximately \$50,000, \$49,000 and \$46,000, in 2018, 2017 and 2016, respectively. Future minimum lease commitments as of December 31, 2018 under all noncancelable operating leases with initial terms of one year or more are shown in the following table:

<u>Year</u>	<u>Lease payments</u>
	(dollars in thousands)
2019	\$ 599
2020	602
2021	606
2022	620
2023	608
Thereafter	3,228
Total	<u>\$ 6,263</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9 – FEDERAL AND STATE INCOME TAXES

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

	<u>2018</u>	<u>2017</u>	<u>2016</u>
	(dollars in thousands)		
Current	\$ 2,453	\$ 3,130	\$ 3,950
Deferred	140	571	(649)
Revaluation of net deferred tax asset	-	1,026	-
Total provision for income taxes	<u>\$ 2,593</u>	<u>\$ 4,727</u>	<u>\$ 3,301</u>

A reconciliation between reported income tax expense and the amounts computed by applying the U.S. federal statutory income tax rate of 21% for 2018 and 34% for 2017 and 2016 to income before income taxes is presented in the following table:

	<u>2018</u>	<u>2017</u>	<u>2016</u>
	(dollars in thousands)		
Tax expense at statutory rate	\$ 3,526	\$ 5,130	\$ 4,628
Increase (decrease) in taxes resulting from:			
Tax-exempt interest	(788)	(1,408)	(1,298)
Nondeductible interest expense	18	25	19
Employee benefits	(214)	(137)	(192)
Revaluation of net deferred tax asset	-	1,026	-
Other nondeductible expenses			
(nontaxable income) - net	16	28	76
State income taxes net of federal tax benefit	3	76	-
Other	32	(13)	68
Total provision for income taxes	<u>\$ 2,593</u>	<u>\$ 4,727</u>	<u>\$ 3,301</u>
Effective tax rate	<u>15.4%</u>	<u>31.3%</u>	<u>24.3%</u>

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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018 and 2017 were based on the U.S. statutory federal income tax rate of 21%.

	(dollars in thousands)	
	2018	2017
Deferred tax effects of principal temporary differences		
Allowance for possible loan and lease losses	\$ 2,426	\$ 2,384
Deferred compensation	1,977	1,881
Amortization of intangibles	(2,100)	(2,100)
Recognition of nonaccrual loan income	43	36
Unrealized losses on available-for-sale securities	1,837	1,137
Post-retirement benefit obligation	530	534
Accelerated depreciation	(720)	(626)
Prepaid expenses	(82)	(66)
REIT dividends	(671)	(641)
Loan fees	358	292
FHLB stock dividends	(428)	(428)
Other	(108)	42
Net deferred tax asset	<u>\$ 3,062</u>	<u>\$ 2,445</u>

No valuation allowance for deferred tax assets was recorded at December 31, 2018 and 2017 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 2015.

Tax Cuts and Jobs Act

The Tax Cuts and Jobs Act was enacted on December 22, 2017. Among other things the new law (i) established a new, flat corporate federal statutory income tax rate of 21%, (ii) eliminated 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) allowed businesses to immediately expense, for tax purposes, the cost of new investments in certain qualified depreciable assets, (v) eliminated or reduced 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 clarified 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.

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 was the tax rate at which these assets and liabilities were expected to reverse in the future. The Company recognized expense related to the revaluation of our deferred tax assets and liabilities totaling \$1.0 million. This expense was included in the 2017 provision for income taxes.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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. As of December 31, 2018, there were two outstanding CMA variable rate advances totaling \$4 million. There were no outstanding advances at December 31, 2017.

Stock held in the FHLB totaling \$3.0 million at December 31, 2018 and 2017 is carried at cost. The stock is restricted and can only be sold back to the FHLB at par. The stock is included in other assets on the balance sheet.

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, 2018 and 2017, disaggregated by the class of collateral pledged.

December 31, 2018		Overnight and Continuous
		(dollars in thousands)
Class of collateral pledged:		
U.S. government sponsored agencies	\$	40,579
December 31, 2017		Overnight and Continuous
		(dollars in thousands)
Class of collateral pledged:		
U.S. government sponsored agencies	\$	31,222

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 2018 and 2017 totaled \$40.7 million and \$34.2 million, respectively, and the monthly average of such agreements totaled \$36.1 million and \$30.0 million for 2018 and 2017, respectively. The agreements at December 31, 2018, mature January 2, 2019.

