

THE BANK OF FINCASTLE AND SUBSIDIARY

Consolidated Financial Statements

Years Ended

December 31, 2019 and 2018



## INDEPENDENT AUDITOR'S REPORT

To the Board of Directors and Stockholders  
The Bank of Fincastle  
Fincastle, Virginia

### Report on the Financial Statements

We have audited the accompanying consolidated financial statements of The Bank of Fincastle and subsidiary (the Bank), which comprise the consolidated balance sheets as of December 31, 2019 and 2018, the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements (collectively, the financial statements).

### Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 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 financial statements based on our audit. We conducted our audit 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 financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 financial statements.

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

### Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the Bank as of December 31, 2019 and 2018, and the results of its operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

*Yount, Hyde & Barbour, P.C.*

Roanoke, Virginia  
April 15, 2020

**THE BANK OF FINCASTLE AND SUBSIDIARY**  
**CONSOLIDATED BALANCE SHEETS**  
**December 31, 2019 and 2018**

<b>ASSETS</b>	<b>2019</b>	<b>2018</b>
Cash and cash equivalents	\$ 3,136,134	\$ 3,305,017
Interest-bearing deposits with banks	8,722,934	4,507,162
Federal funds sold	126,000	132,000
Investment securities available for sale, at fair value	22,892,227	32,250,341
Restricted investment securities	241,350	235,450
Loans held for sale	442,780	573,000
Loans, net of allowance for loan losses of \$2,349,472 at 2019 and \$2,676,945 at 2018	167,759,353	148,820,724
Premises and equipment, net	4,622,301	5,099,030
Accrued interest receivable	596,652	600,216
Other real estate owned	1,788,218	2,107,010
Bank owned life insurance	5,671,829	5,552,722
Other assets	5,295,619	3,907,182
	<b>Total assets</b>	<b>Total assets</b>
	<b>\$ 221,295,397</b>	<b>\$ 207,089,854</b>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Liabilities		
Deposits		
Noninterest-bearing demand deposits	\$ 63,463,543	\$ 61,018,397
Interest-bearing deposits	127,320,902	118,093,537
	<b>Total deposits</b>	<b>Total deposits</b>
	190,784,445	179,111,934
Accrued interest payable	149,809	111,799
Reserve for losses on letters of credit	944,379	1,358,880
Other liabilities	1,236,529	1,208,295
	<b>Total liabilities</b>	<b>Total liabilities</b>
	193,115,162	181,790,908
Stockholders' equity		
Common stock, \$0.04 par value; 25,000,000 shares authorized, 10,104,999 shares at 2019 and 9,999,999 shares at 2018, issued and outstanding	404,200	400,000
Surplus	18,424,702	18,119,152
Retained earnings	9,347,186	7,218,340
Accumulated other comprehensive income (loss)	4,147	(438,546)
	<b>Total stockholders' equity</b>	<b>Total stockholders' equity</b>
	28,180,235	25,298,946
	<b>Total liabilities and stockholders' equity</b>	<b>Total liabilities and stockholders' equity</b>
	<b>\$ 221,295,397</b>	<b>\$ 207,089,854</b>

**THE BANK OF FINCASTLE AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF INCOME**  
**Years Ended December 31, 2019 and 2018**

	<b>2019</b>	<b>2018</b>
<b>INTEREST INCOME</b>		
Interest and fees on loans	\$ 8,032,500	\$ 7,267,180
Interest on investment securities, taxable	417,183	529,153
Interest on interest bearing deposits in banks	337,657	105,162
Total interest income	8,787,340	7,901,495
<b>INTEREST EXPENSE</b>		
Interest on deposits	1,238,142	808,221
Interest on borrowings	1,654	5,146
Total interest expense	1,239,796	813,367
Net interest income	7,547,544	7,088,128
<b>(RECOVERY OF) PROVISION FOR LOAN LOSSES</b>	(200,000)	220,000
Net interest income after (recovery of) provision for loan losses	7,747,544	6,868,128
<b>NONINTEREST INCOME</b>		
Service charges on deposit accounts	127,829	141,886
Rental income	141,600	160,100
Debit and credit card fees	429,237	404,321
Other income	461,598	460,953
Total noninterest income	1,160,264	1,167,260
<b>NONINTEREST EXPENSE</b>		
Salaries and employee benefits	3,451,734	3,496,934
Occupancy and equipment	790,226	752,463
Data processing expenses	1,238,466	1,349,164
Legal and professional fees	367,748	434,529
Postage, stationery and supplies	89,549	93,325
FDIC insurance assessment	46,526	111,394
Losses (gains) on sale and write-downs of other real estate owned, net	440,851	167,968
Expenses of adversely classified items	287,603	118,110
(Gains) losses on letters of credit, net	-	(200,000)
Other expenses	1,348,549	723,204
Total noninterest expense	8,061,252	7,047,091
<b>INCOME BEFORE INCOME TAXES</b>	846,556	988,297
Income tax (benefit) expense	(1,282,290)	139,803
<b>NET INCOME</b>	\$ 2,128,846	\$ 848,494
Per share data:		
Income per share	\$ 0.21	\$ 0.08

**THE BANK OF FINCASTLE AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

**Years Ended December 31, 2019 and 2018**

	<u>2019</u>	<u>2018</u>
<b>NET INCOME</b>	\$ 2,128,846	\$ 848,495
<b>OTHER COMPREHENSIVE INCOME (LOSS):</b>		
Net unrealized gain (loss) arising during the period	560,370	(77,712)
Tax effect	<u>117,677</u>	<u>(16,311)</u>
Other comprehensive income (loss)	<u>442,693</u>	<u>(61,401)</u>
<b>COMPREHENSIVE INCOME</b>	<u>\$ 2,571,539</u>	<u>\$ 787,094</u>

**THE BANK OF FINCASTLE AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY**  
**Years ended December 31, 2019 and 2018**

	Common Stock	Surplus	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total
Balance at December 31, 2017	\$ 400,000	\$ 18,119,152	\$ 6,369,845	\$ (377,145)	\$ 24,511,852
Equity-based compensation	-	-	-	-	-
Net loss	-	-	848,495	-	848,495
Other comprehensive loss	-	-	-	(61,401)	(61,401)
Balance at December 31, 2018	<u>400,000</u>	<u>18,119,152</u>	<u>7,218,340</u>	<u>(438,546)</u>	<u>25,298,946</u>
Equity-based compensation	4,200	305,550	-	-	309,750
Net income	-	-	2,128,846	-	2,128,846
Other comprehensive income	-	-	-	442,693	442,693
Balance at December 31, 2019	<u><u>404,200</u></u>	<u><u>18,424,702</u></u>	<u><u>9,347,186</u></u>	<u><u>4,147</u></u>	<u><u>28,180,235</u></u>

**THE BANK OF FINCASTLE AND SUBSIDIARY**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**Years ended December 31, 2019 and 2018**

	2019	2018
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>		
Net income	2,128,846	848,495
Adjustments to reconcile net income to net cash provided by operations:		
Net amortization of premiums on securities	20,446	20,019
(Recovery of) provision for loan losses	(200,000)	220,000
Depreciation and amortization	345,485	243,452
Net gain from sales of premises and equipment	(664)	(141,250)
Net (gain) loss from sales of other real estate owned	22,773	(545,545)
Increase in cash surrender value of life insurance	(119,107)	(126,650)
Write-downs of other real estate owned	418,077	183,896
Deferred income tax expense, net of allowance	(1,288,468)	136,181
Equity based compensation expense	309,750	-
(Increase) decrease in:		
Loans held for sale	130,220	(573,000)
Accrued interest receivable	3,564	(45,425)
Other assets	(175,821)	127,523
Increase (decrease) in:		
Accrued interest payable	38,010	52,356
Accrued losses on letters of credit	(414,501)	(409,427)
Other liabilities	28,234	311,775
Net cash provided by operating activities	1,246,844	302,400
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>		
Net increase in interest-bearing deposits with banks	(4,215,772)	(1,272,444)
Net decrease in federal funds sold	6,000	956,000
Maturities of investment securities available for sale	21,550,000	-
Purchases of investment securities available for sale	(11,996,511)	-
Principal payments from investment securities	344,549	359,299
Purchases of restricted investment securities	(5,900)	-
Proceeds from sales of restricted investment securities	-	5,100
Net increase in loans	(19,592,229)	(11,004,855)
Purchases of premises and equipment	(434,693)	(107,990)
Proceeds from sales of premises and equipment	9,000	271,818
Proceeds from sales of other real estate owned	1,247,318	4,415,757
Net cash used in investing activities	(13,088,238)	(6,377,315)
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>		
Net increase in deposits	11,672,511	5,654,942
Net cash provided by financing activities	11,672,511	5,654,942
Net decrease in cash and cash equivalents	(168,883)	(419,973)
Cash and cash equivalents at beginning of year	3,305,017	3,724,989
Cash and cash equivalents at end of year	3,136,134	3,305,017

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES**

### **Organization**

The Bank of Fincastle (Bank) provides a variety of banking services to individuals and businesses through its six full-service branches and one drive-through branch located in Botetourt County. The Bank's primary deposit products are interest bearing and non-interest bearing checking accounts, certificates of deposit and savings accounts. Its primary lending products are commercial, real estate mortgage, construction, home equity, and consumer installment loans. The Bank is a Virginia state-chartered bank subject to regulation by the Bureau of Financial Institutions and the Federal Deposit Insurance Corporation. The Bank has a wholly-owned subsidiary, Bank of Fincastle Services, Inc., that owns interests in four limited liability companies that operate in real estate sales, title insurance, and residential mortgages. During 2016, the Bank formed ESF, LLC, another wholly owned subsidiary, to hold other real estate owned.

### **Critical Accounting Policy**

Management believes the policies with respect to the methodology for the determination of the allowance for loan losses, the deferred tax asset valuation allowance, and the other real estate owned valuation involve a high degree of complexity. Management must make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions, or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and Board of Directors.

