

Community First Financial Corporation

Independent Auditor's Report and Consolidated Financial Statements

December 31, 2018 and 2017

Community First Financial Corporation

December 31, 2018 and 2017

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Independent Auditor's Report

Board of Directors
Community First Financial Corporation
Kokomo, Indiana

We have audited the accompanying consolidated financial statements of Community First Financial Corporation and its subsidiaries, which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

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

BKD, LLP

Indianapolis, Indiana
February 6, 2019

Community First Financial Corporation
Consolidated Balance Sheets
December 31, 2018 and 2017

Assets

| | 2018 | 2017 |
|--|----------------|----------------|
| Cash and due from banks | \$ 1,987,299 | \$ 1,616,051 |
| Interest-bearing demand deposits in banks | 42,024,674 | 32,783,210 |
| Federal funds sold | 110,001 | 60,001 |
| Cash and cash equivalents | 44,121,974 | 34,459,262 |
| Available-for-sale securities | 8,501,118 | 10,522,587 |
| Loans held for sale | 305,920 | 1,249,793 |
| Loans, net of allowance for loan losses of \$4,367,121 and \$4,263,696 | 215,558,323 | 198,257,798 |
| Premises and equipment, net | 8,257,159 | 5,006,836 |
| Federal Home Loan Bank stock | 242,000 | 225,600 |
| Bank-owned life insurance | 6,213,553 | 6,050,352 |
| Foreclosed assets held for sale | 444,000 | 790,062 |
| Interest receivable and other assets | 2,691,810 | 3,552,633 |
| Total assets | \$ 286,335,857 | \$ 260,114,923 |

Liabilities

| | | |
|--|---------------|---------------|
| Deposits | | |
| Demand | \$ 41,486,723 | \$ 44,053,881 |
| Savings, NOW and money market | 140,446,364 | 130,434,890 |
| Time | 72,658,350 | 56,112,145 |
| Total deposits | 254,591,437 | 230,600,916 |
| Other borrowings | 725,000 | 815,000 |
| Interest payable and other liabilities | 1,922,155 | 2,333,897 |
| Total liabilities | 257,238,592 | 233,749,813 |

Stockholders' Equity

| | | |
|--|----------------|----------------|
| Common stock, \$1 par value; authorized 10,000,000 shares; 1,299,986 and 1,288,102 shares issued and outstanding at December 31, 2018 and 2017, respectively | 1,299,986 | 1,288,102 |
| Additional paid-in capital | 11,959,666 | 11,686,334 |
| Retained earnings | 15,930,520 | 13,439,528 |
| Accumulated other comprehensive loss | (92,907) | (48,854) |
| Total stockholders' equity | 29,097,265 | 26,365,110 |
| Total liabilities and stockholders' equity | \$ 286,335,857 | \$ 260,114,923 |

Community First Financial Corporation

Consolidated Statements of Income Years Ended December 31, 2018 and 2017

| | 2018 | 2017 |
|--|---------------|---------------|
| Interest Income | | |
| Loans | \$ 12,157,756 | \$ 10,251,230 |
| Securities - taxable | 601,756 | 380,779 |
| Federal funds sold | 32,121 | 16,065 |
| Total interest income | 12,791,633 | 10,648,074 |
| Interest Expense | | |
| Deposits | 1,932,908 | 674,354 |
| Other borrowings | 11,882 | 5,552 |
| Total interest expense | 1,944,790 | 679,906 |
| Net Interest Income | 10,846,843 | 9,968,168 |
| Provision for Loan Losses | 350,000 | 25,000 |
| Net Interest Income After Provision for Loan Losses | 10,496,843 | 9,943,168 |
| Noninterest Income | | |
| Service charges on deposit accounts | 307,968 | 303,138 |
| Interchange and debit card income | 440,350 | 426,590 |
| Net gains on loan sales | 369,167 | 600,968 |
| Increase in cash value of life insurance | 163,202 | 167,791 |
| Gain on foreclosed assets | 2,664 | - |
| Private banking income | 400,617 | 372,988 |
| Other | 127,152 | 245,336 |
| Total noninterest income | 1,811,120 | 2,116,811 |
| Noninterest Expense | | |
| Salaries and employee benefits | 4,945,506 | 5,121,862 |
| Net occupancy expense | 358,520 | 304,629 |
| Equipment expense | 369,043 | 248,639 |
| Data processing fees | 905,381 | 829,238 |
| Professional fees | 139,609 | 303,439 |
| FDIC assessment | 98,000 | 94,000 |
| Problem loan and foreclosed asset expense | 99,827 | 106,641 |
| Other | 1,124,893 | 919,817 |
| Total noninterest expense | 8,040,779 | 7,928,265 |
| Net Income Before Taxes | 4,267,184 | 4,131,714 |
| Income tax expense | 1,072,332 | 2,017,975 |
| Net Income | \$ 3,194,852 | \$ 2,113,739 |

Community First Financial Corporation
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2018 and 2017

| | 2018 | 2017 |
|--|---------------------|---------------------|
| Net Income | \$ 3,194,852 | \$ 2,113,739 |
| Other Comprehensive Loss | | |
| Unrealized depreciation on available-for-sale securities, net of tax benefit of \$9,382 and \$17,925 for 2018 and 2017, respectively | (26,576) | (33,161) |
| Comprehensive Income | \$ 3,168,276 | \$ 2,080,578 |

Community First Financial Corporation
Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2018 and 2017

| | Common Stock | | Additional Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|---|------------------|---------------------|----------------------------------|----------------------|---|----------------------|
| | Shares | Amount | | | | |
| Balance, January 1, 2017 | 1,288,102 | \$ 1,288,102 | \$ 11,686,334 | \$ 12,021,364 | \$ (15,693) | \$ 24,980,107 |
| Net income | | | | 2,113,739 | | 2,113,739 |
| Other comprehensive loss | | | | | (33,161) | (33,161) |
| Dividends on common stock, \$0.54 per share | | | | (695,575) | | (695,575) |
| Balance, December 31, 2017 | 1,288,102 | 1,288,102 | 11,686,334 | 13,439,528 | (48,854) | 26,365,110 |
| Net income | | | | 3,194,852 | | 3,194,852 |
| Reclassification due to <i>Tax Cuts and Jobs Act</i> | | | | 17,477 | (17,477) | - |
| Other comprehensive loss | | | | | (26,576) | (26,576) |
| Dividends on common stock, \$0.56 per share | | | | (721,337) | | (721,337) |
| Issuance of common stock | 11,884 | 11,884 | 273,332 | | | 285,216 |
| Balance, December 31, 2018 | <u>1,299,986</u> | <u>\$ 1,299,986</u> | <u>\$ 11,959,666</u> | <u>\$ 15,930,520</u> | <u>\$ (92,907)</u> | <u>\$ 29,097,265</u> |

