

*2018*  
*Audited Financial*  
*Statements*

**FNBH** BANCORP INC



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## INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders  
FNBH Bancorp, Inc.  
Howell, Michigan

**Report on the Financial Statements**

We have audited the accompanying consolidated financial statements of FNBH Bancorp, Inc., which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the years then ended, and the related notes to consolidated financial statements.

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

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

***Auditor's Responsibility***

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

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

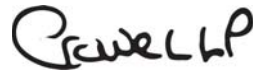
We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

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(Continued)

**Opinion**

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of FNBH Bancorp, Inc. as of December 31, 2018 and 2017, and the results of its operations and its cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in black ink that reads "Crowe LLP". The signature is written in a cursive, stylized font.

Crowe LLP

Grand Rapids, Michigan  
May 17, 2019

**FNBH Bancorp, Inc.**  
**Consolidated Balance Sheets**

	December 31, 2018	December 31, 2017
(in thousands, except share amounts)		
<b>Assets</b>		
Cash and due from banks	\$ 20,889	\$ 41,567
Federal funds sold	3,932	-
Short term investments	47	46
Total cash and cash equivalents	24,868	41,613
Interest-bearing time deposits with other financial institutions	494	941
<b>Investment securities:</b>		
Investment securities available for sale, at fair value	38,761	70,461
Investment securities held to maturity, at amortized cost	3,500	-
Equity securities, at fair value	564	-
FHLBI and FRB stock, at cost	1,445	1,445
Total investment securities	44,270	71,906
Loans held for sale	2,333	1,170
<b>Loans held for investment:</b>		
Commercial	43,243	33,190
Commercial real estate	157,707	133,694
Consumer real estate	69,946	69,336
Consumer and other	52,897	31,025
Total loans held for investment	323,793	267,245
Less allowance for loan losses	(5,655)	(4,897)
Net loans held for investment	318,138	262,348
Premises and equipment, net	6,680	7,034
Premises held for sale	570	-
Net deferred tax asset	2,712	3,569
Bank-owned life insurance	10,448	10,158
Accrued interest receivable and other assets	1,871	1,836
Total assets	\$ 412,384	\$ 400,575
<b>Liabilities and Shareholders' Equity</b>		
<b>Liabilities</b>		
<b>Deposits:</b>		
Demand (non-interest bearing)	\$ 141,405	\$ 135,853
NOW	49,224	41,021
Savings and money market	120,256	121,484
Time deposits	37,553	49,267
Brokered time	12,206	-
Total deposits	360,644	347,625
Other borrowings	-	5,000
Accrued interest payable and other liabilities	2,117	1,706
Total liabilities	362,761	354,331
<b>Shareholders' Equity</b>		
Preferred stock, no par value. Authorized 10,000 Series A shares and 20,000 Series B shares. No shares issued and outstanding	-	-
Common stock, no par value. Authorized 40,000,000 shares; 27,771,251 and 27,770,986 shares issued and outstanding at December 31, 2018 and 2017	25,610	25,572
Retained earnings	24,920	21,205
Deferred directors' compensation	63	101
Accumulated other comprehensive loss	(970)	(634)
Total shareholders' equity	49,623	46,244
Total liabilities and shareholders' equity	\$ 412,384	\$ 400,575

See accompanying notes to consolidated financial statements.

**FNBHBANCORP, INC.**  
**Consolidated Statements of Income**

	Year Ended December 31,	
	2018	2017
	(in thousands, except per share and share amounts)	
Interest and dividend income:		
Interest and fees on loans	\$ 14,067	\$ 10,821
Interest and dividends on investment securities:		
Taxable	1,607	2,193
Tax-exempt	-	3
Interest on time deposits with other financial institutions	16	21
Interest on cash and cash equivalents	191	132
Total interest and dividend income	15,881	13,170
Interest expense on deposits and other borrowings	534	524
Net interest income	15,347	12,646
Provision for loan losses	-	-
Net interest income after provision for loan losses	15,347	12,646
Noninterest income:		
Service charges on deposits and other fee income	2,266	2,056
Gain on sale of loans held for sale	743	83
Net loss on sales of investment securities available for sale	(1,169)	(184)
Loss recognized on the fair value of equity securities	(110)	-
Loss on sale of interest-bearing time deposits with other financial institutions	(7)	-
Loss on valuation write-down of premises held for sale	(60)	-
Net gain on other real estate owned and repossessed assets	-	93
Increase in cash value of bank-owned life insurance	290	158
Other	1	96
Total noninterest income	1,954	2,302
Noninterest expense:		
Salaries and employee benefits	7,799	6,373
Net occupancy expense	972	870
Equipment expense	307	303
Professional and service fees	1,264	1,121
Loan collection and foreclosed property expenses	202	234
Computer service fees	1,015	874
Director fees	204	140
FDIC assessment fees	119	123
Insurance	47	58
Printing and supplies	127	112
Advertising and marketing expenses	178	185
Other	1,032	875
Total noninterest expense	13,266	11,268
Income before income tax expense	4,035	3,680
Income tax expense	815	3,421
Net income	\$ 3,220	\$ 259
Per share statistics:		
Earnings per basic common share	\$ 0.12	\$ 0.01
Weighted-average common shares outstanding	27,771,678	27,771,678

See accompanying notes to consolidated financial statements.

**FNBH BANCORP, INC.**  
**Consolidated Statements of Comprehensive Income**

	Year Ending December 31,	
	2018	2017
	(in thousands)	
Net income	\$ 3,220	\$ 259
Other comprehensive income:		
Unrealized gains/losses on investment securities available for sale:		
Net unrealized holding gains (losses) arising during the year	(968)	1,080
Reclassification adjustment for net loss included in net income (presented in net loss on sales of investment securities available for sale)	1,169	184
Income tax expense (includes \$245 and \$63 of income tax benefit related to reclassification adjustments included in income tax expense)	(42)	(430)
Total other comprehensive income, net of income tax expense	159	834
Comprehensive income	\$ 3,379	\$ 1,093

See accompanying notes to consolidated financial statements.

**FNBH BANCORP, INC.**  
**Consolidated Statements of Shareholders' Equity**

	Preferred Stock	Common Stock	Retained Earnings	Deferred Directors' Compensation	Accumulated Other Comprehensive Loss	Total Shareholders' Equity
	(in thousands)					
Balances at January 1, 2017	\$ -	\$ 25,530	\$ 20,874	\$ 143	\$ (1,396)	\$ 45,151
Issued 283 shares for deferred directors' fees	-	42	-	(42)	-	-
Net income	-	-	259	-	-	259
Other comprehensive income	-	-	-	-	834	834
Reclassification of certain deferred tax items	-	-	72	-	(72)	-
Balances at December 31, 2017	-	25,572	21,205	101	(634)	46,244
Issued 265 shares for deferred directors' fees	-	38	-	(38)	-	-
Net income	-	-	3,220	-	-	3,220
Other comprehensive income	-	-	-	-	159	159
Cumulative effect adjustment, reclassification of unrealized gains on equity securities	-	-	495	-	(495)	-
Balances at December 31, 2018	<u>\$ -</u>	<u>\$ 25,610</u>	<u>\$ 24,920</u>	<u>\$ 63</u>	<u>\$ (970)</u>	<u>\$ 49,623</u>

See accompanying notes to consolidated financial statements.



**FNBH BANCORP, INC.**  
**Consolidated Statements of Cash Flows**

	Year Ended December 31,	
	2018	2017
	(in thousands)	
Cash flows from operating activities:		
Net income	\$ 3,220	\$ 259
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	448	466
Deferred income tax expense	815	3,421
Net amortization on investment securities available for sale	379	799
Net loss on sales of investment securities available for sale	1,169	184
Loss recognized on the fair value of equity securities	110	-
Loss on sale of interest-bearing time deposits with other financial institutions	7	-
Origination of loans held for sale	(33,493)	(6,385)
Proceeds from sales of loans held for sale	33,073	5,298
Gain on sale of loans held for sale	(743)	(83)
Loss on valuation write-down of premises held for sale	60	-
Net gain on other real estate owned and repossessed assets	-	(93)
Increase in cash value of bank-owned life insurance	(290)	(158)
Change in assets and liabilities:		
Accrued interest receivable and other assets	(52)	29
Accrued interest payable and other liabilities	411	141
Net cash provided by operating activities	<u>5,114</u>	<u>3,878</u>
Cash flows from (for) investing activities:		
Purchases of investment securities available for sale	(500)	(3,345)
Proceeds from sales of investment securities available for sale	24,095	63,285
Proceeds from maturities and calls of investment securities available for sale	500	200
Proceeds from principal paydowns on investment securities available for sale	5,584	11,955
Purchase of investment securities held to maturity	(3,500)	-
Proceeds from sale of interest-bearing time deposits with other financial institutions	440	-
Proceeds from sales of other real estate owned and repossessed assets	188	1,675
Net increase in loans held for investment (loans originated, net of principal payments)	(42,026)	(11,220)
Purchases of loans and leases held for investment	(13,963)	(30,898)
Purchase of bank-owned life insurance	-	(10,000)
Capital expenditures	(696)	(716)
Net cash provided by (used in) investing activities	<u>(29,878)</u>	<u>20,936</u>
Cash flows from financing activities:		
Net change in deposits	13,019	15,560
Net repayment of other borrowings	(5,000)	(15,500)
Net cash provided by financing activities	<u>8,019</u>	<u>60</u>
Net change in cash and cash equivalents	(16,745)	24,874
Cash and cash equivalents at beginning of year	41,613	16,739
Cash and cash equivalents at end of year	<u>\$ 24,868</u>	<u>\$ 41,613</u>
Supplemental disclosures:		
Interest paid	\$ 521	\$ 531
Loans held for investment transferred to other real estate owned and repossessed assets	199	1,451
Premises and equipment transferred to premises held for sale	630	-
Cash received for income taxes	-	60

See accompanying notes to consolidated financial statements.

## **FNBH Bancorp, Inc.**

### **Notes to Consolidated Financial Statements**

#### **1. Summary of Significant Accounting Policies**

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions based on available information that affect the amounts reported in the consolidated financial statements and the disclosures provided, and actual results could differ.

##### ***Principles of Consolidation***

The consolidated financial statements include the accounts of FNBH Bancorp, Inc. and its wholly owned subsidiaries, First National Bank in Howell (“the Bank”) and H.B. Realty Co. (herein collectively the “Corporation”). All intercompany balances and transactions have been eliminated in consolidation.

The Bank is a full-service, community based financial institution providing a range of commercial and personal banking services. These include a variety of checking and savings accounts for personal, commercial and non-profit entities, certificates of deposit, commercial equipment and real estate lending, treasury management solutions for businesses, residential mortgage lending, consumer lending options including indirect financing with local vehicle, recreational and marine dealers, and a host of value-added financial services for both businesses and households. The Bank primarily serves Livingston and the surrounding counties of SE Michigan, maintaining physical bank branch offices in five communities of Livingston County, specifically Brighton, Fowlerville, Green Oak Township, Hartland, and Howell. In addition, the Bank’s residential mortgage administration office is located in Waterford in neighboring Oakland County. The Bank is not dependent upon any single industry, business or line of business for its banking opportunities.

H.B. Realty Co. was established to purchase land for a future branch site of the Bank and to hold title to other Bank real estate when it is considered prudent to do so.

The accounting and reporting policies of the Corporation conform to accounting principles generally accepted in the United States of America and to general practice within the banking industry. The following is a description of the more significant of these policies.

##### **(a) *Cash and Cash Equivalents***

Cash and cash equivalents include cash on hand, due from banks, federal funds sold and short-term investments (securities with maturities equal to or less than 90 days). Cash flows are reported net for customer loan and deposit transactions, premises and equipment transactions (“capital expenditures”) and short-term borrowings with maturities of 90 days or less (“other borrowings”), as applicable.

##### **(b) *Interest-Bearing Time Deposits with Other Financial Institutions***

Interest-bearing time deposits with other financial institutions are recorded at cost and are federally insured. Reported balances at December 31, 2018 are scheduled to mature in 2020.

##### **(c) *Investment Securities***

The Bank classifies debt and equity investments as follows:

Debt securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Debt securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income, net of tax. Equity securities are carried at fair value, with changes in fair value reported in net income. Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment.

Interest income includes amortization or accretion of purchase premium or discount. Premiums and discounts on securities are amortized or accreted on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

On January 1, 2018, the Corporation adopted the new accounting standard for Financial Instruments, which requires equity investment (except 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. The adoption of this guidance resulted in a \$495,000 increase to beginning retained earnings and a \$495,000 decrease to beginning accumulated other comprehensive loss.