### **Principles of Consolidation**

The consolidated financial statements include the accounts of The Bank of Fincastle and its wholly-owned subsidiary, Bank of Fincastle Services, Inc. All significant inter-company transactions and balances have been eliminated.

### **Business Segments**

The Bank reports its activities as a single business segment. In determining proper segment definition, the Bank considers the materiality of a potential segment and components of the business about which financial information is available and regularly evaluated, relative to resource allocation and performance assessment.

### **Cash and Cash Equivalents**

For the purpose of presentation in the Consolidated Statement of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions "Cash and cash equivalents."

### **Use of Estimates**

The preparation of financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions, in the application of certain accounting policies, that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, the valuation of real estate acquired in connection with foreclosures or in satisfaction of loans, and the deferred tax asset valuation allowance. In connection with the determination of the allowance for loan losses and valuation of other real estate owned, management obtains independent appraisals for significant properties.

Substantially all of the Bank's loan portfolio consists of loans in its market area. Accordingly, the ultimate collectability of a substantial portion of the Bank's loan portfolio and the recovery of a substantial portion of the carrying amount of other real estate owned are susceptible to changes in market conditions in Botetourt and adjacent counties.

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

While management uses available information to recognize loan and other real estate owned losses, future additions to the allowance for loan losses or write-down of other real estate owned may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as a part of their routine examinations process, periodically review the Bank's allowance for loan losses and valuation of other real estate owned. Such agencies may require additions to the allowance for loan losses or further write-downs on other real estate owned based on their judgments about information available to them at the time of their examinations. Because of these factors, it is reasonably possible that the allowance for loan losses and other real estate owned losses may change materially in the near term.

### **Investment Securities**

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities held principally for the purpose of being sold in the near future are classified as trading and recorded at fair value, with unrealized gains and losses included in earnings. Securities that are not classified as held to maturity or trading, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses reported in other comprehensive income. The amortization of premiums and accretion of discounts on securities are recognized in interest income using methods approximating the interest method over the period-to-maturity. Gains or losses on the sale of securities are recognized on a specific identification basis.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers several factors including the length of time and the extent to which the fair value has been less than cost, the financial condition and near-term prospects of the issuer, and the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

### **Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs and the allowance for loan losses net of deferred origination fees. Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. The loan is returned to accrual status when the facts and circumstances indicate that the borrower has regained the ability to meet required payments. Past due status of loans is determined based on contractual terms. Loans held for sale in the secondary market are recorded at the lower of cost or estimated fair value. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income.

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

Risk factors evaluated include the economic environment's impact on each portfolio segment and the following specific risk factors:

- Commercial real estate loans carry risk associated with either the net operating income generated from the lease of the real estate collateral or income generated from the sale of the collateral. Other risk factors include the credit-worthiness of the sponsor and the value of the collateral.
- Residential real estate loans for consumer purposes carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral. Residential real estate loans for investment purposes carry risks associated with the continued credit-worthiness of the borrower, the value of the collateral, and either the net operating income generated from the lease of the real estate collateral or income generated from the sale of the collateral.
- Real estate construction loans carry risk associated with the credit-worthiness of the borrower, project completion within budget, sale after completion and the value of the collateral.
- Commercial non-real estate loans represent a small portion of the portfolio and carry risk associated with the operations of the business and the value of the collateral, if any.
- Consumer non-real estate and other loans represent a small portion of the portfolio and carry risk associated with the credit-worthiness of the borrower and the value of the collateral, if any.

### **Allowance for Loan Losses**

The allowance for loan losses is maintained at a level which, in management's judgment, is adequate to absorb credit losses inherent in the loan portfolio. The amount of the allowance is based on management's evaluation of the collectability of the loan portfolio, including the nature of the portfolio, credit concentrations, and trends in historical loss experience, specific impaired loans, and economic conditions. The allowance is increased by a provision for loan losses, which is charged to expense and reduced by charge-offs, net of recoveries. Loans are charged against the allowance when management believes that the uncollectability of the loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management's evaluation of the allowance for loan losses is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired, for which an allowance is established when the discounted cash flows (or collateral value or observable market price) of the loan is lower than its carrying value. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

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

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

### Troubled Debt Restructuring

In situations where, for economic or legal reasons related to a borrower's financial condition, management may grant a concession to the borrower that it would not otherwise consider, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify their loan to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring as noted above for impaired loans.

### Premises and Equipment

Land is stated at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Depreciation is charged to operating expense over the estimated useful lives of the assets on the straight-line method.

	<u>Useful Lives</u>
Buildings and improvements	10-40
Furniture and equipment	3-10

Costs of maintenance and repairs are charged to expense as incurred, and improvements are capitalized.

### Other Real Estate Owned

Real estate properties acquired through, or in lieu of, foreclosure are initially recorded at the lower of the recorded investment in the property or its fair value less estimated selling costs at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less estimated costs to sell. Revenues and expenses from operations related to the properties and changes in the carrying value are included in other operating expenses. Gains and losses on the sale of these properties are recorded in income in the year of the sale.

### 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.

### Income Taxes

The federal income tax returns for the Bank and its subsidiary are filed on a consolidated basis. The provision for income taxes is based on amounts reported in the consolidated statements of operations, after exclusion of nontaxable income and nondeductible expenses, and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred income taxes have been determined using the liability method of accounting for income taxes. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statement carrying amounts and tax bases of assets and liabilities and gives current recognition to changes in tax rates and laws.

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

Deferred income tax liabilities relating to unrealized gains (or the deferred tax asset in the case of unrealized losses) on investment securities available for sale are recorded in other liabilities (assets). These items are recorded as an adjustment to accumulated comprehensive income in the financial statements and not included in earnings until realized. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Interest and penalties associated with income tax positions are classified as interest expense on the Consolidated Statements of Income.

### **Deferred Tax Asset Valuation Allowance**

A valuation allowance is required for deferred tax assets if, based on available evidence, it is more likely than not that all or some of the asset may not be realized due to the inability to generate sufficient taxable income in the period and/or of the character necessary to utilize the benefit of the deferred tax asset. In making this assessment, all sources of taxable income available to realize the deferred tax asset are considered, including future reversals of existing temporary differences, tax planning strategies, and future taxable income exclusive of reversing temporary differences and carry-forwards. The predictability that future taxable income, exclusive of reversing temporary differences, will occur is the most subjective of these four sources.

In assessing the need for a valuation allowance, the Bank considered both positive and negative evidence to estimate whether sufficient future taxable income will be generated to permit use of the existing deferred tax assets. A significant piece of objective negative evidence evaluated was the cumulative loss incurred over the three year period ended December 31, 2017. Such objective evidence limits the ability to consider other subjective positive evidence, such as the forecasted future earnings of the Bank. On the basis of this evaluation, as of December 31, 2018, a valuation allowance of \$1.39 million was recorded to recognize only the portion of the deferred tax asset that is more likely than not to be realized.

Based on significantly reduced cumulative losses over the three year period ended December 31, 2019 and recent earnings trends, the \$1.39 million valuation allowance was reversed as of December 31, 2019. In addition, conditions in the Bank's lending function that lead to the losses culmination in the year ending December 31, 2017 and triggering the valuation allowance have been addressed by management. Subjective measures such as budgeted future taxable income indicate the reversal of existing temporary differences and the utilization of carry-forwards.

### **Earnings (Loss) Per Share**

Basic earnings (loss) per share represent income available to common shareholders divided by the weighted average number of shares of common stock outstanding during the period. Diluted earnings (loss) per share reflect additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. The Bank had no potentially diluted common stock outstanding, as of December 31, 2019 and 2018.

Earnings (loss) per share are computed based on 10,104,026 and 9,999,999 weighted average common shares outstanding during the years ended December 31, 2019 and 2018, respectively.

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

### Stock-Based Compensation

Stock compensation accounting guidance Accounting Standards Codification ("ASC") 718, Compensation - Stock Compensation, requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. The Bank's common stock closing price at the date of grant is used for restricted stock awards.

### Comprehensive Income (Loss)

Comprehensive income consists of net income and other comprehensive income. Other comprehensive income (loss) includes unrealized gains (losses) on securities available for sale.

### Credit Related Financial Instruments

In the ordinary course of business, the Bank has entered into off-balance sheet financial instruments consisting of commitments to extend credit and commercial and standby letters of credit. Such financial instruments are recorded in the financial statements when they are funded or related fees are incurred or received.

The Bank does not utilize interest-rate exchange agreements or interest-rate futures contracts.

### Fair Value of Financial Instruments

Generally accepted accounting principles ("GAAP") define fair value as the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. The Bank determines the fair values of its financial instruments based on the fair value hierarchy established by GAAP which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

### Advertising Costs

Advertising costs are expensed as incurred. Advertising expenses of \$151,486 and \$176,613 were incurred for the years ended December 31, 2019 and 2018, respectively.

### Reclassifications

Certain reclassifications have been made to the 2018 financial statements to conform to classifications used in 2019. Reclassifications were insignificant and had no effect on prior year net income or stockholders' equity.

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

### **Adoption of New Accounting Standards**

During 2019, the Bank adopted ASU 2016-02: *Leases (Topic 842)*. Among other things, in the amendments in ASU 2016-02, lessees will be required to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. Certain targeted improvements were made to align, where necessary, lessor accounting with the lessee accounting model and Topic 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early application is permitted upon issuance. Lessees (for capital and operating leases) and lessors (for sales-type, direct financing, and operating leases) must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach. The FASB made subsequent amendments to Topic 842 in July 2018 through ASU 2018-10: Codification Improvements to Topic 842, Leases and ASU 2018-11: Leases Topic 842: Targeted Improvements. Among these amendments is the provision in ASU 2018-11 that provides entities with an additional (and optional) transition method to adopt the new leases standard. Under this new transition method, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the consolidated financial statements in which it adopts the new leases standard will continue to be in accordance with current GAAP (Topic 840, Leases).

