First State BANK

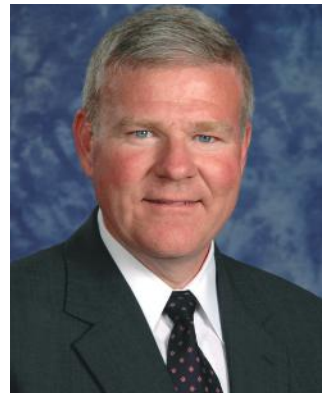
# 2019 ANNUAL REPORT

## FIRST STATE BANCORP, INC. AND SUBSIDIARY

Consolidated Financial Statements
December 31st, 2019 and 2018 with
Independent Auditors' Report

19230 State Route 136
Winchester, Ohio

# Dear Shareholder:



I am pleased to report our consolidated net income for 2019 was $5,341,967 which is up 9.34% from 2018. Net interest income (up 5.61%) contributed to our success. Our allowance for loan loss as of 12/31/2019 was $4,487,333 or 1.35% of total loans. Net charge offs for 2019 were $634,778 (0.19% of average loans) which is up from $440,806 (0.14%) in 2018.

## Other 2019 highlights included:

- Net Loans were $328,217,008 at year-end adding $8 million in balances
- Investment securities were $118,018,750 up $20.6 million
- Deposits were $420,728,833 at year-end adding $13 million in balances
- Total shareholders' equity was $54,186,544 up $7.7 million
- First State Bank paid $1,108,741 in dividends for 2019 (20.76% of earnings)

In August of 2019, we cut the ribbon on our brand new banking center at 1584 Rombach Ave., Wilmington, Ohio. The Wilmington community continues to support our presence as we crossed $20 million in assets which is up 24% from December 2018.

Our top performing banking centers in 2019 were the Winchester and Seaman offices both growing their net income nicely in very mature markets. Our Georgetown office posted an awesome year growing net income 12%.

I'm pleased to report your bank now has a seat on the Federal Home Loan Bank (FHLB) board in Cincinnati. This bank for banks services Ohio, Kentucky, and Tennessee and supports housing and community banking across three states. I was elected by FHLB shareholders in the fall of 2018 for a 4-year term beginning January 1, 2019. To learn more about FHLB visit www.fhlbcin.com.

The current appraised value of First State Bancorp, Inc. stock as of 12/31/2019 is $82.25/share, up 10.41% from 12/31/2018.

We will stay focused on our vision: "To be the premier financial institution in our community, dedicated to providing exceptional customer service and high value products, while enhancing shareholder value."

*Sincerely,*

Michael P Pell
President / CEO

**DAVID E. RICHEY**
**CHIEF FINANCIAL OFFICER**

2019 was another great year for First State Bancorp, Inc. We were able to maintain a consistent net interest margin in a challenging interest rate environment. The bank posted strong earnings with excellent growth in both loans and deposits. Shareholders equity grew significantly due to earnings growth and improved fair market value of the investment portfolio. 2019 was the 15th consecutive year of improved net income for the company.

In 2019, your investment in First State Bancorp, Inc. returned a dividend of $1.40 per share up from $1.24 one year ago. The book value of your stock ended the year at $68.42 per share, up from $58.75 one year ago. Thank you for your role in making First State Bank a success.

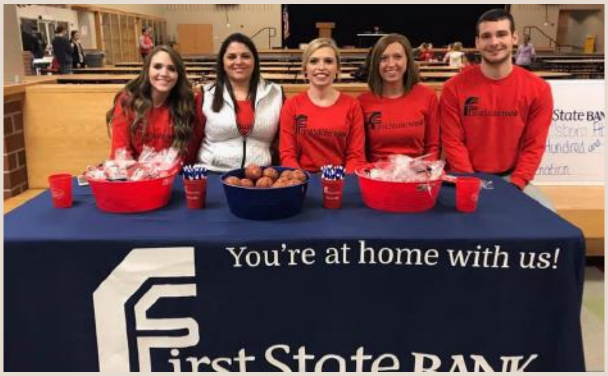
## Financial Highlights and Selected Financial Data

The following table sets forth certain information covering the consolidated financial position and results of operations of the company at the dates indicated.