Community First Financial Corporation
Consolidated Statements of Cash Flows
Years Ended December 31, 2018 and 2017

| | 2018 | 2017 |
|--|---------------|---------------|
| Operating Activities | | |
| Net income | \$ 3,194,852 | \$ 2,113,739 |
| Items not requiring (providing) cash | | |
| Depreciation and amortization | 249,547 | 189,734 |
| Provision for loan losses | 350,000 | 25,000 |
| Deferred income taxes | 106,765 | 343,210 |
| Amortization of premiums and discounts on securities | 51,568 | 61,349 |
| Gain on foreclosed assets | (2,664) | - |
| Changes in | | |
| Interest receivable and other assets | 689,480 | (197,916) |
| Cash surrender value of bank-owned life insurance | (163,201) | (167,792) |
| Interest payable and other liabilities | (411,742) | (108,932) |
| Loans held for sale | 943,873 | (367,410) |
| Net cash provided by operating activities | 5,008,478 | 1,890,982 |
| Investing Activities | | |
| Purchases of available-for-sale securities | - | (5,519,142) |
| Proceeds from calls and maturities of available-for-sale securities | 1,933,913 | 1,660,760 |
| Net change in loans | (17,881,821) | (23,288,407) |
| Purchase of premises and equipment | (3,499,870) | (1,615,543) |
| Proceeds from sale of foreclosed assets | 654,012 | 85,000 |
| Purchase of FHLB stock | (16,400) | - |
| Net cash used in investing activities | (18,810,166) | (28,677,332) |
| Financing Activities | | |
| Net change in demand deposits, money market, NOW and savings accounts | 7,444,316 | 42,668,631 |
| Net change in certificates of deposit | 16,546,205 | (1,216,752) |
| Dividends paid | (721,337) | (695,575) |
| Net change in other borrowings | (90,000) | (498,000) |
| Purchase from issuance of common stock | 285,216 | - |
| Net cash provided by financing activities | 23,464,400 | 40,258,304 |
| Increase in Cash and Cash Equivalents | 9,662,712 | 13,471,954 |
| Cash and Cash Equivalents, Beginning of Year | 34,459,262 | 20,987,308 |
| Cash and Cash Equivalents, End of Year | \$ 44,121,974 | \$ 34,459,262 |
| Supplemental Cash Flows Information | | |
| Interest paid | \$ 1,914,537 | \$ 669,989 |
| Income tax paid | 1,243,805 | 1,624,893 |
| Loan balances transferred to foreclosed and repossessed assets | 231,296 | 1,121,769 |
| SBA receivable | - | 937,423 |

Community First Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Table Dollar Amounts in Thousands, Except Share Data)

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

Nature of Operations

The consolidated financial statements include the accounts of Community First Financial Corporation (Company) and its wholly owned subsidiary, Community First Bank of Indiana (Bank). On August 14, 2009, a bank holding company, Community First Financial Corporation (Company), was formed. The principal activity of the Company is the ownership and management of the Bank.

The Bank commenced operations on January 30, 2003. The Bank is primarily engaged in providing a full range of banking and financial services to individual and corporate customers in Howard and surrounding counties of Indiana. The Bank is subject to competition from other financial institutions. The Bank is also subject to the regulation of certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and the Bank. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions 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 and fair value determination. In connection with the determination of the allowance for loan losses, management obtains independent appraisals for significant properties.

Cash and Cash Equivalents

The Company considers all liquid investments with original maturities of three months or less to be cash equivalents. At December 31, 2018, cash equivalents consisted primarily of federal funds sold.

At December 31, 2018, the Company's accounts exceeded federally insured limits by approximately \$38,983,000. This uninsured amount includes the Company's accounts with the Federal Reserve Bank and Federal Home Loan Bank in the amount of approximately \$2,017,000, which are not federally insured.

Community First Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Table Dollar Amounts in Thousands, Except Share Data)

Securities

Certain 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. Trading securities are recorded at fair value with changes in fair value included in earnings. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as “available for sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive loss. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

For debt securities with fair value below amortized cost when the Company does not intend to sell a debt security, and it is more likely than not the Company will not have to sell the security before recovery of its cost basis, it recognizes the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive loss. For held-to-maturity debt securities, the amount of other-than-temporary impairment recorded in other comprehensive loss for the noncredit portion of a previous other-than-temporary impairment is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance by charges to noninterest income. Gains and losses on loan sales are recorded in noninterest income, and direct loan origination costs and fees are deferred at origination of the loan and are recognized in noninterest income upon sale of the loan.

Loans

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

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

For all loan classes, the accrual of interest is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Past due status is based on contractual terms of the loan. For all loan classes, the entire balance of the loan is considered past due if the minimum payment contractually required to be paid is not received by the contractual due date. For all loan classes, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

Community First Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Table Dollar Amounts in Thousands, Except Share Data)

Management's general practice is to proactively charge down loans individually evaluated for impairment to the fair value of the underlying collateral. Consistent with regulatory guidance, charge-offs on all loan segments are taken when specific loans, or portions thereof, are considered uncollectible. The Company's policy is to promptly charge these loans off in the period the uncollectible loss is reasonably determined.

For all loan portfolio segments except residential and consumer loans, the Company promptly charges off loans, or portions thereof, when available information confirms that specific loans are uncollectible based on information that includes, but is not limited to, (1) the deteriorating financial condition of the borrower, (2) declining collateral values, and/or (3) legal action, including bankruptcy, that impairs the borrower's ability to adequately meet its obligations. For impaired loans that are considered to be solely collateral dependent, a partial charge-off is recorded when a loss has been confirmed by an updated appraisal or other appropriate valuation of the collateral.

The Company charges off residential and consumer loans, or portions thereof, when the Company reasonably determines the amount of the loss. The Company adheres to timeframes established by applicable regulatory guidance, which provides for the charge-down of 1-4 family first and junior lien mortgages to the net realizable value, less costs to sell when the loan is 180 days past due, charge-off of unsecured open-end loans when the loan is 90 days past due, and charge down to the net realizable value when other secured loans are 90 days past due. Loans at these respective delinquency thresholds for which the Company can clearly document that the loan is both well-secured and in the process of collection, such that collection will occur regardless of delinquency status, need not be charged off.

For all classes, all interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Nonaccrual loans are returned to accrual status when, in the opinion of management, the financial position of the borrower indicates there is no longer any reasonable doubt as to the timely collection of interest or principal. The Company requires a period of satisfactory performance of not less than six months before returning a nonaccrual loan to accrual status.

When cash payments are received on impaired loans in each loan class, the Company records the payment as interest income unless collection of the remaining recorded principal amount is doubtful, at which time payments are used to reduce the principal balance of the loan. Troubled debt restructured loans recognize interest income on an accrual basis at the renegotiated rate if the loan is in compliance with the modified terms, no principal reduction has been granted and the loan has demonstrated the ability to perform in accordance with the renegotiated terms for a period of at least six months.

Community First Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Table Dollar Amounts in Thousands, Except Share Data)

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to income. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonimpaired loans and is based on historical charge-off experience by segment. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the prior three years. Management believes the three year historical loss experience methodology is appropriate in the current economic environment. Other adjustments (qualitative/environmental considerations) for each segment may be added to the allowance for each loan segment after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

A loan is considered impaired when, based on current information and events, it is probable that the Company 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 based on the loan's current payment status and the borrower's financial condition including available sources of cash flows. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan-by-loan basis for nonhomogenous type loans such as commercial, nonowner residential and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price or the fair value of the collateral if the loan is collateral dependent. For impaired loans where the Company utilizes the discounted cash flows to determine the level of impairment, the Company includes the entire change in the present value of cash flows as bad debt expense.