### **Recent Accounting Pronouncements**

During June 2016, the FASB issued ASU 2016-13: Financial Instruments – *Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments in this ASU, among other things, require the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to better inform their credit loss estimates. Many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration. For public companies that are not SEC filers, the amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2022. The Bank is currently assessing the impact that ASU 2016-13 will have on its consolidated financial statements. The Bank has formed a committee to address the compliance requirements, data gathering, archiving and analysis efforts. Additionally, the Bank has purchased a software solution that will assist in complying with this regulation. The Bank expects to begin operating in a parallel environment with the existing loss model in mid-2021.

In August 2018, the FASB issued ASU 2018-13: *Fair Value Measurement (Topic 820): Disclosure Framework—Changes to the Disclosure Requirements for Fair Value Measurement*. The amendments modify the disclosure requirements in Topic 820 to add disclosures regarding changes in unrealized gains and losses, the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements and the narrative description of measurement uncertainty. Certain disclosure requirements in Topic 820 are also removed or modified. The amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years. Certain of the amendments are to be applied prospectively while others are to be applied retrospectively. The Bank does not expect the adoption of ASU 2018-13 to have a material impact on its consolidated financial statements.

## **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

In April 2019, the FASB issued ASU 2019-04, “Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments.” This ASU clarifies and improves areas of guidance related to the recently issued standards on credit losses, hedging, and recognition and measurement including improvements resulting from various Transition Resource Group (TRG) Meetings. The effective date of each of the amendments depends on the adoption date of ASU 2016-1, ASU 2016-03, and ASU 2017-12. The Bank is currently assessing the impact that ASU 2019-04 will have on its consolidated financial statements.

In May 2019, the FASB issued ASU 2019-05, “Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief.” The amendments in this ASU provide entities that have certain instruments within the scope of Subtopic 326-20 with an option to irrevocably elect the fair value option in Subtopic 825-10, applied on an instrument-by-instrument basis for eligible instruments, upon the adoption of Topic 326. The fair value option election does not apply to held-to-maturity debt securities. An entity that elects the fair value option should subsequently measure those instruments at fair value with changes in fair value flowing through earnings. The effective date and transition methodology for the amendments in ASU 2019-05 are the same as in ASU 2016-13. The Bank is currently assessing the impact that ASU 2019-05 will have on its consolidated financial statements.

In November 2019, the FASB issued ASU 2019-11, “Codification Improvements to Topic 326, Financial Instruments – Credit Losses.” This ASU addresses issues raised by stakeholders during the implementation of ASU No. 2016-13, “Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” Among other narrow-scope improvements, the new ASU clarifies guidance around how to report expected recoveries. “Expected recoveries” describes a situation in which an organization recognizes a full or partial write-off of the amortized cost basis of a financial asset, but then later determines that the amount written off, or a portion of that amount, will in fact be recovered. While applying the credit losses standard, stakeholders questioned whether expected recoveries were permitted on assets that had already shown credit deterioration at the time of purchase (also known as PCD assets). In response to this question, the ASU permits organizations to record expected recoveries on PCD assets. In addition to other narrow technical improvements, the ASU also reinforces existing guidance that prohibits organizations from recording negative allowances for available-for-sale debt securities. The ASU includes effective dates and transition requirements that vary depending on whether or not an entity has already adopted ASU 2016-13. The Bank is currently assessing the impact that ASU 2019-11 will have on its consolidated financial statements.

In December 2019, the FASB issued ASU 2019-12, “Income Taxes (Topic 740) – Simplifying the Accounting for Income Taxes.” The ASU is expected to reduce cost and complexity related to the accounting for income taxes by removing specific exceptions to general principles in Topic 740 (eliminating the need for an organization to analyze whether certain exceptions apply in a given period) and improving financial statement preparers’ application of certain income tax-related guidance. This ASU is part of the FASB’s simplification initiative to make narrow-scope simplifications and improvements to accounting standards through a series of short-term projects. For public business entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within those fiscal years. Early adoption is permitted. The Bank is currently assessing the impact that ASU 2019-12 will have on its consolidated financial statements.

#### **NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (CONTINUED)**

In August 2018, the FASB issued ASU 2018-14, “Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans.” These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. Certain disclosure requirements have been deleted while the following disclosure requirements have been added: the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates and an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period. The amendments also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed: The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets and the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets. The amendments are effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Bank does not expect the adoption of ASU 2018-14 to have a material impact on its consolidated financial statements.

#### **NOTE 2 - RESTRICTIONS ON CASH**

To comply with Federal Reserve regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately \$503,000 and \$359,000 for the years ended December 31, 2019 and 2018, respectively. The Bank is also required to maintain minimum balances with a correspondent bank. This balance was \$250,000 at December 31, 2019 and 2018.

**NOTE 3 - INVESTMENT SECURITIES**

The amortized cost and estimated market value of investment securities at December 31, 2019 and 2018 as follows:

<u>December 31, 2019</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Securities Available for Sale				
U.S. government agency & treasury securities	\$ 19,256,114	\$ 2,234	\$ (3,852)	\$ 19,254,496
Corporate debt securities	2,028,619	7,181	-	2,035,800
SBA pool securities	462,759	3,133	-	465,892
Mortgage-backed securities	<u>1,139,486</u>	<u>922</u>	<u>(4,369)</u>	<u>1,136,039</u>
Totals	<u>\$ 22,886,978</u>	<u>\$ 13,470</u>	<u>\$ (8,221)</u>	<u>\$ 22,892,227</u>
<u>December 31, 2018</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
Securities Available for Sale				
U.S. government agency & treasury securities	\$ 28,808,896	\$ 30	\$ (423,599)	\$ 28,385,327
Corporate debt securities	2,038,940	-	(81,360)	1,957,580
SBA pool securities	495,854	-	(5,513)	490,341
Mortgage-backed securities	<u>1,461,772</u>	<u>-</u>	<u>(44,679)</u>	<u>1,417,093</u>
Totals	<u>\$ 32,805,462</u>	<u>\$ 30</u>	<u>\$ (555,151)</u>	<u>\$ 32,250,341</u>

The amortized cost and estimated market value of debt securities at December 31, 2019, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

<u>Securities available for sale</u>	<u>Amortized Cost</u>	<u>Fair Value</u>
Due within one year	\$ 14,997,123	\$ 14,993,703
Due after one year through five years	4,258,991	4,260,793
Due after five years through ten years	2,852,476	2,863,711
Due after ten years	<u>778,388</u>	<u>774,020</u>
	<u>\$ 22,886,978</u>	<u>\$ 22,892,227</u>

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**NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**NOTE 3 - INVESTMENT SECURITIES (CONTINUED)**

Securities with a carrying value of \$3,997,115 and \$17,707,310 were pledged at December 31, 2019 and 2018, respectively, to secure public deposits and for other purposes required or permitted by law.

Restricted investment securities, which are carried at cost, consist of stock in the Federal Home Loan Bank of Atlanta (FHLB) and Community Bankers' Bank, a correspondent bank. The FHLB requires financial institutions to purchase stock in the FHLB in order to borrow from it. The Bank's stock in Community Bankers' Bank is restricted in the fact that the stock may only be repurchased by that institution.

The following table shows the unrealized losses and related fair values in the Bank's available for sale investment securities portfolios as of December 31, 2019 and 2018, respectively. This information is aggregated by investment category and by length of time that individual securities have been in a continuous unrealized loss position at December 31, 2019 and 2018. There were ten securities with an unrealized loss position due to interest rate movement as of December 31, 2019 compared to thirty-two securities with an unrealized loss position as of December 31, 2018. No impairment has been recognized on any of the securities in a loss position because management believes that these unrealized losses are primarily attributable to changes in interest rates and financial market conditions and are not the result of credit deterioration of specific securities. As management has the ability and intent to hold debt securities for the foreseeable future and it is not more likely than not that the Bank will be required to sell the securities before recovery of their amortized cost basis, which may be maturity, no declines are deemed to be other-than-temporary.

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2019						
U.S. government agency & treasury securities	\$ 11,996,081	\$ (844)	\$ 4,996,992	\$ (3,008)	\$ 16,993,073	\$ (3,852)
Mortgage-backed securities	-	-	774,020	(4,369)	774,020	(4,369)
Total	<u>\$ 11,996,081</u>	<u>\$ (844)</u>	<u>\$ 5,771,012</u>	<u>\$ (7,377)</u>	<u>\$ 17,767,093</u>	<u>\$ (8,221)</u>

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
December 31, 2018						
U.S. government agency & treasury securities	\$ 989,770	\$ (10,044)	\$ 25,395,557	\$ (413,555)	\$ 26,385,327	\$ (423,599)
Corporate debt securities	1,957,580	(81,360)	-	-	1,957,580	(81,360)
SBA pool securities	490,341	(5,513)	-	-	490,341	(5,513)
Mortgage-backed securities	-	-	1,417,093	(44,679)	1,417,093	(44,679)
Total	<u>\$ 3,437,691</u>	<u>\$ (96,917)</u>	<u>\$ 26,812,650</u>	<u>\$ (458,234)</u>	<u>\$ 30,250,341</u>	<u>\$ (555,151)</u>

#### **NOTE 4 – LOANS**

Net Loans for December 31, 2019 and 2018 consist of the following:

	<u>2019</u>	<u>2018</u>
Real Estate Construction	\$ 19,026,986	\$ 17,237,893
Residential Real Estate	52,446,958	42,346,391
Commercial Real Estate	70,657,585	64,540,354
Commercial	26,604,119	25,612,085
Consumer	<u>1,552,879</u>	<u>1,843,757</u>
Gross Loans	170,288,527	151,580,480
Deferred fees	(179,702)	(82,811)
Allowance for loan losses	<u>(2,349,472)</u>	<u>(2,676,945)</u>
	<u>\$ 167,759,353</u>	<u>\$ 148,820,724</u>

Loans held for sale of \$442,780 and \$573,000 were outstanding at December 31, 2019 and 2018, respectively.

