# 100 YEARS STRONG

PROMPT · COURTEOUS · SECURE · RELIABLE

FB

# FARMERS BANK

CELEBRATING 100 YEARS

*ANNUAL REPORT 2018*

**Dear Shareholder,**

As we commence our one hundredth year as a community bank we are pleased to announce record earnings for the fourth consecutive year. Net income for 2018 grew to $4,875,252, or $1.59 per share, an increase of 8.23% from the $4,504,779 or $1.47 per share reported in 2017. A major contributor to that increase was net interest income which was positively impacted by the rise in interest rates and increased 5.63% when compared to annualized results of 2017. Offsetting a portion of the increase in income were the costs associated with our core conversion which elevated non-interest expenses by approximately $457,000, net of tax. Even with these additional expenses we compare favorably to our peer banks, posting a return on average assets of 1.07% and a return on equity of 10.31%. Our shareholders have benefited from the increased income by way of an increased dividend which was $.42 in 2018 compared to $.40 in 2017. This represents a dividend payout ratio of 26% and a dividend yield of 2.29% based on our share price as of March 15, 2019.

From a regulatory perspective, the Company remains well capitalized and our focus continues to be on efficiently deploying capital in a safe and sound manner. Asset quality is still improving due to positive market conditions and our commitment to prudent lending standards. We have made great strides in this area and plan to grow the loan portfolio in an intentional way that does not compromise this progress.

While our staff and customers encountered challenges in 2018 as we implemented our technology upgrades, we realized several of our strategic goals that will position us for future expansion and competitiveness. We are beginning to realize efficiencies from our core conversion that will aid in managing non-interest expenses in the future. We feel confident in our product offerings and our ability to continue to expand the digital banking experience for our customers.

Our investment in the Chesapeake market is gaining traction and is producing favorable results, which is encouraging as we continue to evaluate further expansion in eastern Tidewater. We have identified a permanent location for our Chesapeake office that we believe will improve visibility and access. This investment is an indication of our long term commitment to the eastern Tidewater area.

We continue to concentrate on organic, balanced growth that we believe will result in long-term benefits for our shareholders. Despite recent consolidation, the banking industry continues to be very competitive which has put pressure on net interest margins. Mergers and acquisitions have reduced the number of banks, increasing the size of many of those that remain. Fintech companies and other non-bank entities are encroaching on market share. While we are experiencing a financial revolution, we still believe the market will continue to embrace community banks that can provide a high level of customization and flexibility. As we have discussed in previous communications to you, we have made great efforts to diversify revenue streams and add complementary business lines to ensure we do not depend solely on net interest margin for profitability. Our investment in Manry Rawls Insurance continues to provide non-interest income and we are further developing that business line through acquisitions of small agencies in contiguous markets.

This year marks our 100th anniversary as a community bank. This accomplishment would not have been possible without the loyalty and friendship you have so graciously shown us through the years. As we celebrate this milestone we want to remain focused on our core values to ensure we continue to provide prompt, reliable, secure and courteous service to our customers and community for the next one hundred years.

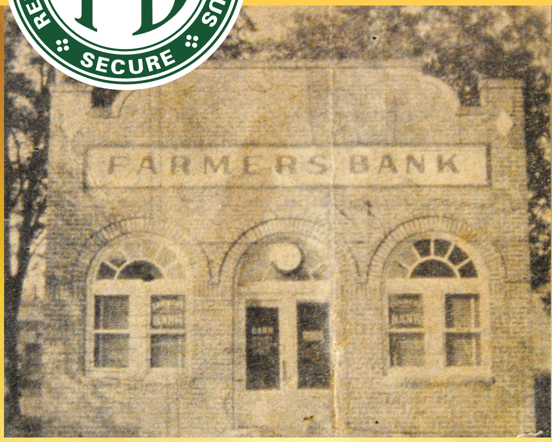
As we embark on our second century, it is a privilege for us to work alongside a Board of Directors, management team and staff that are committed to our mission. We want to conclude by expressing our genuine gratitude to them, and you, our loyal shareholders.

Sincerely,

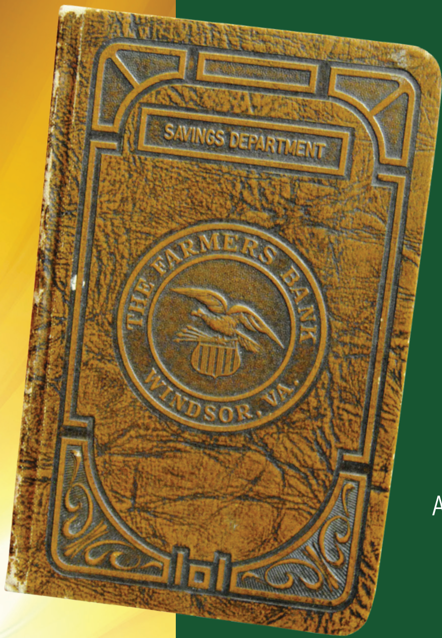
Richard J. Holland, Jr.
*Chairman and CEO*

Vernon M. Towler
*President*

# CELEBRATING 100 YEARS




The Farmers Bank housed in a modern brick building located in the thriving Town of Windsor, is pictured above. The bank was founded in 1919. The officers were W. H. Johnson, President; Lorenzo Bailey, Vice President; S.T. Holland, Cashier.




Shirley T. Holland


WEDNESDAY, JANUARY 15, 1969 SINGLE COPY 10¢

**Shirley Holland Retires After 50 Years in Windsor Bank**

Shirley T. Holland, Chairman of the Board of Farmers Bank, Windsor, has retired from active status with the Bank. A dinner was held in his honor at Cedar Point Club on January 9, at which Richard J. Holland presided.

SHIRLEY T. HOLLAND

In commenting on the 50 active years Mr. Shirley Holland has devoted to Farm…

had grown to the point that … tection was needed," Holland …

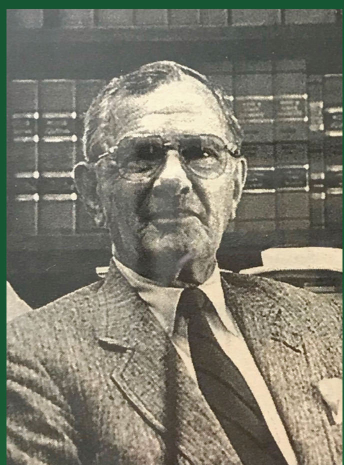
From 1919 to 1927, Shirle… Holland was the only employ… the bank. For eight years he… the chief executive officer, jan… made the fires, and when he… to lunch he hung a sign on the… which read, "be back in 30… utes." A bookeeper was empl… in 1927 to assist the cas…

A twenty-five percent stoc… vidend was declared in 1933 an… cashier's salary had risen to… per month by 1937. In 19… 100% stock dividend was decl… and another 100% stock div… was declared last year.

Shirley Holland was electe… chairman of the Board last y… a position he now holds.

In reinterating the grow… Farmers Bank, Richard Ho… explained that each origina… share now has a book valu… $1,643. A dividend has been… to the stockholders every… since 1922, and the total a… of dividends paid is $237,5… This has been accomplishe… paid capital of $20,000. Last… the dividends paid exceede… paid in capital of the bank.

"These figures, of course… dicate excellent growth, bo… assets and earnings," Mr. … land said. "The Board of D… tors, Officers and Employees… an obligation to the commun… provide courteous, efficie… vice. …



Richard J. Holland Sr.

**November 12, 1919**
Bank is established with one employee; Shirley T. Holland

Assets exceeded $2 million – **1946**

First drive-in teller facility – **1968**

First Computer/Assignment of Account Numbers – **1984**

Richard J. Holland, Jr. named President and CEO – **1994**

Bank develops website – **2000**
Lakeside Branch Opened – **2002**

Harbourview Branch Opened – **2009**

Partnership with Manry Rawls, LLC – **2014**

**November 12, 2019**
Farmers Bank Celebrates 100 Years

**1922** – First dividend to shareholders

**1927** – Second employee hired;
Ida Johnson as a bookkeeper

**1951** – Richard J. Holland, Sr. joins the Bank

**1967** – Richard J. Holland, Sr. elected President and CEO

**1970** – Loans exceeded $5 million

**1977** – Richard J. Holland, Jr. joins the bank

**1985** – Richard J. Holland, Jr. elected President

**1989** – Windsor Branch moves to new location

**1994** – First ATM installed & Smithfield Branch opened

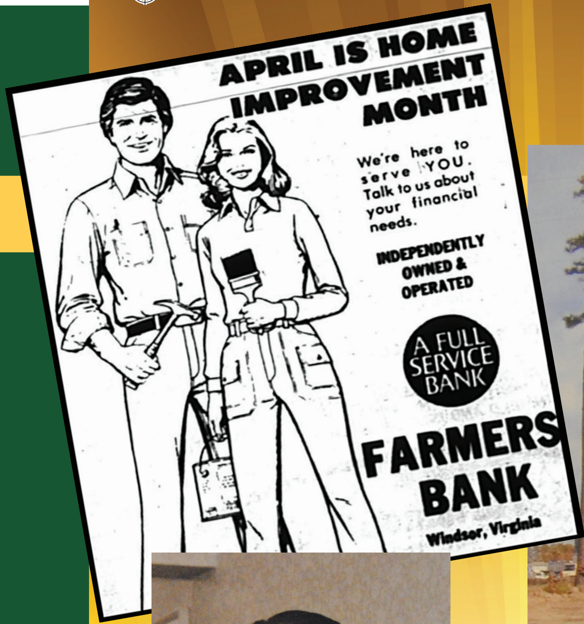
**1999** – Implemented Online Banking

**2004** – Hillpoint Branch Opened

**2008** – Remote Deposit Capture available

**2013** – Courtland Branch Opened & Implemented
Mobile Banking

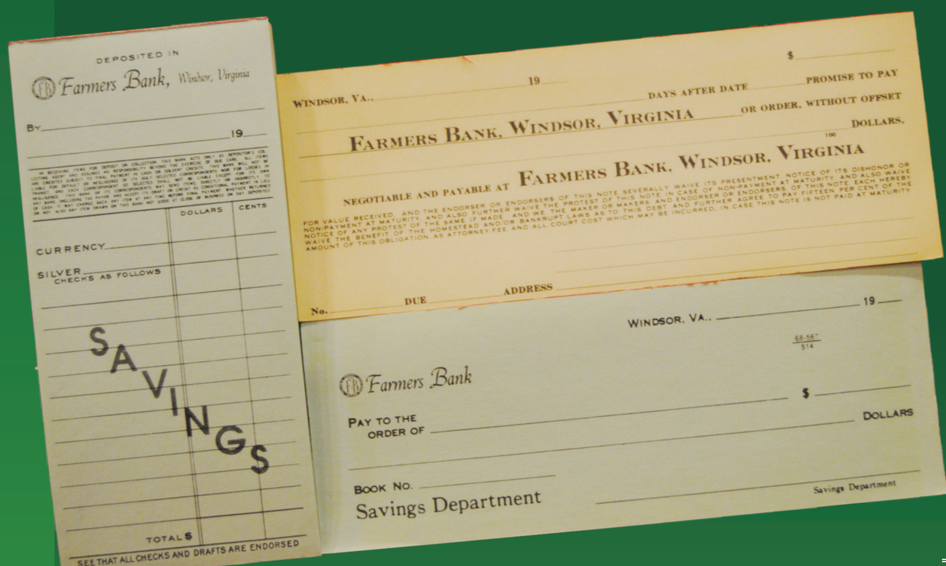
**2017** – Chesapeake Branch opened

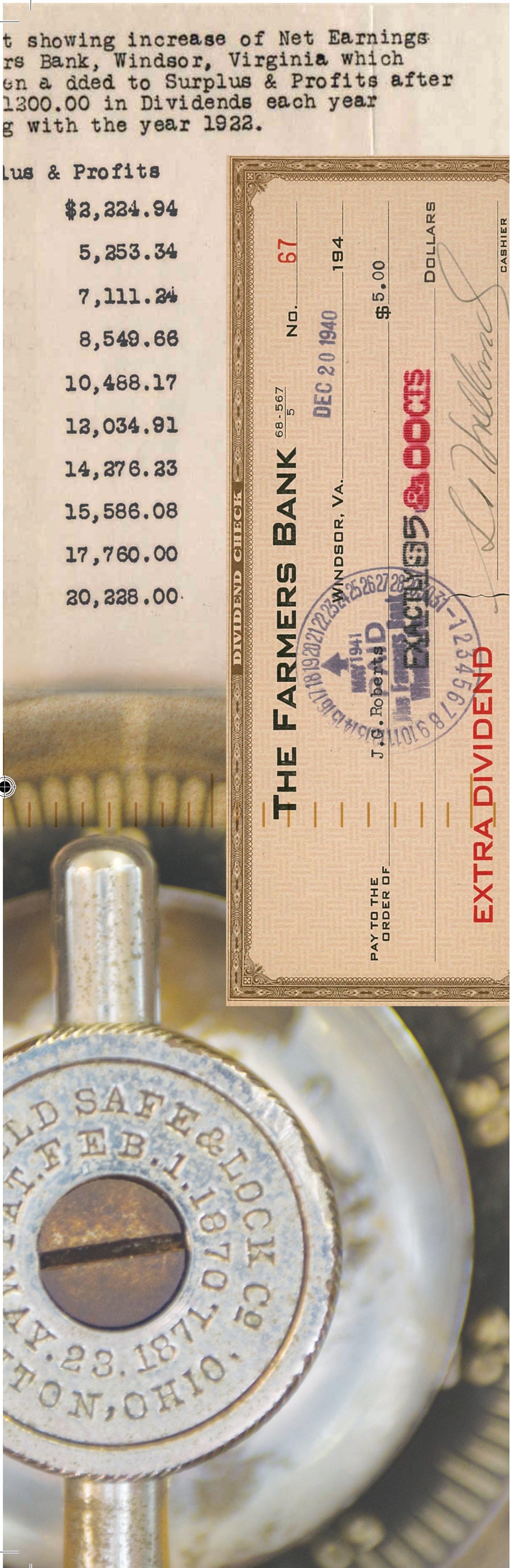



Richard J. Holland, Jr.

Groundbreaking for the Farmers Bank Hillpoint Location, November 10, 2003.

The Ribbon Cutting for the Farmers Bank Smithfield Location held on January 23rd, 1995.






## BOARD OF DIRECTORS

Richard J. Holland, Jr.*
*Chairman*

William A. Gwaltney, Jr.*
*Vice Chairman*
*Indika Farms, Inc., President*

G. Thomas Alphin, Jr.*
*Commonwealth Gin, Co-Owner*

E. Warren Beale, Jr.
*Retired Entrepreneur*

Harold U. Blythe
*Retired Bank CEO*

William L. Chorey
*Chorey & Associates Realty, Ltd., Owner/Broker*

John T. Orlando
*Financial Security Advisory, Inc., President*

David T. Owen*
*Wakefield Farm Service, Inc., President*

Peter D. Pruden, III
*Taste Unlimited, Co-Owner*

William H. Riddick, III*
*Attorney at Law - Smithfield*

Kent B. Spain*
*Suffolk Insurance Corporation, Executive Vice President*

O. A. Spady
*Retired Entrepreneur*

Vernon M. Towler*
*President*

**Farmers Bankshares, Inc. Board Members*

## SUFFOLK COMMUNITY BOARD

James C. Adams, III
*President, Featherlite Coaches*

Mark H. Brinkley
*President, C. W. Brinkley, Inc. Construction*

Richard L. Evans
*President, Chesapeake Controls*

J. Clifton Harrell, Jr.
*President, Suffolk Iron Works, Inc.*

Nicole J. Harrell
*Attorney-at-Law, Kaufman & Canoles*

Brian L. Johnson, M.D.
*Virginia Dermatology*

Charles S. Lowder
*Certified Public Accountant, Charles S. Lowder & Co., LLC*

Timothy K. Palmer, Chairman
*Attorney-at-Law and Certified Public Accountant, Palmer Elder Law*

Roy A. Runyon, III
*Director of Research & Development, The Gartman Letter, L.C.*