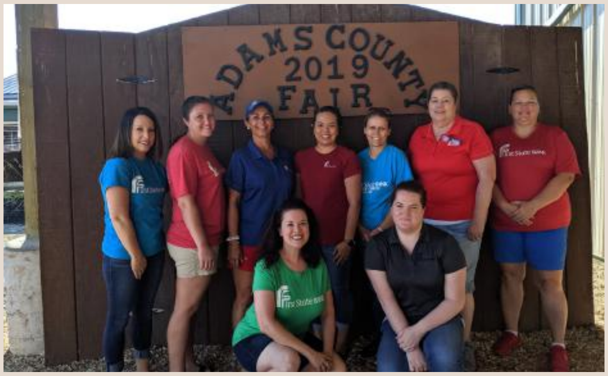
| | As of December 31, | | |
|---|---|---|---|
| | 2019 | 2018 | 2017 |
| **Balance Sheet:** (in thousands) | | | |
| Assets | $ 494,586 | $ 462,816 | $ 448,407 |
| Loans receivable, net | 328,217 | 321,144 | 305,954 |
| Investments | 118,019 | 97,447 | 104,555 |
| Deposits | 420,729 | 407,692 | 395,149 |
| Stockholders' equity | 54,187 | 46,531 | 43,845 |

| | For the Year Ended December 31, | | |
|---|---|---|---|
| | 2019 | 2018 | 2017 |
| **Results of operations:** | | | |
| Net income | 5,341,957 | 4,885,558 | 4,403,050 |
| **Per share data (common stock):** | | | |
| Basic earnings per share | 6.74 | 6.17 | 5.56 |
| Year end book value | 68.42 | 58.75 | 55.36 |
| Dividends declared (common) | 1,108,741 | 982,049 | 918,720 |
| **Performance ratios:** | | | |
| Return on average assets | 1.09% | 1.06% | 0.98% |
| Return on average equity | 10.35% | 11.05% | 10.58% |
| Net interest margin (for the year) | 3.72% | 3.72% | 3.61% |
| Equity to assets (at year end) | 10.96% | 10.05% | 9.78% |
| Allowance to gross loans | 1.35% | 1.24% | 1.23% |