Real Estate Construction loans consist of lines of credit for subdivision development, speculative construction, and personal and commercial real estate construction. Residential Real Estate loans consist primarily of first and second residential adjustable rate mortgages and home equity lines of credit. Commercial Real Estate loans consist of owner occupied and non-owner occupied commercial properties. Commercial loans consist of loans to commercial customers that are unsecured or secured by business assets other than real estate. Consumer loans consist of loans to individuals that are unsecured or secured by vehicles or other personal assets.

Construction lending is generally considered to involve a higher degree of credit risk than long-term permanent financing. If the estimate of construction costs proves to be inaccurate, the Bank may be compelled to advance additional funds to complete the construction with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Bank is forced to foreclose on a project prior to completion, there is no assurance that it will be able to recover the entire unpaid portion of the loan. In addition, the Bank may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time.

The Bank has a concentration of credit in commercial real estate loans of \$65.0 million as of December 31, 2019. These loans consist of acquisition, development and construction loans, multi-family residential property, and non-owner occupied non-farm non-residential property. Of these commercial real estate loans, a further concentration of \$7.1 million applies specifically to real estate builders and developers as of December 31, 2019.

**NOTE 4 – LOANS (CONTINUED)**

The following is an aging of the loan portfolio. The table includes both performing and accruing loans as well as non-performing obligations that are in a non-accruing status. Delinquency data for the year ended December 31, 2019 and 2018 is presented as follows:

	December 31, 2019						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investments > 90 Days Accruing
Real Estate Construction	\$ -	\$ -	\$ -	\$ -	\$ 19,026,986	\$ 19,026,986	\$ -
Residential Real Estate	57,760	387,766	35,554	481,080	51,965,878	52,446,958	-
Commercial Real Estate	-	-	555,148	555,148	70,102,437	70,657,585	-
Commercial	4,744	-	-	4,744	26,599,375	26,604,119	-
Consumer	-	-	-	-	1,552,879	1,552,879	-
<b>Total</b>	<b>\$ 62,504</b>	<b>\$ 387,766</b>	<b>\$ 590,702</b>	<b>\$ 1,040,972</b>	<b>\$ 169,247,555</b>	<b>\$ 170,288,527</b>	<b>\$ -</b>

	December 31, 2018						
	30-59 Days Past Due	60-89 Days Past Due	Greater Than 90 Days	Total Past Due	Current	Total Loans	Recorded Investments > 90 Days Accruing
Real Estate Construction	\$ -	\$ -	\$ -	\$ -	\$ 17,237,893	\$ 17,237,893	\$ -
Residential Real Estate	91,698	-	259,280	350,978	41,995,413	42,346,391	-
Commercial Real Estate	153,118	267,717	1,288,551	1,709,386	62,830,968	64,540,354	-
Commercial	49,996	20,955	-	70,951	25,541,134	25,612,085	-
Consumer	-	-	2,205	2,205	1,841,552	1,843,757	-
<b>Total</b>	<b>\$ 294,812</b>	<b>\$ 288,672</b>	<b>\$ 1,550,036</b>	<b>\$ 2,133,520</b>	<b>\$ 149,446,960</b>	<b>\$ 151,580,480</b>	<b>\$ -</b>

Nonaccrual loans amounted to \$1,258,537 and \$3,039,454 at December 31, 2019 and 2018 respectively. The breakdown of nonaccrual loans at December 31, 2019 and 2018 was as follows:

	<u>2019</u>	<u>2018</u>
Real Estate Construction	\$ 599,961	\$ 1,299,803
Residential Real Estate	100,452	418,531
Commercial Real Estate	555,148	1,288,551
Commercial	2,976	30,364
Consumer	-	2,205
	<b>\$ 1,258,537</b>	<b>\$ 3,039,454</b>

#### **NOTE 4 – LOANS (CONTINUED)**

Management considers several credit quality indicators in its evaluation of the current or potential risk inherent in the loan portfolio. These indicators include but are not limited to credit reports, collateral values, financial statement and tax return information, cash flows, historic payment experience, economic trends and trends in net charge-offs. Every loan is assigned a risk rating grade at the time of loan origination. Management reviews the risk ratings for potential changes on a quarterly basis. The risk ratings are an important element in management's methodology for calculating the allowance for loan losses and determining the necessary amount of loan loss provision. Bank management monitors and reviews loans on an ongoing basis using watch lists of large loans and loans that have been identified due to payment delinquencies or other deficiencies. Management reviews loans for impairment and assesses the adequacy of the allowance for loan losses on a quarterly basis. The assessment of the allowance is based on specific allowances for impaired loans, and allowances for other classified loans, historical loss experience on loan pools and adjustments for economic factors.

The Bank utilizes a risk grading matrix to assign a risk grade to each of its loans. Credits are graded on a scale of 1 to 9. A description of the general characteristics of the nine risk grades is as follows:

##### **Risk Rating 1: Prime (Minimal Risk)**

To qualify as a "1", a credit must be either fully secured by cash or secured by a portfolio of marketable securities within margin. Borrowers receiving this rating would be of unquestionable strength with access to capital markets.

##### **Risk Rating 2: Good (Above Average)**

To qualify as a "2", a credit must be with a borrower exhibiting strong financial trends. The borrower must be a high-rated company whose management, profitability, liquidity and leverage ratios are very strong and above industry averages. Characteristics of such credits should include:

- Well collateralized credits with sound primary and secondary repayment sources
- Strong debt capacity and coverage; debt to income ratio not higher than 25% for consumer loans and debt service coverage ratio (DSCR) not lower than 2:1 on commercial loans
- Good management in all key positions
- Individuals or guarantors showing substantial liquid net worth and income or alternative funds sources to retire the debt as agreed.

##### **Risk Rating 3: Good (Average Risk)**

To qualify as a "3" the criteria of management, industry, profitability, liquidity and leverage must be generally strong and comparable to industry averages. A company rated "3", typically would show the following characteristics:

- Good debt capacity and coverage; debt to income not higher than 30% on consumer loans and DSCR not lower than 1.5: 1 on commercial loans.
- Sound primary and secondary repayment sources
- Industry has only moderate cyclical characteristics
- Good management in all key positions
- Stable earnings with positive or steady trends.

Individual borrowers or guarantors should show average to above average liquid net worth and sufficient income or alternative fund sources to retire the debt as agreed. To qualify as a "3", a commercial credit should be performing to expectations, with evidence that the borrower is continuing to generate adequate cash flow to service the debt. There should be no significant departure from the intended sources and timing of repayment. Unsecured credits, or slightly out-of-margin collateralized credits would qualify for a "3".

#### **NOTE 4 – LOANS (CONTINUED)**

##### Risk Rating 4: Acceptable

To qualify as a “4” assets in this class typically exhibit the following weaknesses which are offset with 2 or more acceptable mitigating factors. The weaknesses are:

- Limited asset base or liquidity
- Individual or Guarantors with limited repayment history or delinquent repayment history > 2 years old.
- Out-of-margin collateral or unsecured

Assets in this class may demonstrate a debt to income ratio higher than 30%, but lower than 40% on consumer loans, and DSCR lower than 1.5:1, but not lower than 1.15: 1, for commercial loans. These assets include credits with positive operating trends and satisfactory financial conditions which are achieving performance expectations. However, the Bank has identified certain risk elements that require close monitoring to ensure expected levels of performance.

##### Risk Rating 5: Pass/Watch

Assets in this class typically exhibit the following:

- Limited asset base and liquidity
- Debt service capacity is strained, but the primary source of repayment is still viable
- Might be a start-up venture that is dependent on guarantor strength

These credits have elements of risk that may be mitigated with an SBA or VSBFA Government Guarantee/Credit Enhancement.

Also included in this category are credits with negative operating trends or companies achieving performance expectations at a much slower pace than anticipated.

This rating may also include loans which exhibit satisfactory credit quality, but which are improperly structured as evidenced by excessive renewals, unusually long repayment schedules, the lack of a specific repayment plan, or which exhibit un-mitigated loan policy exceptions or documentation deficiencies.

#### **NOTE 4 – LOANS (CONTINUED)**

##### Risk Rating 6: Other Assets Especially Mentioned (Special Mention)

Assets in this category are currently protected but are potentially weak. These assets constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard. The risk of loss may be relatively minor, yet constitute an unwarranted risk in light of the circumstances surrounding the specific asset. Other assets especially mentioned have potential weaknesses which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date.

Loans which may be detailed in this category include the following characteristics:

- Credits that the lending officer may be unable to supervise properly because of a lack of expertise
- Inadequate loan agreements or failure to obtain proper documentation
- The condition of and control over collateral is uncertain
- An adverse trend in the obligor's operation or an imbalanced position in the balance sheet which has not reached a point where the liquidation is jeopardized
- Economic or market conditions which may, at some future date, result in the deterioration of the repayment prospects for the credit.
- Any other major deviations from prudent lending practices

This category should not be used to list loans which bear risks usually associated with the particular type of financing. It must be evident that the risk is increasing beyond that at which the loan originally would have been granted. Loans in which actual weaknesses are evident and significant should be considered for a lower classification.

Credits in this class are formally monitored on a quarterly basis and presented to the board for review.

##### Risk Rating 7: Substandard Assets

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 that are classified substandard 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. Loss potential, while existing in the aggregate amount of substandard assets, does not have to exist in individual assets classified substandard.

##### Risk Rating 8: Doubtful Assets

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. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors which may work to strengthen the asset, its classification as "loss" is deferred until its more exact status may be determined. Pending factors include proposed merger, acquisition, or liquidation procedures, capital injection, perfecting liens on additional collateral and refinancing plans.

**NOTE 4 – LOANS (CONTINUED)**

## Risk Rating 9: Loss Assets

An asset is defined as “Loss” and implies there is no possibility of repayment under the current terms and conditions, and the outstanding balance represents a negative asset of the Bank. When a loan balance is classified in this manner, it must be charged against the Allowance for Loan Losses (“ALL”) in the quarter in which it is identified. The identification of loss leaves no room for payment under current terms and conditions, but it does not mean that recovery is not possible at some future date. Items classified as loss should be placed on nonaccrual status, charged to the ALL and worked for collection, with principal recoveries being credited to the ALL, and interest recoveries credited to current income.