Management evaluates securities for other-than-temporary impairment (“OTTI”) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. In addition, with respect to the Corporation’s non-government agency CMO security, management completes a cash flow analysis with the assistance of a third-party specialist. The analysis considers assumptions regarding voluntary prepayment speed, default rate, and loss severity using the CMO’s original yield as the discount rate. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the consolidated statements of income and 2) other-than-temporary impairment (OTTI) related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

(d) ***Federal Home Loan Bank of Indianapolis (“FHLBI”) and Federal Reserve Bank (“FRB”) Stock***

The Bank is a member of the Federal Home Loan Bank System of Indianapolis (“FHLBI”) and the Federal Reserve Bank (“FRB”) and is required to invest in capital stock of the FHLBI and the FRB. The amount of required investment in the FHLBI is based on the level of borrowings and other factors, and the Bank may invest in additional amounts. FHLBI stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on the ultimate recovery of par value. The amount of the required investment in the FRB is determined by the FRB and is carried at cost based on the Bank’s capital and surplus. Both cash and stock dividends on FHLBI and FRB stock are recorded in interest and dividends on investment securities in the consolidated statements of income.

(e) ***Loans Held for Sale***

Mortgage loans originated and intended for sale in the secondary market are presented as loans held for sale and carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings. Mortgage loans held for sale are generally sold with servicing rights released. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the loan sold. If mortgage loans are sold with servicing rights retained, the carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Mortgage loans sold and serviced for others totaled \$7.2 million and \$1.0 million at December 31, 2018 and 2017, respectively.

(f) ***Loans Held for Investment (“Loans”)***

Loans are classified within loans held for investment when management has the intent and ability to hold the loan for the foreseeable future, or until maturity or payoff. The foreseeable future is a management judgment which is determined based upon the type of loan, business strategies, current market conditions, balance sheet management and liquidity needs. Management’s view of the foreseeable future may change based on changes in these conditions. When a decision is made to sell or securitize a loan that was not originated or initially acquired with the intent to sell or securitize, the loan is reclassified from loans held for investment into loans held for sale. Loans are classified as held for sale when management has the intent and ability to sell or securitize. Due to changing market conditions or other strategic initiatives, management’s intent with respect to the disposition of the loan may change, and accordingly, loans previously classified as held for sale may be reclassified into loans held for investment. Loans transferred between loans held for sale and loans held for investment classifications are recorded at the lower of cost or market at the date of transfer.

Loans held for investment are carried at the principal amount outstanding net of unamortized purchase premiums or discounts, deferred loan origination fees and costs, the allowance for loan losses, and fair value adjustments, if any.

Interest income on loans is accrued daily based on the outstanding principal balance. In general, for each loan class, the accrual of interest income is discontinued when a loan becomes 90 days past due and the borrower’s capacity to repay the loan and collateral values appear insufficient. However, loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due if, in management’s judgement, the borrower is unable to meet payment obligations as they become due or as required by regulatory provisions. All interest accrued but not received for all loans placed on nonaccrual is reversed from interest income. Delinquency status for all loans is based on the actual number of days past due as required by the contractual terms of the loan agreement.

Loan origination fees and certain direct loan origination costs are deferred and recognized in interest income using the level-yield method without anticipating prepayments. Net unamortized deferred loan fees amounted to approximately \$493,000 and \$265,000 at December 31, 2018 and 2017, respectively.

(g) ***Allowance for Loan Losses and Credit Commitments***

Some loans will not be repaid in full. Therefore, an allowance for loan losses is established based on management’s periodic evaluation of the loan portfolio and reflects an amount that, in management’s judgement, is adequate to absorb probable incurred credit losses in the existing portfolio. In evaluating the portfolio, management takes into consideration numerous factors, including current economic conditions, prior loan loss experience, nonperforming loan levels, the composition of the loan portfolio, and management’s evaluation of the collectability of specific loans, which includes analysis of the value of the underlying collateral or the present value of expected future cash flows. This overall evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. In addition, although management evaluates the adequacy of the allowance for loan losses based on information known to management at a given time, various regulatory agencies, based on the timing of their normal examination process, may require future additions to the allowance for loan losses.

The methodology for measuring the appropriate level of allowance for loan losses and related provision for loan losses for each portfolio segment relies on several key elements, which include specific allowances for loans considered impaired and general allowances for non-impaired loans, based on our internal loan grading system. General allocations, based primarily on historical trends, are provided for homogeneous groups or classes of loans with similar risk characteristics.

Loss factors are determined based on either actual loss history or migration analysis, by portfolio class and loan grade, and adjusted for significant qualitative and environmental factors that, in management’s judgement, affect the collectability of the portfolio at the analysis date. Migration analysis is used to determine loss factors for those portfolio classes containing a sufficient number and volume of loans (e.g., commercial, owner occupied, non-owner occupied, consumer home equity, residential mortgages and consumer loans) to generate loss rate information. For other portfolio classes, a rolling 12 quarter net loss history is used to compute historical loss experience, which may also be weighted to give emphasis to more recent quarters. However, in successive periods of either limited losses or net recoveries, look-back periods may be extended and/or current period weighting may be suspended to allow for inclusion of some representative estimate of probable credit losses to provide general allowance allocations.

In determining qualitative and environmental factor adjustments, especially in instances where current facts and circumstances have changed significantly enough to cause estimated credit losses to differ from historical loss experience, management considers both internal and external factors specific to each portfolio segment including, but not limited to, changes in lending policies and procedures, underwriting standards in

effect when existing loans were originated, current economic conditions, and values for underlying collateral for collateral dependent loans, as examples.

Within each commercial loan portfolio segment, a general allowance allocation is assigned to non-impaired loans based on the internal risk grade and class of such loans, as primarily determined based on underlying collateral; and if real estate secured, the type of real estate. Each risk grade within a portfolio class is assigned a loss allocation factor, adjusted for qualitative and environmental factors, as deemed appropriate. The higher a risk grade, the greater the assigned loss allocation factor.

Commercial equipment finance leases (included in the commercial loan portfolio segment) purchased from a leasing company known to the Bank are not subjected to the Bank's risk grading system due to a limited recourse agreement provided by the seller that limits the Bank's losses, as described in Note 3. Consequently, the allowance allocation assigned to the leases is based solely on an evaluation of qualitative and environmental factors considered applicable to the commercial equipment finance lease portfolio.

Groups of homogeneous noncommercial loans, such as mortgage - residential, home equity and home equity lines of credit, and consumer and other loans receive allowance allocations using loss rates determined by migration analysis, based on loan type rather than by risk grade. These allocations are adjusted for consideration of general economic and business conditions, credit quality and delinquency trends, collateral values, and recent loss experience for these similar pools of loans.

The Bank also maintains a reserve for losses on unfunded credit commitments and letters of credit to provide for the risk of loss inherent in these arrangements. The reserve is computed using the same methodology as that used to determine the allowance for loan losses. This reserve is reported as a liability in the consolidated balance sheets within accrued interest payable and other liabilities, while the corresponding provision for these losses is recorded in noninterest expense-other in the consolidated statements of income.

**(h) Nonperforming Assets**

Nonperforming assets are comprised of loans for which the accrual of interest has been discontinued, loans 90 days past due and still accruing, and other real estate owned, which has been acquired primarily through foreclosure and is awaiting disposition. Troubled debt restructured loans (TDRs) that are on accrual status and not past due 90 days or more are excluded from nonperforming loan totals.

Loans are generally placed on a nonaccrual status when principal or interest is past due 90 days or more and when, in the judgement of management, full collection of principal and interest is unlikely. At the time a loan is placed on nonaccrual status, interest previously accrued but not yet collected is charged against current interest income. Income on such loans is then recognized only to the extent that cash is received and where future collection of principal is probable. Payments on such loans are generally applied to the principal balance until qualifying to be returned to accrual status. Loans are considered for return to accrual status on an individual basis when interest and principal payments are current and future payments are reasonably assured.

TDRs represent loan modifications, including renewals, where concessions have been extended by the Bank due to financial difficulties experienced by the borrower. In addition, if the restructured loan is renewed at a market rate of interest and is structured consistent with normal lending practices, TDR classification may be removed. TDR loans may be considered for return to accrual status upon satisfaction of the timely, sustained performance requirements identified above and management's determination that future payments under the modified terms are reasonably assured.

The Bank considers a loan to be impaired when it is probable that it will be unable to collect all or part of amounts due according to the contractual terms of the loan agreement or the loan has been restructured and is classified as a troubled debt restructuring. Using an internal loan grading system, commercial purpose loans graded substandard or worse are individually evaluated for impairment if reported as nonaccrual and are greater than \$100,000 or part of an aggregate relationship exceeding \$100,000. Noncommercial purpose loans within the consumer real estate and consumer and other portfolio segments are subjected to impairment assessment upon certain triggering events such as delinquency, bankruptcy and restructuring, etc. Impairment is measured by comparing the Bank's recorded investment in the loan to the present value of expected future cash flows at the loan's effective interest rate, or, as a practical expedient, at the loan's observable market price, or the fair value of the collateral less estimated costs to sell if the loan is collateral dependent. Interest income on impaired loans is accrued based on the principal amounts outstanding. The accrual of interest is generally discontinued when an impaired loan becomes 90 days past due.

All cash payments received on impaired nonaccrual loans are generally applied to the principal balance until qualifying to be returned to accrual status. Cash payments received on accruing impaired loans, including accruing TDRs are applied to principal and interest pursuant to the terms of the related loan agreement.

The Bank charges off all or part of loans when amounts are deemed to be uncollectible, although collection efforts may continue and future recoveries may occur. In general, when available information confirms that loans or portions thereof, other than collateral dependent loans, are uncollectible, such amounts are promptly charged-off against the allowance for loan losses. When an impaired loan is collateral dependent, any portion of the loan balance in excess of the fair value of the collateral (or fair value less estimated costs to sell) is promptly charged-off against the allowance for loan losses.

**(i) Other Real Estate Owned**

Other real estate owned is recorded at the asset's estimated fair value, net of estimated disposal costs, at the time of foreclosure, establishing a new cost basis. Any write-downs at the time of foreclosure are charged to the allowance for loan losses. Expenses incurred in maintaining assets are recorded in loan collection and foreclosed property expenses in the consolidated statements of income. Any subsequent write-down to reflect a decline in fair value is recorded through a valuation allowance and a charge to net gain (loss) on other real estate owned and repossessed assets in the consolidated statements of income.

**(j) 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 Bank, (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 Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

**(k) Premises and Equipment**

Premises and equipment are stated at cost less accumulated depreciation. Depreciation, computed on the straight-line method, is recorded over the estimated useful lives of the assets. Estimated useful lives range up to 40 years for buildings, up to 7 years for furniture and equipment and up to 15 years for land improvements. Leasehold improvements are generally depreciated over the shorter of the respective lease term or estimated useful life.

Premises and equipment are evaluated periodically for impairment when events or changes in circumstances indicate the carrying amount may not be recoverable. Impairment exists when the expected undiscounted future cash flows of a long-lived asset are less than its carrying value. In that event, the Bank recognizes a loss for the difference between the carrying amount and the estimated fair value of the asset based on a quoted market price, if applicable, or a discounted cash flow analysis. Impairment losses on premises and equipment are recorded in noninterest expense-other in the consolidated statements of income.

Premises held for sale represents a commercial office building previously utilized in the Bank's operations and now being held for sale (see Note 6). Premises held for sale is carried at the asset's estimated fair value, net of estimated disposal costs. Any subsequent write-down to reflect a decline in fair value is recorded through a valuation allowance and charge to loss on valuation write-down of premises held for sale in the consolidated statements of income.

**(l) Income Tax Expense**

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the consolidated financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

A valuation allowance, if needed, reduces deferred tax assets to the expected amount more likely than not that is to be realized. Realization of the Corporation's deferred tax assets is primarily dependent upon the generation of a sufficient level of future taxable income. In preparation of income tax returns, tax positions are taken based on interpretation of federal and state income tax laws for which the outcome is uncertain. Management reviews and evaluates the status of tax positions. There were no unrecognized tax benefits during 2018 or 2017. Interest or penalties related to unrecognized tax benefits would be recorded in income tax expense.

**(m) Bank-owned Life Insurance**

The Bank has purchased life insurance on certain of its officers. Bank-owned life insurance is recorded at the amount that can be realized under the insurance contracts at the consolidated balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement. Increases in the asset value are recorded as earnings and included in noninterest income in the consolidated statements of income.

**(n) Stock-Based Compensation**

The Corporation has a legacy stock-based compensation plan which allowed former nonemployee directors to elect to receive stock in lieu of all or a portion of the fees payable to them as directors. The plan is described more fully in Note 14.

The Corporation awards stock appreciation rights (SAR) payable in cash to eligible officers of the Bank as a long-term incentive. Compensation cost is recognized ratably over the required service (vesting) period based on the excess, if any, of the fair market value of a share of the Corporation's common stock over the base price per share. SAR compensation is described more fully in Note 15.