Joseph Wayne Scott
*Certified Public Accountant, Robb, Scott, Bradshaw & Rawls*

Clay K. White
*President, Starr Motors, Inc.*

H. Hadley Whitlock, Jr.
*Retired Commercial Lender*

## EASTERN TIDEWATER COMMUNITY BOARD

James C. Bowen, Sr.
*President, South Norfolk Trucking, Inc.*

Rhonda Bridgeman
*President, Comfort Systems of Virginia, Inc.*

Tracy Colby-Urig
*Certified Public Accountant, Colby & Company*

Kelley C. Holland
*Attorney-at-Law, Williams Mullen*

Robert R. Kinser
*Attorney-at-Law, Basnight, Kinser, Leftwich & Nuckols, P.C.*

Richard H. Matthews, Chairman
*Attorney-at-Law, Pender & Coward, P.C.*

Gregory P. Marshall
*President, Tymar Development, Inc.*

## WESTERN TIDEWATER COMMUNITY BOARD

Christopher T. Alphin
*Commonwealth Gin*

Vincent C. Carollo, Chairman
*Owner, Anna's Ristorante & MVC Holdings, LLC*

P. Milton Cook, Jr., D.D.S.
*P. Milton Cook, Jr., P.C.*

Tammy W. Edwards
*President, Windsor Hardware Supply Co.*

Randolph H. Pack
*President, Smithfield Station*

V. S. Pittman, II
*President, Manry Rawls, LLC*

John T. Randall
*Attorney-at-Law, Randall Page, PC*

T. Craig Stallings
*Certified Public Accountant, Craig Stallings and Associates*

Sharon C. Stallings
*CEO, Hampton Roads Contracting, Inc.*

## OFFICERS

Richard J. Holland, Jr.
*Chairman of the Board & Chief Executive Officer*

Vernon M. Towler
*President*

Kristy E. Dejarnette
*Exec. Vice President/Chief Financial Officer*

N. F. "Pete" Carr, Jr.
*Senior Vice President/Director of Financial Services*

Thomas L. Woodward, III
*Exec. Vice President/Chief Lending Officer*

Patricia T. Allen
*Sr. Vice President/Director of Operations*

Kathy C. Bryant
*Senior Vice President/Director of HR & Retail Administration*

Chad A. Rountree
*Senior Vice President/Western Tidewater Market Executive*

Susan F. Boone
*Executive Assistant/Corporate Secretary*

Jeffrey S. Creekmore
*Sr. Vice President/ Chesapeake Market Exec.*

P. Kelley Gowen
*Sr. Vice President/Loans*

Lauren P. Harper
*Sr. Vice President/Loans*

Andrew D. Perkins
*Sr. Vice President/Chief Credit Officer*

Charles A. Powers, II
*Sr. Vice President/Loans*

Deborah R. Cagle
*Vice President/Retail*

Kelly M. Clinton
*Vice President/Portfolio Manager*

Kelly D. Dewitt
*Vice President/BSA/AML/OFAC/ Security Officer*

Stephanie J. Dickens
*Vice President/Private Banker*

Pamela N. Ellyson
*Vice President/Dir. Of Treasury Mgmt. Services*

Kelley T. Healey
*Vice President/ Smithfield Market Exec.*

Eric L. Shaffner
*Vice President/Loans*

Sharon A. Smith
*Vice President/Compliance Officer*

Candace D. Delia
*Asst. Vice President/Retail*

C. Thomas Eure, Jr.
*Asst. Vice President/Business Systems Analyst*

Melanie S. Gwaltney
*Asst. Vice President/Operations Supervisor*

Blanche E. Hecker
*Asst. Vice President/Retail*

Joanne F. Joyner
*Asst. Vice President/Retail*

Erin W. Park
*Asst. Vice President/Controller*

Donna Renee Scott
*Asst. Vice President/Retail*

Kara H. Smith
*Asst. Vice President/Technology Officer*

Meghan D. White
*Asst. Vice President/Loan Processing Mgr.*

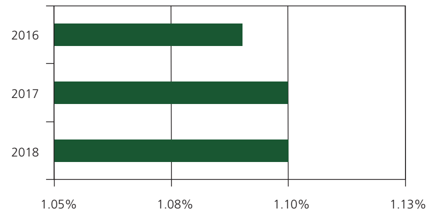
Marsha C. Winslow
*Asst. Vice President/Retail*

# Financial Highlights

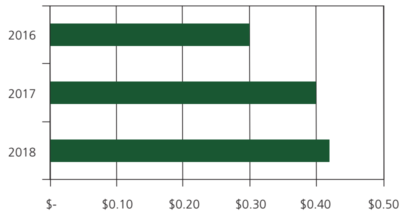
| At or for the Years Ended December 31, | 2018 | 2017 | 2016 |
|---|---|---|---|
| | | (Dollars in thousands, except per share data) | |
| **Summary of Operations** | | | |
| Interest income | **$18,114** | $16,637 | $16,062 |
| Interest expense | **2,811** | 2,150 | 2,116 |
| Net interest income | **15,303** | 14,487 | 13,946 |
| Provision for loan losses | **-** | - | - |
| Net interest income after provision for loan losses | **15,303** | 14,487 | 13,946 |
| Non-interest income | **6,263** | 5,091 | 2,898 |
| Non-interest expense | **15,851** | 13,358 | 11,528 |
| Income before income taxes | **5,715** | 6,220 | 5,316 |
| Income taxes | **619** | 1,451 | 1,129 |
| Net income attributable to noncontrolling interest | **221** | 265 | - |
| Net income | **$4,875** | $4,504 | $4,187 |
| **Per Share and Shares Outstanding (1)** | | | |
| Basic net income | **$1.59** | $1.47 | $1.37 |
| Book value at end of period | **$16.23** | $15.68 | $13.98 |
| Basic weighted average shares outstanding | **3,071,643** | 3,063,661 | 3,056,830 |
| Dividends per share | **$0.42** | $0.40 | $0.30 |
| Shares outstanding at period end | **3,075,860** | 3,066,709 | 3,056,363 |
| **Balance Sheet Data** | | | |
| Total assets | **$478,211** | $456,583 | $423,561 |
| Total loans, net | **269,520** | 266,753 | 260,202 |
| Total deposits | **386,682** | 370,891 | 343,911 |
| Borrowings | **25,000** | 25,000 | 25,000 |
| **Selected Performance Ratios (Bank Only)** | | | |
| Return on average assets | **1.10%** | 1.10% | 1.09% |
| Return on average stockholders' equity | **10.05%** | 9.46% | 9.01% |
| Net interest margin (2) | **3.70%** | 3.87% | 3.82% |
| Non-interest income as a percentage of total revenue (3) | **29.05%** | 26.01% | 17.21% |
| Efficiency ratio (4) | **71.49%** | 65.21% | 63.78% |
| **Asset Quality Ratios** | | | |
| Nonperforming loans to period-end loans | **0.25%** | 0.31% | 0.75% |
| Allowance for loan losses to period-end loans | **2.15%** | 2.17% | 2.15% |
| Net charge-offs to average loans outstanding | **0.00%** | -0.06% | 0.22% |
| **Capital (Bank Only)** | | | |
| Tier 1 leverage ratio | **9.68%** | 9.52% | 11.64% |
| Total risk-based capital ratio | **13.89%** | 14.04% | 16.53% |
| Stockholder's equity | **$52,139** | $50,312 | $49,096 |

(1) Computed based on the weighted average number of shares outstanding during each period.
(2) Net interest margin is net interest income divided by average interest earning assets.
(3) Total revenue consists of net interest income and non-interest income.
(4) Efficiency ratio is non-interest expense divided by the sum of net interest income and non-interest income.

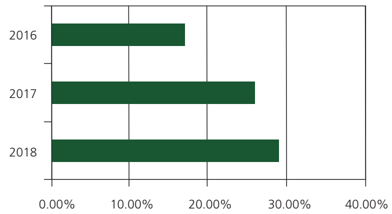
**Return on Assets**




**Dividends Per Share**




**Non-Interest Income as a % of Revenue**



# Farmers Bankshares, Inc.

## Consolidated Financial Statements for Years Ended December 31, 2018 and 2017

Contents

## Independent Auditor's Report

To the Board of Directors and Shareholders
Farmers Bankshares, Inc.
Windsor, Virginia

**Report on the Financial Statements**
We have audited the accompanying consolidated financial statements of Farmers Bankshares, Inc. and Subsidiary (the Company), which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of operations, 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 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 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 Farmers Bankshares, Inc. and Subsidiary 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.

Elliott Davis PLLC

Raleigh, North Carolina
March 15, 2019

# Farmers Bankshares, Inc.
## Consolidated Balance Sheets

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| **Assets** | | |
| Cash and cash equivalents | | |
| Cash and due from banks | $ 15,353,150 | $ 18,473,225 |
| Federal funds sold | 1,137,152 | 440,963 |
| **Total cash and cash equivalents** | 16,490,302 | 18,914,188 |
| Available-for-sale securities (Note 3) | 157,015,508 | 137,803,946 |
| Loans held for investment, net of allowance for loan losses of $5,916,359 and $5,922,333, respectively (Note 4) | 269,520,306 | 266,752,713 |
| Premises and equipment, net (Note 5) | 2,934,749 | 2,881,031 |
| Goodwill (Note 6) | 4,807,857 | 4,511,746 |
| Other intangible assets, net (Note 6) | 3,811,185 | 3,865,251 |
| Other real estate owned | 672,404 | 742,216 |
| Accrued interest receivable | 1,978,401 | 1,787,676 |
| Prepaid expenses | 560,160 | 575,618 |
| Net deferred tax asset (Note 12) | 759,987 | 339,838 |
| Income taxes receivable | 3,022 | 112,517 |
| Non-marketable equity securities (Note 7) | 4,130,699 | 3,569,712 |
| Bank-owned annuity contract | 2,961,521 | 3,028,689 |
| Bank-owned life insurance | 10,851,328 | 10,544,514 |
| Other assets | 1,713,116 | 1,153,134 |
| | 461,720,243 | 437,668,601 |
| **Total assets** | $ 478,210,545 | $ 456,582,789 |
| **Liabilities and Stockholders' Equity** | | |
| Deposits | | |
| Noninterest-bearing deposits | $ 115,871,109 | $ 107,356,868 |
| Interest-bearing deposits (Note 8) | 270,811,346 | 263,533,769 |
| Total deposits | 386,682,455 | 370,890,637 |
| Federal Home Loan Bank borrowings (Note 10) | 25,000,000 | 25,000,000 |
| Capital notes (Note 9) | 6,000,000 | 6,000,000 |
| Securities sold under agreements to repurchase (Note 10) | 3,848,904 | 1,617,766 |
| Deferred compensation plans (Note 11) | 1,520,980 | 1,434,054 |
| Accrued interest payable | 336,608 | 250,025 |
| Deferred revenue on insurance contracts | 1,228,260 | 1,126,209 |
| Other liabilities | 3,681,793 | 2,222,132 |
| **Total liabilities** | 428,299,000 | 408,540,823 |
| **Stockholders' equity** | | |
| Common stock, $0.125 par value; 50,000,000 shares authorized; 3,075,860 and 3,066,709 shares issued and outstanding at December 31, 2018 and 2017, including nonvested shares of 17,806 and 13,011 shares, respectively | 384,484 | 383,340 |
| Capital surplus | 2,895,515 | 2,841,759 |
| Retained earnings | 44,991,893 | 41,399,842 |
| Accumulated other comprehensive (loss) income | (383,711) | 1,394,861 |
| **Total stockholders' equity** | 47,888,181 | 46,019,802 |
| Noncontrolling interest | 2,023,364 | 2,022,164 |
| **Total equity** | 49,911,545 | 48,041,966 |
| **Total liabilities and equity** | $ 478,210,545 | $ 456,582,789 |



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

# Farmers Bankshare, Inc.
## Consolidated Statements of Operations

| | Years Ended December 31, 2018 | 2017 |
|---|---|---|
| **Interest income** | | |
| Interest and fees on loans held for investment | $ 13,289,563 | $ 12,702,805 |
| Interest on mortgage loans held for sale | - | 11,666 |
| Interest on available-for-sale securities | 2,593,586 | 2,068,909 |
| Interest on tax exempt available-for-sale securities | 1,993,818 | 1,663,470 |
| Interest on federal funds sold | 111,489 | 75,025 |
| Other interest income | 125,788 | 115,045 |
| **Total interest and dividend income** | 18,114,244 | 16,636,920 |
| **Interest expense** | | |
| Interest on deposits | 2,087,106 | 1,409,845 |
| Interest on Federal Home Loan Bank advances | 505,981 | 470,188 |
| Interest on capital notes | 195,000 | 254,702 |
| Interest on repurchase agreements | 14,523 | 9,717 |
| Interest on federal funds purchased | 8,501 | 5,144 |
| **Total interest expense** | 2,811,111 | 2,149,596 |
| **Net interest income** | 15,303,133 | 14,487,324 |
| **Provision of loan losses** | - | - |
| **Net interest income after provision for loan losses** | 15,303,133 | 14,487,324 |
| **Noninterest income** | | |
| Service charges | 598,380 | 606,359 |
| Income from automated teller machines and bank card interchange | 560,452 | 535,445 |
| Insurance commissions | 4,452,749 | 2,948,887 |
| Net gain on disposition of securities | 154,773 | 61,216 |
| Income on bank owned life insurance | 306,814 | 313,602 |
| Net gain on sale of premises and equipment | - | 16,665 |
| Income from investment in Manry Rawls, LLC | - | 66,467 |
| Income from mortgage loan sales | - | 164,715 |
| Other income | 190,168 | 377,943 |
| **Total noninterest income** | 6,263,336 | 5,091,299 |
| **Noninterest expense** | | |
| Salaries and employee benefits | 8,955,428 | 8,118,119 |
| Equipment expense | 937,945 | 847,106 |
| Occupancy expense | 931,434 | 801,872 |
| Bank franchise tax | 546,656 | 446,039 |
| Advertising and marketing | 453,971 | 473,275 |
| Data processing | 1,632,519 | 1,187,314 |
| Loan related legal and other expenses | 100,636 | 132,841 |
| Federal Deposit Insurance Corporation assessment | 168,164 | 135,617 |
| Net (gain) loss on sale and write-downs of other real estate owned | 8,318 | (490,264) |
| Other | 2,116,497 | 1,706,369 |
| **Total noninterest expense** | 15,851,568 | 13,358,288 |
| **Income before income taxes & noncontrolling interest** | 5,714,901 | 6,220,335 |
| **Income tax expense (Note 12)** | 619,132 | 1,450,815 |
| **Net income** | $ 5,095,769 | $ 4,769,520 |
| **Net income attributable to noncontrolling interest** | 220,518 | 264,741 |
| **Net income attributable to Farmers Bankshares, Inc.** | $ 4,875,251 | $ 4,504,779 |
| **Basic earnings per common share (Note 19)** | $ 1.59 | $ 1.47 |
| **Diluted earnings per common share** | $ 1.59 | $ 1.47 |

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

# Farmers Bankshares, Inc.
## Consolidated Statements of Comprehensive Income

| | Years Ended December 31, 2018 | 2017 |
|---|---|---|
| **Net income** | $ 5,095,769 | $ 4,769,520 |
| **Other comprehensive loss:** | | |
| Net, Unrealized holding (losses) gains on available-for-sale securities | (2,096,584) | 318,274 |
| Tax effect | 440,283 | (108,213) |
| Unrealized holding (losses) gains on available-for-sale securities, net of tax amount | (1,656,301) | 210,061 |
| Reclassification adjustment for net realized gains | (154,773) | (61,216) |
| Tax effect | 32,502 | 20,812 |
| Reclassification of accumulated comprehensive loss due to tax rate change | - | (229,534) |
| Reclassification adjustment for net realized gains, net of tax amount | (122,271) | (269,938) |
| Other comprehensive loss, net of tax | (1,778,572) | (59,877) |
| **Comprehensive income** | $ 3,317,197 | $ 4,709,643 |



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

# Farmers Bankshares, Inc.

## Consolidated Statements of Changes in Stockholders' Equity

| | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Income | Non-controlling interest | Total |
|---|---|---|---|---|---|---|
| **Balances, December 31, 2016** | $ 382,047 | $ 2,775,106 | $ 38,344,408 | $ 1,225,204 | $ - | $ 42,726,765 |
| Net income | - | - | 4,504,779 | - | 264,741 | 4,769,520 |
| Changes in net unrealized loss on securities available for sale, net of reclassification adjustment and tax effect | - | - | - | (59,877) | - | (59,877) |
| Distribution of interest in Manry Rawls, LLC | - | - | - | - | (292,577) | (292,577) |
| Remeasurements of deferred taxes related to tax reform legislation | - | - | (229,534) | 229,534 | - | - |
| Investment in Manry Rawls, LLC | - | - | - | - | 2,050,000 | 2,050,000 |
| Issuance of common stock - director stock plan | 270 | 47,230 | - | - | - | 47,500 |
| Stock based compensation | 1,023 | 19,423 | - | - | - | 20,446 |
| Cash dividends declared on common shares, $0.40 per share | - | - | (1,219,811) | - | - | (1,219,811) |
| **Balances, December 31, 2017** | $ 383,340 | $ 2,841,759 | $ 41,399,842 | $ 1,394,861 | $ 2,022,164 | $ 48,041,966 |
| Net income | - | - | 4,875,251 | - | 220,518 | 5,095,769 |
| Changes in net unrealized loss on securities available for sale, net of reclassification adjustment and tax effect | - | - | - | (1,778,572) | - | (1,778,572) |
| Distribution of interest in Manry Rawls, LLC | - | - | - | - | (219,318) | (219,318) |
| Issuance of common stock - director stock plan | 187 | 24,314 | - | - | - | 24,501 |
| Stock based compensation | 957 | 29,442 | - | - | - | 30,399 |
| Cash dividends declared on common shares, $0.42 per share | - | - | (1,283,200) | - | - | (1,283,200) |
| **Balances, December 31, 2018** | $ 384,484 | $ 2,895,515 | $ 44,991,893 | $ (383,711) | $ 2,023,364 | $ 49,911,545 |

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

# Farmers Bankshares, Inc.
## Consolidated Statements of Cash Flows

| | Years Ended December 31, 2018 | 2017 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | $ 5,095,769 | $ 4,769,520 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Distribution of interest in Manry Rawls, LLC | (219,318) | (292,577) |
| Depreciation | 511,307 | 475,504 |
| Amortization of intangible assets | 290,945 | 178,889 |
| Provision for deferred income taxes | 52,637 | 167,113 |
| Amortization of investment securities premiums | 660,668 | 567,255 |
| Net gain on disposition of available-for-sale securities | (154,773) | (61,216) |
| Net loss on disposition of non-marketable equity securities | - | 23,597 |
| Loss (gain) on sales and writedowns on other real estate owned | 8,318 | (578,828) |
| Gain on sale of premises and equipment | - | (16,665) |
| Gain on sale of mortgages held for sale | - | (67,009) |
| Increase in cash value of bank owned life insurance and annuity | (306,814) | (313,602) |
| Decrease (increase) in cash value of annuity | 67,168 | (1,799) |
| Stock based compensation | 30,399 | 20,446 |
| Issuance of stock to directors | 24,501 | 47,500 |
| Origination of mortgage loans held for sale | - | (4,853,323) |
| Proceeds from sale of mortgage loans held for sale | - | 6,364,292 |
| Change in operating assets and liabilities: | | |
| Interest receivable | (190,725) | (64,657) |
| Interest payable | 86,583 | 66,325 |
| Prepaid expenses | 15,458 | (216,877) |
| Income taxes receivable | 109,495 | (107,298) |
| Other assets | (559,982) | (286,683) |
| Deferred compensation | 86,926 | 110,410 |
| Deferred revenue | 102,051 | - |
| Other liabilities | 1,126,670 | 820,456 |
| **Net cash provided by operating activities** | 6,837,283 | 6,750,773 |
| **Cash flows from investing activities** | | |
| Proceeds from sales, prepayments and maturities of available-for-sale securities | 21,890,718 | 26,461,528 |
| Purchase of available-for-sale securities | (43,859,532) | (39,115,533) |
| Proceeds from sale of non-marketable equity securities | 10,863 | 438,081 |
| Purchase of non-marketable equity securities | (571,850) | (1,452,129) |
| Proceeds from sale of other real estate owned | 61,494 | 811,390 |
| Loan originations, net of repayments | (2,767,593) | (6,677,814) |
| Proceeds from sale of premises and equipment | - | 61,797 |
| Purchases of premises and equipment | (565,025) | (478,630) |
| Acquisition of business, net of cash acquired | (200,000) | (2,491,216) |
| **Net cash used in investing activities** | (26,000,925) | (22,442,526) |
| **Cash flows from financing activities** | | |
| Cash dividends paid on common shares | (1,283,200) | (1,219,256) |
| Proceeds from issuance of capital notes | - | 6,000,000 |
| Repayment of capital notes | - | (7,888,475) |
| Repayment of debt related to Manry Rawls, LLC | - | (894,750) |
| Net increase in noninterest-bearing deposits | 8,514,241 | 5,804,848 |
| Net increase in interest-bearing deposits | 7,277,577 | 21,174,341 |
| Net increase in securities sold under agreements to repurchase | 2,231,138 | 491,885 |
| **Net cash provided by financing activities** | 16,739,756 | 23,468,593 |
| **Net (decrease) increase in cash and cash equivalents** | (2,423,886) | 7,776,840 |
| **Cash and cash equivalents** | | |
| Beginning of the year | 18,914,188 | 11,137,348 |
| End of year | $ 16,490,302 | $ 18,914,188 |