The following tables are an analysis of risk grades by category for the loan portfolio as of December 31, 2019 and 2018:

	December 31, 2019					Risk Category Total
	Real Estate Construction	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	
	Pass Grades 1-4	\$ 14,344,792	\$ 45,387,139	\$ 54,250,160	\$ 23,715,218	
Watch Grade 5	3,775,559	3,506,320	8,055,452	1,436,141	26,574	16,800,046
Special Mention Grade 6	306,674	2,861,305	6,728,407	1,372,086	14,341	11,282,813
Substandard Grade 7	599,961	692,194	1,623,566	80,674	-	2,996,395
Doubtful Grade 8	-	-	-	-	-	-
Loss Grade 9	-	-	-	-	-	-
Total	<u>\$ 19,026,986</u>	<u>\$ 52,446,958</u>	<u>\$ 70,657,585</u>	<u>\$ 26,604,119</u>	<u>\$ 1,552,879</u>	<u>\$ 170,288,527</u>

	December 31, 2018					Risk Category Total
	Real Estate Construction	Residential Real Estate	Commercial Real Estate	Commercial	Consumer	
	Pass Grades 1-4	\$ 12,316,930	\$ 35,474,903	\$ 51,704,590	\$ 24,388,827	
Watch Grade 5	3,298,383	2,088,595	6,690,508	580,503	45,763	12,703,752
Special Mention Grade 6	322,778	2,685,420	3,589,599	396,535	21,725	7,016,057
Substandard Grade 7	1,299,802	2,097,473	2,555,657	246,220	2,205	6,201,357
Doubtful Grade 8	-	-	-	-	-	-
Loss Grade 9	-	-	-	-	-	-
Total	<u>\$ 17,237,893</u>	<u>\$ 42,346,391</u>	<u>\$ 64,540,354</u>	<u>\$ 25,612,085</u>	<u>\$ 1,843,757</u>	<u>\$ 151,580,480</u>

**NOTE 4 – LOANS (CONTINUED)**

The Bank's loan portfolio also includes certain loans that have been modified in a troubled debt restructuring, where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from the Bank's loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance or other actions. The Bank had eleven modified loans totaling \$2,792,040 that were considered troubled debt restructurings as of the year ended December 31, 2019. These included four residential real estate loans with a balance of \$1,116,674, five commercial real estate loans with a balance of \$1,594,692, and two commercial loans with a balance of \$80,674. As of the year ended December 31, 2018 the Bank had eleven modified loans totaling \$2,736,615 that were considered troubled debt restructurings. These included four residential real estate loans with a balance of \$1,134,076, five commercial real estate loans with a balance of \$1,508,272, and two commercial loans with a balance of \$94,267.

The following table sets forth the Bank's Troubled Debt Restructurings that were restructured during the years ended December 31, 2019 and 2018:

	<b>December 31, 2018</b>				
	Number of Contracts	Pre-Modification		Post-Modification	
		Investment	Outstanding Recorded	Investment	Outstanding Recorded
Real Estate Construction	-	\$ -	-	\$ -	-
Residential Real Estate	-		-		-
Commercial Real Estate	1		263,271		263,271
Commercial	-		-		-
Consumer	-		-		-
Total	1	\$	263,271	\$	263,271

	<b>December 31, 2018</b>				
	Number of Contracts	Pre-Modification		Post-Modification	
		Investment	Outstanding Recorded	Investment	Outstanding Recorded
Real Estate Construction	-	\$ -	-	\$ -	-
Residential Real Estate	-		-		-
Commercial Real Estate	-		-		-
Commercial	1		86,403		86,403
Consumer	-		-		-
Total	1	\$	86,403	\$	86,403

Debt restructured during 2019 and 2018 included one term extension without a principal reduction or principle deferred.

As of December 31, 2019 and 2018, there were no Troubled Debt Restructurings that subsequently defaulted within twelve months of the date of restructuring.

For purposes of this disclosure, the Bank defines default as any payment that occurs more than 90 days past the due date, charge-off or foreclosure subsequent to modification.

As of December 31, 2019 and 2018, the balance of other real estate owned includes no foreclosed residential real estate properties recorded as a result of obtaining physical possession of the property. As of December 31, 2019, there was one residential real estate loans in the process of foreclosure.

## **NOTE 5 - ALLOWANCE FOR LOAN LOSSES**

The following is a summary roll forward of the allowance for loan losses by class from December 31, 2018 through December 31, 2019:

	<u>Real Estate Construction</u>	<u>Residential Real Estate</u>	<u>Commercial Real Estate</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Total</u>
<b>Allowance for loan losses:</b>						
December 31, 2018 balance	\$ 952,053	\$ 267,354	\$ 851,336	\$ 600,609	\$ 5,593	\$ 2,676,945
Charge offs	-	(3,373)	(160,407)	(30,572)	(1,632)	(195,984)
Recoveries	51,781	13,737	-	-	2,993	68,511
Recovery	(282,595)	305,877	84,465	(309,639)	1,892	(200,000)
December 31, 2019 balance	<u>\$ 721,239</u>	<u>\$ 583,595</u>	<u>\$ 775,394</u>	<u>\$ 260,398</u>	<u>\$ 8,846</u>	<u>\$ 2,349,472</u>
<b>Allowance for loan losses:</b>						
Individually evaluated for impairment	-	83,078	50,765	2,390	-	136,233
Collectively evaluated for impairment	721,239	500,517	724,629	258,008	8,846	2,213,239
December 31, 2019 balance	<u>\$ 721,239</u>	<u>\$ 583,595</u>	<u>\$ 775,394</u>	<u>\$ 260,398</u>	<u>\$ 8,846</u>	<u>\$ 2,349,472</u>
<b>Loans receivable:</b>						
Individually evaluated for impairment	694,654	1,101,121	3,233,009	77,698	-	5,106,482
Collectively evaluated for impairment	18,332,332	51,345,837	67,424,576	18,270,459	1,552,879	156,926,083
Guaranteed loans	-	-	-	8,255,962	-	8,255,962
Principal loan balances as of December 31, 2019:	<u>\$ 19,026,986</u>	<u>\$ 52,446,958</u>	<u>\$ 70,657,585</u>	<u>\$ 26,604,119</u>	<u>\$ 1,552,879</u>	<u>\$ 170,288,527</u>

The following is a summary roll forward of the allowance for loan losses by class from December 31, 2017 through December 31, 2018:

	<u>Real Estate Construction</u>	<u>Residential Real Estate</u>	<u>Commercial Real Estate</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Total</u>
<b>Allowance for loan losses:</b>						
December 31, 2017 balance	\$ 971,657	\$ 129,678	\$ 1,055,160	\$ 806,503	\$ 4,672	\$ 2,967,670
Charge offs	(34,959)	(53,899)	(593,610)	(1,297)	(22,399)	(706,164)
Recoveries	40,801	100,601	35,553	8,811	9,673	195,439
Provision	(25,446)	90,974	354,233	(213,408)	13,647	220,000
December 31, 2018 balance	<u>\$ 952,053</u>	<u>\$ 267,354</u>	<u>\$ 851,336</u>	<u>\$ 600,609</u>	<u>\$ 5,593</u>	<u>\$ 2,676,945</u>
<b>Allowance for loan losses:</b>						
Individually evaluated for impairment	-	92,752	189,675	-	-	282,427
Collectively evaluated for impairment	952,053	174,602	661,661	600,609	5,593	2,394,518
December 31, 2018 balance	<u>\$ 952,053</u>	<u>\$ 267,354</u>	<u>\$ 851,336</u>	<u>\$ 600,609</u>	<u>\$ 5,593</u>	<u>\$ 2,676,945</u>
<b>Loans receivable:</b>						
Individually evaluated for impairment	1,299,802	1,327,370	2,555,657	-	-	5,182,829
Collectively evaluated for impairment	15,938,091	41,019,021	61,984,697	16,000,690	1,843,757	136,786,256
Guaranteed loans	-	-	-	9,611,395	-	9,611,395
Principal loan balances as of December 31, 2018:	<u>\$ 17,237,893</u>	<u>\$ 42,346,391</u>	<u>\$ 64,540,354</u>	<u>\$ 25,612,085</u>	<u>\$ 1,843,757</u>	<u>\$ 151,580,480</u>

The following is an analysis by class of impaired loans as of December 31, 2019:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance:</b>					
Real Estate Construction	\$ 694,654	\$ 2,591,442	\$ -	\$ 1,052,069	\$ 5,415
Residential Real Estate	627,361	777,943	-	647,426	45,037
Commercial Real Estate	2,686,851	4,375,265	-	2,298,536	132,575
Commercial	-	-	-	-	-
Consumer	-	-	-	-	-
<b>With an allowance recorded:</b>					
Real Estate Construction	\$ -	\$ -	\$ -	\$ -	\$ -
Residential Real Estate	473,760	499,313	83,078	475,862	25,043
Commercial Real Estate	546,158	547,307	50,765	443,586	30,713
Commercial	77,698	77,698	2,390	47,368	4,838
Consumer	-	-	-	-	-
<b>Total:</b>					
Real Estate Construction	\$ 694,654	\$ 2,591,442	\$ -	\$ 1,052,069	\$ 5,415
Residential Real Estate	1,101,121	1,277,256	83,078	1,123,288	70,080
Commercial Real Estate	3,233,009	4,922,572	50,765	2,742,122	163,288
Commercial	77,698	77,698	2,390	47,368	4,838
Consumer	-	-	-	-	-
	<u>\$ 5,106,482</u>	<u>\$ 8,868,968</u>	<u>\$ 136,233</u>	<u>\$ 4,964,847</u>	<u>\$ 243,621</u>