**(o) Loan Commitments and Related Financial Instruments**

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and letters of credit, issued to meet customer financing needs. The face amount for these items represents the exposure to loss, before considering customer collateral or ability to repay. Such financial instruments are recorded when they are funded. Financial instruments with off-balance risk are disclosed more fully in Note 16.

**(p) Fair Value of Financial Instruments**

Fair values of financial instruments are estimated using market information and other assumptions (as more fully described in Note 19) and involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, assumptions and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or market conditions could significantly affect such estimates.

**(q) Common Stock Repurchases**

The Corporation records common stock repurchases at cost. A portion of the repurchase is charged to common stock based on the average per share dollar amount of stock outstanding, multiplied by the number of shares repurchased, with the remainder charged to retained earnings. Shares repurchased are retired. No common stock repurchases were made by the Corporation during 2018 or 2017.

**(r) Comprehensive Income**

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income includes unrealized gains and losses on investment securities available for sale, net of income tax expense which is also recognized as a separate component of shareholders' equity.

**(s) Earnings Per Basic Common Share**

Earnings per basic common share is calculated by dividing net income available to common shareholders by the weighted average number of common shares outstanding during the year. At December 31, 2018 and 2017, the respective total of weighted average common shares outstanding includes 438 and 703 of remaining common shares earned and available for distribution to certain former directors pursuant to a legacy deferred director compensation plan (Note 14).

(t) **Loss Contingencies**

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the consolidated financial statements.

(u) **Reclassifications**

Certain reclassifications in the prior years' consolidated financial statements have been made to conform to the current year presentation. Reclassifications had no effect on prior year net income or total shareholders' equity.

(v) **New Accounting Standards**

FASB issued ASU 2014-09, *Revenue from Contracts with Customers (Topic 606)*. This ASU, and all subsequent amendments to the ASU, creates a single framework for recognizing revenue from contracts with customers that are within its scope and revises when it is appropriate to recognize a gain or loss from the transfer of nonfinancial assets. The majority of the Corporation's revenues are derived from interest income and other sources, including loans, leases and securities, that are outside the scope of the ASU. The Corporation's primary revenue sources that are within the scope of the ASU, service charges on deposits, interchange income, and gains on the sale of other real estate owned, are presented within noninterest income in the accompanying consolidated statements of income and are recognized as revenue as the Corporation satisfies its obligations to the customer. Refer to Note 20 for further discussion of the Corporation's accounting policies for revenue sources within the scope of the ASU.

The Corporation adopted the ASU using the modified retrospective approach applied to all contacts not completed as of January 1, 2018. Results for 2018 are presented under the new ASU while 2017 results continue to be reported in accordance with previous GAAP. The adoption of the ASU did not result in a change to the accounting for any of the in-scope revenue streams; therefore, no cumulative effect was recorded.

FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10) – Recognition and Measurement of Financial Assets and Financial Liabilities*. This ASU amends existing guidance related to the accounting for certain financial assets and liabilities. These amendments, among other things, require equity investments (except 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, require public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset and eliminate the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost. Management reviewed the types of financial instruments impacted by this amended guidance and determined that the Corporation's Freddie Mac and Fannie Mae preferred stocks constitute equity instruments subject to this new ASU. Accordingly, the Corporation adopted the amended guidance on January 1, 2018 using a modified retrospective approach which resulted in the reclassification of \$495,000 of unrealized gains, net of \$131,000 of deferred tax assets on the preferred stocks from accumulated other comprehensive loss to retained earnings. In addition, this amended guidance impacted certain fair value disclosure items (see Note 19).

FASB issued ASU 2016-02, *Leases (Topic 842)*. This ASU amends existing guidance related to the accounting for leases. These amendments, among other things, require lessees to account for most leases on the consolidated balance sheet while recognizing expense in the consolidated statement of income in a manner similar to existing guidance. For lessors the guidance modifies the classification criteria and the accounting for sales-type and direct finance leases. This amended guidance became effective for the Corporation on January 1, 2019 and did not have a material impact on the Corporation's consolidated operating results or financial condition given the nature and limited number of the Corporation's existing operating leases (see Note 12). The primary impact was the recognition of certain operating leases on the consolidated balance sheet which resulted in the recording of right to use assets and offsetting lease liabilities each totaling approximately \$316,000 at January 1, 2019.

FASB issued ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326), Measurement of Credit Losses on Financial Instruments*. This ASU significantly changes how entities will measure credit losses for most financial assets and certain other instruments that are not measured at fair value through net income. This ASU will replace today's "incurred loss" approach with an "expected loss" model for instruments measured at amortized cost. For securities available for sale, allowances will be recorded rather than reducing the carrying amount as is done under the current other-than-temporary impairment model. This ASU also simplifies the accounting model for purchased credit-impaired debt securities and loans. The amended guidance is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Management continues to stay abreast of industry and regulatory developments regarding the new credit loss guidance and consults periodically with the Corporation's advisors (e.g., external auditors and consultants) on implementation ideas and best practices. In addition, management has evaluated and purchased a software license to facilitate calculation of the allowance for loan losses under the expected credit loss model. As management develops greater proficiency with the software, results of additional data analysis, alternative credit loss methodologies, test calculations, and forecasting capabilities will be reviewed during 2019. Although the impact of the new standard on the Corporation's consolidated financial statements has not yet been quantified, management generally agrees the ASU will result in increased levels of allowance for loan losses as credit losses become accelerated with the elimination of the probable threshold used for "incurred loss" recognition.

FASB issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Comprehensive Income*. This ASU provides accounting guidance which eliminates the stranded tax effects associated with the change in the federal corporate income tax rate included in the Tax Cuts and Jobs Act of 2017. The guidance allows a reclassification from accumulated other comprehensive loss to retained earnings based on the difference between the historical corporate income tax rate and the enacted 21% corporate income tax rate. Although the update is effective for fiscal years beginning after December 31, 2018, the Corporation elected to early adopt the guidance in 2017 resulting in \$72,000 being reclassified from accumulated other comprehensive loss to retained earnings.

## 2. Investment Securities

Investment securities available for sale consist of the following:

	Amortized Cost	Unrealized		Fair Value
		Gains	Losses	
(in thousands)				
<b>December 31, 2018</b>				
Mortgage-backed/CMO - residential	\$ 15,765	\$ 5	\$ (347)	\$ 15,423
U.S. agency	797	-	(10)	787
Obligations of state and political subdivisions	15,256	-	(600)	14,656
Corporate bonds	7,925	53	(83)	7,895
Total investment securities available for sale	<u>\$ 39,743</u>	<u>\$ 58</u>	<u>\$ (1,040)</u>	<u>\$ 38,761</u>
(in thousands)				
<b>December 31, 2017</b>				
Mortgage-backed/CMO - residential	\$ 32,661	\$ 135	\$ (310)	\$ 32,486
U.S. agency	918	8	-	926
Obligations of state and political subdivisions	29,302	5	(1,099)	28,208
Corporate bonds	8,088	105	(26)	8,167
Preferred stock <sup>(1)</sup>	49	625	-	674
Total investment securities available for sale	<u>\$ 71,018</u>	<u>\$ 878</u>	<u>\$ (1,435)</u>	<u>\$ 70,461</u>

<sup>(1)</sup> Represents preferred stocks issued by Freddie Mac and Fannie Mae

Investment securities held to maturity consist of the following:

	Amortized Cost	Unrealized		Fair Value
		Gains	Losses	
(in thousands)				
<b>December 31, 2018</b>				
Corporate bonds	\$ 3,500	\$ -	\$ -	\$ 3,500
Total investment securities held to maturity	<u>\$ 3,500</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,500</u>

No investment securities held to maturity were owned by the Corporation at December 31, 2017.

The amortized cost and fair value of investment securities available for sale, by contractual maturity, follow. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	December 31, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(in thousands)				
Maturing within one year	\$ 2,193	\$ 2,180	\$ 503	\$ 503
Maturing after one year but within five years	9,179	8,898	12,812	12,572
Maturing after five years but within ten years	12,606	12,260	24,993	24,226
Maturing after ten years	-	-	49	674
	<u>\$ 23,978</u>	<u>\$ 23,338</u>	<u>\$ 38,357</u>	<u>\$ 37,975</u>
Mortgage-backed/CMO securities - residential	15,765	15,423	32,661	32,486
Total	<u>\$ 39,743</u>	<u>\$ 38,761</u>	<u>\$ 71,018</u>	<u>\$ 70,461</u>

The contractual maturity of the Corporation's \$3.5 million corporate bond investment security held to maturity occurs in 2023. The issuer has the right to prepay the obligation, in full, or in part any time after June 18, 2019.

Securities are reviewed quarterly for possible other-than-temporary impairment (OTTI) based on guidance included in ASC Topic 320, *Investments—Debt and Equity Instruments*. This guidance requires an entity to assess whether it intends to sell, or whether it is more likely than not that it will be required to sell, a security in an unrealized loss position before the recovery of the security's amortized cost basis. If either of these criteria is met, the entire difference between the amortized cost and fair value is recognized in earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment recognized in earnings is limited to the amount related to credit losses, while impairment related to other factors is recognized in other comprehensive income.

Management's review of the investment securities portfolio for the existence of OTTI considers various qualitative and quantitative factors regarding each investment category, including if the securities were U.S. government issued, the credit rating on the securities, credit outlook, payment status

and financial condition, the length of time the security has been in an unrealized loss position, the size of the unrealized loss position and other meaningful information.

As of December 31, 2018, the Corporation's investment securities available for sale portfolio consisted of 68 securities, 59 of which were in an unrealized loss position.

At December 31, 2018, the Corporation held 17 mortgage-backed/CMO - residential securities in an unrealized loss position, all of which were issued by either Ginnie Mae, Fannie Mae, or Freddie Mac which are U.S. government-sponsored agencies that the government has affirmed its commitment to support. Additionally, the Corporation held one U.S. agency security, 28 obligations of state and political subdivision securities and 13 corporate bonds in an unrealized loss position. Because the decline in the market value of these securities is attributable to changes in interest rates and illiquidity, and not credit quality and because the Corporation does not have the intent to sell these securities and it is likely that it will not be required to sell these securities before their anticipated recovery, the Corporation does not consider these securities to be other than temporary impaired at December 31, 2018.

Until the security was sold in 2018, the Corporation made a quarterly assessment of OTTI on its non-government agency collateralized mortgage obligation (CMO) based on a quarterly cash flow analysis performed by an independent third-party specialist. The evaluation included a comparison of the present value of the expected cash flows to previous estimates to determine whether adverse changes in cash flows resulted during the period. The analysis considered attributes of the security, such as its super tranche position, and specific loan level collateral underlying the security. At December 31, 2017, based on a present value at a prospective yield of future cash flows for the investment as provided by the specialist and after management's evaluation of the reasonableness of the specialist's underlying assumptions regarding Level 2 and Level 3 inputs, the Corporation concluded that the security's expected cash flows continued to support the amortized cost of the security and no additional other-than-temporary impairment had been incurred. Through the date of sale in 2018 and at December 31, 2017, approximately \$290,000 of cumulative credit-loss OTTI charges had been incurred on the security, but none during either 2018 or 2017. During 2018, the non-government agency collateralized mortgage obligation (CMO) was sold for \$657,000 and the Corporation realized a gain on sale of the security of approximately \$120,000 which is included in net loss on sales of investment securities available for sale in the consolidated statements of income.

The following is a summary of the gross unrealized losses and fair value of investment securities available for sale by length of time that individual securities have been in a continuous loss position:

	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
	(in thousands)					
<b>December 31, 2018</b>						
Mortgage-backed/CMO - residential	\$ (13)	\$ 790	\$ (334)	\$ 13,518	\$ (347)	\$ 14,308
U.S. agency	(10)	787	-	-	(10)	787
Obligations of state and political subdivisions	(5)	996	(595)	13,660	(600)	14,656
Corporate bonds	(31)	1,830	(52)	3,316	(83)	5,146
<b>Total</b>	<u>\$ (59)</u>	<u>\$ 4,403</u>	<u>\$ (981)</u>	<u>\$ 30,494</u>	<u>\$ (1,040)</u>	<u>\$ 34,897</u>
	<u>Less than 12 months</u>		<u>12 months or more</u>		<u>Total</u>	
	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value
	(in thousands)					
<b>December 31, 2017</b>						
Mortgage-backed/CMO - residential	\$ (147)	\$ 19,530	\$ (163)	\$ 7,134	\$ (310)	\$ 26,664
Obligations of state and political subdivisions	(44)	2,226	(1,055)	24,973	(1,099)	27,199
Corporate bonds	(2)	2,157	(24)	1,349	(26)	3,506
<b>Total</b>	<u>\$ (193)</u>	<u>\$ 23,913</u>	<u>\$ (1,242)</u>	<u>\$ 33,456</u>	<u>\$ (1,435)</u>	<u>\$ 57,369</u>

Proceeds from sales of investment securities available for sale and the associated gains and losses are as follows:

	<u>2018</u>		<u>2017</u>	
	(in thousands)			
Proceeds	\$	24,095	\$	63,485
Gross gains		120		199
Gross losses		(1,289)		(383)

The tax benefit related to these net realized losses was \$(245) and \$(63), respectively.