# We Love to Volunteer ...

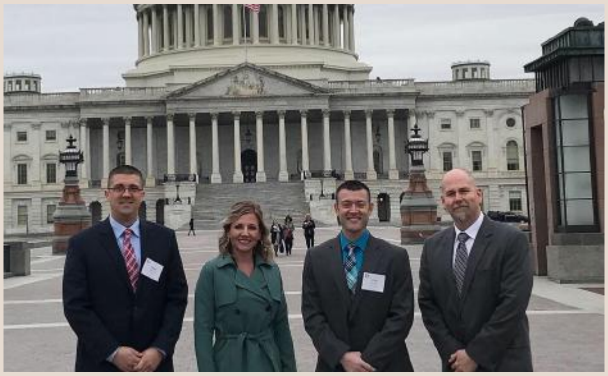



The team showing spirit at FSB Night in Hillsboro



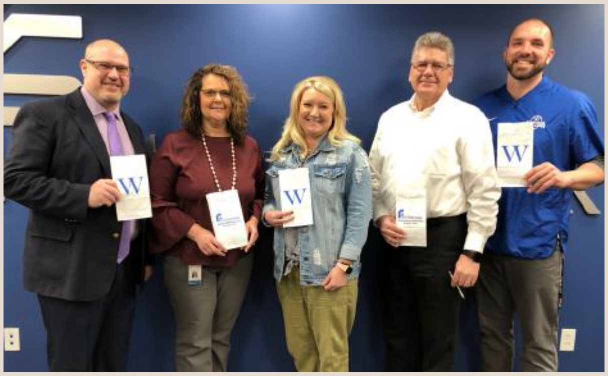

Helping out at the Adams County Fair sale

The FSB team at the Adams County Fair



The annual Ohio Bankers League Fly In event

Enjoying FSB Basketball Night in West Union

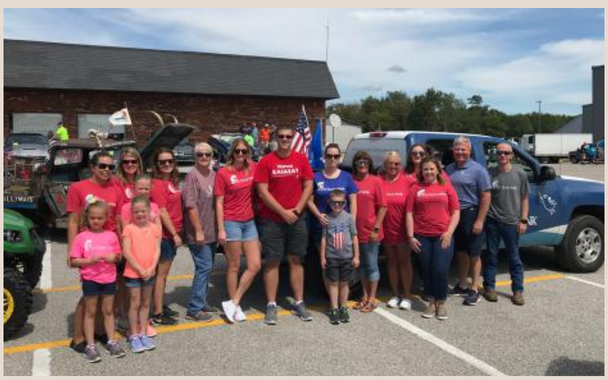


The Washington Court House team sponsors popcorn bags for WCH City Schools

# and Serve Our Communities!

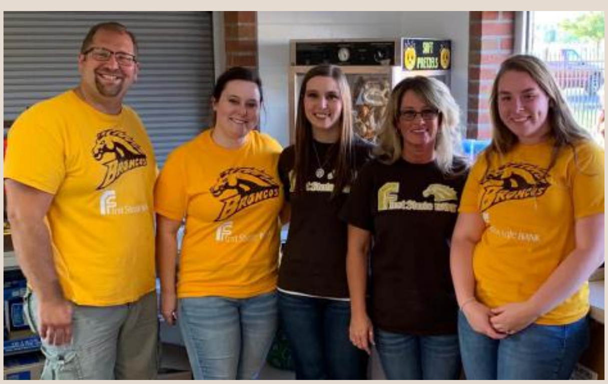
Wilmington Banking Center Ribbon Cutting Celebration


The team representing at Manchester FSB Night

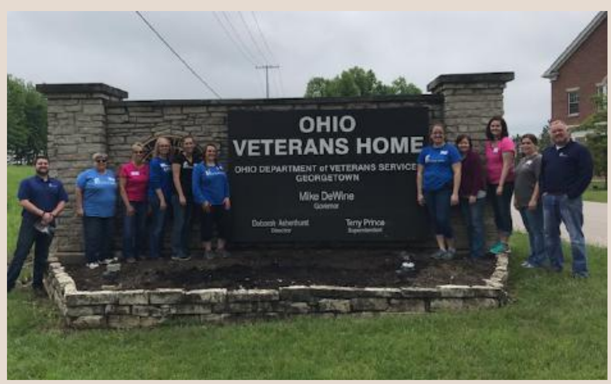


The group is ready for the Winchester Homecoming parade


The FSB team volunteering at the Ronald McDonald House in Cincinnati



Friday night football FSB Night in Mt. Orab




The FSB team giving back at the Ohio Veterans Home in Georgetown

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CLARK SCHAEFER HACKETT
CPAs & ADVISORS

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P. 513.241.3111 | F. 513.241.1212 | cshco.com

**INDEPENDENT AUDITORS' REPORT**

Board of Directors
First State Bancorp, Inc. and Subsidiary:

**Report on the Financial Statements**
We have audited the accompanying consolidated financial statements of First State Bancorp, Inc. and Subsidiary which comprise the consolidated balance sheets as of December 31, 2019 and 2018, and the related consolidated statements of income, comprehensive income, shareholders' equity, and cash flows for the years then ended and the related notes to the consolidated financial statements.