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, cash flows and disclosures 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, 2018 and 2017 were approximately \$440,000 and \$251,000, 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

Current Economic Conditions

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 \$3.5 million and \$3.1 million, at December 31, 2018 and 2017, respectively. Total mortgage loans held-for-sale amounted to \$506,000 and \$1.6 million, at December 31, 2018 and 2017, respectively.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 \$34.2 million and \$31.6 million, at December 31, 2018 and 2017, 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, 2018, the Company had granted unused lines of credit to borrowers for commercial lines and open-end consumer lines aggregating \$150.1 million and \$65.0 million, respectively. At December 31, 2017, unused lines of credit to borrowers for commercial lines and open-end consumer lines aggregated \$121.5 million and \$57.0 million, respectively.

NOTE 12 – FAIR VALUE MEASUREMENT

The fair value of an asset or liability is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in an orderly transaction between market participants on the measurement date. 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. The three levels of inputs that may be used to measure fair values are 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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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 2018 or 2017.

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, 2018				
Total carrying value	Level 1	Level 2	Level 3	
(dollars in thousands)				
Assets				
Available-for-sale investment securities:				
U.S. government sponsored agencies	\$ 57,993	\$ -	\$ 57,993	\$ -
U.S. government sponsored agency mortgage backed securities	189,898	-	189,898	-
State and political subdivision	64,081	-	64,081	-
Corporate bonds	20,265	-	20,265	-
Total assets at fair value	<u>\$ 332,237</u>	<u>\$ -</u>	<u>\$ 332,237</u>	<u>\$ -</u>

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	<u>\$ 371,773</u>	<u>\$ -</u>	<u>\$ 371,773</u>	<u>\$ -</u>

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, 2018.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018 and 2017, by the level within the fair value hierarchy utilized to measure fair value:

December 31, 2018	Level 1	Level 2	Level 3	Total
	(dollars in thousands)			
Impaired loans (collateral-dependent)	\$ -	\$ -	\$ 974	\$ 974
December 31, 2017	Level 1	Level 2	Level 3	Total
	(dollars in thousands)			
Impaired loans (collateral-dependent)	\$ -	\$ -	\$ 2,083	\$ 2,083

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 management. Appraisals are reviewed for accuracy and consistency by management. 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 management by comparison to historical results. There were no fair value adjustments at December 31, 2018 and \$11,000 at December 31, 2017.

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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018 and 2017, 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 management. Appraisals are required annually and reviewed for accuracy and consistency by management. 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				
	Fair value	Valuation technique(s)	Unobservable input	Range (weighted average)
December 31, 2018		(dollars in thousands)		
		Market comparable properties	Marketability discount	9.0% -10.0% (9.1%)
Impaired loans (collateral-dependent)	\$ 974			
Quantitative Information about Level 3 fair value measurements				
	Fair value	Valuation technique(s)	Unobservable input	Range (weighted average)
December 31, 2017		(dollars in thousands)		
		Market comparable properties	Marketability discount	9.0% - 10.0% (9.6%)
Impaired loans (collateral-dependent)	\$ 2,083			

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.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018

	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	\$ 36,100	\$ 36,100	\$ -	-
Interest-bearing deposits in other banks	4,173	4,173	-	-
Federal funds sold	246	246	-	-
Securities available-for-sale	332,237	-	332,237	-
Securities held-to-maturity	18,644	-	17,615	-
Loans, net	885,909	-	506	852,034
Federal Home Loan Bank and Federal Reserve Bank stock	3,879	-	3,879	-
Accrued interest receivable	4,422	-	4,422	-
Financial liabilities				
Non-interest bearing deposits	302,345	302,345	-	-
Interest-bearing deposits	872,325	-	862,691	-
Repurchase agreements	40,579	-	40,579	-
Accrued interest payable	1,001	-	1,001	-
FHLB borrowings				
Off-balance sheet credit related instruments:				
Commitments to extend credit and letters of credit	-	-	-	-

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12 – FAIR VALUE MEASUREMENT, (CONTINUED)

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, net	846,510	-	1,599	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	-	-	-	-

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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, 2018	June 30, 2018	September 30, 2018	December 31, 2018	Total
			(dollars in thousands)		
Interest income	\$ 10,774	\$ 11,280	\$ 11,613	\$ 12,226	\$ 45,893
Interest expense	840	908	1,098	1,326	4,172
Net interest income	9,934	10,372	10,515	10,900	41,721
Provision for loan and lease losses	-	-	-	50	50
Non-interest income	3,377	3,407	3,517	3,740	14,041
Non-interest expenses and non-controlling interest – preferred stock of subsidiary	9,611	9,071	9,733	10,507	38,922
Income before income taxes	3,700	4,708	4,299	4,083	16,806
Income taxes	571	803	708	511	2,593
Net income available to common shareholders	\$ 3,129	\$ 3,905	\$ 3,591	\$ 3,572	\$ 14,197
Basic earnings per share	\$ 0.70	\$ 0.87	\$ 0.80	\$ 0.80	\$ 3.17
Weighted average shares outstanding	4,493,000	4,484,717	4,472,684	4,461,790	4,477,947