At December 31, 2018 and 2017, the Corporation did not own any investment securities issued by states and political subdivisions in which the amortized cost and fair value of such securities individually exceeded 10% of total shareholders' equity.

Investment securities, with an amortized cost of approximately \$23.6 million at December 31, 2018 were pledged to secure public deposits and for other purposes required or permitted by law, including approximately \$734,000 of securities pledged as collateral at the Federal Home Loan Bank of



Indianapolis (FHLBI) to support potential liquidity needs of the Bank. At December 31, 2017, the amortized cost of pledged investment securities totaled \$46.2 million of which \$10.5 million of securities were pledged as collateral at the FHLBI for contingent liquidity needs of the Bank.

The Corporation's preferred stocks have been classified as equity securities at fair value, effective on January 1, 2018 pursuant to the adoption of ASU 2016-01 (see Note 1). Previously, these preferred stocks were classified as securities available for sale. During 2018, the Corporation recognized \$110,000 of unrealized losses in net income related to depreciation in the fair value of the preferred stocks, reported as loss recognized on the fair value of equity securities in the consolidated statements of income.

The Bank owns stock in both the Federal Home Loan Bank of Indianapolis (FHLBI) and the Federal Reserve Bank (FRB), both of which are recorded at cost. The Bank is required to hold stock in the FHLBI equal to 5% of the institution's borrowing capacity with the FHLBI. The Bank's investment in FHLBI stock amounted to \$922,000 at both December 31, 2018 and 2017, respectively. The Bank's investment in FRB stock, which totaled \$523,000 at both December 31, 2018 and 2017, respectively, is a requirement for the Bank's membership in the Federal Reserve System. These investments can only be resold to, or redeemed by, the issuer.

### 3. Loans Held for Investment

Loans held for investment consists of the following:

	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
	(in thousands)	
<b>Commercial</b>	\$ 43,332	\$ 33,232
<b>Commercial real estate:</b>		
Construction, land development, and other land	17,272	5,606
Owner occupied	68,787	53,905
Nonowner occupied	71,971	74,355
<b>Consumer real estate:</b>		
Commercial purpose	10,250	7,272
Mortgage - residential	44,231	46,447
Home equity and home equity lines of credit	15,544	15,664
<b>Consumer and other</b>	52,899	31,029
Subtotal	<u>324,286</u>	<u>267,510</u>
Net deferred loan fees	(493)	(265)
<b>Total loans held for investment</b>	<u><u>\$ 323,793</u></u>	<u><u>\$ 267,245</u></u>

At December 31, 2018 and 2017, commercial loans include approximately \$20.1 million and \$14.6 million of discounted commercial equipment finance leases purchased from, originated by and serviced by a leasing company known to the Bank. The Bank periodically purchases pools of discounted equipment lease cash flows to diversify geographically and by loan type. Pools generally range from \$1 million to \$3 million in size and are comprised of fully-amortizing leases (i.e., no residuals). Individual leases are generally \$50,000 or less with terms of 5-years or less and are generally made to lessees outside the Bank's immediate market area.

In addition, a portion of the consumer real estate loans include commercial purpose loans where the borrower has pledged a 1-4 family residential property as collateral. Loans also include the reclassification of demand deposit overdrafts, which amounted to \$145,000 and \$40,000 at December 31, 2018 and 2017, respectively.

Loans serviced for others, including residential mortgages serviced for Freddie Mac and the FHLB and commercial participations sold, are not reported as assets of the Bank. At December 31, 2018 and December 31, 2017, residential mortgages serviced for others approximated \$7.2 million and \$1.0 million, respectively. Commercial loans serviced for others approximated \$3.0 million at both December 31, 2018 and 2017, respectively.

### 4. Allowance for Loan Losses and Credit Quality of Loans

The Corporation separates its loan portfolio into segments to perform the calculation and analysis of the allowance for loan losses. The four portfolio segments analyzed are Commercial, Commercial Real Estate, Consumer Real Estate, and Consumer and Other. The Commercial portfolio segment includes loans to finance commercial and industrial businesses that are not secured by real estate and discounted equipment finance leases as discussed above in Note 3. The Commercial Real Estate portfolio segment includes: i) construction real estate loans to finance construction and land development and/or loans secured by vacant land and ii) commercial real estate loans secured by non-farm, non-residential real estate which are further classified as either owner occupied or non-owner occupied based on the underlying collateral type. The Consumer Real Estate portfolio segment includes (commercial and non-commercial purpose) loans that are secured by 1 - 4 family residential real estate properties, including first mortgages on residential properties and home equity loans and lines of credit that are secured by first or second liens on residential properties. The Consumer and Other portfolio segment includes all loans not included in any other portfolio segments. These are primarily loans to consumers for household, family, and other personal expenditures, such as automobiles, boats, and recreational vehicles.

Activity in the allowance for loan losses by portfolio segment is as follows:

	<b>Commercial</b>	<b>Commercial Real Estate</b>	<b>Consumer Real Estate</b>	<b>Consumer and Other</b>	<b>Total</b>
			(in thousands)		
<b>2018</b>					
Allowance for loan losses:					
Beginning balance	\$ 529	\$ 2,287	\$ 1,069	\$ 1,012	\$ 4,897
Charge offs	-	-	(1)	(231)	(232)
Recoveries	219	444	237	90	990
Provision for loan losses	(146)	(93)	(384)	623	-
Ending balance	<u>\$ 602</u>	<u>\$ 2,638</u>	<u>\$ 921</u>	<u>\$ 1,494</u>	<u>\$ 5,655</u>

	<b>Commercial</b>	<b>Commercial Real Estate</b>	<b>Consumer Real Estate</b>	<b>Consumer and Other</b>	<b>Total</b>
			(in thousands)		
<b>2017</b>					
Allowance for loan losses:					
Beginning balance	\$ 506	\$ 2,489	\$ 1,252	\$ 579	\$ 4,826
Charge offs	(4)	(312)	-	(244)	(560)
Recoveries	122	341	66	102	631
Provision for loan losses	(95)	(231)	(249)	575	-
Ending balance	<u>\$ 529</u>	<u>\$ 2,287</u>	<u>\$ 1,069</u>	<u>\$ 1,012</u>	<u>\$ 4,897</u>

The following presents the balance in allowance for loan losses and loan balances by portfolio segment based on impairment method:

	<b>Commercial</b>	<b>Commercial Real Estate</b>	<b>Consumer Real Estate</b>	<b>Consumer and Other</b>	<b>Total</b>
			(in thousands)		
<b>December 31, 2018</b>					
Allowance for loan losses:					
Individually evaluated for impairment	\$ -	\$ -	\$ 2	\$ 46	\$ 48
Collectively evaluated for impairment	602	2,638	919	1,448	5,607
Total allowance for loan losses	<u>\$ 602</u>	<u>\$ 2,638</u>	<u>\$ 921</u>	<u>\$ 1,494</u>	<u>\$ 5,655</u>
Recorded investment in loans:					
Individually evaluated for impairment	\$ -	\$ 502	\$ 1,102	\$ 159	\$ 1,763
Collectively evaluated for impairment	43,332	157,528	68,923	52,740	322,523
Total recorded investment in loans	<u>\$ 43,332</u>	<u>\$ 158,030</u>	<u>\$ 70,025</u>	<u>\$ 52,899</u>	<u>\$ 324,286</u>
<b>December 31, 2017</b>					
Allowance for loan losses:					
Individually evaluated for impairment	\$ -	\$ -	\$ 4	\$ -	\$ 4
Collectively evaluated for impairment	529	2,287	1,065	1,012	4,893
Total allowance for loan losses	<u>\$ 529</u>	<u>\$ 2,287</u>	<u>\$ 1,069</u>	<u>\$ 1,012</u>	<u>\$ 4,897</u>
Recorded investment in loans:					
Individually evaluated for impairment	\$ 27	\$ 1,412	\$ 1,634	\$ 8	\$ 3,081
Collectively evaluated for impairment	33,205	132,454	67,749	31,021	264,429
Total recorded investment in loans	<u>\$ 33,232</u>	<u>\$ 133,866</u>	<u>\$ 69,383</u>	<u>\$ 31,029</u>	<u>\$ 267,510</u>

Management's on-going monitoring of the credit quality of the loan portfolio relies on an extensive credit risk monitoring process that considers several factors including: current economic conditions affecting the Bank's customers, the payment performance of individual loans and pools of homogenous loans, portfolio seasoning, changes in collateral values, and detailed reviews of specific relationships.

Our internal loan grading system assigns a risk grade to all commercial, commercial real estate, and consumer real estate - commercial purpose loans ("commercial loans"). This grading system is similar to those employed by banking regulators. Loans having satisfactory risk levels are graded as "pass" credits. As levels of known and perceived risk increase, loans are graded "special mention" and are subject to greater scrutiny. Those loans

graded “substandard” or worse are individually evaluated for impairment if reported as nonaccrual and greater than \$100,000 or part of an aggregate relationship exceeding \$100,000. All commercial loans (except equipment finance leases included in the commercial loan segment) are graded at inception and reviewed, and if appropriate, re-graded at various intervals thereafter. Commercial equipment finance leases are not subjected to the Bank’s loan grading system due to a limited recourse agreement provided by the seller that limits the Bank’s losses in any twelve month period to a fixed percentage of the outstanding beginning balance of each pool for each successive twelve month period the pool exists.

Additionally, our commercial loan portfolio and assigned risk grades are periodically subjected to review by external loan reviewers and banking regulators. Certain of the key factors considered in assigning loan grades include: cash flows, operating performance, financial condition, collateral, industry condition, management, and the strength, liquidity and willingness of guarantors’ support.

A description of the general characteristics of each risk grade within the Bank’s loan grading system follows:

**Minimal Risk (Pass)** - Virtually no credit risk. Exceptionally strong capacity for repayment; highly unlikely to be adversely affected by foreseeable events and/or fully secured by a perfected interest in properly margined, highly liquid, essentially riskless collateral. Almost no chance of default based on (1) payment history, (2) low leverage, and (3) very high liquidity and/or extremely strong, stable income in comparison to debt; cash on deposit at bank; claims on the federal government (or its agencies).

**Modest Risk (Pass)** - Very strong payment record and capacity for repayment; little chance that a down market or economy would threaten ability to repay and/or fully secured by a perfected interest in properly margined investments exhibiting little credit risk or liquidity risk. Combination of excellent payment history, ample liquidity (compared to debt burden), relatively low debt-to-worth and strong, stable income investment grade stocks, municipal bonds, and the like (Moody’s Baa, S&P BBB or better). Generally, such borrowers exhibit very low risk of default in any economy. Weaker borrowers may qualify if the loan is fully secured by investment grade securities (due to lower credit risk by virtue of low risk of loss given default).

**Moderate Risk (Pass)** - Such borrowers tend to have a long track record of successful business operation. Elements of strength are present in such areas as liquidity, stability of margins and cash flows, diversity of assets, and lack of dependence on one type of business. Reasonable access to capital markets or bank financing is present; can always borrow at favorable rates and terms. Well-established regional and excellent local companies operating in a reasonably stable industry that may be moderately affected by the business cycle and moderately open to changes. Management and owners have unquestioned character, as demonstrated by repeated performance. Loans in this category that are unsecured or not fully secured must have very strong payment capacity (cash flow and liquidity) and excellent payment record because risk of loss given default is higher.

**Average (Pass)** - Borrowers with smaller margins of debt service coverage (but generally over 1.2x) and with some elements of reduced strength. Satisfactory asset quality and liquidity; good debt capacity and coverage; and good management in critical positions. These companies have good margins of protection and will qualify as attractive borrowers. These borrowers will be able to obtain similar financing from other financial institutions and can generally borrow at attractive rates and terms. A loss year or a somewhat declining earnings trend may occur, but borrowers have sufficient strength and financial flexibility to offset these issues. These are typically solid companies often operating in cyclical industries that are somewhat vulnerable to change. Management and owners have unquestioned character. Depth of management may become an issue in a growing firm.