The following is an analysis by class of impaired loans as of December 31, 2018:

	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
<b>With no related allowance:</b>					
Real Estate Construction	\$ 1,299,802	\$ 4,484,761	\$ -	\$ 1,716,713	\$ 3,485
Residential Real Estate	852,404	1,113,199	-	1,397,971	96,621
Commercial Real Estate	1,438,224	2,370,829	-	2,648,328	134,050
Commercial	-	-	-	63,028	12,906
Consumer	-	-	-	-	-
<b>With an allowance recorded:</b>					
Real Estate Construction	\$ -	\$ -	\$ -	\$ -	\$ -
Residential Real Estate	474,966	497,137	92,752	477,817	23,377
Commercial Real Estate	1,117,433	1,897,828	189,675	1,144,953	58,780
Commercial	-	-	-	-	-
Consumer	-	-	-	-	-
<b>Total:</b>					
Real Estate Construction	\$ 1,299,802	\$ 4,484,761	\$ -	\$ 1,716,713	\$ 3,485
Residential Real Estate	1,327,370	1,610,336	92,752	1,875,788	119,998
Commercial Real Estate	2,555,657	4,268,657	189,675	3,793,281	192,830
Commercial	-	-	-	63,028	12,906
Consumer	-	-	-	-	-
	<u>\$ 5,182,829</u>	<u>\$ 10,363,754</u>	<u>\$ 282,427</u>	<u>\$ 7,448,810</u>	<u>\$ 329,219</u>

No additional funds are committed to be advanced in connection with impaired loans.

**NOTE 6 - PREMISES AND EQUIPMENT**

Premises and equipment and accumulated depreciation for December 31, 2019 and 2018 are summarized as follows:

	<u>2019</u>	<u>2018</u>
Land and land improvements	\$ 1,589,430	\$ 1,833,735
Buildings	5,049,367	5,410,749
Furniture and equipment	1,315,401	1,275,737
	<u>7,954,198</u>	<u>8,520,221</u>
Less accumulated depreciation	<u>(3,331,897)</u>	<u>(3,421,191)</u>
	<u>\$ 4,622,301</u>	<u>\$ 5,099,030</u>

Depreciation expense amounted to \$339,783 and \$231,135 for the years ended December 31, 2019 and 2018, respectively.

**NOTE 7 – BANK OWNED LIFE INSURANCE**

The Bank has invested in bank owned life insurance. The earnings from these policies will be used to offset employee benefit costs. The cash surrender value of these policies was \$5,671,829 and \$5,552,722 as of December 31, 2019 and 2018, respectively. The increase in cash surrender value of these policies is included in other income on the accompanying consolidated statements of income and amounted to \$119,107 and \$126,650 for the years ended December 31, 2019 and 2018, respectively.

**NOTE 8 – INVESTMENT IN LIMITED LIABILITY COMPANIES**

The Bank’s wholly owned subsidiary, Bank of Fincastle Services, Inc., owns interests in four limited liability companies that are accounted for by the equity method. The amount of these investments was \$1,068,515 and \$1,031,380 at December 31, 2019 and 2018 respectively. The income from these limited liability companies is included in other income on the accompanying consolidated statement of income and amounted to \$37,135 and \$43,200 for the years ended December 31, 2019 and 2018, respectively.

**NOTE 9 - DEPOSITS**

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2019 and 2018 was \$4,987,500 and \$4,051,064, respectively.

At December 31, 2019, the scheduled maturities of certificates of deposits, including individual retirement accounts, were as follows:

2020	\$ 33,213,945
2021	12,870,055
2022	3,120,302
2023	1,081,864
2024	<u>2,004,968</u>
	<u>\$ 52,291,134</u>

Demand deposit accounts with overdraft balances that were reclassified as loans amounted to \$16,152 and \$15,024 at December 31, 2019 and 2018, respectively.

## **NOTE 10 - INCOME TAXES**

The actual tax expense differs from the expected tax expense computed by applying the federal statutory tax rate to income before income taxes as follows:

	<u>2019</u>	<u>2018</u>
Tax expense at statutory rate	\$ 177,777	\$ 207,543
(Increase) decrease in taxes resulting from:		
Increase in cash surrender value of life insurance	(25,012)	(26,597)
State income tax, net of federal tax benefit	4,881	3,622
Other nondeductible expenses	2,401	901
Other differences	(4,032)	2,639
General business credit carryover	(48,305)	(48,305)
Deferred tax asset valuation change	<u>(1,390,000)</u>	<u>-</u>
Reported income tax (benefit) expense	<u>\$ (1,282,290)</u>	<u>\$ 139,803</u>

The tax effects of temporary timing differences that give rise to significant components of the net deferred tax asset, included in other assets, as of December 31, 2019 and 2018 are as follows:

	<u>2019</u>	<u>2018</u>
Deferred tax assets:		
Allowance for loan losses	\$ -	\$ 70,309
Interest on nonaccrual loans	236,493	236,493
Write-downs on other real estate owned	170,345	122,768
Deferred compensation	34,582	99,926
Charitable contribution carryforward	8,669	6,308
Deferred gain on sale of other real estate owned	118,446	118,446
Accrued losses on letters of credit	198,320	285,364
Reserve for premiums on guaranteed loans	792	10,454
Lease Liability	27,692	-
Investment in pass-through entity	15,405	-
Net tax credit carryforward	238,275	189,970
Net operating loss carryforward	2,362,734	2,272,581
Net unrealized loss on securities available for sale	-	116,575
Deferred tax assets	<u>3,411,753</u>	<u>3,529,194</u>
Deferred tax liabilities:		
Depreciation	(115,015)	(69,455)
Right of Use Asset	(27,536)	-
Allowance for loan losses	(37,678)	-
Net unrealized gain on securities available for sale	(1,102)	-
Investment in pass-through entity	-	(10,108)
Deferred tax liabilities	<u>(181,331)</u>	<u>(79,563)</u>
Deferred tax asset valuation allowance	<u>-</u>	<u>(1,390,000)</u>
Net deferred tax asset	<u>\$ 3,230,422</u>	<u>\$ 2,059,631</u>

**NOTE 10 - INCOME TAXES (CONTINUED)**

The provision for income taxes consists of the following components:

	<u>2019</u>	<u>2018</u>
Current expense	\$ 6,178	\$ 3,622
Change in valuation allowance	(1,390,000)	-
Deferred tax expense (benefit)	<u>101,532</u>	<u>136,181</u>
	<u>\$ (1,282,290)</u>	<u>\$ 139,803</u>

Management does not believe that the Bank has any liability related to uncertain tax positions. The Bank's tax filings for the years after 2016 are open for examination by the Internal Revenue Service. As of December 31, 2019, the Bank had a net operating loss carryover in the amount of \$11,251,112. Of this amount, \$9,659,683 will expire in 2036 and \$1,138,884 in 2037. The remaining net operating loss carryover in the amount of \$452,545 will be available indefinitely. The Bank also had general business tax credit carryovers in the amount of \$238,275. These credits will begin to expire in 2035.

**NOTE 11 - PENSION PLAN**

The Bank has a 401(k) and profit sharing plan. The plan covers all employees who meet the minimum service and age requirements. The plan provides for elective salary deferrals by eligible employees and 100% matching contributions by the Bank up to 3% of employee compensation. The Bank may also make discretionary profit sharing contributions for eligible employees at various percentages based on years of service. The Bank did not make a discretionary profit sharing contribution during the year ended December 31, 2019. The Bank's matching contributions to the 401(k) plan and profit sharing plan contributions amounted to \$59,344 and \$57,606 for the years ended December 31, 2019 and 2018, respectively.

**NOTE 12 - TRANSACTIONS WITH RELATED PARTIES**

The Bank conducts banking transactions in the ordinary course of business with directors, principal officers, and their immediate families and affiliated companies (commonly referred to as related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate loan transactions with related parties were as follows:

	<u>2019</u>	<u>2018</u>
Balance, beginning of year	\$ 593,742	\$ 825,039
New loans originated	4,055,656	584,866
Repayments	<u>(614,200)</u>	<u>(816,163)</u>
Balance, end of year	<u>\$ 4,035,198</u>	<u>\$ 593,742</u>

## **NOTE 12 - TRANSACTIONS WITH RELATED PARTIES (CONTINUED)**

The Bank's subsidiary owns a 51% interest in a mortgage company that sells real estate loans on the secondary market. The Bank provides funding for these loans until they are sold by the mortgage company. These loans are presented as loans held for sale on the consolidated balance sheet and amounted to \$442,780 at December 31, 2019 and \$573,000 at December 31, 2017. The total balance of deposit accounts with related parties and affiliated companies of the Bank's subsidiary were \$5,061,737 and \$4,171,187 as of December 31, 2019 and 2018, respectively.

## **NOTE 13 - LEASES**

On January 1, 2019, the Bank adopted ASU No. 2016-02 "Leases (Topic 842)" and all subsequent ASUs that modified Topic 842. The Company elected the prospective application approach provided by ASU 2018-11 and did not adjust prior periods for ASC 842. The Bank also elected certain practical expedients within the standard and consistent with such elections did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases. The implementation of the new standard resulted in recognition of a right-of-use asset and lease liability of \$54,840 at the date of adoption, which is related to the Bank's lease of premises used in operations. The right-of-use asset and lease liability are included in other assets and other liabilities, respectively, in the consolidated balance sheets.

Lease liabilities represent the Bank's obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Bank's incremental borrowing rate in effect at the commencement date of the lease. Right-of-use assets represent the Bank's right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor.

The Bank's long-term lease agreements are classified as operating leases. Certain of these leases offer the option to extend the lease term and the Bank has included such extensions in its calculation of the lease liabilities to the extent the options are reasonably assured of being exercised. The lease agreements do not provide for residual value guarantees and have no restrictions or covenants that would impact dividends or require incurring additional financial obligations.