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

# Farmers Bankshares, Inc.
## Consolidated Statements of Cash Flow (concluded)

| | Years Ended December 31, | |
|---|---|---|
| | 2018 | 2017 |
| **Supplemental disclosure of cash flow information** | | |
| Cash paid for | | |
| Income taxes | $ 457,000 | $ 1,391,000 |
| Interest on deposits and other borrowings | 2,724,528 | 2,083,271 |
| | | |
| **Supplemental schedule of non-cash investing activities** | | |
| Change in unrealized gains on available-for-sale securities, net of income tax | $ (1,778,572) | $ (19,474) |
| Transfer of loans to other real estate owned | - | (127,500) |
| Contribution of other real estate owned | - | (30,000) |
| Income from investment in Manry Rawls, LLC | - | (66,467) |
| | | |
| **Acquisitions** | | |
| Assets acquired | $ 568,351 | $ 10,461,400 |
| Liabilities assumed | - | 4,314,323 |
| Net assets | $ 568,351 | $ 6,147,077 |
| | | |
| Goodwill and fair value acquisition adjustments | $ 296,111 | $ 4,511,407 |

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

# Farmers Bankshares, Inc.

## Notes to Consolidated Financial Statements
## For Years Ended December 31, 2018 and 2017

**Note 1 - Organization and nature of business**

Farmers Bankshares, Inc. (the "Company") was organized and incorporated under the laws of the Commonwealth of Virginia on July 26, 2013. On December 31, 2013, the Company was consummated as the Bank Holding Company of Farmers Bank, Windsor, Virginia (the "Bank") through a reorganization plan, under the laws of the Commonwealth of Virginia. As of this date, the Bank became a wholly-owned subsidiary of Farmers Bankshares, Inc. The Bank was formed on November 12, 1919 and has offices in Windsor, Smithfield, Suffolk, Chesapeake and Courtland, Virginia. Through its banking subsidiary, the Company provides a wide variety of banking services primarily in southeastern Virginia.

The Bank provides small and mid-sized businesses, professionals, corporate executives and entrepreneurs with banking services comparable to those of the large national and regional institutions. These services include loans that are priced on a deposit-based relationship, direct access to the Bank's decision makers, and quick, innovative response to customers' financial needs. If customers have credit requirements that exceed the Bank's credit limits, the Bank seeks to accommodate those customers by arranging loans on a participation basis with other financial institutions.

During 2014, the Bank purchased a one-third ownership interest in Manry Rawls, LLC ("Manry Rawls"). Manry Rawls is a local and independent regional insurance agency offering a wide array of insurance products. In May 2017, the Bank purchased an additional one-third interest in Manry Rawls. This additional interest made the Bank's total ownership two-thirds or approximately 67%. Prior to the additional purchase in 2017, the Bank's proportionate share of Manry Rawls' income was recorded as an increase in the investment and other non-interest income. After May 12, 2017 the acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with Financial Accounting Standards Board ("FASB") Accounting Standards Codification ("ASC)" 805, *Business Combinations.* As such, the assets acquired and liabilities assumed in the transactions were recorded at their respective fair values as of the acquisition date. The results of operations of the acquired business were included in the Company's Consolidated Statements of Operations commencing May 12, 2017.

During 2018, the Company acquired The Lankford Agency, an independent insurance agency, which was merged with the operations of Manry Rawls. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, Business Combinations, and, as such, the assets acquired were recorded at their respective fair values as of the acquisition date. There were no liabilities assumed with this purchase. The results of operations of the acquired business are included in the Company's Consolidated Statements of Operations commencing October 1, 2018. The total purchase price for the transaction was $200,000 in cash and contingent future payments with a net present value of $332,989. The allocation of the purchase price results in goodwill of $296,111 and other intangible assets including customer lists of $236,879.

**Note 2 - Summary of significant accounting policies**

*Basis of presentation and consolidation* - The consolidated financial statements of the Company are prepared in conformity with accounting principles generally accepted in the United States of America. The consolidated financial statements include the accounts of the Company, its wholly-owned subsidiary, the Bank and Manry Rawls. All significant intercompany balances and transactions have been eliminated in consolidation.

*Reclassification* – Certain amounts in the 2017 consolidated financial statements have been reclassified to conform to the 2018 presentation. The reclassifications had no effect on net income or shareholders' equity as previously reported.

*Cash and cash equivalents* - For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, interest-bearing deposits with banks and federal funds sold, all of which mature within 90 days or less. The Company is required by the Federal Reserve to maintain average reserve balances. For the final quarterly reporting period in 2018 and 2017, the aggregate amount of daily-required balances was $63,000 and $159,000, respectively.

**Note 2 - Summary of significant accounting policies** (continued)

*Investment securities -* Investments in debt securities classified as held-to-maturity, if any, are stated at cost, and adjusted for amortization of premiums and accretion of discounts using the interest method. The Company held no such securities during the periods reported in the financial statements. Investments in debt securities classified as trading, if any, are stated at fair value. Such securities are purchased and held principally for the purpose of selling them in the near term. Unrealized holding gains and losses for trading securities are included in the Statements of Operations. The Company held no such securities during the periods reported on in the financial statements.

Investments not classified as either held-to-maturity or trading are classified as available-for-sale. Debt securities classified as available-for-sale are stated at fair value with unrealized holding gains and losses excluded from earnings and reported as a component of accumulated other comprehensive income until realized.

The income statement line items impacted by the reclassification of realized gains (losses) on the sale of securities are the gains (losses) on disposition of securities and income tax expense line items in the Statement of Operations. Gains and losses on the sale of securities are determined using the specific identification method and are recognized on a trade date basis. Other than temporary declines in the fair value of individual held-to-maturity and available-for-sale securities below their cost, if any, are included in earnings as realized losses. Other than temporarily impaired (“OTTI”) guidance for investments states that an impairment is OTTI if any of the following conditions exist: the entity intends to sell the security; it is more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis; or, the entity does not expect to recover the security’s entire amortized cost basis (even if the entity does not intend to sell).

*Loans -* The Bank grants mortgage, commercial and consumer loans to customers. A substantial portion of the loan portfolio is represented by commercial and consumer mortgage loans throughout Southeastern Virginia. The ability of the Bank’s debtors to honor their contracts is dependent upon the real estate and general economic conditions in this area.

Loans held for investment that management has the intent and ability to hold for the foreseeable future or until maturity generally are stated at their outstanding unpaid principal balances. Loans held for sale are originated and intended for sale in the secondary market. These loans are carried at the lower of cost or market in the aggregate. Net unrealized losses, if any, are recognized through charges to income. Interest income is accrued on the unpaid principal balance for all loan classes. Discounts and premiums are amortized to income using the interest method. Net deferred fees and costs are amortized over the lives of the applicable loans using the effective interest rate method.

*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 earnings. 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 a specific, a historic and a qualitative component. The specific component relates to loans that are considered impaired. For such loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price less selling costs) of an impaired loan are lower than the carrying value of that loan. The historic component covers non-classified and criticized loans and is based on historical loss experience adjusted for qualitative factors. The qualitative reserve of the allowance reflects adjustments to historical experience to account for current conditions impacting the loan portfolio.

**Note 2 - Summary of significant accounting policies** (continued)

*Allowance for loan losses (concluded)* - For all classes, 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 for 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 less selling costs if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. The allowance model is applied to determine the specific allowance balance for impaired loans and the general allowance balance for unimpaired loans grouped by loan type.

The Bank's loan charge-off policy for all loan classes is to charge down loans to net realizable value once a portion of the loan is determined to be uncollectible, and the underlying collateral shortfall is assessed. Loans are moved to nonaccrual status when the loan becomes 90 days delinquent or a portion of the loan is determined to be uncollectible and supporting collateral is not considered to be sufficient to cover potential losses.

Nonaccrual loans are reviewed monthly to determine if all or a portion of the loan is uncollectible. Nonaccrual loans that are determined to be solely collateral dependent are monitored for possible charge downs to net realizable value upon determination that they are impaired.

*Income recognition on impaired and non-accrual loans* - All classes of loans are generally classified as non-accrual if they are past due as to maturity or payment of principal or interest for a period of more than 90 days, unless such loans are well-secured and in the process of collection. All classes of loans that are on a current payment status or past due less than 90 days may also be classified as non-accrual, if repayment in full of principal and/or interest is in doubt.

All classes of loans may be returned to accrual status when all principal and interest amounts contractually due (including arrearages) are reasonably assured of repayment within an acceptable period of time, and there is a sustained period of repayment performance by the borrower, in accordance with the contractual terms of interest and principal.

When all classes of loans are classified as non-accrual and the future collectibility of the recorded loan balance is doubtful, collections of interest and principal are generally applied as a reduction to principal outstanding. When the future collectibility of the recorded loan balance is expected, interest income may be recognized on a cash basis. In the case where a non-accrual loan had been partially charged off, recognition of interest on a cash basis is limited to that which would have been recognized on the recorded loan balance at the contractual interest rate. Cash interest receipts in excess of that amount are recorded as recoveries to the allowance for loan losses until prior charge-offs have been fully recovered.

*Other real estate owned* - Real estate acquired through, or in lieu of, foreclosure is held for sale and is initially recorded at fair value less estimated cost to sell at the date of foreclosure, establishing a new cost basis. Principal and interest losses existing at the time of acquisition of such assets are charged against the allowance for loan losses and interest income, respectively. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less estimated cost to sell. Costs of significant property improvements are capitalized, whereas costs relating to holding property are expensed. Revenue and expenses from operations associated with other real estate owned and the impact of any subsequent changes in the carrying value are included in other expenses.

**Note 2 - Summary of significant accounting policies** (continued)

*Premises and equipment* - Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. For financial reporting purposes, assets are depreciated over their estimated useful lives using the straight-line method. Useful lives for these assets are within the following ranges: buildings from 10-39 years; equipment, furniture and fixtures 3-15 years; computer equipment 3-7 years and software 3-5 years. For income tax purposes, the accelerated cost recovery system and the modified accelerated cost recovery system are used.

*Goodwill and other intangibles* - Goodwill is not subject to amortization, but is subject to an annual assessment for impairment by applying a fair-value-based test as required by ASC 350, *Goodwill and Other Intangible Assets*. Additionally, under ASC 350, acquired intangible assets are separately recognized if the benefit of the assets can be sold, transferred, licensed, rented, or exchanged, and amortized over their useful life.

Goodwill is tested for impairment at the reporting unit level on an annual basis as of September 30, or more often if events or circumstances indicate there may be impairment. Testing is conducted in two steps: identifying the potential impairment and then, if necessary, identifying the amount of impairment. The first step (step 1) compares the fair value of the reporting unit to its carrying amount. If the fair value is less than the carrying amount, a second test is conducted by comparing the implied fair value of goodwill with the carrying amount of that goodwill. If the carrying amount exceeds the implied fair value, an impairment loss is recognized in an amount equal to that excess. For our annual impairment testing conducted during 2018, we identified one reporting unit with goodwill: Manry Rawls. For purposes of performing step 1 of the goodwill impairment test, the Company primarily uses the income approach to value the reporting unit. The income approach consists of discounting projected long-term future cash flows, which are derived from internal forecasts and economic expectations for the respective reporting unit. The significant inputs to the income approach include expected future cash flows, the long-term target tangible equity to tangible assets ratio, and the discount rate. Discount rates are unique to the reporting unit and are based upon the cost of capital specific to the industry in which the reporting unit operates. Management evaluated the sensitivity of the significant assumptions in its impairment analysis, including consideration of the effect of changes in estimated future cash flows or the discount rate for the reporting unit. Based on our analysis, we determined there is no goodwill impairment, since the fair value for the reporting unit was in excess of the respective reporting unit's carrying value as of September 30, 2018.

The second step (step 2) of impairment testing is necessary only if the reporting unit does not pass step 1. Step 2 compares the implied fair value of the reporting unit goodwill with the carrying amount of the goodwill for the reporting unit. The implied fair value of goodwill is determined in the same manner as goodwill that is recognized in a business combination. Significant judgment and estimates are involved in estimating the fair value of the assets and liabilities of the reporting unit. Since the reporting unit did not fail step 1, step 2 was not applicable during 2018 testing. The Company monitored events and circumstances during the fourth quarter of 2018, and it determined that there were no triggering events requiring an updated impairment test as of December 31, 2018.

Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. Selection and weighting of the various fair value techniques may result in a higher or lower fair value. Judgment is applied in determining the weightings most representative of fair value.

Intangible assets are amortized or tested for impairment based on whether they have finite or indefinite lives. Intangibles that have finite lives are amortized on a straight-line basis over their useful life and tested for impairment whenever events or circumstances indicate the carrying amount of the assets may not be recoverable. The useful life applied to amortize the customer list intangible, which was created from the acquisition of Manry Rawls, is 15 years. Note 6 provides additional information related to goodwill and other intangibles.

**Note 2 - Summary of significant accounting policies** (continued)

*Non-marketable equity securities* - Non-marketable equity securities are restricted securities, carried at cost, and periodically evaluated for impairment. These securities are restricted, do not have a readily determinable fair value, and lack a market. Because of the redemption provisions of the Federal Reserve Bank and Federal Home Loan Bank stock, the Bank estimated that the fair value equaled or exceeded the cost of these investments and the investments were not impaired. Equity method investments are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the investment might not be recoverable. No such impairment was identified in 2018 or 2017.

*Mergers and acquisitions* - Mergers and acquisitions are accounted for using the acquisition method, as required by ASC 805, *Business Combinations*. Under this method, the cost of the acquired entity will be allocated to the assets acquired and liabilities assumed based on their fair values at the date of acquisition. The excess of the cost over the fair value of the acquired net assets is recognized as goodwill.

*Income taxes* - Income taxes are provided for the tax effects of transactions reported in the financial statements, and consist of taxes currently due plus deferred taxes related primarily to differences between the basis of investment securities, deferred loan fees, allowance for loan losses, deferred compensation, interest on non-performing loans and accumulated depreciation for financial and income tax reporting.

Deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered in income. Deferred tax assets are reduced if it is more likely than not that the tax benefits will not be realized. Management has evaluated all other tax positions that could have a significant effect on the financial statements and determined the Company had no uncertain income tax positions at December 31, 2018 and 2017. The years ending on or after December 31, 2015 remain subject to examination by federal and state tax authorities. The Company recognizes interest and/or penalties related to income tax matters in income tax expense.

*Deferred compensation plans* - The Company maintains deferred compensation and retirement arrangements with certain officers. The Company's policy is to accrue the estimated amounts to be paid under the contracts over the expected period of active employment. The Company purchased life insurance and annuity contracts to fund the expected liabilities under the contracts.

*Revenue recognition on insurance contracts* – Insurance commission income is recorded as of the effective date of insurance coverage or the billing date, whichever is later. Contingent commissions are recognized when determinable, which is generally when such commissions are received or when the Company receives data from the insurance companies that allows the reasonable estimation of these amounts. The income effects of subsequent premium and fee adjustments are recorded when the adjustments become known.

*Earnings per common share* - Basic earnings per share (EPS) is computed by dividing income available to common shareholders by the weighted-average number of shares outstanding for the period. Diluted earnings per share reflects the potential dilution if restricted stock, or other common stock equivalents, would result in the issuance of additional shares of common stock that share in earnings. Potential common shares that may be issued by the Company relate solely to outstanding non-vested restricted stock.

*Off-balance sheet financial instruments* - In the ordinary course of business, the Company has entered into off-balance sheet financial instruments consisting of commitments to extend credit, commitments under credit card arrangements, commercial letters of credit, standby letters of credit, and financial guarantees written. Such financial instruments are generally recorded in the financial statements when they become payable. A reserve for these off-balance sheet financial instruments is considered immaterial as is the fair value of the financial guarantees.

**Note 2 - Summary of significant accounting policies** (continued)

*Use of estimates* - The preparation of financial statements 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.

*Estimation of fair values* - The following notes summarize the major methods and assumptions used in estimating the fair value of financial instruments:

Short-term financial instruments are valued at their carrying amounts included in the Company's balance sheet, which are reasonable estimates of fair value due to the relatively short period to maturity of the instruments. This approach applies to cash and cash equivalents, deposits in other banks, federal funds sold, and short-term borrowings.