**Management Watch (Pass)** - These are credits that have somewhat elevated risk of default, though still acceptable and should be brought to the attention of the Senior Management for closer scrutiny. These credits however are non-criticized assets. Borrowers may experience declining earnings, strained cash flow (generally DSC >1x, < 1.2x), increasing leverage and/or weakening market fundamentals that indicate above average risk. Borrowers who have historically exhibited stable earnings may also experience a period when DSC drops below 1.0x, but based on in-depth conversations with management, there is a good probability that DSC will improve in a quarter or two based on known circumstances. These borrowers generally have limited additional debt capacity and modest coverage and average or below average margins, and market share. Some management weakness may exist. These borrowers should be able to obtain similar financing with comparable terms or somewhat worse, from other banks, but that ability may diminish in difficult economic times. Also, borrowers who are currently performing as agreed but could be adversely affected by such developing factors as deteriorating industry conditions, operating problems, pending litigation of a significant nature, or declining collateral quality/adequacy, and so forth. Companies with average or smaller market shares operating in a cyclical or declining industry. Management and owners have good character, with no basis for questions.

**Special Mention (OaEM)** - Supervisory Definition: "A special mention asset has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution’s credit position at some future date. Special mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification." Included in special mention assets could be turnaround situations, as well as those borrowers previously rated as “Moderate Risk” to “Management Watch” who have shown deterioration, for whatever reason, indicating a downgrading from the better categories. Typically, companies in start-up or deteriorating industries or with a poor and declining market share in an average industry. An element of asset quality, financial flexibility, or management is below average. Management and owners may have limited depth and backup. Borrowers who have been or would normally be categorized special mention by regulatory authorities.

**Substandard Accrual** - Regulatory Definition: “A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness, or weaknesses, that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.” From Comptroller’s Handbook: Substandard assets have a high probability of payment default, or they have other well-defined weaknesses. They require more intensive supervision by bank management. Substandard assets are generally characterized by current or expected unprofitable operations, inadequate debt service coverage, inadequate liquidity, or marginal capitalization. Repayment may depend on collateral or other credit risk mitigants. Although substandard assets in the aggregate will have a distinct potential for loss, an individual asset’s loss potential does not have to be distinct for the asset to be rated substandard. Despite weaknesses, reasonable assurance of full collection of interest and principal remains.

**Substandard Non-Accrual** - Same definition as “Substandard Accrual” above, but with the added caveat that full collection of interest and principal may be in doubt.

**Doubtful** - Regulatory Definition: “An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.” From Comptroller’s Handbook: A doubtful asset has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as loss is deferred. Doubtful borrowers are usually in default, lack adequate

liquidity or capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, the perfection of liens on additional collateral, the valuation of collateral, and refinancing. Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on the new information. Because of high probability of loss, nonaccrual accounting treatment is required for doubtful assets.

**Loss - Regulatory Definition:** “Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.” From Comptroller’s Handbook: With loss assets, the underlying borrowers are often in bankruptcy, have formally suspended debt repayments, or have otherwise ceased normal business operations. Once an asset is classified loss, there is little prospect of collecting either its principal or interest. When access to collateral, rather than the value of the collateral, is a problem, a less severe classification may be appropriate. However, banks should not maintain an asset on the balance sheet if realizing its value would require long-term litigation or other lengthy recovery efforts. Losses are to be recorded in the period an obligation becomes uncollectible.

The assessment of compensating factors may result in a rating plus or minus one grade from those listed above. These factors include, but are not limited to collateral, guarantors, environmental conditions, history, plan/projection reasonableness, quality of information, and payment delinquency.

The internal loan grading system is applied to the residential real estate portion of our consumer loan portfolio upon certain triggering events (e.g., delinquency, bankruptcy, restructuring, etc.). However, large groups of smaller balance homogeneous loans, such as mortgage – residential, home equity and home equity lines of credit and consumer and other are collectively evaluated for impairment and are not separately identified for impairment disclosures, unless an individual loan is determined to be a substandard credit based on management’s review following a triggering event. The primary risk element for these classes of loans is the timeliness of borrowers’ scheduled payments. We rely primarily on our internal reporting system to monitor past due loans and have internal policies and procedures to pursue collection and protect our collateral interests in order to mitigate losses.

Our monitoring of credit quality is further denoted by classification of loans as nonperforming, which reflects loans where the accrual of interest has been discontinued and loans that are past due 90 days or more and still accruing interest. Nonperforming loans include troubled debt restructured loans (as discussed below) that are on nonaccrual status or past due 90 days or more. Troubled debt restructured loans that are accruing interest and not past due 90 days or more are excluded from nonperforming loans.

The following presents the recorded investment in loans by risk grade and a summary of nonperforming loans, by class of loan:

	Pass	Special Mention	Substandard	Total	Nonperforming
	(in thousands)				
<b>December 31, 2018</b>					
<b>Commercial</b>	\$ 43,195	\$ 137	\$ -	\$ 43,332	\$ 16
<b>Commercial real estate:</b>					
Construction, land development, and other land	17,269	-	3	17,272	3
Owner occupied	67,608	872	307	68,787	307
Nonowner occupied	71,400	533	38	71,971	38
<b>Consumer real estate:</b>					
Commercial purpose	10,230	-	20	10,250	20
Mortgage - residential	43,656	-	575	44,231	523
Home equity and home equity lines of credit	15,418	-	126	15,544	126
<b>Consumer and other</b>	52,740	-	159	52,899	159
<b>Total</b>	<u>\$ 321,516</u>	<u>\$ 1,542</u>	<u>\$ 1,228</u>	<u>\$ 324,286</u>	<u>\$ 1,192</u>
<b>December 31, 2017</b>					
<b>Commercial</b>	\$ 33,205	\$ -	\$ 27	\$ 33,232	\$ 27
<b>Commercial real estate:</b>					
Construction, land development, and other land	5,599	-	7	5,606	7
Owner occupied	53,244	431	230	53,905	230
Nonowner occupied	73,216	137	1,002	74,355	1,002
<b>Consumer real estate:</b>					
Commercial purpose	7,247	-	25	7,272	25
Mortgage - residential	45,641	-	806	46,447	752
Home equity and home equity lines of credit	15,558	-	106	15,664	106
<b>Consumer and other</b>	31,021	-	8	31,029	8
<b>Total</b>	<u>\$ 264,731</u>	<u>\$ 568</u>	<u>\$ 2,211</u>	<u>\$ 267,510</u>	<u>\$ 2,157</u>

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality. Amounts presented in the Nonperforming column are included in the preceding risk grade columns.

Loans are considered past due when contractually required principal or interest has not been received. The amount classified as past due is the entire principal balance outstanding of the loan, not just the amount of payments that are past due.

An aging analysis of the recorded investment in past due loans, segregated by class of loans follows:

	<b>Loans Past Due</b>				Current	Total	90+ Days
	30-59 Days	60-89 Days	90+ Days	Total			Past Due and Accruing
	(in thousands)						
<b>December 31, 2018</b>							
<b>Commercial</b>	\$ 72	\$ 5	\$ 16	\$ 93	\$ 43,239	\$ 43,332	\$ 16
<b>Commercial real estate:</b>							
Construction, land development, and other land	-	-	3	3	17,269	17,272	-
Owner occupied	130	-	-	130	68,657	68,787	-
Nonowner occupied	-	-	-	-	71,971	71,971	-
<b>Consumer real estate:</b>							
Commercial purpose	20	-	-	20	10,230	10,250	-
Mortgage - residential	186	77	3	266	43,965	44,231	-
Home equity and home equity lines of credit	-	-	14	14	15,530	15,544	-
<b>Consumer and other</b>	30	-	128	158	52,741	52,899	-
<b>Total</b>	<u>\$ 438</u>	<u>\$ 82</u>	<u>\$ 164</u>	<u>\$ 684</u>	<u>\$ 323,602</u>	<u>\$ 324,286</u>	<u>\$ 16</u>

	<b>Loans Past Due</b>				Current	Total	90+ Days
	30-59 Days	60-89 Days	90+ Days	Total			Past Due and Accruing
	(in thousands)						
<b>December 31, 2017</b>							
<b>Commercial</b>	\$ 21	\$ -	\$ -	\$ 21	\$ 33,211	\$ 33,232	\$ -
<b>Commercial real estate:</b>							
Construction, land development, and other land	-	-	7	7	5,599	5,606	-
Owner occupied	312	-	82	394	53,511	53,905	-
Nonowner occupied	-	190	41	231	74,124	74,355	-
<b>Consumer real estate:</b>							
Commercial purpose	-	-	-	-	7,272	7,272	-
Mortgage - residential	414	85	116	615	45,832	46,447	-
Home equity and home equity lines of credit	22	20	17	59	15,605	15,664	-
<b>Consumer and other</b>	38	25	8	71	30,958	31,029	-
<b>Total</b>	<u>\$ 807</u>	<u>\$ 320</u>	<u>\$ 271</u>	<u>\$ 1,398</u>	<u>\$ 266,112</u>	<u>\$ 267,510</u>	<u>\$ -</u>

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality.

Loans are placed on nonaccrual when, in the judgement of management, the collection of additional interest is doubtful. Loans are generally placed on nonaccrual upon becoming 90 days past due. However, loans may be placed on nonaccrual regardless of whether or not they are past due. All cash received on nonaccrual loans is applied to the principal balance. Loans are considered for return to accrual status on an individual basis when all principal and interest amounts contractually due are brought current and future payments are reasonably assured.

The following is a summary of the recorded investment in nonaccrual loans, by class of loan:

	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
	(in thousands)	
<b>Commercial</b>	\$ -	\$ 27
<b>Commercial real estate:</b>		
Construction, land development, and other land	3	7
Owner occupied	307	230
Nonowner occupied	38	1,002
<b>Consumer real estate:</b>		
Commercial purpose	20	25
Mortgage - residential	523	752
Home equity and home equity lines of credit	126	106
<b>Consumer and other</b>	159	8
<b>Total</b>	<u>\$ 1,176</u>	<u>\$ 2,157</u>

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality.

The following presents information pertaining to impaired loans and related allowance for loan losses by class of loan:

	December 31, 2018			December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Allowance for Loan Losses	Recorded Investment	Unpaid Principal Balance	Allowance for Loan Losses
	(in thousands)					
<b>With an allowance for loan losses recorded:</b>						
<b>Commercial</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Commercial real estate:</b>						
Construction, land development, and other land	-	-	-	-	-	-
Owner occupied	-	-	-	-	-	-
Nonowner occupied	-	-	-	-	-	-
<b>Consumer real estate:</b>						
Commercial purpose	-	-	-	-	-	-
Mortgage - residential	37	47	2	40	48	3
Home equity and home equity lines of credit	-	-	-	60	67	1
<b>Consumer and other</b>	113	113	46	-	-	-
<b>Total</b>	150	160	48	100	115	4
<b>With no related allowance for loan losses recorded:</b>						
<b>Commercial</b>	-	-	-	27	31	-
<b>Commercial real estate:</b>						
Construction, land development, and other land	3	70	-	7	74	-
Owner occupied	307	437	-	230	408	-
Nonowner occupied	192	305	-	1,175	1,370	-
<b>Consumer real estate:</b>						
Commercial purpose	20	30	-	25	33	-
Mortgage - residential	919	1,718	-	1,463	2,338	-
Home equity and home equity lines of credit	126	145	-	46	57	-
<b>Consumer and other</b>	46	81	-	8	22	-
<b>Total</b>	1,613	2,786	-	2,981	4,333	-
<b>Total:</b>						
<b>Commercial</b>	-	-	-	27	31	-
<b>Commercial real estate:</b>						
Construction, land development, and other land	3	70	-	7	74	-
Owner occupied	307	437	-	230	408	-
Nonowner occupied	192	305	-	1,175	1,370	-
<b>Consumer real estate:</b>						
Commercial purpose	20	30	-	25	33	-
Mortgage - residential	956	1,765	2	1,503	2,386	3
Home equity and home equity lines of credit	126	145	-	106	124	1
<b>Consumer and other</b>	159	194	46	8	22	-
<b>Total impaired loans</b>	\$ 1,763	\$ 2,946	\$ 48	\$ 3,081	\$ 4,448	\$ 4

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality. Unpaid principal balance represents the contractual amount due and is not reduced by partial charge-offs or other adjustments.

The following presents information pertaining to the recorded investment in impaired loans as follows:

	December 31, 2018		December 31, 2017	
	Average Outstanding Balance	Interest Income Recognized	Average Outstanding Balance	Interest Income Recognized
	(in thousands)			
<b>Commercial</b>	\$ 207	\$ 18	\$ 26	\$ -
<b>Commercial real estate:</b>				
Construction, land development, and other land	4	-	119	33
Owner occupied	341	1	334	18
Nonowner occupied	1,126	86	2,932	92
<b>Consumer real estate:</b>				
Commercial purpose	22	-	37	37
Mortgage - residential	1,123	62	1,794	90
Home equity and home equity lines of credit	123	7	116	14
<b>Consumer and other</b>	70	-	17	-
<b>Total</b>	<b>\$ 3,016</b>	<b>\$ 174</b>	<b>\$ 5,375</b>	<b>\$ 284</b>

The recorded investment in loans excludes accrued interest receivable and net deferred fees due to immateriality. Most interest income recognized on impaired loans was also received during 2018 and 2017.