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

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

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

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

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

*Clark, Schaefer, Hackett & Co.*

Cincinnati, Ohio
February 10, 2019

First State Bancorp, Inc. and Subsidiary
Consolidated Balance Sheets
December 31, 2019 and 2018

| | | 2019 | 2018 |
|---|---|---|---|
| Assets | | | |
| Cash and due from banks: | | | |
| Cash and cash items | $ | 2,706,362 | 2,432,204 |
| Due from banks | | 20,892,847 | 16,380,008 |
| Federal funds sold | | 461,000 | 1,197,000 |
| | | 24,060,209 | 20,009,212 |
| Investment securities, available-for-sale | | 116,540,228 | 96,948,775 |
| Investment security, held-to-maturity | | 1,478,522 | 498,334 |
| Loans held-for-sale | | - | 986,450 |
| Loans receivable, net | | 328,217,008 | 320,157,403 |
| Accrued interest receivable | | 2,021,020 | 1,913,893 |
| Premises and equipment, net | | 10,221,422 | 9,628,896 |
| Other real estate owned | | 95,600 | - |
| Federal Home Loan Bank, at cost | | 1,281,100 | 1,078,600 |
| Bank owned life insurance | | 6,825,568 | 6,676,544 |
| Intangible assets, net | | 67,683 | 136,334 |
| Goodwill, net | | 1,488,784 | 1,733,814 |
| Deferred taxes | | 472,047 | 1,270,711 |
| Other assets | | 1,816,720 | 1,776,772 |
| Total assets | $ | 494,585,911 | 462,815,738 |
| Liabilities and Shareholders' Equity | | | |
| Deposits: | | | |
| Demand | $ | 65,163,603 | 58,309,840 |
| Savings and interest checking | | 226,479,240 | 209,247,260 |
| Time deposits | | 129,085,990 | 140,134,681 |
| Total | | 420,728,833 | 407,691,781 |
| Federal Home Loan Bank advances | | 15,250,022 | 5,310,889 |
| Accrued interest payable | | 189,260 | 163,841 |
| Accrued taxes and other liabilities | | 4,231,252 | 3,118,721 |
| Total liabilities | | 440,399,367 | 416,285,232 |
| Shareholders' equity: | | | |
| Capital stock, no par value, 2,000,000 shares authorized at December 31, 2019 and 2018, 792,000 issued and outstanding at December 31, 2019 and 2018 | | 5,178,533 | 5,178,533 |
| Additional paid-in capital | | 1,800,000 | 1,800,000 |
| Retained earnings | | 46,028,321 | 41,795,095 |
| Accumulated other comprehensive gain (loss) | | 1,179,690 | (2,243,122) |
| Total shareholders' equity | | 54,186,544 | 46,530,506 |
| Total liabilities and shareholders' equity | $ | 494,585,911 | 462,815,738 |

See accompanying notes to the consolidated financial statements

First State Bancorp, Inc. and Subsidiary
Consolidated Statements of Income
Years Ended December 31, 2019 and 2018

| | 2019 | 2018 |
|---|---|---|
| Interest income: | | |
| Interest and fees on loans | $ 17,455,513 | 16,113,209 |
| Interest on investment securities: | | |
| Taxable | 2,067,674 | 1,040,031 |
| Tax-exempt | 1,128,733 | 1,568,378 |
| Interest on federal funds sold and deposits in banks | 441,643 | 296,705 |
| | 21,093,563 | 19,018,323 |
| Interest expense: | | |
| Savings and interest checking | 1,211,251 | 816,839 |
| Other time deposits | 2,384,424 | 1,722,856 |
| Federal funds purchased and FHLB advances | 158,234 | 59,348 |
| | 3,753,909 | 2,599,043 |
| Net interest income | 17,339,654 | 16,419,280 |
| Provision for loan losses | 1,074,778 | 663,630 |
| Net interest income after provision for loan losses | 16,264,876 | 15,755,650 |
| Other income (loss): | | |
| Earnings on bank owned life insurance | 149,024 | 154,904 |
| Gain (loss) on sale of investments | 783,512 | (96,586) |
| Gain on sale of loans | 332,676 | 261,641 |
| (Loss) gain on sale of other real estate owned | (10,074) | 8,131 |
| Service charges on deposit accounts | 1,328,104 | 1,235,214 |
| ATM service charges and other fees, net | 1,108,989 | 952,028 |
| | 3,692,231 | 2,515,332 |
| Other expenses: | | |
| Salaries, directors' fees and employee benefits | 7,890,049 | 6,969,758 |
| Software and equipment expenses | 1,330,705 | 1,162,764 |
| Supplies and postage expenses | 298,543 | 303,650 |
| Taxes other than federal income taxes | 533,813 | 505,291 |
| Occupancy expenses | 731,135 | 729,554 |
| FDIC insurance premiums and assessments | 61,500 | 138,000 |
| Professional fees | 399,412 | 346,833 |
| Telephone and data expenses | 202,805 | 192,556 |
| Marketing expenses | 397,297 | 294,170 |
| Amortization of intangible assets and goodwill | 313,684 | 440,069 |
| Impairment loss on fixed assets | 103,923 | 164,975 |
| Other operating expenses | 1,284,162 | 1,325,185 |
| | 13,547,028 | 12,572,805 |
| Income before federal income taxes | 6,410,079 | 5,698,177 |
| Federal income taxes | 1,068,112 | 812,619 |
| Net income | 5,341,967 | 4,885,558 |
| Net income per share of common stock | $ 6.74 | 6.17 |