Prior to adopting ASU No. 2016-01, "Recognition and Measurement of Financial Assets and Liabilities", the Company was allowed to measure fair value under an entry price notion. The entry price notion previously applied by the Company used a discounted cash flows technique to calculate the present value of expected future cash flows for a financial instrument. The exit price notion uses the same approach, but also incorporates other factors, such as enhanced credit risk, illiquidity risk and market factors that sometimes exist in exit prices in dislocated markets. As of December 31, 2018, the technique used by the Company to estimate the exit price of the loan portfolio consists of similar procedures to those used as of December 31, 2017, but with added emphasis on both illiquidity risk and credit risk not captured by the previously applied entry price notion.

Investment securities are valued at quoted market prices, if available. The fair value of equity investments in the restricted stock of the FRB and FHLB approximates the carrying value due to the redemptive provisions of these securities.

For unquoted securities, the fair value is estimated by the Company on the basis of financial and other information.

The carrying amounts of accrued interest approximate fair value.

The fair value of demand deposits and deposits with no defined maturity is taken to be the amount payable on demand at the reporting date. The fair value of fixed-maturity deposits is estimated using discounted cash flow analyses and rates currently offered for deposits of similar remaining maturities. The intangible value of long-term relationships with depositors is not taken into account in estimating the fair values disclosed.

Fair values of capital notes are based on market prices for debt securities having similar maturity and interest rate characteristics. The impact of the Company's assessment of its own credit risk is not factored into the fair value of the notes.

The carrying amounts of federal funds purchased and borrowings under repurchase agreements approximate their fair values.

The fair values of the Company's Federal Home Loan Bank advances are estimated using discounted cash flow analyses based on current rates offered on similar debt instruments.

It is not practicable to separately estimate the fair values for off-balance-sheet credit commitments, including standby letters of credit and guarantees written, due to the lack of cost-effective, reliable measurement methods for these instruments.

**Note 2 - Summary of significant accounting policies** (continued)

*Certain significant estimates* - Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for losses on loans and the valuation of other real estate owned. Management uses available information to recognize losses on loans and other real estate owned. Future additions to the allowance may be necessary based on changes in local economic conditions and other factors. Management believes the allowance recorded at December 31, 2018 and 2017 is sufficient to cover inherent losses in the portfolio.

*Recent accounting pronouncements* - February 2016, the FASB issued ASU 2016-02, “Leases (Topic 842).” This ASU replaces ASC 840, “Leases” and was issued in order to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet for those leases classified as operating leases under previous GAAP. The ASU requires that a lessee should recognize a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term on the balance sheet. For leases with a term of twelve months or less, a lessee is permitted to make an accounting policy election by class of underlying asset not to recognize lease assets and lease liabilities. If a lessee makes this election, it should recognize lease expense for such leases generally on a straight-line basis over the lease term. The ASU is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years and early adoption is permitted. The Company expects to adopt the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow us to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. The Company has started an initial evaluation of our leasing contracts and activities. The Company expects that the adoption of ASU 2016-02 will result in the recognition of lease liabilities totaling $681,000 and the recognition of right-of-use assets totaling $724,000, with a corresponding increase to retained earnings of approximately $43,000. The Company does not expect a material change to the timing of expense recognition. The Company is evaluating our existing disclosures and may need to provide additional information as a result of adoption of the ASU.

In June 2016, the FASB issued ASU 2016-13, “Measurement of Credit Losses on Financial Instructions.” This ASU changes the way entities recognize impairment of many financial assets by requiring immediate recognition of estimated credit losses expected to occur over the remaining life. The main objective of this ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in ASU 2016-13 replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The changes are effective for annual and interim periods in fiscal years beginning after December 15, 2020. An entity may early adopt the standard for annual and interim periods in fiscal years beginning after December 15, 2018. The Company is currently evaluating the impact of this standard.

In January 2017, the FASB issued ASU No. 2017-04, Intangibles – Goodwill and Other (Topic 350): Simplifying the test for Goodwill Impairment. This ASU is intended to simplify goodwill impairment testing by eliminating the second step of the analysis under which the implied fair value of goodwill is determined as if the reporting unit were being acquired in a business combination. The update instead requires entities to compare the fair value of a reporting unit with its carrying amount and recognize an impairment charge for any amount by which the carrying amount exceeds the reporting unit’s fair value, to the extent that the loss recognized does not exceed the amount of goodwill allocated to that reporting unit. The amendments are effective for public business entities for fiscal years beginning after December 15, 2019. Early adoption is permitted. The Company does not expect the amendments to the standard to have a material effect on its consolidated financial statements.

**Note 2 - Summary of significant accounting policies** (continued)

In March 2017, the FASB issued ASU No. 2017-08, "Receivables-Nonrefundable Fees and Other Costs (Topic 310-20), Premium Amortization on Purchased Callable Debt Securities." The amendments in this ASU shorten the amortization period for certain callable debt securities purchased at a premium. Upon adoption of the standard, premiums on these qualifying callable debt securities will be amortized to the earliest call date. Discounts on purchased debt securities will continue to be accreted to maturity. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. Upon transition, entities should apply the guidance on a modified retrospective basis, with a cumulative-effect adjustment to retained earnings as of assessing the impact that ASU 2017-08 will have on its consolidated financial statements. The Company does not expect the amendments to the standard to have a material effect on its consolidated financial statements.

In June 2018, the FASB issued ASU No. 2018-07, "Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting." The amendments expand the scope of Topic 718 to include share-based payments issued to non-employees for good or services, which were previously excluded. The amendments will align the accounting for share-based payments to non-employees and employees more similarly. The amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-07 to have a material impact on its consolidated financial statements.

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. Early adoption is permitted. The Company does not expect the adoption of ASU 2018-13 to have a material impact on its consolidated financial statements.

Other accounting standards that have been issued or proposed by the FASB or other standards-setting bodies are not expected to have a material impact on the Company's financial position, results of operations or cash flows.

**Accounting Standards Adopted in 2018**

In August 2015, the FASB issued Accounting Standards Updated ("ASU") No. 2015-14, "Revenue from Contracts with Customers: Topic 606". This ASU is an update to the original ASU No. 2014-09 and the deferral of the effective date. Both ASU's apply to any entity using U.S. GAAP that either enters into contracts with customers to transfer goods or services or enters into contracts for the transfer of nonfinancial assets unless those contracts are within the scope of other standards. The guidance supersedes the current revenue recognition requirements in Topic 605, "Revenue Recognition." The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. To be in alignment with the core principle, an entity must apply a five-step process including: identification of the contract(s) with a customer, identification of performance obligations in the contract(s), determination of the transaction price, allocation of the transaction price to the performance obligations, and recognition of revenue when (or as) the entity satisfies a performance obligation. Additionally, the existing requirements for the recognition of a gain or loss on the transfer of nonfinancial assets that are not in a contract with a customer have also been amended to be consistent with the guidance on recognition and measurement. The amendments in this ASU became effective for the Company on January 1, 2018. The Company applied the guidance using a modified retrospective approach. See Note 21 for additional information.

**Note 2 - Summary of significant accounting policies** (concluded)

In January 2016, the FASB issued ASU No. 2016-01, "Financial Instruments – Overall: Subtopic 825-10: Recognition and Measurement of Financial Assets and Financial Liabilities." This ASU addresses certain aspects of recognition, measurement, presentation and disclosure. The amendments in this ASU (1) require equity investments to be measured at fair value with changes in fair value recognized in net income; (2) simplify the impairment assessment of equity investments without readily determinable fair value; (3) require public business entities to use exit prices, rather than entry prices, when measuring fair value of financial instruments for disclosure purposes; (4) require separate presentation of financial assets and financial liabilities by measurement category and form of financial assets on the balance sheet or the accompanying notes to the financial statements; (5) eliminate the requirement to disclose the method(s) and significant assumptions used to estimate the fair value for financial statements measured at amortized cost on the balance sheet; (6) require separate presentation in other comprehensive income of the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments; and (7) state that a valuation allowance on deferred tax assets related to available-for-sale securities should be evaluated in combination with other deferred tax assets. The Company adopted the accounting standard on January 1, 2018. The adoption of the accounting standard did not have a material impact on the Company's Consolidated Financial Statements. In accordance with the new guidance, the Company began measuring the fair value of its loan portfolio, using an exit price notion. See Note 17 for additional information.

In August 2016, the FASB issued ASU 2016-15, "Statement of Cash Flow." This ASU is intended to reduce diversity in practice in how certain transactions are classified in the statement of cash flows. The guidance addresses: (1) debt prepayment on debt extinguishment costs; (2) settlement of zero-coupon debt instruments; (3) contingent consideration payments made after a business combination; (4) proceeds from the settlement of insurance claims; (5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned life insurance policies; (6) distributions received from equity method investments; (7) beneficial interest in securitizations transactions; and (8) separately identifiable cash flows and application of the predominance principle. On January 1, 2018, the Company adopted the accounting standard. The adoption did not have a material impact on the Company's Consolidated Financial Statements.

In February 2017, the FASB amended the "Other Income Topic of the Accounting Standards Codification" to clarify the scope of the guidance on nonfinancial asset derecognition as well as the accounting for partial sales of nonfinancial assets. The amendments conform the derecognition guidance on nonfinancial assets with the model for transactions in the new revenue standard. The Company adopted the standard effective January 1, 2018 using the modified retrospective approach.

In February 2018, the FASB Issued (2018-02), "Income Statement (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income", which requires Companies to reclassify the stranded effects in other comprehensive income to retained earnings as a result of the change in the tax rates under the Tax Cuts and Jobs Act. The Company has opted to early adopt this pronouncement in 2017 by retrospective application to each period (or periods) in which the effect of the change in the tax rate under the Tax Cuts and Jobs Act is recognized. The impact of the reclassification from other comprehensive income to retained earnings was $229,534.

**Note 3 - Available-for-sale securities**

At December 31, 2018 and 2017, securities are as follows:

| December 31, 2018 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| State and municipal | $ 65,906,841 | $ 698,572 | $ 441,306 | $ 66,164,107 |
| Residential mortgage-backed securities | 24,754,971 | 71,749 | 467,297 | 24,359,423 |
| Collateralized mortgage obligations | 52,982,245 | 65,203 | 827,298 | 52,220,150 |
| Small Business Administration loan securities | 13,857,161 | 417,665 | 2,998 | 14,271,828 |
| Total | $ 157,501,218 | $ 1,253,189 | $ 1,738,899 | $ 157,015,508 |

| December 31, 2017 | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
|---|---|---|---|---|
| State and municipal | $ 51,551,857 | $ 1,539,085 | $ 51,202 | $ 53,039,740 |
| Residential mortgage-backed securities | 17,452,768 | 34,034 | 139,739 | 17,347,063 |
| Collateralized mortgage obligations | 48,104,162 | 109,685 | 539,339 | 47,674,508 |
| Small Business Administration loan securities | 18,929,512 | 813,123 | - | 19,742,635 |
| Total | $ 136,038,299 | $ 2,495,927 | $ 730,280 | $ 137,803,946 |

At December 31, 2018 and 2017, gross unrealized losses and fair value by length of time that the individual securities have been in a continuous unrealized loss position, are as follows:

| | | Losses Existing for: | | |
|---|---|---|---|---|
| December 31, 2018 | Fair Value | Less than 12 Months | More than 12 Months | Total Losses |
| Available-for-sale securities: | | | | |
| State and municipal | $ 21,516,251 | $ 357,208 | $ 84,098 | $ 441,306 |
| Residential mortgage-backed securities | 16,767,519 | 86,217 | 381,080 | 467,297 |
| Collateralized mortgage obligations | 40,812,165 | 77,666 | 749,632 | 827,298 |
| Small Business Administration loan securities | 260,429 | 2,998 | - | 2,998 |
| Total temporarily impaired investment securities | $ 79,356,364 | $ 524,089 | $ 1,214,810 | $ 1,738,899 |

| | | Continuous Unrealized Losses Existing for: | | |
|---|---|---|---|---|
| December 31, 2017 | Fair Value | Less than 12 Months | More than 12 Months | Total Losses |
| Available-for-sale securities: | | | | |
| State and municipal | $ 2,087,083 | $ 7,312 | $ 43,890 | $ 51,202 |
| Residential mortgage-backed securities | 12,476,225 | 61,292 | 78,447 | 139,739 |
| Collateralized mortgage obligations | 34,952,462 | 247,227 | 292,112 | 539,339 |
| Total temporarily impaired investment securities | $ 49,515,770 | $ 315,831 | $ 414,449 | $ 730,280 |

**Note 3 - Available-for-sale securities** (continued)

*State and municipal* - The Company's unrealized losses on state and municipal securities were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because of the Company's intent to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

*Residential mortgage-backed securities and collateralized mortgage obligations* - The Company's unrealized losses on residential mortgage-backed securities and collateralized mortgage obligations were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Our mortgage-related securities are backed by the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC"), which are Government Sponsored Entities ("GSE") or are collateralized by securities backed by these agencies. The Company intends to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery. Because of the preceding factors the Company does not consider these investments other than temporarily impaired.

*Small Business Administration loan securities* - The Company's unrealized losses on small business administration loans were caused by the interest rate fluctuations. The severity and duration of these unrealized losses will fluctuate with interest rates in the economy. Based on the credit quality of the issuers, and because of the Company's intent to hold the securities until a market price recovery or maturity, and it is more likely than not that the Company will not be required to sell these securities before their anticipated recovery, the Company does not consider these investments other than temporarily impaired.

At December 31, 2018 and 2017, securities with a carrying value of approximately $50,922,015 and $52,883,572, respectively, were pledged to the Commonwealth of Virginia to secure public deposits. In addition, at December 31, 2018 and 2017, securities with a carrying value of $13,431,015 and $7,312,036, respectively, were pledged to the Federal Home Loan Bank to secure advances. Investment securities with carrying values of $5,874,785 and $3,054,577 were pledged to secure repurchase agreements at December 31, 2018 and 2017, respectively.

At December 31, 2018, the amortized cost and fair value of debt securities by maturity date are as follows:

| | Amortized Cost | Fair Value |
|---|---|---|
| Due in one year or less | $ 917,230 | $ 931,863 |
| Due from one to five years | 5,320,775 | 5,425,199 |
| Due from five to ten years | 15,691,466 | 15,935,846 |
| Due after ten years | 135,571,747 | 134,722,600 |
| Total debt securities | $ 157,501,218 | $ 157,015,508 |

Gross realized gains on available-for-sale securities were:

| | 2018 | 2017 |
|---|---|---|
| State and municipal | $ 154,773 | $ 116,397 |
| Collateralized mortgage obligations | - | 19,733 |
| Total gross realized gains | $ 154,773 | $ 136,130 |

**Note 3 - Available-for-sale securities** (concluded)

Gross realized losses on available-for-sale securities were:

| | 2018 | 2017 |
|---|---|---|
| Residential mortgage-backed securities | $ - | 74,914 |
| Total gross realized gains | $ - | $ 74,914 |

Proceeds from the sale of available-for-sale securities totaled $3,979,003 and $10,446,016 for the years ended December 31, 2018 and 2017, respectively.

**Note 4 - Loans and Allowance for Loan Losses**

*General* - The Bank provides to its customers a full range of short- to medium-term commercial, agricultural, Small Business Administration guaranteed, mortgage, home equity, and personal loans, both secured and unsecured. The Bank also makes real estate mortgage and construction loans. At December 31, 2018 and 2017, loans held for investment consisted of the following:

| | 2018 | 2017 |
|---|---|---|
| Mortgage loans on real estate: | | |
| Construction | $ 37,308,602 | $ 35,828,855 |
| Commercial Real Estate: | | |
| Non-owner occupied | 26,693,164 | 31,423,300 |
| Owner occupied | 63,422,601 | 64,905,599 |
| Residential 1-4 family | 39,010,134 | 40,745,349 |
| Multifamily | 5,333,956 | 4,631,773 |
| Equity lines of credit | 10,946,435 | 13,278,388 |
| Total mortgage loans on real estate | 182,714,892 | 190,813,264 |
| Commercial and industrial | 60,469,780 | 55,987,931 |
| Agricultural | 23,243,498 | 23,836,897 |
| Individuals | 8,951,568 | 1,987,347 |
| Total loans | 275,379,738 | 272,625,439 |
| Less: Allowance for loan losses | (5,916,359) | (5,922,333) |
| Net deferred loan fees and costs | 56,927 | 49,607 |
| Loans, net | $ 269,520,306 | $ 266,752,713 |

*Real Estate Loans* - Real estate loans include construction and land development loans, commercial real estate loans, home equity lines of credit, multi-family and residential mortgages.

Construction/development lending totaled $37.3 million and $35.8 million at December 31, 2018 and 2017, respectively. The Bank originates one-to-four family residential construction loans for the construction of custom homes (where the home buyer is the borrower) and provides financing to builders and consumers for the construction of homes. The Bank generally receives a pre-arranged permanent financing commitment from an outside banking entity prior to financing the construction of pre-sold homes. The Bank also makes commercial real estate construction loans, primarily for owner-occupied properties. The Bank limits its construction lending risk through adherence to established underwriting procedures. Residential one-to-four family loans amounted to $39.0 million and $40.7 million at December 31, 2018 and 2017, respectively.

**Note 4 – Loans and Allowance for Loan Losses** (continued)

Commercial real estate loans totaled $90.1 million and $96.3 million at December 31, 2018 and 2017, respectively. This lending has involved loans secured by owner-occupied commercial buildings for office, storage and warehouse space, as well as non-owner occupied commercial buildings. The Bank generally requires the personal guaranty of borrowers and a demonstrated cash flow capability sufficient to service the debt. Loans secured by commercial real estate may be larger in size and may involve a greater degree of risk than one-to-four family residential mortgage loans. Payments on such loans are often dependent on successful operation or management of the properties.

Multifamily loans totaled $5.3 million and $4.6 million at December 31, 2018 and 2017, respectively. These loans are residential housing projects containing five or more rental units. Traditional multifamily projects charge market rents and are located in both city and suburban markets. Equity lines of credit are open-ended revolving lines of credit secured by the equity in a borrower's residence. Equity lines of credit totaled $10.9 million and $13.3 million at December 31, 2018 and 2017, respectively.