For loans where impairment is measured based on the present value of expected future cash flows, subsequent changes in present value and related allowance for loan loss adjustments resulting from the passage of time are accounted for within the provision for loan losses rather than interest income.

#### Troubled Debt Restructurings

The Corporation may agree to modify the terms of a loan to improve its ability to collect amounts due. The modified terms are intended to enable customers to mitigate the risk of foreclosure by creating a payment structure that provides for continued loan payment requirements based on their current cash flow ability. Modifications, including renewals, where concessions are made by the Bank and result from the debtor's financial difficulties are considered troubled debt restructurings (TDRs).

Loan modifications are considered TDRs when the modification includes terms outside of normal lending practices (i.e., concessions) to a borrower who is experiencing financial difficulties.

Typical concessions granted include, but are not limited to:

1. Agreeing to interest rates below prevailing market rates for debt with similar risk characteristics
2. Extending the amortization period beyond typical lending guidelines for debt with similar risk characteristics
3. Forbearance of principal
4. Forbearance of accrued interest

To determine if a borrower is experiencing financial difficulties, the Corporation considers if:

1. The borrower is currently in default on any other of their debt
2. It is likely that the borrower would default on any of their debt if the concession was not granted
3. The borrower's cash flow was sufficient to service all of their debt if the concession was not granted
4. The borrower has declared, or is in the process of declaring bankruptcy
5. The borrower is a going concern (if the entity is a business)

The following summarizes troubled debt restructurings:

	December 31, 2018			December 31, 2017		
	Outstanding	Recorded Investment	Total	Outstanding	Recorded Investment	Total
	Accruing	Nonaccrual		Accruing	Nonaccrual	
	(in thousands)					
<b>Commercial</b>	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
<b>Commercial real estate:</b>						
Construction, land development, and other land	-	3	3	-	7	7
Owner occupied	-	130	130	-	230	230
Nonowner occupied	154	38	192	7	41	48
<b>Consumer real estate:</b>						
Commercial purpose	-	20	20	-	25	25
Mortgage - residential	433	202	635	741	259	1,000
Home equity and home equity lines of credit	-	54	54	-	60	60
<b>Consumer and other</b>	-	-	-	-	-	-
<b>Total</b>	<b>\$ 587</b>	<b>\$ 447</b>	<b>\$ 1,034</b>	<b>\$ 748</b>	<b>\$ 622</b>	<b>\$ 1,370</b>

Troubled debt restructurings of consumer real estate-mortgage residential, consumer real estate-home equity and home equity lines of credit, and consumer and other loans included in the table above are not separately identified for impairment disclosures.

Troubled debt restructured loans may qualify for return to accrual status if the borrower complies with the revised terms and conditions and has demonstrated sustained payment performance consistent with the modified terms for a minimum of six consecutive payment cycles after the restructuring date. In addition, the collection of future payments must be reasonably assured.

The following presents information regarding loans that were restructured during 2018, resulting in the loan being classified as a troubled debt restructuring. During 2017 there were no loan modifications that met the definition of a troubled debt restructuring.

	<b>Loans Restructured in 2018</b>	
	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
Number of Loans	(dollars in thousands)	
<b>Commercial</b>	1	\$ 250
<b>Commercial real estate:</b>		
Construction, land development, and other land	-	-
Owner occupied	1	179
Nonowner occupied	1	40
<b>Consumer real estate:</b>		
Commercial purpose	-	-
Mortgage - residential	-	-
Home equity and home equity lines of credit	-	-
<b>Consumer and other</b>	-	-
<b>Total</b>	<u>3</u>	<u>\$ 469</u>

During the year ended December 31, 2018, there were no troubled debt restructured loans that defaulted within 12 months of restructuring. During the year ended December 31, 2017, the Corporation had one troubled debt restructured loan with a recorded investment of \$14,000 that defaulted within 12 months of restructuring. A loan is considered to be in payment default generally once it is 90 days contractually past due under the modified terms. The 2017 payment default on the troubled debt restructured loan had an immaterial impact on the allowance for loan losses and resulted in an immaterial charge off during the year ended December 31, 2017.

The following summarizes the nature of concessions granted by the Corporation to borrowers experiencing financial difficulties which resulted in troubled debt restructurings during 2018. No loan modifications met the definition of a troubled debt restructuring during 2017.

	<b>Non-Market Interest Rate and Extension of Amortization Period</b>	
	Pre-Modification Recorded Investment	
Number of Loans	(dollars in thousands)	
<b>December 31, 2018</b>		
<b>Commercial</b>	1	\$ 250
<b>Commercial real estate:</b>		
Construction, land development, and other land	-	-
Owner occupied	1	179
Nonowner occupied	1	40
<b>Consumer real estate:</b>		
Commercial purpose	-	-
Mortgage - residential	-	-
Home equity and home equity lines of credit	-	-
<b>Consumer and other</b>	-	-
<b>Total</b>	<u>3</u>	<u>\$ 469</u>

The troubled debt restructurings identified above had an immaterial impact on the allowance for loan losses and resulted in an immaterial amount of charge offs during the year ended December 31, 2018.



## 5. Premises and Equipment

A summary of premises and equipment and related accumulated depreciation follows:

	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
	(in thousands)	
Land and land improvements	\$ 2,882	\$ 2,902
Premises	9,892	10,597
Furniture and equipment	4,150	4,109
	<u>16,924</u>	<u>17,608</u>
Less accumulated depreciation	(10,244)	(10,574)
Premises and equipment, net	<u>\$ 6,680</u>	<u>\$ 7,034</u>

## 6. Premises Held for Sale

In January 2018, following relocation of the Bank's operations staff to the Main Office, the Corporation's operations center building was taken out of service and recorded as premises held for sale. Upon transfer from premises and equipment, the existing net book value of the facility became the property's carrying value, as supported by an independent appraisal less estimated costs to sell. At December 31, 2018, management completed an internal evaluation of the property and recorded a \$60,000 valuation reserve against the property based on market conditions, reflecting a decline in estimated market value based on recent comparable sales transactions for commercial office buildings in the area. The valuation charge is reported as loss on valuation write-down of premises held for sale in the consolidated statements of income.

## 7. Other Real Estate Owned

During the year ended December 31, 2018, the Bank had no other real estate owned activity. The Bank did have repossessed asset activity during 2018 which is reported with other real estate owned activity in the consolidated statements of cash flows but excluded from the disclosures presented below. In 2017, other real estate owned activity was as follows:

	<b>2017</b>
	(in thousands)
Beginning balance	\$ 296
Loans transferred to other real estate owned	1,333
Capitalized expenditures	-
Direct write-downs	-
Sales of other real estate owned	(1,629)
Ending balance	<u>\$ -</u>

There was no recorded investment in consumer mortgage loans secured by residential real estate properties for which foreclosure proceedings were in process at December 31, 2018 or 2017, respectively.

During 2017, activity in the other real estate owned valuation allowance was as follows:

	<b>2017</b>
	(in thousands)
Beginning of year	\$ 126
Provisions/recoveries charged/(credited) to expense	-
Reductions from sales of other real estate owned	(126)
Direct write-downs	-
Ending balance	<u>\$ -</u>

During 2017, income and expenses related to other real estate owned included:

	<b>2017</b>
	(in thousands)
Net gain on sales	\$ (103)
Provision for unrealized losses	-
Net operating income	38

Net gain on the sales, provision for unrealized losses and write-downs of other real estate owned are included in net gain on other real estate owned and repossessed assets in the consolidated statements of income.

## 8. Deposits

The Corporation participates as a member of Promontory Interfinancial Network's Insured Cash Sweep® ("ICS®") deposit program. Through ICS®, the Corporation may accept deposits in excess of the FDIC insured maximum from a depositor and place the deposits through the ICS® network into other member banks in increments of less than the FDIC insured maximum in order to provide the depositor full FDIC insurance coverage. The Corporation receives an equal dollar amount of deposits from other ICS® member banks in exchange for the deposits the Corporation places into the ICS® network. These deposits are recorded on the Corporation's consolidated balance sheets within demand and money market accounts and are considered reciprocal deposits.

The Corporation also participates as a member of Promontory Interfinancial Network's Certificate of Deposit Account Registry Service ("CDARS®") deposit product program. Through CDARS®, the Corporation may accept deposits in excess of the FDIC insured maximum from a depositor through a network of other CDARS® member banks in increments of less than the FDIC insured maximum to provide the depositor full FDIC insurance coverage. The Corporation receives an equal dollar amount of deposits from other CDARS® member banks in exchange for the deposits the Corporation places into the network. The deposits are recorded on the Corporation's consolidated balance sheets within time deposits and are considered reciprocal deposits.

A summary of reciprocal deposits at December 31 follows:

	<u>2018</u>	<u>2017</u>
	(in thousands)	
Demand (non-interest bearing)	\$ 4,628	\$ 2,426
Savings and money market	6,324	4,123
Time deposits	257	-
Total	<u>\$ 11,209</u>	<u>\$ 6,549</u>

The scheduled maturities of time deposits at December 31, 2018 are as follows:

	<u>Under \$250,000</u>	<u>\$250,000 and over</u>	<u>Total</u>
	(in thousands)		
Year ending December 31:			
2019	\$ 21,581	\$ 2,320	\$ 23,901
2020	6,959	550	7,509
2021	2,394	-	2,394
2022	3,157	-	3,157
2023 and thereafter	592	-	592
Total	<u>\$ 34,683</u>	<u>\$ 2,870</u>	<u>\$ 37,553</u>

As a participant member of the Promontory Interfinancial Network, the Corporation may also utilize CDARS® One-Way Buy® service to purchase cost-effective, fixed rate, wholesale funding without collateralization requirements. Funds come from Promontory Interfinancial Network member banks that want to sell their excess CDARS® deposits. Funding received through the CDARS® One-Way Buy® service is recorded on the Corporation's consolidated balance sheet as brokered time deposits (not as reciprocal deposits). At December 31, 2018, the Corporation had approximately \$12.2 million of CDARS® One-Way Buy® deposits which were repaid at maturity on February 28, 2019. No CDARS® One-Way Buy® funding (i.e., brokered time deposits) was utilized by the Corporation in 2017.

A summary of interest expense on deposits for the years ended December 31 follows:

	<u>2018</u>	<u>2017</u>
	(in thousands)	
NOW, savings and money market	\$ 173	\$ 148
Time deposits	271	336
Brokered time	49	-
Total	<u>\$ 493</u>	<u>\$ 484</u>

## 9. Other Borrowings

The Bank maintains a line of credit with the Federal Home Loan Bank of Indianapolis ("FHLBI") which provides total borrowing capacity of approximately \$19.7 million as of December 31, 2018. The line is secured by unencumbered qualified residential mortgage and home equity loans with outstanding principal balances of \$19.0 million and unencumbered investment securities available for sale with a fair value of \$718,000 (amortized cost of \$734,000). At December 31, 2018 there were no outstanding FHLBI borrowings. At December 31, 2017, a \$5.0 million FHLBI advance was outstanding which was repaid at maturity on January 3, 2018. The Bank utilizes FHLBI advances for general short-term liquidity needs and temporary funding of loan growth and loan purchases. Interest expense incurred on FHLBI advances during 2018 and 2017 approximated \$33,000 and \$40,000, respectively. In 2019, the Bank began pledging certain unencumbered eligible commercial real estate loans with outstanding principal balances totaling approximately \$87.1 million as additional collateral on the FHLBI line of credit which increased the Bank's total borrowing capacity to approximately \$70.9 million.

Beginning in 2018, the Bank also utilizes a federal funds line of credit provided by its primary correspondent bank for periodic overnight and short-term funding needs, primarily related to daily settlement of cash letter and ACH activity. The line is unsecured, limited to \$9.5 million and is subject to suspension or termination at any time by the correspondent bank. Advances on the federal funds line bear interest at the correspondent's daily fed funds rate and are payable on demand. No amounts were outstanding on the federal funds line at December 31, 2018. Interest expense on federal funds purchased approximated \$8,000 for the year ended December 31, 2018.

## 10. Income Tax Expense

Income tax expense consists of the following for the year-ending December 31:

	<u>2018</u>	<u>2017</u>
	(in thousands)	
Current expense	\$ -	\$ -
Deferred expense	815	1,222
Expense due to enactment of federal tax reform	-	2,199
Total income tax expense	<u>\$ 815</u>	<u>\$ 3,421</u>

On December 22, 2017, H.R.1, commonly known as the Tax Cuts and Jobs Act (the "Act") was signed into law. Among other things, the Act reduced the Corporation's federal tax rate from 34% to 21% effective January 1, 2018. As a result, the Corporation was required to re-measure its deferred assets and liabilities using the enacted rate at which the deferred assets and liabilities are expected to be recovered or settled, which is now the reduced federal tax rate. The required re-measurement adjustment approximated \$2.2 million and was recorded as additional 2017 income tax expense.