	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 for loan and lease losses	-	-	-	(225)	(225)
Non-interest income	2,758	3,036	3,291	3,155	12,240
Non-interest expenses and non-controlling interest – preferred stock of subsidiary	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

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14 – DEPOSITS

The Bank does not have any foreign offices and all deposits are serviced in its 23 domestic offices. Maturities of time deposits of \$250,000 or more at December 31, 2018 and 2017 are as follows:

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Under 3 months	\$ 4,620	\$ 2,675
3 to 12 months	11,794	19,457
Over 12 months	<u>6,869</u>	<u>5,085</u>
Total	<u>\$ 23,283</u>	<u>\$ 27,217</u>

At December 31, 2018 and 2017, the Bank had \$198,000 and \$356,000, 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, 2018:

	(dollars in thousands)	
2019	\$	128,240
2020		23,124
2021		16,425
2022		8,276
2023		13,137
Thereafter		<u>67</u>
Total	<u>\$</u>	<u>189,269</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 15 – CONDENSED FINANCIAL INFORMATION OF THE PARENT COMPANY

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

CONDENSED BALANCE SHEET

	As of December 31,	
	2018	2017
	(dollars in thousands)	
Cash	\$ 632	\$ 594
Investment in bank subsidiary	131,266	124,671
Investment in credit life insurance company	54	54
Investment in other securities	-	17
Dividends receivable from bank subsidiary	935	1,029
(Due to) due from Bank	(7)	-
Total assets	<u>\$ 132,880</u>	<u>\$ 126,365</u>
Liabilities		
Accrued liabilities	\$ 2,057	\$ 2,181
Dividends payable	935	899
Total liabilities	<u>2,992</u>	<u>3,080</u>
Shareholders' equity		
Common stock - \$10 par value, 8,000,000 shares authorized; 4,451,447 and 4,493,855 shares issued and outstanding as of the periods presented	44,514	44,939
Retained earnings	89,299	79,793
Accumulated other comprehensive loss	(3,925)	(1,447)
Total shareholders' equity	<u>129,888</u>	<u>123,285</u>
Total liabilities and shareholders' equity	<u>\$ 132,880</u>	<u>\$ 126,365</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

CONDENSED STATEMENTS OF INCOME

	Years ended December 31,		
	2018	2017	2016
Operating income		(dollars in thousands)	
Dividends from bank subsidiary	\$ 5,774	\$ 6,674	\$ 11,178
Other dividend income	-	-	5
Other	21	95	77
Operating expenses	(360)	(360)	(1,092)
Income before equity in undistributed net income of bank subsidiary	5,435	6,409	10,168
Equity in undistributed net income of bank subsidiary	8,778	3,969	158
Net income	\$ 14,213	\$ 10,378	\$ 10,326
Noncontrolling interest – dividends on preferred stock	(16)	(16)	(16)
Net income available to common shareholders	\$ 14,197	\$ 10,362	\$ 10,310

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

CONDENSED STATEMENTS OF CASH FLOWS

	Years ended December 31,		
	2018	2017	2016
	(dollars in thousands)		
Operating activities			
Net income	\$ 14,213	\$ 10,378	\$ 10,326
Adjustments to reconcile net income to net cash provided by operating activities			
Equity in undistributed net income of bank subsidiary	(8,778)	(3,969)	(158)
Increase in cash surrender value of life insurance contracts	-	(77)	(357)
(Gain) on sale of investment	(6)	-	-
Decrease (increase) in other assets	118	(166)	892
(Decrease) increase in payables	(123)	217	(36)
Total adjustments	(8,789)	(3,995)	341
Net cash provided by operating activities	5,424	6,383	10,667
Investing activities			
Proceeds from sale of investment	23	-	-
Purchase of single premium life insurance policies	-	(962)	-
Net cash provided by (used in) investing activities	23	(962)	-
Financing activities			
Payment to repurchase common stock	(1,809)	(1,890)	(6,082)
Common stock dividends paid	(3,584)	(3,484)	(4,316)
Preferred stock of subsidiary dividends paid	(16)	(16)	(16)
Net cash used by financing activities	(5,409)	(5,390)	(10,414)
	38		
Increase in cash		31	253
Cash at beginning of year	594	563	310
Cash at end of year	\$ 632	\$ 594	\$ 563

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 \$1.2 million, \$712,000, and \$791,000 in 2018, 2017 and 2016, 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 \$606,000 and \$332,000 was included in other liabilities as of December 31, 2018 and 2017, respectively.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 16 – EMPLOYEE BENEFIT PLANS, (CONTINUED)

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 \$6.9 million and \$6.8 million at December 31, 2018 and 2017, respectively. The charge to expense for the agreements was \$844,000, \$837,000 and \$737,000 for the years ended December 31, 2018, 2017 and 2016, 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 \$148,000 to the plan in 2019.