*Commercial and Industrial Loans -* At December 31, 2018 and 2017, the Bank's commercial loan portfolio totaled $60.5 million and $55.9 million, respectively. Commercial loans include both secured and unsecured loans for working capital, expansion, and other business purposes. Short-term working capital loans are secured by accounts receivable, inventory and/or equipment. The Bank also makes term commercial loans secured by equipment and real estate. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. With few exceptions, the Bank requires personal guarantees and secondary sources of repayment. Commercial loans generally provide greater yields and re-price more frequently than other types of loans, such as real estate loans.

*Agricultural Loans* – Agricultural loans totaled $23.2 million and $23.8 million at December 31, 2018 and 2017, respectively and include loans secured by farm equipment, inventory and farm land. Lending decisions are based on an evaluation of the financial strength, cash flow, management and credit history of the borrower, and the quality of the collateral securing the loan. Payments on such loans are often dependent on successful operation or management of the farming operation.

*Loans to Individuals -* Loans to individuals (consumer loans) include automobile loans, boat and recreational vehicle financing, and miscellaneous secured and unsecured personal loans and totaled $8.9 million and $1.9 million at December 31, 2018 and 2017, respectively. Overdrafts totaling $32 thousand and $24 thousand at December 31, 2018 and 2017, respectively, were reclassified from deposits to loans and are also classified in loans to individual. Consumer loans generally can carry significantly greater risks than other loans, even if secured, if the collateral consists of rapidly depreciating assets such as automobiles and equipment. Repossessed collateral securing a defaulted consumer loan may not provide an adequate source of repayment of the loan. Consumer loan collections are sensitive to job loss, illness and other personal factors. The Bank manages the risks inherent in consumer lending by following established credit guidelines and underwriting practices designed to minimize risk of loss.

*Loan Approvals -* The Bank's loan policies and procedures establish the basic guidelines governing its lending operations. The guidelines address the type of loans that the Bank seeks, target markets, underwriting and collateral requirements, terms, interest rate and yield considerations and compliance with laws and regulations. All loans or credit lines are subject to approval procedures and amount limitations. These limitations apply to the borrower's total outstanding indebtedness to the Bank, including any indebtedness as a guarantor. The policies are reviewed and approved at least annually by the Board of Directors of the Bank. The Bank supplements its own supervision of the loan underwriting and approval process with periodic loan reviews by independent, outside professionals experienced in loan review. Responsibility for loan review and loan underwriting resides with the Chief Credit Officer position. This position is responsible for loan underwriting and approval. On an annual basis, the Board of Directors of the Bank determines officers' lending authority. Authorities may include loans, letters of credit, overdrafts, uncollected funds and such other authorities as determined by the Board of Directors.

**Note 4 - Loans and Allowance for Loan Losses** (continued)

Substantially all of the Bank's loans have been granted to customers in the Hampton Roads area of Virginia.

*Credit Review and Evaluation -* The Bank outsources the credit risk review function which reports to the Board of Directors. The focus of the engagement is on policy compliance and proper grading of higher credit risk loans as well as new and existing loans on a sample basis. Additional reporting for problem/criticized assets has been developed along with an after-the-fact loan review.

The Bank uses a risk grading program to facilitate the evaluation of probable inherent loan losses and the adequacy of the allowance for loan losses. In this program, risk grades are initially assigned by loan officers, reviewed by the Chief Credit Officer and reviewed by credit review analysts on a test basis. The Bank strives to maintain the loan portfolio in accordance with conservative loan underwriting policies that result in loans specifically tailored to the needs of the Bank's market area. Every effort is made to identify and minimize the credit risks associated with such lending strategies.

*Credit Review and Evaluation* (concluded) - All loans are risk graded on a scale from 1 (highest quality) to 9 (loss). Acceptable loans at inception are grades 1 through 5. These grades have underwriting requirements that at least meet the minimum requirements of a secondary market source. If borrowers do not meet credit history requirements, other mitigating criteria such as substantial liquidity and low loan-to-value ratios could be considered and would generally have to be met in order to make the loan. The Bank's loan policy states that a guarantor may be necessary if reasonable doubt exists as to the borrower's ability to repay.

The Board of Directors has authorized the loan officers to have individual approval authority for risk grade 1 through 5 loans up to maximum exposure limits for each customer. New or renewed loans that are graded 6 (special mention) or lower must have approval from the Chief Credit Officer and Chief Lending Officer. Any changes in risk assessments as determined by loan officers, credit administrators, regulatory examiners and management are also considered.

The risk grades, normally assigned by the loan officers when the loan is originated and reviewed by the Chief Credit Officer, are based on several factors including historical data, current economic factors, composition of the portfolio, and evaluations of the total loan portfolio and assessments of credit quality within specific loan types. In some cases the risk grades are assigned by the Chief Credit Officer or the Chief Lending Officer, depending upon dollar exposure. Because these factors are dynamic, the provision for loan losses can fluctuate. Credit quality reviews are based primarily on analyses of borrowers' cash flows, with asset values considered only as a second source of payment. Credit analysts work with lenders in underwriting, structuring and risk grading the Bank's credits. The Chief Lending Officer and the Chief Credit Officer focus on lending policy compliance, credit risk grading, and credit risk reviews on larger dollar exposures. Management uses the information developed from the procedures above in evaluating and grading the loan portfolio. This continual grading process is used to monitor the credit quality of the loan portfolio and to assist management in determining the appropriate levels of the allowance for loan losses. The following is a summary of the credit risk grade definitions for all loan types:

"1" — Prime – Credits in this category are virtually risk-free and are well-collateralized by cash or cash-equivalent instruments held by the Bank. The repayment program is well-defined and achievable, and repayment sources are numerous. No material documentation deficiencies or exceptions exist.

"2" — Good – This grade is reserved for loans secured by readily marketable collateral, or loans within guidelines to borrowers with liquid financial statements. A liquid financial statement is generally a financial statement with substantial liquid assets, particularly relative to the debts. These loans have excellent sources of repayment, with no significant identifiable risk of collection, and conform in all respects to Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).

**Note 4 - Loans and Allowance for Loan Losses** (continued)

"3" — Acceptable 1 – This grade is reserved for the Bank's high-quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection. Generally, loans assigned this risk grade will demonstrate the following characteristics:

- Conformity in all respects with Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

"4" — Acceptable 2 – This grade is given to acceptable loans. These loans have adequate sources of repayment, with little identifiable risk of collection. Loans assigned this risk grade will demonstrate the following characteristics:

- General conformity to the Bank's underwriting requirements, with limited exceptions to the Bank's policy, product or underwriting guidelines. All exceptions noted have documented mitigating factors that offset any additional risk associated with the exceptions noted.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

"5" — Weak Pass – This grade is given to acceptable loans that show signs of weakness in either adequate sources of repayment or collateral, but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Loans assigned this grade may demonstrate some or all of the following characteristics:

- Additional exceptions to the Bank's policy requirements, product guidelines or underwriting standards that present a higher degree of risk to the Bank. Although the combination and/or severity of identified exceptions is greater for this risk grade, the exceptions may be properly mitigated by other documented factors that offset any additional risks.
- Unproved, insufficient or marginal primary sources of repayment that appear sufficient to service the debt at this time. Repayment weaknesses may be due to minor operational issues, financial trends, or reliance on projected (not historic) performance.
- Marginal or unproven secondary sources to liquidate the debt, including combinations of liquidation of collateral and liquidation value to the net worth of the borrower or guarantor.

"6" — Special Mention – Special Mention loans include the following characteristics:

- Loans with underwriting guideline tolerances and/or exceptions and with no mitigating factors;
- Extending loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank's position at some future date. Potential weaknesses are the result of deviations from prudent lending practices; or
- Loans where adverse economic conditions have developed subsequent to the loan origination that do not jeopardize liquidation of the debt, but do substantially increase the level of risk, may also warrant this rating.

"7" — Substandard – A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as 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 institution will sustain some loss if the deficiencies are not corrected. Loans consistently not meeting the repayment schedule should be downgraded to substandard. Loans in this category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action. The weaknesses may include, but are not limited to:

- High debt to worth ratios

**Note 4 - Loans and Allowance for Loan Losses** (continued)

- Declining or negative earnings trends
- Declining or inadequate liquidity
- Questionable repayment sources
- Lack of well-defined secondary repayment source, and
- Unfavorable competitive comparisons.

Such loans are no longer considered to be adequately protected due to the borrower's declining net worth, lack of earnings capacity, declining collateral margins and/or unperfected collateral positions. A possibility of loss of a portion of the loan balance cannot be ruled out. The repayment ability of the borrower is marginal or weak and the loan may have exhibited excessive overdue status or extensions and/or renewals.

"8" — Doubtful – Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus 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. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Among these events are:

- Injection of capital
- Alternative financing
- Liquidation of assets or the pledging of additional collateral.

The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is presently not quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off.

"9" — Loss – Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan even though partial recovery may be effected in the future. Probable Loss portions of problem assets should be charged against the Allowance for Loan Losses. Loans may reside in this classification for administrative purposes for a period not to exceed the earlier of thirty (30) days or calendar quarter-end.

The following is a summary of credit quality indicators by class at December 31, 2018 and 2017:

**Real Estate Credit Exposure as of December 31, 2018**

| | | Commercial Real Estate | | | | |
|---|---|---|---|---|---|---|
| | Construction | Non-owner occupied | Owner occupied | Residential 1-4 Family | Multifamily | Equity lines of credit |
| | | | (in thousands) | | | |
| Good | $ - | $ - | $ - | $ 15 | $ - | $ - |
| Acceptable 1 | 2,448 | 1,832 | 3,263 | 5,126 | - | 4,534 |
| Acceptable 2 | 26,393 | 11,136 | 34,402 | 20,766 | 1,931 | 5,415 |
| Weak Pass | 7,968 | 13,432 | 24,369 | 10,476 | 3,403 | 522 |
| Special Mention | 500 | - | 140 | 1,231 | - | 60 |
| Substandard | - | 293 | 1,249 | 1,396 | - | 415 |
| | $ 37,309 | $ 26,693 | $ 63,423 | $ 39,010 | $ 5,334 | $ 10,946 |

**Note 4 - Loans and Allowance for Loan Losses** (continued)

**Other Credit Exposures as of December 31, 2018**

| | Commerical and industrial | Agricultural | Individuals | Total |
|---|---|---|---|---|
| | (in thousands) | | | |
| Good | $ - | $ - | $ - | $ 15 |
| Acceptable 1 | 7,929 | 1,962 | 186 | 27,280 |
| Acceptable 2 | 35,930 | 12,835 | 1,055 | 149,863 |
| Weak Pass | 16,243 | 8,446 | 7,427 | 92,286 |
| Special Mention | 350 | - | 284 | 2,565 |
| Substandard | 18 | - | - | 3,371 |
| | $ 60,470 | $ 23,243 | $ 8,952 | $ 275,380 |

**Real Estate Credit Exposure as of December 31, 2017**

| | | Commercial Real Estate | | | | |
|---|---|---|---|---|---|---|
| | Construction | Non-owner occupied | Owner occupied | Residential 1-4 Family | Multifamily | Equity lines of credit |
| | (in thousands) | | | | | |
| Good | $ - | $ - | $ - | $ 15 | $ - | $ 45 |
| Acceptable 1 | 1,927 | 2,876 | 3,016 | 7,083 | - | 6,238 |
| Acceptable 2 | 17,757 | 12,549 | 33,805 | 19,112 | 1,125 | 5,918 |
| Weak Pass | 13,990 | 13,865 | 26,085 | 10,769 | 3,507 | 744 |
| Special Mention | 1,902 | 1,815 | 1,941 | 2,764 | - | 144 |
| Substandard | 253 | 318 | 59 | 1,002 | - | 189 |
| | $ 35,829 | $ 31,423 | $ 64,906 | $ 40,745 | $ 4,632 | $ 13,278 |

**Other Credit Exposures as of December 31, 2017**

| | Commerical and industrial | Agricultural | Individuals | Total |
|---|---|---|---|---|
| | (in thousands) | | | |
| Good | $ - | $ - | $ 16 | $ 76 |
| Acceptable 1 | 4,175 | 5,564 | 251 | 31,130 |
| Acceptable 2 | 36,645 | 12,281 | 1,189 | 140,380 |
| Weak Pass | 14,202 | 5,289 | 208 | 88,658 |
| Special Mention | 930 | 703 | 323 | 10,523 |
| Substandard | 36 | - | - | 1,858 |
| | $ 55,988 | $ 23,837 | $ 1,987 | $ 272,625 |

**Note 4 - Loans and Allowance for Loan Losses** (continued)

*Nonaccrual loans and past due loans -* Nonperforming assets include loans classified as nonaccrual, foreclosed bank-owned property and loans past due 90 days or more on which interest is still being accrued. There were no financing receivables past due over 90 days accruing interest as of December 31, 2018 or 2017. Nonaccrual loans as of December 31, 2018 totaled $700 thousand, or 0.25% of total loans, compared with $834 thousand, or 0.31% of total loans, as of December 31, 2017. The Bank aggressively pursues the collection and repayment of all loans. Other nonperforming assets, such as repossessed and foreclosed collateral are aggressively liquidated by the Bank's management. The total number of loans on nonaccrual status as of December 31, 2018 and 2017 was 10 and 9, respectively.

For the years ended December 31, 2018 and 2017, the Bank recognized $-0- in interest income on nonaccrual loans. If interest on those loans had been accrued in accordance with the original terms, interest income would have increased by approximately $38,829 and $59,263 for the years ended December 31, 2018 and 2017, respectively.

The following is a breakdown of nonaccrual loans as of December 31, 2018 and 2017:

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| Mortgage loans on real estate: | | |
| Construction | $ - | $ 252,743 |
| Commercial real estate: | | |
| Non-owner occupied | 151,523 | 166,192 |
| Residential 1-4 family | 327,853 | 189,863 |
| Equity lines of credit | 204,887 | 188,924 |
| Commerical and industrial | 15,341 | 36,327 |
| Total | $ 699,604 | $ 834,049 |

*Nonaccrual loans and past due loans* (concluded) - All classes of loans are considered past due if the required principal and interest income have not been received as of the date such payments were due. The following tables present the Bank's aged analysis of past due loans as of December 31, 2018 and 2017:

| December 31, 2018 (in thousands) | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Greater Than 90 Days Still Accruing | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|---|
| Mortgage loans on real estate: | | | | | | | |
| Construction | $ 248 | $ - | $ - | $ - | $ 248 | $ 37,061 | $ 37,309 |
| Commercial real estate: | | | | | | | |
| Non-owner occupied | - | - | 70 | - | 70 | 26,623 | 26,693 |
| Owner occupied | 49 | - | - | - | 49 | 63,374 | 63,423 |
| Residential 1-4 family | 142 | 12 | 193 | - | 347 | 38,663 | 39,010 |
| Multifamily | - | - | - | - | - | 5,334 | 5,334 |
| Equity lines of credit | - | - | - | - | - | 10,946 | 10,946 |
| Commercial and industrial | 84 | - | - | - | 84 | 60,386 | 60,470 |
| Agricultural | - | - | - | - | - | 23,243 | 23,243 |
| Individuals | - | - | - | - | - | 8,952 | 8,952 |
| Total | $ 523 | $ 12 | $ 263 | $ - | $ 798 | $ 274,582 | $ 275,380 |

**Note 4 - Loans and Allowance for Loan Losses** (continued)

| December 31, 2017 | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Greater Than 90 Days Still Accruing | Total Past Due | Current | Total Loans |
|---|---|---|---|---|---|---|---|
| | | | | (in thousands) | | | |
| Mortgage loans on real estate: | | | | | | | |
| Construction | $ - | $ - | $ - | $ - | $ - | $ 35,829 | $ 35,829 |
| Commercial real estate: | | | | | | | |
| Non-owner occupied | - | 4 | 73 | - | 77 | 31,346 | 31,423 |
| Owner occupied | - | - | - | - | - | 64,906 | 64,906 |
| Residential 1-4 family | - | 15 | - | - | 15 | 40,730 | 40,745 |
| Multifamily | - | - | - | - | - | 4,632 | 4,632 |
| Equity lines of credit | - | 24 | - | - | 24 | 13,254 | 13,278 |
| Commercial and industrial | - | - | 36 | - | 36 | 55,952 | 55,988 |
| Agricultural | - | - | - | - | - | 23,837 | 23,837 |
| Individuals | 9 | - | - | - | 9 | 1,978 | 1,987 |
| Total | $ 9 | $ 43 | $ 109 | $ - | $ 161 | $ 272,464 | $ 272,625 |

*Troubled Debt Restructurings* - In order to maximize the collection of loan balances, the Bank evaluates troubled loan accounts on a case-by-case basis to determine if a loan modification would be appropriate. Loan modifications may be utilized where there is a reasonable chance that an appropriate modification would allow the Bank's customers to continue servicing debt. A loan is a troubled debt restructuring ("TDR") if both of the following exist: 1) a creditor has granted a concession to the debtor, and, 2) the debtor is experiencing financial difficulties. Non-accruing loans that are modified can be placed back on accrual status when both principal and interest are current and it is probable that the Bank will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement and a sustained period of payment performance is demonstrated. Interest on troubled debt restructured loans is accrued at the restructured rates when it is anticipated that no loss of original principal will occur and a sustained payment performance period is obtained. For the years ended December 31, 2018 and 2017, the following table presents a breakdown of the types of concession made by loan class:

| | Year ended December 31, 2018 | | | Year ended December 31, 2017 | | |
|---|---|---|---|---|---|---|
| | Number of loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Number of loans | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment |
| Extended payment terms | | | | | | |
| Mortgage loans on real estate: | | | | | | |
| Construction | - | $ - | $ - | 1 | $ 252,743 | $ 252,743 |
| Commercial real estate: | | | | | | |
| Non-owner occupied | 1 | 47,157 | 47,157 | 1 | 102,103 | 102,103 |
| Residential 1-4 family | 2 | 163,607 | 163,607 | - | - | - |
| Equity lines of credit | 3 | 373,039 | 373,039 | - | - | - |
| Total | 6 | $ 583,803 | $ 583,803 | 2 | $ 354,846 | $ 354,846 |

**Note 4 - Loans and Allowance for Loan Losses** (continued)

*Troubled Debt Restructurings* - The restructured loans generally include terms to reduce the interest rate and extend payment terms. The Bank did not forgive any principal associated with any of the above loans during 2018 or 2017. Within the last 12 months, no loans that were restructured in 2018 or 2017, subsequently defaulted and were foreclosed upon. These modifications resulted in specific reserves in the Bank's allowance for loan losses of $252 thousand and $-0- as of December 31, 2018 and 2017, respectively.