Income tax expense differed from the amounts computed by applying the U.S. Federal corporate income tax rate (of 21% in 2018 and 34% in 2017) to income before income tax expense as a result of the following:

	<u>2018</u>	<u>2017</u>
	(in thousands)	
Computed "expected" income tax expense	\$ 847	\$ 1,251
Increase (reduction) in tax resulting from:		
Expense due to enactment of federal tax reform	-	2,199
Tax-exempt interest and dividends, net	(4)	(7)
Bank-owned life insurance	(61)	(54)
Other, net	33	32
Total income tax expense	<u>\$ 815</u>	<u>\$ 3,421</u>

The tax effects of temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities are presented below:

	<u>December 31,</u>	
	<u>2018</u>	<u>2017</u>
	(in thousands)	
Deferred tax assets:		
Net operating loss carryforward	\$ 2,479	\$ 3,208
AMT credit carryforward	13	26
Other-than-temporary impairment on investment securities	398	475
Premises and equipment	123	135
Non-accrual interest	55	71
Deferred directors' fees	13	21
Valuation allowance on premises held for sale	13	-
Unrealized loss on investment securities available for sale	206	117
Other	30	23
Total gross deferred tax assets	<u>3,330</u>	<u>4,076</u>
Deferred tax liabilities:		
Allowance for loan losses	(436)	(436)
Deferred loan fees	(60)	(41)
Accretion	(2)	(18)
Unrealized gain on equity securities	(108)	-
Other	(12)	(12)
Total gross deferred tax liabilities	<u>(618)</u>	<u>(507)</u>
Net deferred tax asset	<u>\$ 2,712</u>	<u>\$ 3,569</u>

Accounting guidance requires that companies assess whether a valuation allowance should be established against their deferred tax assets based on the consideration of all available evidence using a "more likely than not" standard. At December 31, 2018 and 2017, management's evaluation of the Corporation's financial results and favorable profitability trends over the past five years provided significant objective and verifiable positive evidence that the Corporation is more likely than not able to maintain a level of sustained profitability sufficient to realize its net deferred tax assets in future years, including full utilization of its remaining net operating loss carry forward. Consequently, management concluded it was not necessary to carry a valuation allowance against the Corporation's net deferred tax asset at December 31, 2018 and 2017, respectively.

It is the Corporation's policy to evaluate the realizability of deferred tax assets related to unrealized losses on investment securities available for sale separately from its other deferred tax assets when it has the intent and ability to hold the security to recovery (maturity, if necessary). Because the future taxable income implicit in the recovery of the basis of investment securities available for sale for financial reporting purposes will offset the

deductions underlying the deferred tax asset, a valuation allowance would generally not be necessary, even in cases where a valuation allowance might be necessary related to the Corporation's other deferred tax assets.

At December 31, 2018, the Corporation had a net operating loss carryforward of approximately \$11.8 million that expires beginning in 2029 if not previously utilized.

The Corporation has no unrecognized tax benefits and does not anticipate any increase to unrecognized tax benefits in the next twelve months. Tax years from 2015 through the current year remain open to examination. The Corporation does not believe the results from any exam of these open years would have a material adverse effect on the Corporation.

## 11. Related Party Transactions

Certain directors and executive officers, including their immediate families and companies in which they are principal owners, were loan customers of the Bank during 2018 and 2017. Loans were made to such individuals in the ordinary course of business, in accordance with the Bank's normal lending policies, including the interest rate charged and collateralization, and do not represent more than a normal credit risk. Such loans approximated \$114,000 and \$125,000 at December 31, 2018 and 2017, respectively.

Deposits from such individuals and their related interests approximated \$1.3 million and \$1.5 million at December 31, 2018 and 2017, respectively.

## 12. Leases

The Bank has noncancelable operating leases for a branch facility, a commercial office building, remote office workspace and off-site space for auxiliary communications equipment. The branch facility lease extends through September 2022 which is also the end of its final renewal term. The office building lease began in January 2018 and includes five 3-year renewal options beginning January 2021 which the Bank will evaluate prior to expiration of each respective lease term. Total expected future minimum lease payments under the noncancelable leases as of December 31, 2018 are as follows:

Year ending December 31 (in thousands):

2019	\$	153
2020		148
2021		56
2022		41
2023 and after		-
Total lease payments	\$	<u>398</u>

Rental expense included in noninterest expense - net occupancy expense in the consolidated statements of income amounted to approximately \$154,000 and \$75,000 in 2018 and 2017, respectively, including amounts paid under short term, cancelable leases.

## 13. Retirement Plan

The Bank sponsors a 401(k) defined contribution plan covering all employees 21 years of age or older. Plan expenses recognized for discretionary employer contributions equal to 50% of an employee's contribution, limited to 3% of the employee's total compensation or the maximum amount permitted by the Internal Revenue Code, totaled approximately \$146,000 and \$104,000 in 2018 and 2017, respectively.

## 14. Director Compensation

Under a legacy Director Stock Fee Plan, nonemployee directors could receive stock in lieu of all or a portion of the fees payable to them as directors. Under the plan, director fees consisted of a fixed per-meeting fee paid for attendance at board and committee meetings and a variable fee based on a director's fixed fees earned during the preceding calendar year, multiplied by the bonus percentage of base compensation paid to Bank officers in the preceding calendar year.

The plan allowed for payment of director fees into a deferred stock account for which stock units were recorded until converted to shares and issued upon retirement, pursuant to a director's installment payment election. At December 31, 2018, there were 438 remaining shares earned and available for distribution in deferred stock accounts owned by former directors. No director fee compensation expense related to the legacy plan was recognized in 2018 or 2017.

Under the current Director Compensation Plan, nonemployee directors are paid a fixed monthly fee for their services to the Corporation and Bank. In addition, beginning in 2018, nonemployee directors are also eligible to receive an incentive bonus based on the Bank's performance relative to peer bank performance. Total director fee compensation in 2018 and 2017 amounted to \$204,000 and \$140,000, respectively.

## 15. Stock Appreciation Rights

In 2017, the Corporation's Board of Directors approved a Stock Appreciation Right (SAR) Agreement to provide a long-term incentive to eligible officers of the Bank. The SAR agreement grants each recipient the right to receive from the Bank a cash payment equal to the excess, if any, of the fair market value of a share of the Corporation's common stock on the exercise date over the base (exercise) price per share, multiplied by the number of shares subject to the exercised SAR. SARs have a term of ten years and vest over a period of five years with 15 percent vesting occurring at the first and second anniversary of the grant date, 20 percent vesting at the third and fourth anniversary of the grant date and 30 percent vesting at the fifth

anniversary of the grant date, respectively. The base price per share is determined by the average closing price per share of the Corporation's common stock over the 60-days preceding the grant date. SARs may be exercised in an amount equal to the number of shares corresponding to the portion of the SAR then vested. In the event of a sale of the Bank, SARs become 100% vested as of the effective sale date and are exercisable for the next 90-days at the fair market value price per share paid by the buyer in connection with the sale of the Bank.

Under the Bank's incentive compensation program, a portion of each officer's annual incentive compensation (ranging from 20% – 65%, depending on level) is awarded as a SAR. The noncash portion of the officer's incentive compensation is multiplied by a factor to determine the number of shares covered by the SAR award. The factor serves to adjust the intrinsic value of the SAR award to the officer's incentive that was not paid in cash. The factor is derived based on inputs to the Black-Scholes option-pricing model, subject to discretionary adjustment by the Board of Directors.

Compensation cost is recognized ratably over the required service (vesting) period based on the excess, if any, of the fair market value of a share of the Corporation's common stock on the measurement date (quarterly) over the base price per share, multiplied by the percentage of the SAR award then vested. At any measurement date, including those after the vesting period is satisfied and prior to expiration of the SAR award, recognized compensation expense may be positive or negative based on changes in the fair market value of the Corporation's stock and the cumulative portion of the SAR award then exercisable. The Corporation's policy is to recognize forfeitures as they occur.

A summary of the SARs under the Agreement is presented below:

	<b>2018</b>	
	<b>Shares</b>	<b>Weighted Average Exercise Price</b>
SARs outstanding at January 1	-	-
Granted	77,143	\$ 2.08
Exercised	-	-
Forfeited	-	-
Expired	-	-
SARs outstanding at December 31	<u>77,143</u>	\$ 2.08
SARs exercisable at December 31, 2018	-	\$ -

The one-year anniversary date of the initial SARs granted by the Corporation in 2018 is January 24, 2019. As such, no SARs were vested or exercisable at December 31, 2018. SARs outstanding at December 31, 2018 have a remaining life of 9.07 years. The market value of the Corporation's stock at December 31, 2018 was \$1.82, which was less than the exercise price of the outstanding SARs.

No compensation expense related to the SAR plan was recognized during the years ended December 31, 2018 and 2017, respectively. In January 2019, the Board of Directors granted SAR awards for 157,628 shares with a base price of \$1.99 per share. Compensation expense related to the 2018 and 2019 SAR awards will be recognized prospectively pursuant to the vesting schedule and the aforementioned accounting treatment.

## 16. Financial Instruments with Off-Balance-Sheet Risk

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 are loan commitments to extend credit and letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amounts recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of the nonperformance by the other party to the financial instruments for loan commitments to extend credit and letters of credit is represented by the contractual amounts of these instruments. The Bank uses the same credit policies in making credit commitments as it does for on-balance-sheet loans.

Financial instruments whose contract amounts represent credit risk are as follows:

	<b>December 31,</b>	
	<b>2018</b>	<b>2017</b>
	(in thousands)	
Commercial	\$ 23,153	\$ 17,204
Commercial real estate	57,306	27,741
Consumer real estate	15,579	12,917
Consumer and other	2,104	2,147
Total credit commitments	<u>\$ 98,142</u>	<u>\$ 60,009</u>

Loan commitments to extend credit 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 many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based on management's credit evaluation of the counterparty. Collateral held varies but may include accounts receivable; inventory; property, plant, and equipment; residential real estate; and income-producing commercial properties. Market risk may arise if interest rates move adversely subsequent to the extension of commitments.

As of December 31, 2018 and 2017, the Bank had outstanding irrevocable standby letters of credit, which carry a maximum potential commitment of approximately \$254,000 and \$431,000, respectively. These letters of credit are conditional commitments issued by the Bank to guarantee the

performance of a customer to a third party. The majority of these letters of credit are short term guarantees of one year or less, although some have maturities which extend as long as two years. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Bank primarily holds real estate as collateral supporting those commitments for which collateral is deemed necessary. The extent of collateral held on those commitments at December 31, 2018 and 2017, where there is collateral, is in excess of the committed amount. A letter of credit is not recorded in the consolidated balance sheets until a customer fails to perform.

## 17. Regulatory Capital

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

The final rules implementing Basel Committee on Banking Supervision's capital guidelines for US banks (Basel III rules) became effective for the Bank on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under the Basel III rules, a capital conservation buffer must be maintained above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer for 2018 is 1.875% and for 2017 is 1.25%. The net unrealized gain or loss on investment securities available for sale is not included in computing regulatory capital. Management believes as of December 31, 2018, the Bank met all capital adequacy requirements to which it is subject.

Prompt corrective action ("PCA") regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At December 31, 2018 and 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for PCA. There are no conditions or events since that notification that management believes have changed the Bank's category.

Actual and required capital amounts and ratios, including the phase-in of the capital conservation buffer, are presented in the following table:

As of December 31, 2018	Actual		Minimum Required for Capital Adequacy Purposes (Inclusive of Capital Conservation Buffer)		To be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to risk weighted assets)			(dollars in thousands)			
Bank	\$ 49,111	13.00%	\$ 37,314	9.875%	\$ 37,786	10.00%
Consolidated	52,914	13.97%	37,395	9.875%	N/A	N/A
Tier 1 Capital (to risk weighted assets)						
Bank	44,373	11.74%	29,756	7.875%	30,229	8.00%
Consolidated	48,165	12.72%	29,821	7.875%	N/A	N/A
Common Equity Tier 1 Capital (to risk weighted assets)						
Bank	44,373	11.74%	24,089	6.375%	24,561	6.50%
Consolidated	48,165	12.72%	24,141	6.375%	N/A	N/A
Tier 1 Capital (to average assets)						
Bank	44,373	11.35%	15,640	4.000%	19,550	5.00%
Consolidated	48,165	12.20%	15,792	4.000%	N/A	N/A

As of December 31, 2017	Actual		Minimum Required for Capital Adequacy Purposes (Inclusive of Capital Conservation Buffer)		To be Well Capitalized Under Prompt Corrective Action Provision	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(dollars in thousands)						
Total Capital (to risk weighted assets)						
Bank	\$ 43,921	14.04%	\$ 28,931	9.250%	\$ 31,277	10.00%
Consolidated	47,816	15.25%	29,008	9.250%	N/A	N/A
Tier 1 Capital (to risk weighted assets)						
Bank	39,708	12.70%	22,676	7.250%	25,022	8.00%
Consolidated	43,591	13.90%	22,736	7.250%	N/A	N/A
Common Equity Tier 1 Capital (to risk weighted assets)						
Bank	39,708	12.70%	17,984	5.750%	20,330	6.50%
Consolidated	43,591	13.90%	18,032	5.750%	N/A	N/A
Tier 1 Capital (to average assets)						
Bank	39,708	10.19%	15,591	4.00%	19,489	5.00%
Consolidated	43,591	11.14%	15,647	4.00%	N/A	N/A

Consolidated capital amounts and ratios are not required to be disclosed due to total consolidated assets being less than \$1 billion; however, such consolidated disclosures are provided to illustrate the overall capital position of the Corporation.