See accompanying notes to the consolidated financial statements

| | 2019 | 2018 |
|---|---|---|
| Net income | $ 5,341,967 | 4,885,558 |
| Other comprehensive income (loss): | | |
| Unrealized holding gains (losses) during the period on securities available-for-sale, net of deferred tax expense (benefit) of $313,589 and ($596,273) | 2,803,838 | (1,141,847) |
| Reclassification adjustment for gains (losses) included in net income on securities available-for-sale, net of deferred tax expense (benefit) of $164,538 and ($20,283) | 618,974 | (76,303) |
| Other comprehensive income (loss) | 3,422,812 | (1,218,150) |
| Comprehensive income | $ 8,764,779 | 3,667,408 |

See accompanying notes to the consolidated financial statements

First State Bancorp, Inc. and Subsidiary
Consolidated Statements of Shareholders' Equity
Years Ended December 31, 2019 and 2018

| | Capital Stock | Additional Paid In Capital | Treasury Stock | Retained Earnings | Accumulated Other Comprehensive Loss | Total |
|---|---|---|---|---|---|---|
| Balance, January 1, 2018 | $ 5,178,533 | 1,800,000 | - | 37,891,586 | (1,024,972) | 43,845,147 |
| Net income | - | - | - | 4,885,558 | - | 4,885,558 |
| Other comprehensive loss, net of tax | - | - | - | - | (1,218,150) | (1,218,150) |
| Purchase of 1,659 shares of treasury stock | - | - | (110,043) | - | - | (110,043) |
| Proceeds from sale of 1,659 shares of treasury stock | - | - | 110,043 | - | - | 110,043 |
| Cash dividends declared ($1.24 per share) | - | - | - | (982,049) | - | (982,049) |
| Balance, December 31, 2018 | 5,178,533 | 1,800,000 | - | 41,795,095 | (2,243,122) | 46,530,506 |
| Net income | - | - | - | 5,341,967 | - | 5,341,967 |
| Other comprehensive gain, net of tax | - | - | - | - | 3,422,812 | 3,422,812 |
| Purchase of 617 shares of treasury stock | - | - | (44,042) | - | - | (44,042) |
| Proceeds from sale of 617 shares of treasury stock | - | - | 44,042 | - | - | 44,042 |
| Cash dividends declared ($1.40 per share) | - | - | - | (1,108,741) | - | (1,108,741) |
| Balance, December 31, 2019 | $ 5,178,533 | 1,800,000 | - | 46,028,321 | 1,179,690 | 54,186,544 |