There were two TDRs that were on non-accrual status and have an unpaid principal balance of $249,685 as of December 31, 2018. There were two TDRs that were on non-accrual status and had an unpaid principal balance of $325,411 as of December 31, 2017. Twelve TDRs with a current principal balance of $1.4 million and nine TDRs with current principal balance of $1.3 million were considered performing loans and are accruing interest based on their sustained payment performance as of December 31, 2018 and 2017, respectively.

The specific reserve portion of the allowance for loan losses on TDRs is determined by discounting the restructured cash flows at the original effective rate of the loan before modification or is based on the underlying collateral value less costs to sell, if repayment of the loan is collateral-dependent. If the resulting amount is less than the recorded book value, the Bank either establishes a valuation allowance as a component of the allowance for loan losses or charges off the impaired balance if it determines that such amount is a confirmed loss. This method is used consistently for all segments of the portfolio.

*Other real estate owned* - At December 31, 2018 and 2017 the Company held $-0- and $15,000, respectively of foreclosed residential real estate. The recorded investment in one-to-four family residential loans secured by residential real estate properties where formal foreclosure procedures were in process as of December 31, 2018 and 2017 was $-0-. The remaining balance of other real estate owned consists of construction and commercial real estate properties.

*Impaired Loans* - Management considers certain loans graded "doubtful" (loans graded 8) or "loss" (loans graded 9) to be individually impaired and may consider "substandard" loans (loans graded 7) individually impaired depending on the borrower's payment history. Any loans classified as troubled debt restructurings regardless of loan grade are also classified as impaired loans. The Bank measures impairment based upon discounted expected cash flows or the value of the collateral. Collateral value is assessed based on collateral value trends, liquidation value trends, and other liquidation expenses to determine logical and credible discounts that may be needed. Updated appraisals are required for all impaired loans and typically at renewal or modification of larger loans if the appraisal is more than 12 months old.

Impaired loans for all classes of loans typically include nonaccrual loans, loans over 90 days past due still accruing, troubled debt restructured loans and other problem loans considered impaired based on other underlying factors. Potential problem loans totaled $3.8 million and $2.4 million as of December 31, 2018 and 2017, respectively. These totals include loans which are currently performing and are not included in nonaccrual or restructured loans above, but about which we have serious doubts as to the borrower's ability to comply with present repayment terms. These loans are likely to be included later in nonaccrual, past due or troubled debt restructured loans, so they are considered by management in assessing the adequacy of the allowance for loan losses. No additional funds are committed to be advanced in connection with impaired loans.

## Farmers Bankshares, Inc.

**Notes to Consolidated Financial Statements**
**For Years Ended December 31, 2018 and 2017**

**Note 4 - Loans and Allowance for Loan Losses** (continued)

The following tables present the Bank's investment in loans considered to be impaired and related information on those impaired loans as of December 31, 2018 and 2017:

| | | | | Year to Date | |
|---|---|---|---|---|---|
| **December 31, 2018** | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
| | | | (in thousands) | | |
| **Impaired loans without a related allowance for loan losses** | | | | | |
| Mortgage loans on real estate: | | | | | |
| Construction | $ 263 | $ 263 | $ - | $ 313 | $ 13 |
| Commercial real estate: | | | | | |
| Non-owner occupied | 212 | 212 | - | 225 | 6 |
| Owner occupied | 1,196 | 1,196 | | 1,197 | 46 |
| Residential 1-4 family | 615 | 658 | - | 751 | 26 |
| Equity lines of credit | 63 | 63 | | 63 | 3 |
| Commercial and industrial | 2 | 2 | - | 2 | - |
| **Impaired loans with a related allowance for loan losses** | | | | | |
| Mortgage loans on real estate: | | | | | |
| Commercial real estate: | | | | | |
| Non-owner occupied | 81 | 81 | 7 | 83 | - |
| Residential 1-4 family | 1,000 | 1,000 | 172 | 1,001 | 43 |
| Equity lines of credit | 352 | 352 | 252 | 359 | 7 |
| Commercial and industrial | 15 | 15 | 15 | 15 | - |
| **Total impaired loans** | | | | | |
| Mortgage loans on real estate: | | | | | |
| Construction | $ 263 | $ 263 | $ - | $ 313 | $ 13 |
| Commercial real estate: | | | | | |
| Non-owner occupied | 293 | 293 | 7 | 308 | 6 |
| Owner occupied | 1,196 | 1,196 | - | 1,197 | 46 |
| Residential 1-4 family | 1,615 | 1,658 | 172 | 1,752 | 69 |
| Equity lines of credit | 415 | 415 | 252 | 422 | 10 |
| Commercial and industrial | 17 | 17 | 15 | 17 | - |
| **Total impaired loans** | $ 3,799 | $ 3,842 | $ 446 | $ 4,009 | $ 144 |

**Note 4 - Loans and Allowance for Loan Losses** (continued)

| December 31, 2017 | Recorded Investment | Unpaid Principal Balance | Related Allowance | Year to Date Average Recorded Investment | Year to Date Interest Income Recognized |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| **Impaired loans without a related allowance for loan losses** | | | | | |
| Mortgage loans on real estate: | | | | | |
| Construction | $ 278 | $ 278 | $ - | $ 285 | $ 17 |
| Commercial real estate: | | | | | |
| Non-owner occupied | 225 | 225 | - | 234 | 8 |
| Residential 1-4 family | 376 | 444 | - | 477 | 17 |
| Commercial and industrial | - | - | - | 238 | 10 |
| **Impaired loans with a related allowance for loan losses** | | | | | |
| Mortgage loans on real estate: | | | | | |
| Construction | 253 | 253 | 55 | 274 | - |
| Commercial real estate: | | | | | |
| Non-owner occupied | 94 | 94 | 15 | 100 | - |
| Residential 1-4 family | 940 | 940 | 90 | 955 | 55 |
| Equity lines of credit | 189 | 189 | 77 | 193 | - |
| **Total impaired loans** | | | | | |
| Mortgage loans on real estate: | | | | | |
| Construction | $ 531 | $ 531 | $ 55 | $ 559 | $ 17 |
| Commercial real estate: | | | | | |
| Non-owner occupied | 319 | 319 | 15 | 334 | 8 |
| Residential 1-4 family | 1,316 | 1,384 | 90 | 1,432 | 72 |
| Equity lines of credit | 189 | 189 | 77 | 193 | - |
| Commercial and industrial | - | - | - | 238 | 10 |
| **Total impaired loans** | $ 2,355 | $ 2,423 | $ 237 | $ 2,756 | $ 107 |

*Allowance for Loan Losses* - The allowance for loan losses is a reserve established through a provision for loan losses charged to expense, which represents management's best estimate for probable losses that have been incurred within the existing portfolio of loans. The primary risks inherent in the Bank's loan portfolio, including the adequacy of the allowance or reserve for loan losses, are based on management's assumptions regarding, among other factors, general and local economic conditions, which are difficult to predict and are beyond the Bank's control. In estimating these risks, and the related loss reserve levels, management also considers the financial conditions of specific borrowers and credit concentrations with specific borrowers, groups of borrowers, and industries.

**Note 4 - Loans and Allowance for Loan Losses** (continued)

The allowance for loan losses is adjusted by direct charges to provision expense. Losses on loans are charged against the allowance for loan losses in the accounting period in which they are determined by management to be uncollectible. Recoveries during the period are credited to the allowance for loan losses. The Bank realized no provisions for the years ended December 31, 2018 and 2017, respectively. The provision expense is determined by the Bank's allowance for loan losses model. The components of the model are specific reserves for impaired loans and a general allocation for unimpaired loans. The general allocation has three components, an estimate based on historical loss experience, an additional estimate based on internal and external environmental factors due to the uncertainty of historical loss experience in predicting current embedded losses in the portfolio that will be realized in the future and an unallocated portion to cover uncertainties that could affect management's estimate of probable losses.

In determining the general allowance allocation, the ratios from the actual loss history for the various categories are applied to the homogeneous pools of loans in each category.
The portion of the general allocation on environmental factors includes estimates of losses related to the following:

- Current national and local economic conditions
- Composition of the nature and volume of the portfolio
- Changes in the trend or volume of past due, watch list and classified loans
- The existence and effect of concentrations or changes in concentrations upon the portfolio
- The existence and effect of granularity in the size of credits in the portfolio
- The existence and effect of loan to values in excess of regulatory guidance – percentage of loans in each category with regulatory exceptions
- Cumulative effect of other factors such as loan portfolio quality, underwriting strength and general determinations about the portfolio held by executive management

Markets served by the Bank continue to experience some uncertainty from the general economy and a slow real estate market. Other factors impacting the allowance at December 31, 2018 were watch list trends, unemployment rate trends, government spending expectations and underwriting and servicing assessments.

The following table's present changes in the allowance for loan losses for the years ended December 31, 2018 and 2017:

| | December 31, 2017 | Charge-offs | Recoveries | Provision | December 31, 2018 |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Mortgage loans on real estate: | | | | | |
| Construction | $ 643 | $ - | $ - | $ (31) | $ 612 |
| Commercial real estate: | | | | | |
| Non-owner occupied | 601 | - | - | (107) | 494 |
| Owner occupied | 1,630 | - | 1 | (259) | 1,372 |
| Residential 1-4 family | 1,123 | 8 | 53 | (287) | 881 |
| Multifamily | 101 | - | 20 | (69) | 52 |
| Equity lines of credit | 262 | 48 | 2 | 215 | 431 |
| Commercial and industrial | 1,150 | - | 6 | 92 | 1,248 |
| Agricultural | 385 | - | - | 7 | 392 |
| Individuals | 27 | 33 | 1 | 439 | 434 |
| | $ 5,922 | $ 89 | $ 83 | $ - | $ 5,916 |

**Note 4 - Loans and Allowance for Loan Losses** (continued)

| | December 31, 2016 | Charge-offs | Recoveries | Provision | December 31, 2017 |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Mortgage loans on real estate: | | | | | |
| Construction | $ 546 | $ - | $ - | $ 97 | $ 643 |
| Commercial real estate: | | | | | |
| Non-owner occupied | 538 | 42 | - | 105 | 601 |
| Owner occupied | 2,015 | - | 243 | (628) | 1,630 |
| Residential 1-4 family | 1,113 | 205 | 162 | 53 | 1,123 |
| Multifamily | 65 | - | 19 | 17 | 101 |
| Equity lines of credit | 277 | 21 | 4 | 2 | 262 |
| Commercial and industrial | 901 | - | 6 | 243 | 1,150 |
| Agricultural | 279 | - | - | 106 | 385 |
| Individuals | 22 | - | - | 5 | 27 |
| | $ 5,756 | $ 268 | $ 434 | $ - | $ 5,922 |

The activity in the allowance for loan loss for 2018 and 2017 are summarized by loan class as follows:

| As of December 31, 2018 | Reserves for loans individually evaluated for impairment | Loans individually evaluated for impairment | Reserves for loans collectively evaluated for impairment | Loans collectively evaluated for impairment |
|---|---|---|---|---|
| | | (in thousands) | | |
| Mortgage loans on real estate: | | | | |
| Construction | $ - | $ 263 | $ 612 | $ 37,046 |
| Commercial real estate: | | | | |
| Non owner occupied | 7 | 293 | 487 | 26,400 |
| Owner occupied | - | 1,196 | 1,372 | 62,227 |
| Residential 1-4 family | 172 | 1,615 | 709 | 37,395 |
| Multifamily | - | - | 52 | 5,334 |
| Equity lines of credit | 252 | 415 | 179 | 10,531 |
| Commercial and industrial | 15 | 17 | 1,233 | 60,453 |
| Agricultural | - | - | 392 | 23,243 |
| Individuals | - | - | 434 | 8,952 |
| | $ 446 | $ 3,799 | $ 5,470 | $ 271,581 |

**Note 4 - Loans and Allowance for Loan Losses** (concluded)

| As of December 31, 2017 | Reserves for loans individually evaluated for impairment | Loans individually evaluated for impairment | Reserves for loans collectively evaluated for impairment | Loans collectively evaluated for impairment |
|---|---|---|---|---|
| | | (in thousands) | | |
| Mortgage loans on real estate: | | | | |
| Construction | $ 55 | $ 531 | $ 588 | $ 35,298 |
| Commercial real estate: | | | | |
| Non owner occupied | 15 | 319 | 586 | 31,104 |
| Owner occupied | - | - | 1,630 | 64,906 |
| Residential 1-4 family | 90 | 1,316 | 1,033 | 39,429 |
| Multifamily | - | - | 101 | 4,632 |
| Equity lines of credit | 77 | 189 | 185 | 13,089 |
| Commercial and industrial | - | - | 1,150 | 55,988 |
| Agricultural | - | - | 385 | 23,837 |
| Individuals | - | - | 27 | 1,987 |
| | $ 237 | $ 2,355 | $ 5,685 | $ 270,270 |

**Note 5 - Premises and equipment**

At December 31, 2018 and 2017, premises and equipment consist of the following:

| | 2018 | 2017 |
|---|---|---|
| Land | $ 456,450 | $ 456,450 |
| Buildings | 6,151,012 | 6,151,012 |
| Equipment, furniture and fixtures | 3,075,892 | 3,038,464 |
| Computer equipment | 892,140 | 364,542 |
| | 10,575,494 | 10,010,468 |
| Less accumulated depreciation | (7,640,745) | (7,129,437) |
| Total premises and equipment, net | $ 2,934,749 | $ 2,881,031 |

For 2018 and 2017, depreciation charged to operating expense was $511,307 and $475,504, respectively.

### Note 6 – Goodwill and intangible assets

The gross carrying amount and accumulated amortization for the Company's intangible assets as of December 31,

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | Gross Carrying | Accumulated Amortization | Gross Carrying | Accumulated Amortization |
| **Intangible assets subject to amortization** | | | | |
| Customer lists | $ 4,261,879 | $ 450,693 | $ 4,025,000 | $ 178,889 |
| Total intangible assets subject to amortization | 4,261,879 | 450,693 | 4,025,000 | 178,889 |
| Goodwill | 4,807,857 | - | 4,511,746 | - |
| **Total intangible assets** | $ 9,069,736 | $ 450,693 | $ 8,536,746 | $ 178,889 |

Aggregate amortization expense for intangible assets with finite lives for the year ended December 31, 2018 was $271,804, compared to $178,889 for 2017. The estimated aggregate annual amortization expense for each of the five years subsequent to December 31, 2018, is $284,125.

The Company recorded $296,111 in net increases to goodwill and $236,879 in intangible assets. These intangibles were created by the acquisition of The Lankford Agency. During 2017, the Company recorded $4,511,746 in increases to goodwill and $4,025,000 in intangible assets from the acquisition of Manry Rawls. The intangible assets acquired are finite-lived, consisting primarily of book-of-business purchases. No impairment charges were recorded in any year reported. Impairment testing indicated that goodwill was not impaired in 2018 or 2017.

| | |
|---|---|
| Balance, December 31, 2017 | $ 4,511,746 |
| Additions to goodwill | 296,111 |
| Other adjustments | - |
| **Balance, December 31, 2018** | $ 4,807,857 |

### Note 7 - Non-marketable equity securities

Non-marketable equity securities consist of the following at December 31, 2018 and 2017:

| | 2018 | 2017 |
|---|---|---|
| Federal Home Loan Bank stock | $ 1,473,600 | $ 1,443,800 |
| Federal Reserve Bank stock | 401,800 | 399,750 |
| Community Bankers' Bank stock | 61,300 | 61,300 |
| Plexus Captial, LLC | 961,007 | 444,024 |
| Tidewater Home Funding, LLC | 732,992 | 720,838 |
| Senior Housing Crime Prevention Foundation stock | 500,000 | 500,000 |
| Total non-marketable equity securities | $ 4,130,699 | $ 3,569,712 |

**Note 8 - Interest-bearing deposits**

Interest-bearing deposits consist of the following:

| | 2018 | 2017 |
|---|---|---|
| NOW accounts | $ 20,391,339 | $ 28,369,941 |
| Money market accounts | 95,240,589 | 84,752,856 |
| Personal relationship checking | 993,604 | - |
| Business interest checking | 24,977,600 | 15,573,635 |
| Savings accounts | 27,397,406 | 26,115,117 |
| Certificates of deposits and IRAs $250,000 and over | 42,113,656 | 39,809,923 |
| Certificates of deposit and IRAs under $250,000 | 59,697,152 | 68,912,297 |
| Total interest-bearing deposits | $ 270,811,346 | $ 263,533,769 |

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

| | |
|---|---|
| 2019 | $ 54,639,134 |
| 2020 | 12,222,848 |
| 2021 | 8,397,440 |
| 2022 | 12,385,191 |
| 2023 | 13,587,007 |
| Thereafter | 579,188 |
| Total time deposits | $ 101,810,808 |

**Note 9 – Capital notes**

During the fourth quarter of 2013, the Company closed the private placement of unregistered debt securities (the "2013 Offering") pursuant to which the Company issued approximately $11.3 million in principal of notes (the "2013 Notes"). The 2013 Notes were not registered under the Securities Act of 1933 and could not be offered or sold in the United States absent registration or an applicable exemption from registration requirements. The 2013 Notes bore interest at the rate of 5% per year with interest payable quarterly in arrears. The 2013 Notes had a maturity date of December 31, 2018, but were subject to prepayment in whole or in part on or after December 31, 2014 at the Company's sole discretion on 30 days written notice to the holders. There were no assets pledged as collateral for the 2013 Notes. During 2017, the Company fully repaid the outstanding balance of the 2013 notes totaling, $7.9 million at the original investment price to reduce debt service obligations.