## 18. Dividend Restrictions

On a parent company-only basis, the Corporation's only source of funds is dividends paid by the Bank. The ability of the Bank to pay dividends is subject to limitations under various laws and regulations and to prudent and sound banking principles. The Bank may declare a dividend without the approval of the Office of the Comptroller of the Currency (OCC) unless the total dividends in a calendar year exceeds the total of its net profits for the year combined with its retained profits of the two preceding years. No dividends were paid by the Bank to the Corporation in 2018 or 2017. At December 31, 2018, approximately \$12.5 million remains available for dividends by the Bank to the Corporation without the prior approval of the OCC. The payment of dividends may be further limited because of the Bank's need to maintain capital ratios satisfactory to applicable regulatory agencies.

## 19. Fair Value

ASC Topic 820 defines fair value and establishes a consistent framework for measuring fair value and expands disclosure requirements for fair value measurements. Fair values represent the estimated price that would be received from selling an asset or paid to transfer a liability, otherwise known as an "exit price". The three levels of inputs that may be used to measure fair value are as follows:

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

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

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

The following is a description of the Corporation's valuation methodologies used to measure and disclose the fair values of its financial assets:

*Investment Securities.* The fair values for investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2), using matrix pricing. Matrix pricing is a mathematical technique commonly used to price debt securities that are not actively traded, values debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities (Level 2 inputs). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3). The fair value measurement of the Corporation's only Level 3 security (sold in 2018), a non-investment grade, non-government agency CMO, and details regarding significant inputs and assumptions used in estimating its fair value at December 31, 2017, are detailed in Note 2.

*Impaired Loans.* The fair value of impaired loans with specific allocations of the allowance for loans losses is generally based on recent real estate appraisals. When the fair value of the collateral is based on an observable market price or a current appraised value, the Corporation assigns the inputs for fair value determination a Level 2 classification. Non-real estate collateral may be valued using an appraisal, net book value per the borrower's financial statements, or aging reports, adjusted or discounted based on management's historical knowledge, changes in market conditions from the time of valuation, and management's expertise and knowledge of the client and the client's business, resulting in a Level 3

fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted in accordance with the allowance for loan losses policy.

*Other Real Estate Owned.* Assets acquired through or instead of loan foreclosure are initially recorded at fair value less estimated costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. Other real estate owned is evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Appraisals for both collateral dependent impaired loans and other real estate owned are performed by certified general appraisers (for commercial properties) or certified residential appraisers (for residential properties) whose qualifications and licenses have been reviewed and verified by the Corporation. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available for similar loans and collateral underlying such loans. When such adjustments are significant, a Level 3 classification typically results for the inputs used in determining fair value. In addition, management periodically evaluates the appraised values and will discount a property's appraised value to account for a number of factors including but not limited to the cost of liquidating the collateral, the age of the appraisal, observable deterioration since the appraisal, or other factors unique to the property, resulting in a Level 3 classification of the fair value inputs. See Note 6 regarding management's fair value measurement (Level 3) of the Corporation's premises held for sale at December 31, 2018.

*Loans Held for Sale.* Loans held for sale are carried at the lower of cost or fair value. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of a loan or other observable market data, such as outstanding purchase commitments from third party investors (Level 2).

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

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
(in thousands)				
<b>December 31, 2018</b>				
Investment securities available-for-sale				
Mortgage-backed/CMO - residential	\$ 15,423	\$ -	\$ 15,423	\$ -
U.S. agency	787	-	787	-
Obligations of state and political subdivisions	14,656	-	14,656	-
Corporate bonds	7,895	-	7,895	-
Total investment securities available for sale	<u>\$ 38,761</u>	<u>\$ -</u>	<u>\$ 38,761</u>	<u>\$ -</u>
Equity securities	<u>\$ 564</u>	<u>\$ -</u>	<u>\$ 564</u>	<u>\$ -</u>
(in thousands)				
<b>December 31, 2017</b>				
Investment securities available-for-sale				
Mortgage-backed/CMO - residential	\$ 32,486	\$ -	\$ 31,949	\$ 537
U.S. agency	926	-	926	-
Obligations of state and political subdivisions	28,208	-	28,208	-
Corporate bonds	8,167	-	8,167	-
Preferred stock	674	-	674	-
Total investment securities available for sale	<u>\$ 70,461</u>	<u>\$ -</u>	<u>\$ 69,924</u>	<u>\$ 537</u>

There were no transfers between Level 1 and Level 2 during 2018 or 2017.

The reconciliation of the beginning and ending balances of the Corporation's non-investment grade, non-government agency CMO security measured at fair value on a recurring basis and classified by the Corporation within Level 3 of the valuation hierarchy is as follows:



	2018		2017	
	Fair Value Measurement Using Significant Unobservable Inputs (Level 3)		Fair Value Measurement Using Significant Unobservable Inputs (Level 3)	
	(in thousands)			
Fair value of non-government agency CMO security, beginning of year <sup>(1)</sup>	\$	537	\$	683
Total gains (losses) realized/unrealized:				
Included in earnings <sup>(2)</sup>		120		-
Included in other comprehensive income <sup>(2)</sup>		-		61
Purchases, sales, issuances, and other settlements		(657)		(207)
Transfers into Level 3		-		-
Fair value of non-government agency CMO security, end of year	\$	-	\$	537
Total amount of losses for the year included in earnings attributable to the change in unrealized losses relating to assets still held at end of year	\$	-	\$	-

<sup>(1)</sup> Non-government agency CMO security classified as available for sale is valued using internal valuation models and pricing information from third parties.

<sup>(2)</sup> Realized gains (losses), including unrealized losses deemed other-than-temporary, are reported in noninterest income. Unrealized gains (losses) are reported in accumulated other comprehensive loss.

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

	Total	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
	(in thousands)			
<b>December 31, 2018</b>				
Impaired loans <sup>(1)</sup>	\$ 102	\$ -	\$ -	\$ 102
Premises held for sale	570	-	-	570
<b>December 31, 2017</b>				
Impaired loans <sup>(1)</sup>	\$ 96	\$ -	\$ -	\$ 96

<sup>(1)</sup> Represents carrying value and related write-downs and specific reserves pertaining to collateral dependent loans for which adjustments are based on the appraised value of the collateral or by other unobservable inputs.

Impaired collateral dependent loans at December 31, 2018 and 2017 resulted in no additional provision for loan losses for the years then ended. Premises held for sale as of December 31, 2018 carried at \$570,000 fair value, net of a valuation allowance of \$60,000, resulted in valuation reserve write-downs of \$60,000 during the year then ended.

The following table presents quantitative information about Level 3 fair value measurements for the larger classes of financial instruments measured at fair value on a non-recurring basis at December 31, 2018 and 2017, respectively:

	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
	(dollars in thousands)			
<b>2018</b>				
Impaired loans -				
Consumer real estate	\$ 35	Sales comparison approach	Management adjustment for property type and recent market volatility	22% (22%)
Consumer	\$ 67	Sales comparison approach	Management adjustment for property type and recent comparable sales	10% (10%)
Premises held for sale	\$ 570	Sales comparison approach	Management discount for property type and recent market activity	8.1% (8.1%)

	Fair Value	Valuation Techniques	Unobservable Inputs	Range (Weighted Average)
<b>2017</b>				
Impaired loans -				
Consumer real estate	\$ 96	Sales comparison approach	Management discount for property type and recent market volatility	5% (5%)

#### Fair Value of Financial Instruments

In connection with the adoption of the new accounting principal ASU 2016-01, *Financial Instruments*, as discussed in Note 1, the Corporation no longer discloses the methods and significant assumptions used to estimate fair value for financial instruments measured at amortized cost on the consolidated balance sheet. Additionally, at December 31, 2018, the Corporation uses the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The Corporation believes fair value disclosures for assets and liabilities classified as Level 1 or Level 2 at December 31, 2017 generally approximate an exit price notion. However, the fair value of net loans held for investment at December 31, 2017 was determined using entrance pricing rather than the exit price notion.

The carrying amounts and estimated fair values of financial instruments not carried at fair value, at December 31, 2018 and 2017 are as follows:

	Carrying Amount	Fair Value Measurements at December 31, 2018 Using:				Total
		Level 1	Level 2 (in thousands)	Level 3		
Financial assets:						
Cash and cash equivalents	\$ 24,868	\$ 24,868	\$ -	\$ -	\$ 24,868	
Interest-bearing time deposits with other financial institutions	494	-	488	-	488	
Investment securities held to maturity	3,500	-	-	3,500	3,500	
Loans held for sale	2,333	-	2,404	-	2,404	
Net loans held for investment	318,138	-	-	314,258	314,258	
Financial liabilities:						
Deposits (without stated maturities)	\$ 310,885	\$ 310,885	\$ -	\$ -	\$ 310,885	
Deposits (with stated maturities)	49,759	-	48,986	-	48,986	

	Carrying Amount	Fair Value Measurements at December 31, 2017 Using:				Total
		Level 1	Level 2 (in thousands)	Level 3		
Financial assets:						
Cash and cash equivalents	\$ 41,613	\$ 41,613	\$ -	\$ -	\$ 41,613	
Interest-bearing time deposits with other financial institutions	941	-	939	-	939	
Loans held for sale	1,170	-	1,209	-	1,209	
Net loans held for investment	262,348	-	-	261,353	261,353	
Financial liabilities:						
Deposits (without stated maturities)	\$ 298,358	\$ 298,358	\$ -	\$ -	\$ 298,358	
Deposits (with stated maturities)	49,267	-	48,732	-	48,732	
Other borrowings	5,000	-	5,000	-	5,000	

## 20. Revenue from Contracts with Customers

All of the Corporation's revenue from contracts with customers in the scope of ASU 2014-09 (ASC 606) is recognized in noninterest income in the consolidated statements of income. The following table presents the Corporation's sources of non-interest income for the twelve months ended December 31, 2018. Items outside the scope of ASC 606 are noted as such.

	Year Ending December 31,	
	2018	2017 <sup>(b)</sup>
Noninterest income:	(in thousands)	
Services charges on deposits and other fee income	\$ 2,266	\$ 2,056
Gain on sale of loans held for sale <sup>(a)</sup>	743	83
Net loss on sales of investment securities available for sale <sup>(a)</sup>	(1,169)	(184)
Loss recognized on the fair value of equity securities <sup>(a)</sup>	(110)	-
Loss on sale of interest-bearing time deposits with other financial institutions <sup>(a)</sup>	(7)	-
Loss on valuation write-down of premises held for sale <sup>(a)</sup>	(60)	-
Net gain on other real estate owned and repossessed assets	-	93
Increase in cash value of bank-owned life insurance <sup>(a)</sup>	290	158
Other	1	96
Total noninterest income	<u>\$ 1,954</u>	<u>\$ 2,302</u>

(a) Not within the scope of ASC 606

(b) The Corporation elected the modified retrospective approach of adoption; therefore, prior period balances are presented under legacy GAAP and may not be comparable to current year presentation.

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

*Service Charges on Deposit Accounts.* The Corporation earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use 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 Corporation fulfils 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 Corporation satisfies the performance obligation. Overdraft fees are recognized at the point in time the overdraft occurs. Service charges on deposits are withdrawn from the customer's deposit account balance.

*Interchange Income.* The Corporation earns interchange fees from debit card holder transactions conducted through the MasterCard payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with transaction processing services provided to the card holder. Interchange income is included in service charges on deposits and other fee income as a component of noninterest income in the consolidated statements of income.

*Gains/Losses on Sale of Other Real Estate Owned.* The Corporation records a gain or loss from the sale of other real estate owned when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Corporation finances the sale of other real estate owned to the buyer, the Corporation assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the other real estate owned is derecognized and the gain or loss on sale is recognized upon transfer of control of the property to the buyer. In determining the gain or loss on sale, the Corporation adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.