The following table provides further information about the plan:

	Post-retirement benefits	
	2018	2017
	(dollars in thousands)	
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 2,044	\$ 2,170
Service cost	34	38
Interest cost	74	78
Expected benefits paid	(143)	(159)
Actuarial loss (gain)	19	(83)
Benefit obligation at end of year	<u>\$ 2,028</u>	<u>\$ 2,044</u>
Change in fair value of assets		
Fair value of plans assets at beginning of year	\$ -	\$ -
Employer contribution	143	159
Benefits paid	(143)	(159)
Fair value of plan assets at end of year	<u>\$ -</u>	<u>\$ -</u>
Reconciliation of funded status to benefit costs recognized		
Projected benefit obligation, end of year	\$ (2,028)	\$ (2,044)
Fair value of assets, end of year	-	-
Funded status, end of year	<u>\$ (2,028)</u>	<u>\$ (2,044)</u>

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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:

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Unrecognized net actuarial gain	\$ (1,703)	\$ (1,912)
Unrecognized prior service cost	(26)	(31)
	<u>\$ (1,729)</u>	<u>\$ (1,943)</u>

Amounts recognized in statement of financial position are as follows:

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Accounts payable and accrued liabilities	\$ 2,028	\$ 2,044

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

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Accumulated other comprehensive income (loss) beginning of year	\$ (1,943)	\$ (2,044)
Amortization of net actuarial gain	190	179
Loss (gain) incurred in current year	19	(83)
Prior service cost established in current year	5	5
Other comprehensive income (loss)	214	101
Ending balance (before tax effects)	<u>\$ (1,729)</u>	<u>\$ (1,943)</u>

	<u>2018</u>	<u>2017</u>
	(dollars in thousands)	
Components of net periodic benefit cost		
Service cost	\$ 34	\$ 38
Interest cost	74	78
Amortization of prior service cost	(5)	(5)
Recognized net actuarial gain	(190)	(179)
Net periodic benefit cost	<u>\$ (87)</u>	<u>\$ (68)</u>

The components of net periodic benefit cost other than the service cost component are included in the line item other non-interest expense in the income statement. 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 \$167,000.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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

	Post-retirement benefits	
	2018	2017
Weighted-average assumption used to determine benefit obligation:		
Discount rate	4.30%	3.75%
Rate of compensation increase	NA	NA
	Post-retirement benefits	
	2018	2017
Weighted-average assumptions used to determine benefit costs:		
Discount rate	4.30%	3.75%

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:

	2018	2017
Health care trend rate		
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)
2019	\$ 148
2020	143
2021	180
2022	178
2023	171
2024-2027	<u>972</u>
	<u>\$ 1,792</u>

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	\$ 7	\$ (4)
Effect on post-retirement benefit obligation	156	(96)

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 18 – REGULATORY CAPITAL

The Company and 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.

In May of 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act was signed into law. The new law makes a variety of changes aimed to simplify regulatory reporting requirements on community banks and scale down requirements previously required by Dodd-Frank Act. The new law contains a Small Bank Holding Company Policy statement which provides a capital requirement exemption for holding companies with total consolidated assets under \$3 billion. The Company, which was previously subject to similar regulatory capital requirements as the Bank, is now subject to the Federal Reserve’s “Small Bank Holding Company and Savings and Loan Policy Statement.” As such, the Company is no longer subject to certain capital adequacy guidelines and regulatory reporting.

To be considered well capitalized under applicable banking regulations, 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.

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. The Bank has opted out of this requirement.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 18 – REGULATORY CAPITAL, (CONTINUED)

Actual capital amounts and ratios are presented in the table below. Management believes, as of December 31, 2018, that the Bank met the guidelines to which they were subject.