During the second quarter of 2017, the Company closed the private placement of unregistered debt securities (the "2017 Offering") pursuant to which the Company issued $6.0 million in principal of notes (the "2017 Notes"). The 2017 Notes have not been and will not be registered under the Securities Act of 1933 and may not be offered or sold in the United States absent registration or an applicable exemption from registration requirements. The 2017 Notes bear interest at the rate of 3.25% per year with interest payable quarterly in arrears. The 2017 Notes mature on March 31, 2022, but are subject to prepayment in whole or in part on or after March 31, 2018 at the Company's sole discretion on 30 days written notice to the holders. There are no assets pledged as collateral for the 2017 Notes. Of these capital notes, $-0- is due to executive officers and board members of the Company as of December 31, 2018 and 2017, respectively.

There was no interest expense paid to these related parties on the capital notes for the years ended December 31, 2018 and 2017, respectively.

**Note 10 - Securities sold under agreements to repurchase and other borrowings**

The Bank utilizes securities sold under agreement to repurchase to facilitate the needs of customers. Securities sold under agreements to repurchase, are classified as secured borrowings, generally mature within one day from the transaction date. Securities sold under agreements to repurchase are reflected at the amount of cash received in connection with the transaction. The average interest rate was 0.58% and 0.50% during the years ended December 31, 2018 and 2017, respectively.

The Bank monitors collateral levels on a continuous basis and maintains records of each transaction specifically describing the applicable security and the customer's fractional interest in that security, and the Bank segregates the security from its general assets in accordance with regulations governing custodial holding of securities. The primary risk with the Bank's repurchase agreements is market risk associated with the investments securing the transactions, as the Bank may be required to provide additional collateral based on air value changes of the underlying investments. Securities pledged as collateral under repurchase agreements are maintained with the Bank's safekeeping agent. The carrying value of available for sale investment securities pledged as collateral under repurchase agreement was $5,874,785 and $3,054,577 at December 31, 2018 and 2017, respectively.

The remaining contractual maturity of the securities sold under agreements to repurchase by class of collateral pledged included in short-term borrowings in the Consolidated Balance Sheets as of December 31, 2018 and December 31, 2017 is presented in the following tables.

| December 31, 2018 | Overnight and continuous | Up to 30 Days | 30-90 Days | Greater than 90 | Total |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Repurchase agreements: | | | | | |
| Small Business Administration Pools | $ 3,849 | $ - | $ - | $ - | $ 3,849 |
| Total borrowings | $ 3,849 | $ - | $ - | $ - | $ 3,849 |
| Gross amount of recognized liabilities for repurchase agreements | | | | | $ 3,849 |

| December 31, 2017 | Overnight and continuous | Up to 30 Days | 30-90 Days | Greater than 90 | Total |
|---|---|---|---|---|---|
| | | | (in thousands) | | |
| Repurchase agreements: | | | | | |
| Small Business Administration Pools | $ 1,618 | $ - | $ - | $ - | $ 1,618 |
| Total borrowings | $ 1,618 | $ - | $ - | $ - | $ 1,618 |
| Gross amount of recognized liabilities for repurchase agreements | | | | | $ 1,618 |

The Bank has arrangements with various banks which enables the Bank to borrow up to $30,000,000 in federal funds on an unsecured basis, at a variable rate. At December 31, 2018 and 2017, the Bank had no outstanding federal funds purchased.

The Bank also has arrangements with the Federal Home Loan Bank which enables the Bank to borrow up to 25% of total assets.

**Note 10 - Securities sold under agreements to repurchase and other borrowings** (concluded)

At December 31, 2018 and 2017, Federal Home Loan Bank advances were as follows:

**December 31, 2018**

| Maturity date | Call Feature | Amount | Rate |
|---|---|---|---|
| January 8, 2019 | - | $ 5,000,000 | 1.977% |
| September 3, 2019 | - | 5,000,000 | 1.999% |
| April 15, 2020 | - | 2,500,000 | 2.040% |
| July 29, 2020 | - | 5,000,000 | 1.944% |
| October 13, 2020 | - | 2,500,000 | 2.176% |
| May 17, 2021 | - | 5,000,000 | 1.953% |
| Total FHLB borrowings/weighted average rate | | $ 25,000,000 | 2.000% |

**December 31, 2017**

| Maturity date | Call Feature | Amount | Rate |
|---|---|---|---|
| January 8, 2019 | - | $ 5,000,000 | 1.977% |
| September 3, 2019 | - | 5,000,000 | 1.999% |
| April 15, 2020 | - | 2,500,000 | 2.040% |
| July 29, 2020 | - | 5,000,000 | 1.944% |
| October 13, 2020 | - | 2,500,000 | 2.176% |
| May 17, 2021 | - | 5,000,000 | 1.953% |
| Total FHLB borrowings/weighted average rate | | $ 25,000,000 | 2.000% |

The carrying value of loans pledged as collateral to the Federal Home Loan Bank were $20.8 million and $28.7 million at December 31, 2018 and 2017, respectively.

During 2018 and 2017, $-0- million and $5 million of FHLB advances were repaid.

**Note 11 - Employee benefit plans**

*Profit sharing plan -* The Company has a profit sharing plan covering substantially all employees. Contributions to the plan are determined annually by the Compensation Committee and are the lesser of 10% of the participants' base compensation or 10% of the net income of the Company. Employee benefits expense included $454,996 and $476,116 for the plan for 2018 and 2017, respectively.

*Post-retirement benefits -* The Company has entered into deferred compensation arrangements with certain key personnel which call for the payment of benefits upon the retirement or death of the individuals. In 2016, the Company amended one of these plans and froze the other plan while creating a new plan for this executive, such that upon the executives' retirement, the Company will provide for a monthly retirement payment for their lifetime. The agreements provide that a retirement benefit is payable upon a defined normal retirement age while in service to the Company and a lesser benefit is payable upon early retirement. Other benefits are payable upon disability, death or change in control.

The agreements are unfunded arrangements maintained primarily to provide supplemental retirement benefits and comply with Section 409A of the Internal Revenue Code.

**Note 11 - Employee benefit plans** (concluded)

However, the Company has elected to finance the retirement benefits by purchasing annuities that have been designed to provide a future source of funds for the lifetime retirement benefits of the agreements. The primary impetus for utilizing these annuities is a substantial savings in compensation expense for the Company as opposed to a typically designed supplemental retirement plan.

The liabilities associated with these deferred compensation arrangements were $1,520,980 and $1,434,054 as of December 31, 2018 and 2017, respectively. The annuity had a balance of $2,961,521 and $3,028,689 as of December 31, 2018 and 2017, respectively, and is recorded at amortized cost. Salaries and employee benefits expense included $115,956 and $114,410 of expense related to these arrangements for 2018 and 2017, respectively.

**Note 12 - Income taxes**

On December 22, 2017 the President of the United States signed into law the Tax Cuts and Jobs Act (the "2017 Tax Act"). The 2017 Tax Act includes a number of changes to existing U.S. tax laws that impact the Company, most notably a reduction of the U.S. corporate income tax rate from 35 percent to 21 percent for tax years beginning after December 31, 2017.

The Company recognized the income tax effects of the 2017 Tax Act in its 2017 financial statements in accordance with Staff Accounting Bulletin No. 118, which provides guidance for the application of ASC Topic 740, Income Taxes, in the reporting period in which the 2017 Tax Act was signed into law. As such, the Company's financial results reflect the income tax effects of the 2017 Tax Act for which the accounting under ASC Topic 740 is complete and provisional amounts for those specific income tax effects of the 2017 Tax Act for which the accounting under ASC Topic 740 is incomplete but a reasonable estimate could be determined. The Company did not identify items for which the income tax effects of the 2017 Tax Act have been completed and a reasonable estimate could not be determined as of December 31, 2017.

The principal components of the income tax expense as of December 31, 2018 and 2017 are as follows:

| | 2018 | 2017 |
|---|---|---|
| Federal - current tax provision | $ 566,495 | $ 1,283,702 |
| Federal - deferred | 52,637 | 167,113 |
| | $ 619,132 | $ 1,450,815 |

The differences between expected federal income taxes at statutory rates and actual income tax expense are summarized as follows:

| | 2018 | 2017 |
|---|---|---|
| Income tax expense computed at federal statutory rate (21%) | $ 1,200,129 | $ 2,114,914 |
| Tax effects of: | | |
| Tax-exempt interest | (475,598) | (660,499) |
| Non-taxable bank owned life insurance | (59,523) | (98,733) |
| Non-deductible (income) expenses | 21,112 | (22,483) |
| Minority investment interest | (46,309) | (90,012) |
| Remeasurement of deferred taxes under TCJA | - | 209,879 |
| Other | (20,679) | (2,251) |
| Total income tax expense | $ 619,132 | $ 1,450,815 |

**Note 12 - Income taxes** (concluded)

The Bank's deferred tax assets and liabilities and their components are included on the balance sheets. The components of these deferred tax assets and liabilities are as follows:

| | 2018 | 2017 |
|---|---|---|
| Deferred tax assets: | | |
| Available-for-sale investment securities | $ 101,999 | $ - |
| Allowance for loan losses | 663,634 | 663,634 |
| Deferred compensation | 319,406 | 301,151 |
| Interest on non-performing loans | 20,762 | 19,285 |
| Other real estate owned | 2,599 | 2,599 |
| Other | 24,442 | 4,987 |
| Total deferred tax asset | 1,132,842 | 991,656 |
| Deferred tax liabilities: | | |
| Available-for-sale investment securities | - | (370,786) |
| Accumulated depreciation | (226,649) | (191,426) |
| Accumulated accretion | (80,065) | (85,004) |
| Net unamortized deferred fees and expenses | (66,141) | (4,602) |
| Total deferred tax liability | (372,855) | (651,818) |
| Net deferred tax asset | $ 759,987 | $ 339,838 |

The Company measures deferred tax assets and liabilities using enacted tax rates that will apply in the years in which the temporary differences are expected to be recovered or paid. In 2017, the Company's deferred tax assets and liabilities were remeasured to reflect the reduction in the U.S. corporate income tax rate from 34 percent to 21 percent, resulting in a $209,879 increase in income tax expense for the year ended December 31, 2017 and a corresponding $209,879 decrease in net deferred tax assets as of December 31, 2017.

In assessing the realizability of deferred tax assets, management considers whether it is more likely than not that some portion or all of the deferred tax asset will not be realized. Management considers recoverable taxes paid in prior years, projected future taxable income, and tax planning strategies in making this assessment. It is management's belief that the realization of the net deferred tax assets is more likely than not.

The Company has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions.

The Company and its subsidiaries file income tax returns with the federal government. With few exceptions, the Company is no longer subject to federal income tax examinations by tax authorities for years before 2015.

**Note 13 - Commitments and contingencies**

The Company leases banking premises and various equipment for periods extending through February 2026. Total rental expense was $451,418 and $374,705 for 2018 and 2017, respectively.

Pursuant to the terms of non-cancelable lease agreements in effect at December 31, 2018, pertaining to bank premises and equipment, future minimum rental commitments under various operating leases are as follows:

| | |
|---|---|
| 2018 | $ 398,136 |
| 2019 | 389,589 |
| 2020 | 275,139 |
| 2021 | 240,061 |
| 2022 | 49,367 |
| Thereafter | 120,038 |
| | $ 1,472,330 |

Various legal claims also arise from time to time in the normal course of business which, in the opinion of management, will have no material effect on the Company's consolidated financial statements.

**Note 14 - Related party transactions**

In the ordinary course of business, the Company has loan and deposit transactions with its executive officers and directors, and with companies in which the officers and directors have a significant financial interest. These transactions are at substantially the same rates as similarly situated customers. A summary of related party loan activity during 2018 and 2017 is as follows:

| | 2018 | 2017 |
|---|---|---|
| Beginning balance, January 1 | $ 6,096,986 | $ 4,696,223 |
| Originations | - | 1,995,396 |
| Repayments | (672,441) | (594,633) |
| Ending balance, December 31 | $ 5,424,545 | $ 6,096,986 |

Commitments to extend credit to related parties amounted to $5,109,850 and $5,569,738 at December 31, 2018 and 2017, respectively.

Deposits from related parties held by the Bank amounted to $12,068,589 and $7,189,066 at December 31, 2018 and 2017, respectively.

The Bank currently has loans outstanding to Manry Rawls, LLC with a current principal balance of $1,568,824 and $2,250,880 as of December 31, 2018 and 2017, respectively. These loans are eliminated during the consolidation with Manry Rawls under ASC 805, *Business Combination*. These loans are at substantially the same terms as similarly situated customers.

**Note 15 - Credit commitments and concentrations of credit risk**

Commitments to extend credit are agreements to lend funds 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. The commitments for equity lines of credit may expire without being drawn upon. Therefore, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if it is deemed necessary by the Bank, is based on management's credit evaluation of the customer. Unfunded commitments under

**Note 15 - Credit commitments and concentrations of credit risk** (concluded)

commercial lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit are uncollateralized, usually do not contain a specified maturity date and may not be drawn upon to the total extent to which the Bank is committed.

Commercial and standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year.

The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank generally holds collateral supporting those commitments if deemed necessary.

The Bank also has commitments, as detailed below, to invest in a private investment fund that focuses on investments and partnerships with middle market businesses that need capital for growth.

The amounts of loan commitments, guarantees and standby letters of credit are set out in the following table as of December 31, 2018 and 2017. Because many commitments and almost all standby letters of credit and guarantees expire without being funded in whole or in part, the contract amounts are not estimates of future cash flows. A summary of loan commitments and standby letters of credit is as follows:

| | 2018 | 2017 |
|---|---|---|
| Loan commitments | $ 76,245,388 | $ 65,759,153 |
| Standby letters of credit and guarantees written | 519,958 | 440,787 |
| Capital commitment to private investment funds | 540,000 | 1,550,000 |

Standby letters of credit outstanding at December 31, 2018 expire between 2019 and 2021.

Loan commitments, standby letters of credit and written guarantees have off-balance sheet credit risk because only origination fees and accruals for probable losses, if any, are recognized in the statements of financial position until the commitments are fulfilled or the standby letters of credit or guarantees expire. Credit risk represents the accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted. The credit risk amounts are equal to the contractual amounts, assuming that the amounts are fully advanced and collateral or other security is of no value. The Bank's policy is to require customers to provide collateral prior to the disbursement of approved loans. For retail loans, the Bank usually retains a security interest in the property or products financed, which provides repossession rights in the event of default by the customer. For business loans and financial guarantees, collateral is usually in the form of inventory or marketable securities (held in trust) or property (notations on title).

Concentrations of credit risk (whether on or off-balance sheet) arising from financial instruments exist in relation to certain groups of customers. A group concentration arises when a number of counterparties have similar economic characteristics that would cause their ability to meet contractual obligations to be similarly affected by changes in economic or other conditions. A group concentration exists as most of the Bank's customers are located within southeastern Virginia.

The credit risk amounts represent the maximum accounting loss that would be recognized at the reporting date if counterparties failed completely to perform as contracted and any collateral or security proved to be of no value. The Bank has experienced little difficulty in accessing collateral when required.

**Note 16 - Regulatory matters**

The Bank is 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 Bank's consolidated financial statements. Under 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 weighting, and other factors.

In July 2013, the FDIC and other federal banking agencies approved the final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. banks (commonly known as Basel III).

On January 1, 2015, the Bank became subject to the Basel III Capital Rules which revises definitions of regulatory capital, the new minimum regulatory capital ratios, and various regulatory capital adjustments and deductions according to transition provision and timelines. The revised rules now require the Bank to maintain (i) a minimum ratio of Common Tier 1 capital to risk-weighted assets of at least 4.5%, plus 2.5% "capital conservation buffer" (conservation buffer will be phased in), (ii) minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, (iii) a minimum ratio of total capital to risk-weighted assets of at 8.0%, and (iv) a minimum leverage ratio of 4.0%. A transition period for the capital conservation buffer under Basel III for all banking organizations began on January 1, 2016 and ends on January 1, 2019. The conservation buffer began at the 0.625% level and is phased in over a four-year period (increasing on each subsequent January 1, until it reaches 2.5% on January 1, 2019).

Management believes, as of December 31, 2018 and 2017, the Bank met all capital adequacy requirements to which it is subject.

As of December 31, 2018, the most recent notification from the Board of Governors of the Federal Reserve Board 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 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 institution's category.

**Note 16 - Regulatory matters** (concluded)

The Bank's actual capital amounts (dollars in thousands) and ratios are presented in the table below:

| | Actual | | For Capital Adequacy Purposes | | Under Prompt Corrective Well Capitalized | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2018: | | | *(Dollars in thousands)* | | | |
| Total Capital | | | | | | |
| (to Risk-Weighted Assets) | $ 48,267 | 13.8% | $ 27,923 | 8.0% | $ 34,904 | 10.0% |
| Tier I Risk-Based Capital | | | | | | |
| (to Risk-Weighted Assets) | 43,904 | 12.6% | 20,943 | 6.0% | 27,923 | 8.0% |
| Common Equity Risk-Based Capital | | | | | | |
| (to Risk-Weighted Assets) | 43,904 | 12.6% | 15,707 | 4.5% | 22,688 | 6.5% |
| Tier I Leverage Ratio | | | | | | |
| (to Average Assets) | 43,904 | 9.7% | 18,146 | 4.0% | 22,682 | 5.0% |

| | Actual | | For Capital Adequacy Purposes | | Under Prompt Corrective Well Capitalized | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| As of December 31, 2017: | | | *(Dollars in thousands)* | | | |
| Total Capital | | | | | | |
| (to Risk-Weighted Assets) | $ 45,376 | 14.0% | $ 26,011 | 8.0% | $ 32,513 | 10.0% |
| Tier I Risk-Based Capital | | | | | | |
| (to Risk-Weighted Assets) | 41,312 | 12.7% | 19,508 | 6.0% | 26,011 | 8.0% |
| Common Equity Risk-Based Capital | | | | | | |
| (to Risk-Weighted Assets) | 41,312 | 12.7% | 14,631 | 4.5% | 21,134 | 6.5% |
| Tier I Leverage Ratio | | | | | | |
| (to Average Assets) | 41,312 | 9.5% | 17,665 | 4.0% | 22,081 | 5.0% |

The above tables set forth the capital position and analysis for the Bank only. Because total assets on a consolidated basis are less than $500 million, the Company is not subject to the consolidated capital requirements imposed by the Bank Holding Company Act. Consequently, the Company does not calculate its financial ratios on a consolidated basis. If calculated, the capital ratios for the Company on a consolidated basis would no longer be comparable to the capital ratios of the Bank because the proceeds of the capital notes do not qualify as equity capital on a consolidated basis.