Community First Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Table Dollar Amounts in Thousands, Except Share Data)

The fair values of collateral dependent impaired loans are based on independent appraisals of the collateral. In general, the Company acquires an updated appraisal upon identification of impairment and annually thereafter for commercial, commercial real estate and multi-family loans. If the most recent appraisal is over a year old and a new appraisal is not performed, due to lack of comparable values or other reasons, the existing appraisal is utilized and discounted 10%-50% based on the age of the appraisal, condition of the subject property, and overall economic conditions. After determining the collateral value as described, the fair value is calculated based on the determined collateral value, less selling expenses. The potential for outdated appraisal values is considered in our determination of the allowance for loan losses through our analysis of various trends and conditions including the local economy, trends in charge-offs and delinquencies, etc. and the related qualitative adjustments assigned by the Company.

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

In the course of working with borrowers, the Company may choose to restructure the contractual terms of certain loans. In this scenario, the Company attempts to work out an alternative payment schedule with the borrower in order to optimize collectability of the loan. Any loans that are modified are reviewed by the Company to identify if a troubled debt restructuring ("TDR") has occurred, which is when, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession to the borrower that it would not otherwise consider. Terms may be modified to fit the ability of the borrower to repay in line with its current financial status and the restructuring of the loan may include the transfer of assets from the borrower to satisfy the debt, a modification of loan terms, or a combination of the two. If such efforts by the Company do not result in a satisfactory arrangement, the loan is referred to legal counsel, at which time foreclosure proceedings are initiated. At any time prior to a sale of the property at foreclosure, the Company may terminate foreclosure proceedings if the borrower is able to work out a satisfactory payment plan.

It is the Company's policy to have any restructured loans which are on nonaccrual status prior to being restructured remain on nonaccrual status until six months of satisfactory borrower performance, at which time, management would consider its return to accrual status. If a loan was accruing at the time of restructuring, the Company reviews the loan to determine if it is appropriate to continue the accrual of interest on the restructured loan.

With regard to determination of the amount of the allowance for credit losses, troubled debt restructured loans are considered to be impaired. As a result, the determination of the amount of impaired loans for each portfolio segment within troubled debt restructurings is the same as detailed previously.

Premises and Equipment

Depreciable assets are stated at cost, less accumulated depreciation. Depreciation is charged to expense using the straight-line method over the estimated useful lives of the assets.

Community First Financial Corporation

Notes to Consolidated Financial Statements

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(Table Dollar Amounts in Thousands, Except Share Data)

Long-Lived Asset Impairment

The Company evaluates the recoverability of the carrying value of long-lived assets whenever events or circumstances indicate the carrying amount may not be recoverable. If a long-lived asset is tested for recoverability and the undiscounted estimated future cash flows expected to result from the use and eventual disposition of the asset is less than the carrying amount of the asset, the asset cost is adjusted to fair value and an impairment loss is recognized as the amount by which the carrying amount of a long-lived asset exceeds its fair value. No asset impairment was recognized during the years ended December 31, 2018 and 2017.

Federal Home Loan Bank Stock

Federal Home Loan Bank stock is a required investment for institutions that are members of the Federal Home Loan Bank system. The required investment in the common stock is based on a predetermined formula and carried at cost.

Foreclosed Assets Held for Sale

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

Stock-Based Compensation

The Company has stock-based employee compensation plans, which are described more fully in Note 12.

Income Taxes

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

Community First Financial Corporation

Notes to Consolidated Financial Statements

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(Table Dollar Amounts in Thousands, Except Share Data)

Uncertain tax positions are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more-likely-than-not means a likelihood of more than 50 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.

The Company recognizes interest and penalties on income taxes as a component of income tax expense.

The Company files consolidated income tax returns with its subsidiary.

Note 2: Restriction on Cash and Due From Banks

The Bank is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The reserve required at December 31, 2018 was \$1,852,000.

Note 3: Securities

The amortized cost and approximate fair values, together with gross unrealized gains and losses, of securities are as follows:

| | 2018 | | | |
|---|-------------------|------------------------------|-------------------------------|-----------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available-for-Sale Securities | | | | |
| U.S. Government and federal agencies | \$ 5,023 | \$ - | \$ (68) | \$ 4,955 |
| Mortgage-backed securities - Government-sponsored enterprises (GSE) residential | 3,604 | 4 | (62) | 3,546 |
| | <u>\$ 8,627</u> | <u>\$ 4</u> | <u>\$ (130)</u> | <u>\$ 8,501</u> |

Community First Financial Corporation

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

(Table Dollar Amounts in Thousands, Except Share Data)

| | 2017 | | | Fair Value |
|---|-------------------|------------------------------|-------------------------------|------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | |
| Available-for-Sale Securities | | | | |
| U.S. Government and federal agencies | \$ 5,542 | \$ - | \$ (58) | \$ 5,484 |
| Mortgage-backed securities - Government-sponsored enterprises (GSE) residential | 5,071 | 19 | (51) | 5,039 |
| | <u>\$ 10,613</u> | <u>\$ 19</u> | <u>\$ (109)</u> | <u>\$ 10,523</u> |

The amortized cost and fair value of available-for-sale securities at December 31, 2018, by contractual maturity, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

| | Amortized Cost | Fair Value |
|--|-------------------|-----------------|
| Less than one year | \$ 2,008 | \$ 1,990 |
| One to five years | 3,015 | 2,965 |
| | <u>5,023</u> | <u>4,955</u> |
| Mortgage-backed securities - GSE residential | 3,604 | 3,546 |
| Totals | <u>\$ 8,627</u> | <u>\$ 8,501</u> |

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$5,131,000 and \$6,714,000 at December 31, 2018 and 2017, respectively.

Certain investments in debt securities are reported in the consolidated financial statements at an amount less than their historical cost. Total fair value of these investments at December 31, 2018 and 2017 was \$8,060,000 and \$9,557,000, which is approximately 95% and 91% of the Company's available-for-sale investment portfolio. These declines primarily resulted from recent increases in market interest rates, failure of certain investments to maintain consistent credit quality ratings, changes in the market's perception of the current risks or failure to meet projected earnings targets.

Management believes the declines in fair value for these securities are temporary.