See accompanying notes to the consolidated financial statements

First State Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows
Years Ended December 31, 2019 and 2018

| | | 2019 | 2018 |
|---|---|---|---|
| Operating activities: | | | |
| Net income | $ | 5,341,967 | 4,885,558 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | |
| Amortization of premiums and discounts on securities, net | | 1,734,085 | 1,268,176 |
| (Gain) loss on sale of investments | | (783,512) | 96,586 |
| Change in loans held-for-sale | | 986,450 | (777,580) |
| Gain on sale of mortgage loans | | (332,676) | (261,641) |
| Proceeds from sale of mortgage loans | | 14,687,158 | 12,022,593 |
| Loans disbursed for sale in the secondary market | | (14,354,482) | (11,760,801) |
| Provision for loan losses | | 1,074,778 | 663,630 |
| Loss (gain) on sale of other real estate owned | | 10,074 | (8,131) |
| Impairment loss on fixed assets | | 103,923 | 164,975 |
| Depreciation expense | | 664,964 | 646,208 |
| Earnings on bank owned life insurance | | (149,024) | (154,905) |
| Amortization of intangible assets, goodwill and other assets | | 459,743 | 556,480 |
| Deferred federal income tax benefit | | (111,198) | (59,697) |
| Changes in assets and liabilities: | | | |
| Accrued interest receivable | | (107,127) | (96,078) |
| Other assets | | (186,010) | (11,341) |
| Accrued interest payable | | 25,419 | 16,311 |
| Accrued taxes and other liabilities | | 1,112,531 | 272,114 |
| Net cash provided by operating activities | | 10,177,063 | 7,462,457 |
| Investing activities: | | | |
| Repayment of mortgage-backed securities | | 6,744,335 | 7,896,723 |
| Proceeds from sale, call and maturities of securities available-for-sale | | 59,406,258 | 11,317,643 |
| Purchases of securities available-for-sale | | (82,340,133) | (14,513,597) |
| Purchase of security held-to-maturity | | (1,000,000) | (40,918) |
| Net increase in loans | | (9,260,483) | (15,128,296) |
| Capital expenditures | | (1,361,413) | (1,696,419) |
| Proceeds from sale of other real estate owned | | 20,426 | 60,511 |
| Purchase of FHLB stock | | (202,500) | (18,300) |
| Net cash used by investing activities | | (27,993,510) | (12,122,653) |
| Financing activities: | | | |
| Net increase in deposits | | 13,037,052 | 12,542,949 |
| Net change in repurchase agreements | | - | (1,551,138) |
| Net proceeds from (repayments of) FHLB advances | | 9,939,133 | (16,332) |
| Dividends paid | | (1,108,741) | (982,049) |
| Purchase of treasury stock | | (44,042) | (110,043) |
| Proceeds from sale of treasury stock | | 44,042 | 110,043 |
| Net cash provided by financing activities | | 21,867,444 | 9,993,430 |
| Change in cash and due from banks | | 4,050,997 | 5,333,234 |
| Cash and due from banks, beginning of year | | 20,009,212 | 14,675,978 |
| Cash and due from banks, end of year | $ | 24,060,209 | 20,009,212 |
| Supplemental disclosures of cash flow information: | | | |
| Change in unrealized gain (loss) on securities | $ | 4,332,674 | (1,541,962) |
| Real estate owned acquired through foreclosure | $ | 185,682 | 99,205 |
| Cash paid during the year for: | | | |
| Federal income taxes | $ | 1,221,000 | 910,000 |
| Interest | $ | 3,728,490 | 2,582,732 |

See accompanying notes to the consolidated financial statements

## 1. SUMMARY OF SIGNIFICANT ACCOUNTING AND REPORTING POLICIES:

The following accounting policies are set forth to facilitate the understanding of data presented in the consolidated financial statements:

**Nature of operations**
First State Bancorp, Inc. (the Company) and First State Bank (the Bank) revenues, operating income and assets are primarily from the banking industry. The Bank operates thirteen branches in Adams, Brown, Highland, Fayette, Clinton, and Hamilton Counties in Ohio. The Bank generates commercial, mortgage and consumer loans and receives deposits from customers located primarily in South Central Ohio. Substantially all loans are secured by specific items of collateral including business assets, consumer assets, and commercial and residential real estate. Commercial loans are expected to be repaid from cash flow from operations or businesses. There are no significant concentrations of loans to any one industry or customer. However, the customers' ability to repay their loans is dependent on the real estate and general economic environment in the area.