	<b><u>December 31, 2019</u></b>
Lease liabilities	\$ 131,583
Right-of-use assets	\$ 131,125
Weighted average remaining lease term	4.85 years
Weighted average discount rate	2.63%
	<b><u>For the Year Ended December 31, 2019</u></b>
<b>Lease cost</b>	
Operating lease cost	\$ 22,564
Variable lease cost	-
Short-term lease cost	28,400
Total lease cost	<u>\$ 50,964</u>
Cash paid for amounts included in the measurement of lease liabilities	\$ 21,800

**NOTE 13 – LEASES (CONTINUED)**

A maturity analysis of operating lease liabilities and reconciliation of the undiscounted cash flows to the total of operating lease liabilities is as follows:

Lease payments due		
Twelve months ending December 31, 2020	\$	28,680
Twelve months ending December 31, 2021		29,160
Twelve months ending December 31, 2022		29,640
Twelve months ending December 31, 2023		30,120
Twelve months ending December 31, 2024		16,200
Twelve months ending December 31, 2025		6,750
Total undiscounted cash flows	\$	140,550
Discount		(8,967)
Lease liabilities	\$	131,583

**NOTE 14 - 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 include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized in the consolidated balance sheet.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments.

A summary of commitments as of December 31, 2019 and 2018 is as follows:

	<u>2019</u>	<u>2018</u>
Commitments to extend credit	\$ 24,965,396	\$ 26,018,019
Standby letters of credit and financial guarantees written	\$ 4,859,203	\$ 6,233,826

#### **NOTE 14 - FINANCIAL INSTRUMENTS WITH OFF-BALANCE-SHEET RISK (CONTINUED)**

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 credit worthiness 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 customer. Collateral held varies but may include securities, accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements, including commercial paper, bond financing and similar transactions. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies but may include securities, accounts receivable, inventory, property, plant and equipment, and income-producing commercial properties.

In 2017, management accrued \$1,888,000 of estimated expenses to fulfill potential obligations on letters of credit related to certain properties in other real estate and certain impaired loans. The Bank incurred \$414,501 and \$209,427 related to these letters of credit in 2019 and 2018, respectively. The accrued liability was \$944,379 as of December 31, 2019 and \$1,358,880 as of December 31, 2018.

#### **NOTE 15 - CONCENTRATIONS OF CREDIT RISK**

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. The concentrations of credit by type of loan are set forth in Note 4 - Loans. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers. Although the Bank has a reasonably diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent upon economic conditions in Botetourt and Roanoke counties.

The Bank has established operating policies relating to the credit process and collateral in loan originations. Loans to purchase real and personal property are generally collateralized by the related property with loan amounts established based on certain percentage limitations of the property's total stated or appraised value. Credit approval is primarily a function of the evaluation of the creditworthiness of the individual borrower or project based on available financial information and collateral.

The Bank maintains a cash balance with a correspondent bank that, from time to time, exceeds the \$250,000 insurance limits of the Federal Deposit Insurance Corporation. The Bank has not experienced losses in its account and believes it is not exposed to significant credit risk on cash and cash equivalents.

#### **NOTE 16 – DEFERRED COMPENSATION AGREEMENT**

In December 2005, the Bank entered into a deferred compensation agreement with a key employee which fully vested on January 2, 2013. The agreement provides for a benefit of approximately \$4,200 per month for ten years following the termination of active employment, death or disability, or a lump sum payment of the unpaid obligation in the event of a change in ownership or effective control or in the ownership of a substantial portion of assets of the Bank. The employee retired in 2015 and the Bank made payments under the agreement of which \$0 and \$2,061 was charged to expense for the years ended December 31, 2019 and 2018, respectively. The accrued liability under this agreement was \$0 and \$293,622 at December 31, 2019 and 2018, respectively. During 2019, the employee surrendered their right to payments under the agreement.

**NOTE 17 – SUPPLEMENTAL CASH FLOW INFORMATION**

The following is supplemental information for the statement of cash flows as of December 31, 2019 and 2018:

	<u>2019</u>	<u>2018</u>
Supplemental disclosure of cash paid during the year for:		
Interest	\$ 1,201,786	\$ 769,444
Taxes	-0-	6,000
Non-cash investing and financing activities		
Loans transferred to other real estate owned (OREO)	\$ 853,600	\$ 11,440
Fixed assets transferred to OREO	515,777	455,741
Other assets transferred to OREO	-0-	70,743
Unrealized gains (losses) on securities available for sale	560,370	(77,712)

**NOTE 18 – LINES OF CREDIT**

The Bank has established credit availability with a correspondent bank for unsecured borrowings of federal funds of \$10.0 million. The Bank also has established a credit availability of \$13.545 million with the Federal Home Loan Bank for borrowings secured by the Bank's portfolio of 1-4 family first mortgages, commercial real estate loans, and investment portfolio securities. At December 31, 2019, a \$6,000,000 letter of credit in favor of the Commonwealth of Virginia-Treasury Board, to secure public deposits, was utilized from this line of credit. This pledging arrangement reduced the available credit for secondary liquidity needs to \$7.545 million. There were no outstanding balances borrowed from these sources as of December 31, 2019 or 2018.

**NOTE 19 - RESTRICTION ON PAYMENT OF DIVIDENDS**

The Bank, as a Virginia banking corporation, may pay dividends only out of its retained earnings. Regulatory authorities may limit payment of dividends by any bank when it is determined that such a limitation is in the public interest and necessary to ensure financial soundness of the bank.

## **NOTE 20 - REGULATORY MATTERS**

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory, and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements.

Under regulatory capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors. Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total Capital, Tier I Capital, and Common Equity Tier 1 Capital to risk-weighted assets, and of Tier I Capital - Leverage to average assets, as all of these terms are defined in the regulations. Management believes, as of December 31, 2019 and 2018, that the Bank met all capital adequacy requirements to which it is subject.

The most recent notification of the Federal Deposit Insurance Corporation (FDIC) as of December 31, 2019 categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Tier I risk-based, common equity Tier 1 risk-based and Tier I-leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

Final rules implementing BASEL III regulatory capital guidance for U.S. banks (Basel III rules) became effective January 1, 2015. The Basel III rules established a capital conservation buffer that was phased in beginning January 1, 2016 and was fully phased in by January 1, 2019. Under the Basel III rules, a bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer requirement will be gradually phased in starting with 0.625% on January 1, 2016 and increased each year until it is fully implemented at 2.5% on January 1, 2019. If banks do not maintain the required capital conservation buffer, their ability to pay dividends, repurchase shares, or pay discretionary bonuses could be limited. As of December 31, 2019, the Bank met the capital conservation buffer requirement.

**NOTE 20 - REGULATORY MATTERS**

The Bank's actual capital amounts and ratios as of December 31, 2019 and 2018 are as follows (dollars in thousands):

<u>December 31, 2019</u>	<u>Actual</u>		<u>Minimum for Capital Adequacy Purposes</u>		<u>Minimum to be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Total Capital (to Risk Weighted Assets)	\$ 27,734	16.15%	\$ 13,731	8.00%	\$17,163	10.00%
Tier I Capital (to Risk Weighted Assets)	\$ 25,575	14.90%	\$ 10,298	6.00%	\$13,731	8.00%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$ 25,575	14.90%	\$ 7,723	4.50%	\$11,156	6.50%
Tier I Capital - Leverage (to Average Assets)	\$ 25,575	11.71%	\$ 8,730	4.00%	\$10,913	5.00%
<u>December 31, 2018</u>	<u>Actual</u>		<u>Minimum for Capital Adequacy Purposes</u>		<u>Minimum to be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
Total Capital (to Risk Weighted Assets)	\$ 26,393	16.17%	\$ 13,058	8.00%	\$16,322	10.00%
Tier I Capital (to Risk Weighted Assets)	\$ 24,329	14.90%	\$ 9,793	6.00%	\$13,058	8.00%
Common Equity Tier 1 Capital (to Risk Weighted Assets)	\$ 24,329	14.90%	\$ 7,345	4.50%	\$10,609	6.50%
Tier I Capital - Leverage (to Average Assets)	\$ 24,329	11.89%	\$ 8,184	4.00%	\$10,230	5.00%

## **NOTE 21 - FAIR VALUE MEASUREMENTS**

Accounting standards provide a framework for measuring and disclosing fair value information about assets and liabilities recognized in the balance sheet. Fair value is defined as the amount that would be received to sell an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants. Fair value is best determined based upon quoted market prices. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to individual markets and, in many cases, could not be realized in immediate settlement of the instruments. Certain financial instruments and all nonfinancial instruments are excluded from these disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Bank and its subsidiary.

In accordance with accounting principles, the Bank groups assets and liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions that are used to determine fair value. The three levels of the fair value hierarchy are as follows:

Level 1 – Quoted prices in active markets for identical assets or liabilities.

Level 2 – Observable inputs including quoted prices for similar assets or liabilities in active markets; quoted prices for identical or similar assets or liabilities in markets that are less active, and model-based valuation techniques for which significant assumptions can be derived primarily from or corroborated by observable data in the market.

Level 3 – Unobservable inputs that are based on model-based valuation techniques using one or more significant inputs or assumptions that are unobservable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models, and similar techniques.