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The following tables show the Company's investments' gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment class and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2018 and 2017:

| Description of Securities | 2018 | | | | | |
|---------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Less Than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government and federal agencies | \$ - | \$ - | \$ 4,955 | \$ 68 | \$ 4,955 | \$ 68 |
| Mortgage-backed securities - | | | | | | |
| GSE residential | 156 | 1 | 2,949 | 61 | 3,105 | 62 |
| Total temporarily impaired securities | \$ 156 | \$ 1 | \$ 7,904 | \$ 129 | \$ 8,060 | \$ 130 |

| Description of Securities | 2017 | | | | | |
|---------------------------------------|---------------------|-------------------|-------------------|-------------------|------------|-------------------|
| | Less Than 12 Months | | 12 Months or More | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| U.S. Government and federal agencies | \$ 4,495 | \$ 48 | \$ 989 | \$ 10 | \$ 5,484 | \$ 58 |
| Mortgage-backed securities - | | | | | | |
| GSE residential | 1,402 | 13 | 2,671 | 38 | 4,073 | 51 |
| Total temporarily impaired securities | \$ 5,897 | \$ 61 | \$ 3,660 | \$ 48 | \$ 9,557 | \$ 109 |

There were no sales of available-for-sale securities during 2018 and 2017.

Note 4: Loans and Allowance for Loan Losses

Classes of loans at December 31 include:

| | 2018 | 2017 |
|---------------------------|------------|------------|
| Commercial | \$ 44,022 | \$ 39,781 |
| Construction | 22,441 | 17,620 |
| Commercial real estate | 95,624 | 89,965 |
| Residential | 25,066 | 21,678 |
| Home equity | 30,358 | 31,682 |
| Consumer | 2,414 | 1,796 |
| Total loans | 219,925 | 202,522 |
| Less | | |
| Allowance for loan losses | (4,367) | (4,264) |
| Net loans | \$ 215,558 | \$ 198,258 |

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The risk characteristics of each loan portfolio segment are as follows:

Commercial

The commercial segment includes agricultural and construction loan classes. Commercial loans are primarily based on the identified cash flows of the borrower and secondarily on the underlying collateral provided by the borrower. The cash flows of borrowers, however, may not be as expected and the collateral securing these loans may fluctuate in value. Most commercial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and may include a personal guarantee. Short-term loans may be made on an unsecured basis. In the case of loans secured by accounts receivable, the availability of funds for the repayment of these loans may be substantially dependent on the ability of the borrower to collect amounts due from its customers.

Construction loans are underwritten utilizing feasibility studies, independent appraisal reviews and financial analysis of the developers and property owners. Construction loans are generally based on estimates of costs and value associated with the complete project. These estimates may be inaccurate. Construction loans often involve the disbursement of substantial funds with repayment substantially dependent on the success of the ultimate project. Sources of repayment for these types of loans may be pre-committed permanent loans from approved long-term lenders, sales of developed property or an interim loan commitment from the Company until permanent financing is obtained. These loans are closely monitored by on-site inspections and are considered to have higher risks than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, governmental regulation of real property, general economic conditions and the availability of long-term financing.

Commercial Real Estate

Commercial real estate loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves higher loan principal amounts, and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The characteristics of properties securing the Company's commercial real estate portfolio are diverse, but with geographic location almost entirely in the Company's market area. Management monitors and evaluates commercial real estate loans based on collateral, geography and risk grade criteria. In general, the Company avoids financing single purpose projects unless other underwriting factors are present to help mitigate risk. In addition, management tracks the level of owner-occupied commercial real estate versus nonowner-occupied loans.

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Residential and Consumer

Residential and consumer loans consist of two segments - residential mortgage loans and consumer loans. For residential mortgage loans that are secured by 1-4 family residences and are generally owner-occupied, the Company generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. The consumer loan segment includes home equity loans. Home equity loans are typically secured by a subordinate interest in 1-4 family residences, and consumer personal loans are secured by consumer personal assets, such as automobiles or recreational vehicles. Some consumer personal loans are unsecured, such as small installment loans and certain lines of credit. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market areas, such as unemployment levels. Repayment can also be impacted by changes in property values on residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

The following presents, by portfolio segment, the activity in the allowance for loan losses for the years ended December 31, 2018 and 2017:

| | 2018 | | | | |
|--------------------|-----------------|------------------------|---------------|---------------|-----------------|
| | Commercial | Commercial Real Estate | Residential | Consumer | Total |
| Beginning Balance | \$ 1,303 | \$ 1,439 | \$ 988 | \$ 534 | \$ 4,264 |
| Provision (credit) | 325 | 478 | (542) | 89 | 350 |
| Loans charged off | (181) | (119) | (10) | (11) | (321) |
| Recoveries | 55 | 9 | 7 | 3 | 74 |
| Ending Balance | <u>\$ 1,502</u> | <u>\$ 1,807</u> | <u>\$ 443</u> | <u>\$ 615</u> | <u>\$ 4,367</u> |

| | 2017 | | | | |
|--------------------|-----------------|------------------------|---------------|---------------|-----------------|
| | Commercial | Commercial Real Estate | Residential | Consumer | Total |
| Beginning Balance | \$ 1,135 | \$ 1,699 | \$ 1,138 | \$ 664 | \$ 4,636 |
| Provision (credit) | 501 | (198) | (156) | (122) | 25 |
| Loans charged off | (445) | (99) | (3) | (10) | (557) |
| Recoveries | 112 | 37 | 9 | 2 | 160 |
| Ending Balance | <u>\$ 1,303</u> | <u>\$ 1,439</u> | <u>\$ 988</u> | <u>\$ 534</u> | <u>\$ 4,264</u> |

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The following tables present the balance in the allowance for loan losses and the recorded investment in loans based on the portfolio segment and impairment method as of December 31, 2018 and 2017:

| | 2018 | | | | |
|---------------------------------------|-------------------------|-------------------------|-------------------------|------------------------|--------------------------|
| | Commercial | Commercial Real Estate | Residential | Consumer | Total |
| Allowance Balances: | | | | | |
| Individually evaluated for impairment | \$ 293 | \$ 110 | \$ 20 | \$ - | \$ 423 |
| Collectively evaluated for impairment | <u>1,209</u> | <u>1,697</u> | <u>423</u> | <u>615</u> | <u>3,944</u> |
| Total allowance for loan losses | <u><u>\$ 1,502</u></u> | <u><u>\$ 1,807</u></u> | <u><u>\$ 443</u></u> | <u><u>\$ 615</u></u> | <u><u>\$ 4,367</u></u> |
| Loan Balances: | | | | | |
| Individually evaluated for impairment | \$ 1,391 | \$ 2,509 | \$ 351 | \$ - | \$ 4,251 |
| Collectively evaluated for impairment | <u>65,072</u> | <u>93,115</u> | <u>55,073</u> | <u>2,414</u> | <u>215,674</u> |
| Total loan balances | <u><u>\$ 66,463</u></u> | <u><u>\$ 95,624</u></u> | <u><u>\$ 55,424</u></u> | <u><u>\$ 2,414</u></u> | <u><u>\$ 219,925</u></u> |
| | 2017 | | | | |
| | Commercial | Commercial Real Estate | Residential | Consumer | Total |
| Allowance Balances: | | | | | |
| Individually evaluated for impairment | \$ 415 | \$ 175 | \$ 721 | \$ - | \$ 1,311 |
| Collectively evaluated for impairment | <u>888</u> | <u>1,264</u> | <u>267</u> | <u>534</u> | <u>2,953</u> |
| Total allowance for loan losses | <u><u>\$ 1,303</u></u> | <u><u>\$ 1,439</u></u> | <u><u>\$ 988</u></u> | <u><u>\$ 534</u></u> | <u><u>\$ 4,264</u></u> |
| Loan Balances: | | | | | |
| Individually evaluated for impairment | \$ 1,897 | \$ 864 | \$ 1,654 | \$ - | \$ 4,415 |
| Collectively evaluated for impairment | <u>55,504</u> | <u>89,101</u> | <u>51,706</u> | <u>1,796</u> | <u>198,107</u> |
| Total loan balances | <u><u>\$ 57,401</u></u> | <u><u>\$ 89,965</u></u> | <u><u>\$ 53,360</u></u> | <u><u>\$ 1,796</u></u> | <u><u>\$ 202,522</u></u> |

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Internal Risk Categories

Loan grades are numbered 1 through 8. Grades 1 through 4 are considered satisfactory grades. The grade of 5, or Watch, represents loans of lower quality and is considered criticized. The grades of 6, or Substandard, and 7, or Doubtful, refer to assets that are classified. The use and application of these grades by the bank will be uniform and shall conform to the bank's policy.