The Bank is a state-chartered bank subject to regulation by the Ohio Department of Commerce, Division of Financial Institutions and the Federal Deposit Insurance Corporation (FDIC). The Bank is also a member of the Federal Home Loan Bank (FHLB) system, and as a member, maintains a required investment in the capital stock of the FHLB of Cincinnati.

Deposit accounts are insured within certain limitations by the Deposit Insurance Fund (DIF), which is administered by the FDIC. An annual premium is required by the DIF for insurance of such deposits.

**Basis of presentation**
The accounting and reporting policies of the Company conform with accounting principles generally accepted in United States of America (GAAP) as contained in the Accounting Standards Codification (ASC) issued by the Financial Accounting Standards Board (FASB) and general practices within the financial services industry.

**Principles of consolidation**
The consolidated financial statements include the accounts of the Company and its wholly owned subsidiary the Bank. All significant intercompany transactions have been eliminated in consolidation.

**Use of estimates**
The preparation of the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Significant estimates include the allowance for loan losses. Actual results could differ from those estimates.

**Cash flows**
Cash and cash equivalents include deposits with other financial institutions with maturities fewer than 90 days and federal funds sold. Net cash flows are reported for customer loan and deposit transactions, interest bearing deposits in other financial institutions, and federal funds purchased and repurchase agreements.

The Company and Bank may at times maintain deposit accounts with other financial institutions in excess of FDIC limits. The Company and Bank have not experienced any losses in such accounts and do not believe they are exposed to any significant credit risk on cash.

**Investment securities**

Investment securities are classified as held-to-maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Investment securities are classified as available-for-sale when they might be sold before maturity for any reason, including liquidity needs, changes in market interest rates, or asset/liability management strategies. Investment securities available-for-sale are carried at fair value with unrealized holding gains and losses reported separately in shareholders' equity, net of applicable taxes. Equity securities without readily determinable fair values are carried at cost, minus impairment, if any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment.

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

Management evaluates securities for other-than-temporary impairment (OTTI) on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or more likely than not will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which is recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and amortized cost basis. For equity securities, the entire amount of impairment is recognized through earnings.

**Loans held-for-sale**

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value, as determined by outstanding commitments from investors. Net unrealized losses, if any, are recorded as a valuation allowance and charged to earnings.

Mortgage loans held-for-sale are generally sold with servicing rights retained. The carrying value of mortgage loans sold is reduced by the amount allocated to the servicing right. Gains and losses on sales of mortgage loans are based on the difference between the selling price and the carrying value of the related loan sold.

**Loans receivable**

Loans which management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of deferred loan fees and costs, and an allowance for loan losses. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized in interest income using the level-yield method without anticipating prepayments.

Loans are placed on non-accrual status at 90 days delinquent or when management believes the borrower's financial condition, after giving consideration to economic and business conditions and collection efforts, is such that collection of interest is doubtful. Interest income is not reported when full loan repayment is in doubt, typically when payments are past due over 90 days and evaluated as such by management. Loans are charged against the allowance for loan losses when management believes that the collectability of the principal is unlikely.

All interest accrued but not received for loans placed on non-accrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis, until qualifying for return to accrual. Under the cash-basis method, interest income is recorded when the payment is received in cash. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

**Allowance for loan losses**

The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. Management estimates the allowance balance required using past loan loss experience, current loan to value, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged-off.

The allowance consists of specific and general components. The specific component relates to loans individually classified as impaired or loans otherwise classified as substandard or doubtful. The general component covers non-classified loans and is based on historical loss experience adjusted for current environmental factors.

A loan is impaired when, based on current information and events, it is probable the Bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans, for which the terms have been modified, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Factors considered by management in determining impairment include payment status 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 relevant 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.

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a troubled debt restructuring (TDR). These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral.