**Note 17 - Fair value measurements**

The Company refers to the *Fair Value Measurements and Disclosures* Topic of the FASB Accounting Standards Codification (ASC 820) to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. This guidance clarifies that fair value of certain assets and liabilities is an exit price, representing the amount that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

The fair market value measurement specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources, while unobservable inputs reflect the Company's market assumptions.

**Note 17 - Fair value measurements** (continued)

The three levels of the fair value hierarchy are based on these two types of inputs are as follows:

Level 1 – Valuation is based on quoted prices in active markets for identical assets and liabilities.

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

Level 3 – Valuation is based on model-based techniques that use one or more significant inputs or assumptions that are unobservable in the market.

The following describes the valuation techniques used by the Company to measure certain financial assets and liabilities recorded at fair value on a recurring basis in the consolidated financial statements:

*Securities available for sale* - 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 pricing models that considers observable market data (Level 2).

The following table presents the balances of available-for-sale securities measured at fair value on a recurring basis as of December 31, 2018 and 2017:

| Description | Balance as of December 31, 2018 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| State and municipal | $ 66,164,107 | $ - | $ 66,164,107 | $ - |
| Residential mortgage-backed securities | 24,359,423 | - | 24,359,423 | - |
| Collateralized mortgage obligations | 52,220,150 | - | 52,220,150 | - |
| Small Business Administration loan securities | 14,271,828 | - | 14,271,828 | - |
| | $ 157,015,508 | $ - | $ 157,015,508 | $ - |

| Description | Balance as of December 31, 2017 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| State and municipal | $ 53,039,740 | $ - | $ 53,039,740 | $ - |
| Residential mortgage-backed securities | 17,347,063 | - | 17,347,063 | - |
| Collateralized mortgage obligations | 47,674,508 | - | 47,674,508 | - |
| Small Business Administration loan securities | 19,742,635 | - | 19,742,635 | - |
| | $ 137,803,946 | $ - | $ 137,803,946 | $ - |

Certain financial assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The following describes the valuation techniques used by the Company to measure certain financial assets recorded at fair value on a nonrecurring basis in the consolidated financial statements:

**Note 17 - Fair value measurements** (continued)

*Impaired Loans -* Loans are designated as impaired when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected. The measurement of loss associated with impaired loans can be based on the observable market price of the loan, the fair value of the collateral or by using the discounted cash flow method. Fair value is measured based on the value of the collateral securing the loans. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate.

The value of real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company. The Company records impaired loans secured by real estate as Level 3 assets. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivables collateral are based on financial statement balances or aging reports are recorded as Level 3 assets. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Operations.

*Other real estate owned -* Other real estate owned is considered held for sale and is adjusted to fair value less estimated selling costs upon transfer of the loan to foreclosed assets. Fair value is based upon independent market prices, appraised value of the collateral or management's estimation of the value of the collateral. The Company considers the other real estate owned as nonrecurring Level 3.

The following table summarizes the Company's financial assets that were measured at fair value on a nonrecurring basis during the periods.

| Description | Balance as of December 31, 2018 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets | | | | |
| Other real estate owned | $ 672,404 | $ - | $ - | $ 672,404 |
| Impaired loans | 3,353,434 | - | - | 3,353,434 |
| Total assets | $ 4,025,838 | $ - | $ - | $ 4,025,838 |

| Description | Balance as of December 31, 2017 | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|
| Assets | | | | |
| Other real estate owned | $ 742,216 | $ - | $ - | $ 742,216 |
| Impaired loans | 2,116,082 | - | - | 2,116,082 |
| Total assets | $ 2,858,298 | $ - | $ - | $ 2,858,298 |

**Note 17 - Fair value measurements** (concluded)

The following table summarized quantitative information about Level 3 fair value measurements:

| Description | Fair Value at December 31, 2018 | Valuation Technique | Unobservable Input | Range (Weighted Average) |
|---|---|---|---|---|
| Assets | | | | |
| Other real estate owned | $ 672,404 | Discounted appraisals | Collateral discounts | 10-20% |
| Impaired loans | 3,353,434 | Discounted appraisals | Collateral discounts | 10-30% |
| | | Discounted cash flows | Discount rate | 6% |
| Total assets | $ 4,025,838 | | | |

| Description | Fair Value at December 31, 2017 | Valuation Technique | Unobservable Input | Range (Weighted Average) |
|---|---|---|---|---|
| Assets | | | | |
| Other real estate owned | $ 742,216 | Discounted appraisals | Collateral discounts | 10-20% |
| Impaired loans | 2,116,082 | Discounted appraisals | Collateral discounts | 10-30% |
| | | Discounted cash flows | Discount rate | 6% |
| Total Assets | $ 2,858,298 | | | |

The following table presents the carrying amounts and fair value of the Company's financial instruments as of December 31, 2018 and 2017. FASB Accounting Standards Codification's *Financial Instruments* (ASC 825), defines the fair value of financial instruments as the amount at which the instrument could be exchanged in a current transaction between willing parties, other than in a forced or liquidation sale. The carrying amounts in the table are included in the balance sheets under the indicated captions. The capital notes are valued at amortized cost based on the lack of marketability due to transfer restrictions.

| | 2018 | | 2017 | |
|---|---|---|---|---|
| | Carrying amount | Estimated fair value | Carrying amount | Estimated fair value |
| | *(Dollars in thousands)* | | | |
| Financial assets: | | | | |
| Cash and cash equivalents | $ 16,490 | $ 16,490 | $ 18,914 | $ 18,914 |
| Investment securities, available-for-sale | 157,016 | 157,016 | 137,804 | 137,804 |
| Loans held for investment, net | 269,520 | 273,701 | 266,753 | 273,981 |
| Accrued interest receivable | 1,978 | 1,978 | 1,788 | 1,788 |
| Bank-owned annuity contract | 2,961 | 2,961 | 3,029 | 3,029 |
| Financial liabilities: | | | | |
| Demand deposits, NOW, savings and money market accounts | 284,872 | 283,762 | 262,168 | 262,168 |
| Time deposits | 101,810 | 100,239 | 108,722 | 107,817 |
| Accrued interest payable | 337 | 337 | 250 | 250 |
| FHLB Advances | 25,000 | 24,723 | 25,000 | 24,923 |
| Capital notes | 6,000 | 5,636 | 6,000 | 5,527 |
| Securities sold under agreement to repurchase | 3,849 | 3,849 | 1,618 | 1,618 |

**Note 18 - Stock incentive plan**

The Company's shareholders approved stock incentive plans effective January 1, 2018 and previously January 1, 2007. The plans authorize the grant of awards for a period of ten years, which expires on December 31, 2028 and previously December 31, 2017. The number of shares authorized for issuance under both of the plans is limited to 2.25% of the total authorized and unissued shares of common stock. Three types of awards may be granted under the plans: Incentive Stock Options, Nonqualified Stock Options and Restricted Stock. The Company granted restricted stock awards during 2018 and 2017. The Company accounts for this plan in accordance with the *Stock Compensation* Topic of the FASB Accounting Standards Codification (ASC 718). The non-vested equity share or non-vested equity share unit awarded to an employee is measured at its fair value on the grant date. The compensation expense is recognized over the requisite service period.

The vesting requirements range from three to five years. The compensation expense recognized for the years ended December 31, 2018 and 2017 was $167,284 and $200,423, respectively. Members of the Board of Directors of the Company can elect to receive a portion or all of their director's fees in the form of common stock. During the year ended December 31, 2018 and 2017, the expense related to these issuances was $57,975 and $47,500, respectively.

A summary of the status of the non-vested shares in relation to our restricted stock awards as of December 31, 2018 and 2017, and changes during the years ended December 31, 2018 and 2017, is presented below; the weighted average price is the weighted average fair value at the date of grant:

| | 2018 | | 2017 | |
|---|---|---|---|---|
| Restricted Share Awards | Shares | Weighted Average Price | Shares | Weighted Average Price |
| Nonvested - Beginning of the year | 13,011 | $ 13.43 | 8,223 | $ 8.70 |
| Granted | 9,020 | 20.50 | 8,629 | 19.75 |
| Vested | 2,864 | 11.91 | 3,397 | 9.46 |
| Forfeited | 1,361 | 10.54 | 444 | 8.70 |
| Nonvested - End of year | 17,806 | $ 15.54 | 13,011 | $ 13.43 |

**Note 19 - Earnings per share**

The following shows the weighted average number of shares used in computing earnings per share and the effect on weighted average number of shares of diluted potential common stock. Potential dilutive common stock had no effect on income attributable to common shareholders.

| | 2018 | 2017 |
|---|---|---|
| **Basic** | | |
| Net income attributable to common shareholders | $ 4,875,251 | $ 4,504,779 |
| Average common shares outstanding | 3,071,643 | 3,063,661 |
| Basic earnings per share amount | $ 1.59 | $ 1.47 |
| **Diluted** | | |
| Net income attributable to common shareholders | $ 4,875,251 | $ 4,504,779 |
| Average common shares outstanding | 3,071,643 | 3,063,661 |
| Effect of dilutive unvested restricted stock awards | 2,784 | 692 |
| Average diluted shares outstanding | 3,074,427 | 3,064,353 |
| Diluted earnings per share | $ 1.59 | $ 1.47 |

## Farmers Bankshares, Inc.

### Notes to Consolidated Financial Statements
### For Years Ended December 31, 2018 and 2017

**Note 20 – Condensed financial statements of parent company**

On July 26, 2013, the Board of Directors of the Bank approved an Agreement and Plan of Reorganization and Share Exchange (the "Agreement") whereby the Bank would become a subsidiary of Farmers Bankshares, Inc., a company incorporated in Virginia on July 26, 2013 for the purpose of becoming a holding company for the Bank. The Agreement provided for the statutory share exchange of all of the Bank's common stock held by stockholders for the common stock of Farmers Bankshares, Inc., on a one-for-one basis.

The Agreement was approved by the Bank's stockholders at a special meeting of the Bank's stockholders held on September 26, 2013 (the "Special Stockholders' Meeting"). The holding company reorganization was consummated on December 31, 2013 (see Note 1). Prior to the holding company reorganization, Farmers Bankshares, Inc. conducted no operations other than obtaining regulatory approval for the holding company reorganization. As this event is considered reorganization under common control, the consolidated financial statements, discussion of the statements and all other information presented herein for the years ended December 31, 2018 and 2017 are presented for the Company as a consolidated entity.

Financial information pertaining only to Farmers Bankshares, Inc. is as follows:

**Balance Sheets**

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| **Assets** | | |
| Cash | $ 1,066,093 | $ 968,593 |
| Taxes receivable | 682,365 | 641,415 |
| Investment in Farmers Bank | 52,139,723 | 50,312,294 |
| Other assets | 336,386 | 402,870 |
| **Total assets** | $ 54,224,567 | $ 52,325,172 |
| **Liabilities and Stockholders' Equity** | | |
| **Liabilities** | | |
| Capital notes | $ 6,000,000 | $ 6,000,000 |
| Other liabilities | 336,386 | 305,370 |
| **Total liabilities** | 6,336,386 | 6,305,370 |
| **Stockholders' equity** | | |
| Common stock, $0.125 par value | 384,484 | 383,340 |
| Capital surplus | 2,895,515 | 2,841,759 |
| Retained earnings | 44,991,893 | 41,399,842 |
| Accumulated other comprehensive (loss) income | (383,711) | 1,394,861 |
| **Total stockholders' equity** | 47,888,181 | 46,019,802 |
| **Total liabilities and stockholders' equity** | $ 54,224,567 | $ 52,325,172 |

# Farmers Bankshares, Inc.

Notes to Consolidated Financial Statements
For Years Ended December 31, 2018 and 2017

**Note 20 – Condensed financial statements of parent company** (concluded)

**Statements of Operations**

| | December 31, 2018 | December 31, 2017 |
|---|---|---|
| **Assets** | | |
| **Income** | $ 1,478,200 | $ 3,464,668 |
| **Operating expenses** | | |
| Interest expense | 195,000 | 254,702 |
| **Total expenses** | 195,000 | 254,702 |
| **Allocated income tax benefits** | (40,950) | (87,333) |
| **Income before equity in undistributed income of subsidiary** | 1,324,150 | 3,297,299 |
| **Equity in undistributed income - Farmers Bank** | 3,551,101 | 1,207,480 |
| **Net income** | $ 4,875,251 | $ 4,504,779 |

**Statements of Cash Flows**

| | Years Ended December 31, 2018 | Years Ended December 31, 2017 |
|---|---|---|
| **Cash flows from operating activities** | | |
| Net income | $ 4,875,251 | $ 4,504,779 |
| Adjustments to reconcile net income to net cash provided by operating activities | | |
| Taxes receivable | (40,950) | (87,333) |
| Other assets | 66,484 | (88,210) |
| Other liabilities | 31,016 | (304,816) |
| Equity in undistributed net income of Farmers Bank | (3,551,101) | (1,207,480) |
| **Net cash provided by operating activities** | 1,380,700 | 2,816,940 |
| **Cash flows from financing activities** | | |
| Cash dividends paid on common shares | (1,283,200) | (914,441) |
| Proceeds from issuance of capital notes | - | 6,000,000 |
| Redemption of capital notes | - | (7,888,475) |
| **Net cash used in financing activities** | (1,283,200) | (2,802,916) |
| **Increase (decrease) in cash and cash equivalents** | 97,500 | 14,024 |
| **Cash and cash equivalents** | | |
| Beginning of the year | 968,593 | 954,569 |
| End of year | $ 1,066,093 | $ 968,593 |

**Note 21 – Revenue from Contracts with Customers**

All of the Company's revenue from contracts with customers in the scope of ASC 606 is recognized within Non-Interest Income. A description of the Company's revenue streams accounted for under ASC 606 is as follows:

*Service Charges on Deposit Accounts -* Service charges on deposit accounts consist of account analysis fees (i.e., net fees earned on analyzed business and public checking accounts), monthly service fees, and other deposit account related fees. The Company'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. Other deposit account related fees are largely transactional based, and therefore, the Company'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.

*Other Service Charges, Commissions and Fees-* Other service charges, commissions and fees are primarily comprised of debit card income, ATM fees, merchant services income, and other service charges. Debit card income is primarily comprised of interchange fees earned whenever the Company's debit and credit cards are processed through card payment networks. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. Other service charges include revenue from processing wire transfers, safe deposit box rentals, cashier's checks, and other services. The Company's performance obligation for other service charges, commission and fees 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.

*Insurance Commissions -* Insurance income primarily consists of commissions received on insurance product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the insurance policy. Shortly after the insurance policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue.

*Gain on Sales of OREO -* The Company records a gain or loss from the sale of other real estate owned when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. When the Company finances the sale of other real estate owned to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the other real estate owned asset is derecognized and the gain on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain on the sale, the Company adjusts the transaction price and related gain on sale if a significant financing component is present.

The following table presents the Company's sources of Non-Interest Income for the twelve months ended December 31, 2018. Items outside the scope of ASC 606 are noted as such.

**Note 21 – Revenue from Contracts with Customers** (concluded)

The following table presents the Company's sources of Non-Interest Income for the twelve months ended December 31, 2018. Items outside the scope of ASC 606 are noted as such.

| | 2018 | 2017 |
|---|---|---|
| **Non-interest income** | | |
| Service charges on deposits | | |
| Overdraft fees | $ 375,771 | $ 345,562 |
| Other | 222,609 | 260,797 |
| Income from automated teller machines and bank card interchange | 560,452 | 535,445 |
| Insurance commissions | 4,452,749 | 2,948,887 |
| Net gain on disposition of securities (outside of scope) | 154,773 | 61,216 |
| Income on bank owned life insurance (outside of scope) | 306,814 | 313,602 |
| Net gain on sale of premises and equipment (outside of scope) | - | 16,665 |
| Income from investment in Manry Rawls (outside of scope) | - | 66,467 |
| Income from mortgage loans (outside of scope) | - | 164,715 |
| Other income (outside of scope) | 190,168 | 377,943 |
| Total non-interest income | $ 6,263,336 | $ 5,091,299 |

**Note 22 – Subsequent events**

On January 2, 2019, The Company completed its acquisition of Carolina East Insurance, an independent insurance agency which will be merged with the operations of Manry Rawls, LLC. The acquisition was accounted for as a business combination under the acquisition method of accounting in accordance with ASC 805, *Business Combinations*, and, as such, the assets and liabilities acquired were recorded at their respective fair values as of the acquisition date. Due to the recency and nature of the transaction, the Company is still in the process of evaluating the fair value adjustments necessary to adjust the acquired assets and assumed liabilities to estimated fair value, as well as the related intangible assets associated with the transaction. Therefore, it is impractical to estimate and disclose the provisional allocation amounts and the pro forma impact of the acquisition at this time. The value, before any fair value adjustments of assets acquired was approximately $69,000 and no liabilities were assumed.

## BRANCH LOCATIONS

**Chesapeake**
1403 Greenbrier Parkway, Suite 110

**Courtland**
28319 Southampton Parkway, Suite D

**Smithfield**
1119 South Church Street, PO Box 888

**Suffolk – Harbour View**
6255 College Drive, Suite L

**Suffolk – Hillpoint**
3100 Godwin Boulevard

**Suffolk – Lakeside**
1008 West Washington Street

**Windsor**
50 East Windsor Boulevard, PO Box 285

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