Prime (1) Loans are of superior quality with excellent credit strength and repayment ability providing a nominal credit risk.

Good (2) Loans are of above average credit strength and repayment ability providing only a minimal credit risk.

Satisfactory (3) Loans are of reasonable credit strength and repayment ability providing an average credit risk due to one or more underlying weaknesses.

Monitored (4) Loans are of the lowest acceptable credit strength and weakened repayment ability providing a cautionary credit risk due to one or more underlying weaknesses. Loans which require a higher level of monitoring than most pass credits are also included in this classification.

Watch (5) A watch asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Watch assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

Substandard (6) Loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful (7) Loans classified as doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of current known facts, conditions and values, highly questionable and improbable.

Loss (8) Loans classified as loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off even though partial recovery may be affected in the future.

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The following tables present the credit risk profile of the Company's loan portfolio based on rating category and payment activity as of December 31, 2018 and 2017:

| | 2018 | | | | | | |
|-----------------|------------------|------------------|------------------------|------------------|------------------|-----------------|-------------------|
| | Commercial | Construction | Commercial Real Estate | Residential | Home Equity | Consumer | Total |
| Grade: | | | | | | | |
| Pass (1-4) | \$ 39,386 | \$ 22,241 | \$ 88,246 | \$ 22,383 | \$ 30,117 | \$ 2,300 | \$ 204,673 |
| Watch (5) | 3,269 | 200 | 4,457 | 2,259 | 198 | 114 | 10,497 |
| Substandard (6) | 1,367 | - | 2,921 | 424 | 43 | - | 4,755 |
| Doubtful (7) | - | - | - | - | - | - | - |
| Loss (8) | - | - | - | - | - | - | - |
| Total | <u>\$ 44,022</u> | <u>\$ 22,441</u> | <u>\$ 95,624</u> | <u>\$ 25,066</u> | <u>\$ 30,358</u> | <u>\$ 2,414</u> | <u>\$ 219,925</u> |

| | 2017 | | | | | | |
|-----------------|------------------|------------------|------------------------|------------------|------------------|-----------------|-------------------|
| | Commercial | Construction | Commercial Real Estate | Residential | Home Equity | Consumer | Total |
| Grade: | | | | | | | |
| Pass (1-4) | \$ 37,045 | \$ 17,491 | \$ 86,920 | \$ 18,659 | \$ 31,380 | \$ 1,637 | \$ 193,132 |
| Watch (5) | 885 | 129 | 2,026 | 970 | 198 | 159 | 4,367 |
| Substandard (6) | 1,851 | - | 1,019 | 2,049 | 104 | - | 5,023 |
| Doubtful (7) | - | - | - | - | - | - | - |
| Loss (8) | - | - | - | - | - | - | - |
| Total | <u>\$ 39,781</u> | <u>\$ 17,620</u> | <u>\$ 89,965</u> | <u>\$ 21,678</u> | <u>\$ 31,682</u> | <u>\$ 1,796</u> | <u>\$ 202,522</u> |

The following tables present the Company's loan portfolio aging analysis and nonaccrual loans as of December 31, 2018 and 2017:

| | 2018 | | | | | | |
|------------------------|---------------------|---------------------|----------------------|----------------|-------------------|-------------------|----------------------------------|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Total Loans > 90 Days & Accruing |
| Commercial | \$ - | \$ 22 | \$ 293 | \$ 315 | \$ 43,707 | \$ 44,022 | \$ 293 |
| Construction | - | - | - | - | 22,441 | 22,441 | - |
| Commercial real estate | 113 | - | 63 | 176 | 95,448 | 95,624 | - |
| Residential | 83 | - | 90 | 173 | 24,893 | 25,066 | 90 |
| Home equity | - | - | 95 | 95 | 30,263 | 30,358 | 95 |
| Consumer | 7 | 2 | - | 9 | 2,405 | 2,414 | - |
| Total loans | <u>\$ 203</u> | <u>\$ 24</u> | <u>\$ 541</u> | <u>\$ 768</u> | <u>\$ 219,157</u> | <u>\$ 219,925</u> | <u>\$ 478</u> |

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| | 2017 | | | | | | Total Loans > 90 Days & Accruing |
|------------------------|------------------------|------------------------|----------------------------|-------------------|-------------------|-------------------|--|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | |
| Commercial | \$ - | \$ 51 | \$ - | \$ 51 | \$ 39,730 | \$ 39,781 | \$ - |
| Construction | - | - | - | - | 17,620 | 17,620 | - |
| Commercial real estate | 79 | - | 148 | 227 | 89,738 | 89,965 | - |
| Residential | - | - | - | - | 21,678 | 21,678 | - |
| Home equity | 13 | - | - | 13 | 31,669 | 31,682 | - |
| Consumer | - | - | 10 | 10 | 1,786 | 1,796 | 10 |
| Total loans | \$ 92 | \$ 51 | \$ 158 | \$ 301 | \$ 202,221 | \$ 202,522 | \$ 10 |

The following tables present impaired loans for the years ended December 31, 2018 and 2017:

| | 2018 | | | | |
|--|---------------------|--------------------------------|-----------------------|---|----------------------------------|
| | Recorded Balance | Unpaid Principal Balance | Specific Allowance | Average Investment in Impaired Loans | Interest Income Recognized |
| Impaired loans without a specific valuation allowance: | | | | | |
| Commercial | \$ 923 | \$ 923 | \$ - | \$ 966 | \$ 55 |
| Construction | - | - | - | - | - |
| Commercial real estate | 2,137 | 2,137 | - | 672 | 48 |
| Residential | 62 | 62 | - | 63 | 4 |
| Home equity | 24 | 24 | - | 31 | 2 |
| Consumer | - | - | - | - | - |
| Total impaired loans with no related specific reserve | \$ 3,146 | \$ 3,146 | \$ - | \$ 1,732 | \$ 109 |
| Impaired loans with a specific valuation allowance: | | | | | |
| Commercial | \$ 468 | \$ 468 | \$ 293 | \$ 736 | \$ 52 |
| Construction | - | - | - | - | - |
| Commercial real estate | 372 | 372 | 110 | 511 | 26 |
| Residential | 245 | 245 | - | 760 | 41 |
| Home equity | 20 | 20 | 20 | 20 | 1 |
| Consumer | - | - | - | - | - |
| Total impaired loans with an allowance recorded | \$ 1,105 | \$ 1,105 | \$ 423 | \$ 2,027 | \$ 120 |
| Total impaired loans | \$ 4,251 | \$ 4,251 | \$ 423 | \$ 3,759 | \$ 229 |