(Dollars in thousands) As of December 31, 2018	Actual		Minimum capital requirement		Minimum to be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Common equity Tier 1 (to risk weighted assets)	\$ 126,174	13.4%	\$ 42,264	4.5%	\$ 61,049	6.5%
Total capital (to risk weighted assets)	135,456	14.4%	75,137	8.0%	93,921	10.0%
Tier 1 capital (to risk weighted assets)	126,174	13.4%	56,352	6.0%	75,137	8.0%
Tier 1 capital (to average assets)	126,174	9.3%	54,318	4.0%	67,897	5.0%

(Dollars in thousands) As of December 31, 2017	Actual		Minimum capital requirement		Minimum to be well capitalized	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Common equity Tier 1 (to risk weighted assets)	\$ 117,099	12.9%	\$ 40,694	4.5%	\$ 58,780	6.5%
Total capital (to risk weighted assets)	126,221	14.0%	72,345	8.0%	90,431	10.0%
Tier 1 capital (to risk weighted assets)	117,099	12.9%	54,259	6.0%	72,345	8.0%
Tier 1 capital (to average assets)	117,099	8.7%	53,748	4.0%	67,185	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, 2018, approximately \$9.2 million of retained earnings were available for dividend declaration without prior approval.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 19 – REVENUE FROM CONTRACTS WITH CUSTOMERS

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within non-interest income. The following table presents the Company's sources of non-interest income for the periods presented. Items outside the scope of ASC 606 are noted as such.

	Years ended December 31,		
	2018	2017	2016
	(dollars in thousands)		
Mortgage banking activities ⁽¹⁾	\$ 849	\$ 583	\$ 498
Trust service fees income	3,650	3,122	2,673
Service fees on deposit accounts			
Overdraft fees	2,245	2,147	1,996
Interchange income	2,995	2,772	2,520
Maintenance fees and charges	1,133	1,203	1,170
Other	813	803	765
Investment service fees income	584	423	289
Earnings on bank-owned life insurance ⁽¹⁾	487	504	411
(Loss) gain on sales of available-for-sale securities ⁽¹⁾	(205)	21	267
Gain on redemption of bank-owned life insurance ⁽¹⁾	542	-	123
Other non-interest income	726	681	725
Total non-interest income	<u>\$ 13,819</u>	<u>\$ 12,259</u>	<u>\$ 11,437</u>

⁽¹⁾ Not within the scope of ASC 606.

A description of the Company's revenue streams accounted for under ASC 606 follows:

Trust service fees - The Company earns wealth management fees from its contracts with trust customers to manage assets for investment, and/or to transact on their accounts. These fees are primarily earned over time as the Company provides the contracted monthly services and are generally assessed based on a tiered scale of the market value of assets under management at month-end. The fees are recognized monthly when the Company satisfies the performance obligation. Other services provided include third party benefit plan administration and estate management. Fees for third party benefit plan administration are billed quarterly or annually and accrued for over the period the performance obligation of administering the third party plan is being performed. Executor fees earned for estate management are a source of nonrecurring revenue and are recorded upon the satisfaction of the performance obligation, which is determined to be when the estate is closed and/or in some instances when the court has approved the executor's billing to the estate.

Service fees on deposit accounts - The Company earns fees on its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM usage fees, stop payment charges, statement rendering, and ACH fees are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Account maintenance fees are recognized in the same month the Company earns and satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

FIRST FARMERS AND MERCHANTS CORPORATON AND SUBSIDIARIES
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 19 – REVENUE FROM CONTRACTS WITH CUSTOMERS, (CONTINUED)

The Company earns interchange fees from debit cardholder transactions conducted through the Visa payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and is concurrent with the transaction processing services provided to the cardholder. Revenue activity associated with cardholder transactions is recognized on the business day the Company satisfies the performance obligation. Additionally, the Company is acting as an agent in providing cardholder services to customers, thus costs associated with cardholder transactions is netted against the fee income from such transactions.

Investment service fees income - The Company earns fees from investment brokerage services provided to its customers by a third-party service provider. The Company receives commissions from the third-party service provider on a bi-monthly basis based upon customer activity for the month. The fees are recognized monthly when the Company satisfies the performance obligation. Because the Company (1) acts as an agent in arranging the relationship between the customer and third-party service provider and (2) does not control the services rendered to the customer, investment brokerage fees are presented net of related servicing and administration costs.

NOTE 20 – 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, 2018, through March 6, 2019. On January 18, 2019, the Company sold its White Bluff office. The sale included loans, deposits and the branch real property. As part of the sale, the Company recorded a gain of \$2.7 million. There were no other material recognizable subsequent events that occurred after December 31, 2018 through the date of the independent auditor’s report that require recognition or disclosure in the December 31, 2018 financial statements.