**NOTE 21 - FAIR VALUE MEASUREMENTS (CONTINUED)**

The estimated fair values of the Bank's financial instruments as of December 31, 2019 and 2018 are as follows (dollars in thousands):

<b>Fair Value as of December 31, 2019</b>					
<u>Financial Assets</u>	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Cash and due from banks	\$ 3,136	\$ 3,136	\$ 3,136		
Interest bearing deposits with banks	8,723	8,723	8,723		
Federal funds sold	126	126	126		
Investment securities	22,892	22,892		22,892	
Restricted investment securities	241	241			241
Loans held for sale	443	443		443	
Loans, net of allowance for loan losses	167,759	163,386			163,386
Accrued interest receivable	597	597		597	
<u>Financial Liabilities</u>					
Noninterest-bearing deposits	\$ 63,464	\$ 63,464		\$ 63,464	
Interest-bearing deposits	127,321	127,628			127,628
Accrued interest payable	150	150		150	
<b>Fair Value as of December 31, 2018</b>					
<u>Financial Assets</u>	<u>Carrying Amount</u>	<u>Fair Value</u>	<u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u>	<u>Significant Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
Cash and due from banks	\$ 3,305	\$ 3,305	\$ 3,305		
Interest bearing deposits with banks	4,507	4,507	4,507		
Federal funds sold	132	132	132		
Investment securities held to maturity	32,250	32,250		32,250	
Restricted investment securities	235	235			235
Loans held for sale	573	573		573	
Loans, net of allowance for loan losses	148,821	145,228			145,228
Accrued interest receivable	600	600		600	
<u>Financial Liabilities</u>					
Noninterest-bearing deposits	\$ 61,018	\$ 61,018		\$ 61,018	
Interest-bearing deposits	118,094	118,084			118,084
Accrued interest payable	112	112		112	

**NOTE 21 - FAIR VALUE MEASUREMENTS (CONTINUED)**

Fair value measurements are disclosed based on whether the assets or liabilities are valued on a recurring or nonrecurring basis. The following is a description of the valuation methodologies used for assets measured at fair value as well as the general classification of such assets pursuant to the valuation hierarchy:

**Recurring basis:**

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted market prices, when available (Level 1). If quoted market prices are not available, fair values are measured utilizing independent valuation techniques of identical or similar securities for which significant assumptions are derived primarily from or corroborated by observable market data. Third party vendors compile prices from various sources and may determine the fair value of identical or similar securities by using price models that consider observable market data (Level 2). Mortgage-backed securities are included in Level 2 if observable inputs are available. In certain cases securities have been valued using unobservable inputs including discounted cash flow methodologies or similar techniques that require management judgment or estimation. Such securities are included in Level 3. The table below present the recorded amount of assets and liabilities measured at fair value on a recurring basis (dollars in thousands).

<u>December 31, 2019</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment Securities Available for Sale:				
U.S. government agency & treasury securities	\$ 19,254	\$ -	\$ 19,254	\$ -
Corporate debt securities	2,036	-	2,036	-
SBA pools	466	-	466	-
Mortgage-backed securities	1,136	-	1,136	-
Totals	<u>\$ 22,892</u>	<u>\$ -</u>	<u>\$ 22,892</u>	<u>\$ -</u>
<u>December 31, 2018</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Investment Securities Available for Sale:				
U.S. government agency & treasury securities	\$ 28,385	\$ -	\$ 28,385	\$ -
Corporate debt securities	1,958	-	1,958	-
SBA pools	490	-	490	-
Mortgage-backed securities	1,417	-	1,417	-
Totals	<u>\$ 32,250</u>	<u>\$ -</u>	<u>\$ 32,250</u>	<u>\$ -</u>

**NOTE 21 - FAIR VALUE MEASUREMENTS (CONTINUED)**

Nonrecurring basis:

Impaired Loans – Loans are determined to be impaired when, in the judgment of management based on current information, it is probable that all amounts due will not be collected according to the contractual terms of the loan when due. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan, the fair value of the collateral that secures the loan or the present value of expected cash flows from the loan. Collateral may be in the form of real estate, personal property or business assets including equipment, inventory and accounts receivable. The value of real estate collateral may be determined by an appraisal using an income or market valuation approach by an independent licensed appraiser (Level 2). Management may use other valuation methods that include unobservable inputs or assumptions for other types of collateral, if an appraisal is not available for real estate collateral or if management determines that the value of real estate collateral is impaired below the appraised value (Level 3). The fair value of an impaired loan may also be based on the present value of expected cash flows which include unobservable inputs and assumptions (Level 3).

Other real estate owned – Loans transferred to other real estate owned may be adjusted to fair value at the time of foreclosure or written down to fair value if management obtains information that the fair value is less than the carrying value of the real estate. Fair value may be based on independent observable market prices or appraised values of the collateral (Level 2). Management may determine that the fair value of other real estate owned is further impaired below the appraised value or an appraisal may not be available. Fair value is then determined by management using other valuation methods that include unobservable inputs and assumptions (Level 3).

The following table summarizes the Bank’s assets that were measured at fair value on a nonrecurring basis as of December 31, 2019 and 2018:

Description	Balance as of December 31, 2019	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 961,383	\$ -	\$ -	\$ 961,383
Other real estate	\$ 1,788,218	\$ -	\$ -	\$ 1,788,218

Description	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Impaired loans	\$ 1,309,972	\$ -	\$ -	\$ 1,309,972
Other real estate	\$ 2,107,010	\$ -	\$ -	\$ 2,107,010

## **NOTE 21 - FAIR VALUE MEASUREMENTS (CONTINUED)**

The following table presents quantitative information about Level 3 Fair Value Measurements (in thousands):

<u>Description</u>	<u>Fair Value</u>	<u>Valuation Techniques</u>	<u>Unobservable Inputs</u>	<u>Range</u>	<u>Weighted Average</u>
<b>As of December 31, 2019:</b>					
Assets					
Impaired Loans	\$ 961	Discounted appraised value Discounted cash flow analysis	Estimated selling cost Discount for lack of marketability and age of appraisal	10% - 15% 0% - 5%	11% 0%
Other real estate owned	1,788	Discounted appraised value	Market rate for borrower Discount for lack of marketability and age of appraisal	5.50% - 6.75% 10%	6% 10%
<b>As of December 31, 2018:</b>					
Assets					
Impaired Loans	\$ 1,310	Discounted appraised value Discounted cash flow analysis	Estimated selling cost Discount for lack of marketability and age of appraisal	10% - 15% 0% - 5%	11% 0%
Other real estate owned	2,107	Discounted appraised value	Market rate for borrower Discount for lack of marketability and age of appraisal	6.25% - 7.5% 10%	7% 10%

## **NOTE 22 – STOCK BASED COMPENSATION**

The Company's 2019 Stock Incentive Plan (the "2019 Plan") was adopted by the Board of Directors of the Company on March 27, 2019 and approved by shareholders on May 22, 2019 at the Company's 2019 Annual Meeting of Shareholders. The 2019 Plan provides for the granting of restricted stock awards, incentive and non-statutory options, and other equity-based awards to employees and directors at the discretion of the Compensation Committee of the Board of Directors. The 2019 Plan authorizes the issuance of up to 500,000 shares of common stock. Not more than 250,000 of those shares may be available as any type of awards other than Incentive Stock Options.

### **Restricted Stock**

The Bank from time-to-time grants shares of restricted stock to key employees and non-employee directors. These awards help align the interests of these employees and directors with the interests of the shareholders of the Bank by providing economic value directly related to increases in the value of the Bank's common stock. The value of the stock awarded is established as the fair market value of the stock at the time of the grant. The Bank recognizes expense, equal to the total value of such awards, ratably over the vesting period of the stock grants. On December 18, 2019, the Bank issued 105,000 shares of restricted common stock at \$2.95 per share which vested upon the grant, resulting in compensation expense of \$309,750.

## **NOTE 23 – REVENUE RECOGNITION**

On January 1, 2018, the Bank adopted ASU No. 2016-10 “Revenue from Contracts with Customers” (Topic 606) and all subsequent ASUs that modified Topic 606. As stated in Note 1 Summary of Significant Accounting Policies, the implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

Topic 606 does not apply to revenue associated with financial instruments, including revenue from loans and securities. In addition, certain noninterest income streams such as fees associated with mortgage servicing rights, financial guarantees, derivatives, and certain credit card fees are also not in scope of the new guidance. Topic 606 is applicable to noninterest revenue streams such as trust and asset management income, deposit related fees, interchange fees, merchant income, and annuity and insurance commissions. However, the recognition of these revenue streams did not change significantly upon adoption of Topic 606. Substantially all of the Bank's revenue is generated from contracts with customers. Noninterest revenue streams in-scope of Topic 606 are discussed below.

### **Service Charges on Deposit Accounts**

Service charges and fees on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, check orders, and other deposit account related fees. The Bank's performance obligation for account analysis fees and monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Check orders and other deposit account related fees are largely transactional based, and therefore, the Bank's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

### **Debit and Credit Card Fees**

Debit and credit card fees are primarily comprised of debit and credit card income, merchant services income, and other service charges. Debit and credit card income is primarily comprised of interchange fees earned whenever the Bank's debit and credit cards are processed through card payment networks such as Visa. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. The Bank's performance obligation for fees, exchange, and other service charges are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month.

### **Other Income**

Other fees consist of safe deposit rents, ATM surcharges, wire fees, check cashing fees, and other miscellaneous income. These fees are largely transaction-based; therefore, the Bank's performance obligation is satisfied and the resultant revenue is recognized at the point in time the service is rendered. Payments for transaction-based fees are generally received immediately or in the following month by a direct charge to the customer's account.

#### **NOTE 24 - SUBSEQUENT EVENTS**

In accordance with FASB ASC Topic 855-10, the Bank evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) non-recognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Subsequent events have been evaluated through April 15, 2020, which is the date the financial statements were available to be issued.

On January 22, 2020, the Bank issued 82,500 shares of restricted common stock at \$2.91 per share which vested upon the grant, resulting in compensation expense of \$240,075.

The impact of the coronavirus outbreak, which became widespread beginning in February of 2020, had immediate impact on the stock market, consumer confidence and interest rates. The full impact on the US and global economy has yet to be determined but signs are that it will have a significant impact on 2020 GDP and overall financial performance of US corporations, including the banking sector. While management has and will continue to actively take steps to mitigate the impact of the recent market conditions on the balance sheet and earnings of the Bank, it should be noted that fair values, rates, yields, balance sheet composition and earnings could be altered by the event. Additionally, it is reasonably possible that estimates made in the financial statements have been, or will be, materially and adversely impacted in the near term as a result of these conditions, including the allowance for loan losses and other-than-temporary impairment of investment securities.