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| | 2017 | | | | |
|--|---------------------|--------------------------------|-----------------------|---|----------------------------------|
| | Recorded Balance | Unpaid Principal Balance | Specific Allowance | Average Investment in Impaired Loans | Interest Income Recognized |
| Impaired loans without a specific valuation allowance: | | | | | |
| Commercial | \$ 953 | \$ 953 | \$ - | \$ 1,408 | \$ 110 |
| Construction | - | - | - | - | - |
| Commercial real estate | 152 | 152 | - | 552 | 10 |
| Residential | 65 | 65 | - | 66 | 4 |
| Home equity | 32 | 32 | - | 34 | 2 |
| Consumer | - | - | - | 66 | 3 |
| | <u>-</u> | <u>-</u> | <u>-</u> | <u>66</u> | <u>3</u> |
| Total impaired loans with no related specific reserve | <u>\$ 1,202</u> | <u>\$ 1,202</u> | <u>\$ -</u> | <u>\$ 2,126</u> | <u>\$ 129</u> |
| Impaired loans with a specific valuation allowance: | | | | | |
| Commercial | \$ 944 | \$ 944 | \$ 415 | \$ 856 | \$ 62 |
| Construction | - | - | - | - | - |
| Commercial real estate | 712 | 729 | 175 | 654 | 36 |
| Residential | 1,536 | 1,536 | 700 | 1,452 | 51 |
| Home equity | 21 | 21 | 21 | 22 | 1 |
| Consumer | - | - | - | - | - |
| | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> | <u>-</u> |
| Total impaired loans with an allowance recorded | <u>\$ 3,213</u> | <u>\$ 3,230</u> | <u>\$ 1,311</u> | <u>\$ 2,984</u> | <u>\$ 150</u> |
| Total impaired loans | <u>\$ 4,415</u> | <u>\$ 4,432</u> | <u>\$ 1,311</u> | <u>\$ 5,110</u> | <u>\$ 279</u> |

The following table presents the Company's nonaccrual loans at December 31, 2018 and 2017. This table excludes purchased impaired loans and performing troubled debt restructurings.

| | 2018 | 2017 |
|------------------------|--------------|---------------|
| Commercial | \$ - | \$ 51 |
| Construction | - | - |
| Commercial real estate | 63 | 148 |
| Residential | - | 86 |
| Home equity | - | - |
| Consumer | - | - |
| | <u>-</u> | <u>-</u> |
| Total loans | <u>\$ 63</u> | <u>\$ 285</u> |

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Interest income on loans individually classified as impaired is recognized on a cash basis after all past due and current principal payments have been made.

There were no newly issued troubled debt restructurings during the year ended December 31, 2018. At December 31, 2017, the Company had a number of loans that were modified in troubled debt restructurings and impaired. The modification of terms of such loans included one or a combination of the following: an extension of maturity, a reduction of the stated interest rate or a permanent reduction of the recorded investment in the loan.

The following tables present information regarding troubled debt restructurings by class for the year ended December 31, 2017.

Newly classified troubled debt restructurings:

| | Number of Loans | 2017 Pre- Modification Recorded Balance | Post- Modification Recorded Balance |
|------------------------|----------------------------|--|--|
| Commercial | 1 | \$ 264 | \$ 264 |
| Construction | - | - | - |
| Commercial real estate | 1 | 88 | 88 |
| Residential | - | - | - |
| Home equity | - | - | - |
| Consumer | - | - | - |
| | <u>2</u> | <u>\$ 352</u> | <u>\$ 352</u> |

The troubled debt restructurings described above did not increase the allowance for loan losses and resulted in no charge-offs during the year ended December 31, 2017.

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Newly restructured loans by type of modification:

| | Interest Only | Term | 2017 Principal Reduction | Combination | Total Modifications |
|------------------------|------------------|-------------|--------------------------------|---------------|------------------------|
| Commercial | \$ - | \$ - | \$ - | \$ 264 | \$ 264 |
| Construction | - | - | - | - | - |
| Commercial real estate | - | - | - | 88 | 88 |
| Residential | - | - | - | - | - |
| Home equity | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 352</u> | <u>\$ 352</u> |

There were no troubled debt restructured loans modified in the last 12 months that subsequently defaulted.

Note 5: Premises and Equipment

Major classifications of premises and equipment, stated at cost, are as follows:

| | 2018 | 2017 |
|-------------------------------|-----------------|-----------------|
| Land | \$ 973 | \$ 973 |
| Buildings and improvements | 3,389 | 3,253 |
| Equipment | 1,764 | 1,361 |
| Fixed assets in process | 3,973 | 1,202 |
| | <u>10,099</u> | <u>6,789</u> |
| Less accumulated depreciation | <u>(1,842)</u> | <u>(1,782)</u> |
| Net premises and equipment | <u>\$ 8,257</u> | <u>\$ 5,007</u> |

At December 31, 2018, the Company had commitments for construction contracts totaling approximately \$2,663,000.

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Note 6: Deposits

Interest-bearing deposits in denominations of \$250,000 or more were approximately \$32,980,000 and \$22,172,000 on December 31, 2018 and 2017, respectively. The Company has one customer that represents approximately \$42,950,000 and \$38,553,000 of total deposits as of December 31, 2018 and 2017, respectively. The Company held \$23,362,000 and \$14,635,000 in brokered deposits at December 31, 2018 and 2017, respectively.

At December 31, 2018, the scheduled maturities of time deposits are as follows:

| | | |
|------|----|-------------|
| 2019 | \$ | 45,684 |
| 2020 | | 20,311 |
| 2021 | | 3,826 |
| 2022 | | 415 |
| 2023 | | 2,422 |
| | | <hr/> |
| | \$ | 72,658 |
| | | <hr/> <hr/> |

Note 7: Other Borrowings

Other borrowings included the following at December 31:

| | <u>2018</u> | <u>2017</u> |
|---|-------------|-------------|
| Securities sold under repurchase agreements | \$ 725 | \$ 815 |
| | <hr/> <hr/> | <hr/> <hr/> |

Securities sold under agreements to repurchase consist of obligations of the Company to other parties. The obligations are secured by investment securities, and such collateral is held by the Company's safekeeping agent. The maximum amount of outstanding agreements at any month end during 2018 and 2017 totaled \$1,065,000 and \$4,523,000, respectively, and the monthly average of such agreements totaled \$859,000 and \$1,507,000 for 2018 and 2017, respectively. The agreements at December 31, 2018 mature daily.

Securities sold under agreements to repurchase are secured by U.S. Government and federal agencies and mortgage-backed securities - GSE residential. The Company may be required to provide additional collateral securing the borrowings in the event of a decrease in the market value of the pledged securities. The Company mitigates this risk by monitoring the market value and liquidity of the collateral and ensuring that it holds a sufficient level of eligible securities to cover potential increases in collateral requirements.

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The following tables represent the remaining contractual maturity of repurchase agreements disaggregated by the class of securities pledged as of December 31.

| | 2018 | | | | Total |
|--|------------------------|-------------|-------------|-------------|---------------|
| | Overnight & Continuous | < 30 Days | 30-90 Days | > 90 Days | |
| U.S. Government and federal agencies | \$ 201 | \$ - | \$ - | \$ - | \$ 201 |
| Mortgage-backed securities - GSE residential | 524 | - | - | - | 524 |
| Total | <u>\$ 725</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 725</u> |

| | 2017 | | | | Total |
|--|------------------------|-------------|-------------|-------------|---------------|
| | Overnight & Continuous | < 30 Days | 30-90 Days | > 90 Days | |
| U.S. Government and federal agencies | \$ 237 | \$ - | \$ - | \$ - | \$ 237 |
| Mortgage-backed securities - GSE residential | 578 | - | - | - | 578 |
| Total | <u>\$ 815</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ -</u> | <u>\$ 815</u> |

Note 8: Income Taxes

The provision for income taxes includes these components:

| | 2018 | 2017 |
|-------------------|-----------------|-----------------|
| Currently payable | | |
| Federal | \$ 719 | \$ 1,425 |
| State | 246 | 250 |
| Deferred | | |
| Federal | 96 | 344 |
| State | 11 | (1) |
| | <u>\$ 1,072</u> | <u>\$ 2,018</u> |

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A reconciliation of income tax expense at the statutory rate to the Bank's actual income tax expense is shown below:

| | 2018 | 2017 |
|--|-----------------|-----------------|
| Computed at the statutory rate (21% and 34%) | \$ 896 | \$ 1,405 |
| Increase (decrease) resulting from | | |
| Tax-exempt interest | (1) | (2) |
| Increase in cash surrender value of bank-owned life insurance | (34) | (57) |
| State income taxes | 203 | 164 |
| Tax rate change impact on deferred tax assets and liabilities | - | 506 |
| Other | 8 | 2 |
| | <u>8</u> | <u>2</u> |
| Actual tax expense | <u>\$ 1,072</u> | <u>\$ 2,018</u> |

The tax effects of temporary differences related to deferred taxes shown on the consolidated balance sheets in other assets were:

| | 2018 | 2017 |
|------------------------------|-----------------|-----------------|
| Deferred tax assets | | |
| Allowance for loan losses | \$ 943 | \$ 864 |
| Organizational costs | 8 | 9 |
| Accrued compensated absences | 99 | 149 |
| Deferred compensation | 323 | 304 |
| Nonaccrual loans | 18 | 76 |
| Investment securities | 33 | 23 |
| Other real estate owned | 28 | - |
| Other | 14 | 14 |
| | <u>1,466</u> | <u>1,439</u> |
| Deferred tax liabilities | | |
| Prepaid expenses | (29) | (22) |
| Depreciation | (290) | (165) |
| State tax | (71) | (73) |
| Loans held for sale | (14) | (20) |
| | <u>(404)</u> | <u>(280)</u> |
| Net deferred tax asset | <u>\$ 1,062</u> | <u>\$ 1,159</u> |

On December 22, 2017, the United States enacted tax reform legislation through the *Tax Cuts and Jobs Act*, which significantly changes the existing U.S. tax laws, including a reduction in the corporate tax rate from 34% to 21%, as well as other changes. As a result of the enactment of the legislation, the Company incurred additional one-time income tax expense of \$506,000 during the fourth quarter of 2017, primarily related to the remeasurement of certain deferred tax assets and liabilities. Included in this additional one-time income tax expense of \$506,000 is \$17,000 related to the adjustment of deferred tax assets for net unrealized losses on available-for-sale securities included in accumulated other comprehensive loss.

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Note 9: Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive losses, included in the consolidated statements of stockholders' equity, are related to unrealized losses in the available-for-sale investment portfolio. Net unrealized losses as of December 31, 2018 and 2017 were approximately \$126,000 and \$90,000 with related deferred income tax of approximately \$33,000 and \$23,000, respectively.

Note 10: Regulatory Matters

The Company and Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's and Bank's consolidated financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and Bank must meet specific capital guidelines that involve quantitative measures of the Company's and Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Company's and Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Furthermore, the Company's and Bank's regulators could require adjustments to regulatory capital not reflected in these consolidated financial statements.

Quantitative measures established by regulation to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios (set forth in the table below) of total and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), common equity Tier I capital (as defined) to total risk-weighted assets (as defined) and of Tier I capital (as defined) to average assets (as defined). Management believes, as of December 31, 2018 and 2017, that the Company and Bank meet all capital adequacy requirements to which they are subject.

As of December 31, 2018, the most recent notification from the regulators categorized the Company and Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company and Bank must maintain minimum total risk-based, Tier I risk-based capital, common equity Tier I risk-based capital 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 Company's and Bank's category.

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The Company's and Bank's actual capital amounts and ratios are also presented in the table.

| | Actual | | Minimum Required For Capital Adequacy Purposes | | Minimum Required To Be Well Capitalized Under Prompt Corrective Action Provisions | |
|--------------------------------|-----------|-------|--|-------|---|-------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2018 | | | | | | |
| Total capital ¹ | | | | | | |
| (to risk-weighted assets) | \$ 32,265 | 12.7% | \$ 20,371 | 8.0% | \$ 25,464 | 10.0% |
| Tier I capital ¹ | | | | | | |
| (to risk-weighted assets) | 29,067 | 11.4% | 15,278 | 6.0% | 20,371 | 8.0% |
| Common Equity Tier 1 capital | | | | | | |
| (to risk-weighted assets) | 29,067 | 11.4% | 11,459 | 4.5% | 16,552 | 6.5% |
| Tier I capital ¹ | | | | | | |
| (to average assets) | 29,067 | 10.9% | 10,621 | 4.0% | 13,277 | 5.0% |
| As of December 31, 2017 | | | | | | |
| Total capital ¹ | | | | | | |
| (to risk-weighted assets) | \$ 29,256 | 12.4% | \$ 18,871 | 8.0% | \$ 23,588 | 10.0% |
| Tier I capital ¹ | | | | | | |
| (to risk-weighted assets) | 26,291 | 11.1% | 14,153 | 6.0% | 18,871 | 8.0% |
| Common Equity Tier 1 capital | | | | | | |
| (to risk-weighted assets) | 26,291 | 11.1% | 10,615 | 4.5% | 15,332 | 6.5% |
| Tier I capital ¹ | | | | | | |
| (to average assets) | 26,291 | 10.6% | 9,953 | 4.0% | 12,442 | 5.0% |

The above minimum capital requirements exclude the capital conservation buffer required to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. The capital conservation buffer is being phased in from 0.0% for 2015 to 2.50% by 2019. The capital conservation buffer was 1.875% at December 31, 2018. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital.

Basel III Capital Rules

In July 2013, the three federal bank regulatory agencies jointly published final rules (the Basel III Capital Rules) establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. These rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. These rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules were effective for the Bank on January 1, 2015 (subject to a four-year phase-in period).

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The Basel III Capital Rules, among other things, (i) introduce a new capital measure called “Common Equity Tier 1” (CET1), (ii) specify that Tier 1 capital consist of CET1 and “Additional Tier 1 Capital” instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments as compared to existing regulations.

Note 11: Related Party Transactions

At December 31, 2018 and 2017, the Company had loans outstanding to executive officers, directors, significant shareholders and their affiliates (related parties), in the amount of \$4,659,000 and \$4,468,000, respectively.

In management’s opinion, such loans and other extensions of credit and deposits were made in the ordinary course of business and were made on substantially the same terms (including interest rates and collateral) as those prevailing at the time for comparable transactions with other persons. Further, in management’s opinion, these loans did not involve more than normal risk of collectability or present other unfavorable features.

Deposits from related parties held by the Company at December 31, 2018 and 2017 totaled approximately \$4,034,000 and \$3,693,000, respectively.

Note 12: Employee Benefits

The Company has a retirement savings 401(k) plan covering substantially all employees. Employees may contribute up to 100% of their compensation with the Bank matching 100% of contributions up to 6% of the employee’s compensation for the plan year. In addition, the Company contributes, on a nondiscretionary basis, a profit-sharing of 3% of employee’s salaries. In 2014, the Company amended the plan to allow employees the option of investing in Company stock. Employer contributions charged to expense for 2018 and 2017 were \$254,000 and \$262,000, respectively.

In 2005, the Board of Directors approved a phantom stock plan. The plan will reward certain Directors and employees of the Company based on the value of the Company’s stock. The phantom stock plan has a 20% per year vesting period beginning in the first year the phantom shares are awarded. Employee payout is to be made in cash. Expenses recognized for the plan in 2018 and 2017 were approximately \$156,000 and \$217,000, respectively.

The Company has entered into employment agreements with certain officers that provide for the continuation of salary and certain benefits for a specified period of time under certain conditions. Under the terms of the agreements, these payments could occur in the event of a change in control of the Bank, as defined, along with other specific conditions.

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Note 13: Stock Repurchase Program

In 2013, the Company approved the repurchase of stock with the maximum amount of 58,862 shares totaling \$725,000.

Additionally, in 2014, the Company approved the repurchase of stock with the maximum amount of 32,000 shares totaling \$496,000.

There were no shares repurchased by the Company during 2018 and 2017.

Note 14: Lease

During 2015, the Company entered into an operating lease for a loan production office. The lease may be subject to additional payments based on building operating costs and property taxes in excess of specified amounts. The Company has the option to renew the lease for a period of up to five years upon termination of the initial lease term. In 2018, the Company entered into another operating lease for an additional loan production office. The lease term commenced on September 1, 2018 and is on a month to month basis. The lease can be terminated with a 14 day written notice. Rental expense for the years ended December 31, 2018 and 2017 was approximately \$45,000 and \$40,000, respectively.

Future minimum lease payments under operating leases are:

| | Operating Lease |
|------------|----------------------------|
| 2019 | \$ 39 |
| 2020 | 33 |
| 2021 | - |
| 2022 | - |
| 2023 | - |
| Thereafter | - |
| | <hr/> <hr/> |
| | \$ 72 |

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Note 15: Disclosures About Fair Values of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value measurements must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs supported by little or no market activity and are significant to the fair value of the assets or liabilities

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets and liabilities pursuant to the valuation hierarchy.

Available-for-Sale Securities

The Company uses a third-party provider to provide market prices on its securities. Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. No securities are priced as Level 1. If quoted market prices are not available, then fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flows. Level 2 securities include U.S. Government agency securities, mortgage-backed securities and obligations of state, municipals and certain corporate and other securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3. No securities are priced as Level 3.

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The following tables present the fair value measurements of assets recognized in the accompanying consolidated balance sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2018 and 2017:

| | 2018 | | | |
|--|---|---|--|-------------|
| | Fair Value Measurements Using | | | |
| Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| U.S. Government and federal agencies | \$ 4,955 | \$ - | \$ 4,955 | \$ - |
| Mortgage-backed securities - GSE residential | 3,546 | - | 3,546 | - |
| | <u>\$ 8,501</u> | <u>\$ -</u> | <u>\$ 8,501</u> | <u>\$ -</u> |

| | 2017 | | | |
|--|---|---|--|-------------|
| | Fair Value Measurements Using | | | |
| Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| U.S. Government and federal agencies | \$ 5,484 | \$ - | \$ 5,484 | \$ - |
| Mortgage-backed securities - GSE residential | 5,039 | - | 5,039 | - |
| | <u>\$ 10,523</u> | <u>\$ -</u> | <u>\$ 10,523</u> | <u>\$ -</u> |

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy. For assets classified within Level 3 of the fair value hierarchy, the process used to develop the reported fair value is described below.

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

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

The following tables present the fair value measurement of assets measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2018 and 2017:

| | 2018 | | | |
|-------------------|---|--|--|--------|
| | Fair Value Measurements Using | | | |
| Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Impaired loans | \$ 100 | \$ - | \$ - | \$ 100 |

| | 2017 | | | |
|-------------------|---|--|--|--------|
| | Fair Value Measurements Using | | | |
| Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Impaired loans | \$ 241 | \$ - | \$ - | \$ 241 |

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Unobservable (Level 3) Inputs

The following tables present quantitative information about unobservable inputs used in nonrecurring Level 3 fair value measurements other than goodwill.

| | Fair Value at December 31, 2018 | Valuation Technique | Unobservable Inputs | Range (Weighted- Average) |
|-------------------------------------|--|--------------------------------|--------------------------------|--|
| Collateral-dependent impaired loans | \$ 100 | Market comparable properties | Marketability discount | 50% (50%) |

| | Fair Value at December 31, 2017 | Valuation Technique | Unobservable Inputs | Range (Weighted- Average) |
|-------------------------------------|--|--------------------------------|--------------------------------|--|
| Collateral-dependent impaired loans | \$ 241 | Market comparable properties | Marketability discount | 20% - 60% (40%) |

Note 16: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Estimates related to the allowance for loan losses are reflected in the footnote regarding loans. Current vulnerabilities due to certain concentrations of credit risk are discussed in the footnote on commitments and credit risk. Deposit concentrations are discussed in the deposit footnote.

Note 17: Commitments and Credit Risk

Letters of Credit

Letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These 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 loans to customers. The Company had total outstanding letters of credit amounting to \$220,000 and \$565,000 at December 31, 2018 and 2017, respectively.

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Lines of Credit

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

Management uses the same credit policies in granting lines of credit as it does for on-balance-sheet instruments.

At December 31, 2018 and 2017, the Company had granted unused lines of credit to borrowers aggregating approximately \$44,983,000 and \$45,531,000, respectively.

Note 18: Subsequent Events

Subsequent events have been evaluated through February 6, 2019, which is the date the consolidated financial statements were available to be issued.