Troubled debt restructurings are measured at the present value of estimated future cash flows using the loan's effective rate at inception including the probability of re-default. If a TDR is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of collateral. For troubled debt restructurings that subsequently default, the Bank determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: current loan to value, current credit score, levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations. The following portfolio segments have been identified: residential real estate, commercial real estate, commercial and industrial and consumer. The Bank reviews the credit risk exposure of all its portfolio segments by internally assessing risk factors. Risk factors impacting loans in each of the portfolio segments include broad deterioration of property values, and reduced credit availability.

**Servicing rights**

When mortgage loans are sold with servicing retained, servicing rights are initially recorded at fair value with the income statement effect recorded in gains on sale of loans. Fair value is based on market prices for comparable mortgage servicing contracts when available, or alternatively, based on a valuation model that calculates the present value of estimated future net servicing income. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing rights are evaluated for impairment based upon the fair value of the rights as compared to their carrying amount. Impairment, if any, is recognized through a valuation allowance to the extent that fair value is less than the carrying amount. If the Bank later determines that all or a portion of the impairment no longer exists, a reduction of the allowance may be recorded as an increase to income. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income is recorded in other service charges and fees within the income statement. The fees are based on a contractual percentage of the outstanding principal; or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights is netted against loan servicing fee income.

**Other real estate owned (OREO)**

Other real estate owned is initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. Physical possession of real estate property collateralizing a mortgage loan occurs when legal title is obtained upon completion of foreclosure or when the borrower conveys all interest in the property to satisfy the loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Operating costs after acquisition are expensed as incurred.

**Premises and equipment**

Land is carried at cost. Premises and equipment are stated at cost, less accumulated depreciation computed on straight-line and accelerated methods over the estimated useful lives of the related assets. Buildings and improvements are depreciated over useful lives ranging from 3 to 39 years. Furniture, fixtures and equipment are depreciated over useful lives ranging from 3 to 20 years. Gains and losses on dispositions are included in current operations. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized.

**Federal Home Loan Bank stock**

The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

**Bank owned life insurance**

The Bank has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due which are probable at settlement.

**Intangible assets**

Intangible assets consist of premiums paid for core deposits. Intangible assets are stated at cost, less accumulated amortization computed on straight line and net present value methods over the estimated life of the related premium, and consist of the following:

| | 2019 | 2018 |
|---|---|---|
| Intangible assets, net - January 1 | $ 136,334 | 331,372 |
| Amortization expense | (68,651) | (195,038) |
| Intangible assets, net - December 31 | $ 67,683 | 136,334 |

Accumulated amortization was $4,223,816 and $4,155,165 at December 31, 2019 and 2018, respectively. Future amortization expense is as follows:

| | |
|---|---|
| 2020 | 38,374 |
| 2021 | 18,967 |
| 2022 | 8,280 |
| 2023 | 2,062 |
| | $ 67,683 |

**Goodwill**

Goodwill arises from business combinations and is generally determined as the excess of the fair value of the consideration transferred over the fair value of the net assets acquired and liabilities assumed as of the acquisition date. Goodwill consists of the branch acquisition of the Washington Court House branch in 2014 and the merger of First Safety Bank in 2016. The Company made the accounting policy election to test goodwill for impairment at the entity level and to amortize the goodwill on straight line basis over ten years upon acquisition.

Goodwill consists of the following:

| | 2019 | 2018 |
|---|---|---|
| Goodwill, net - January 1 | $ 1,733,814 | 1,978,845 |
| Amortization expense | (245,030) | (245,031) |
| Goodwill, net - December 31 | $ 1,488,784 | 1,733,814 |

Accumulated amortization was $961,526 and $716,496 at December 31, 2019 and 2018, respectively. Future net amortization expense is as follows:

| | |
|---|---|
| 2020 | $ 245,031 |
| 2021 | 245,031 |
| 2022 | 245,031 |
| 2023 | 245,031 |
| 2024 | 205,068 |
| Thereafter | 303,592 |
| | $ 1,488,784 |

**Income taxes**

Income tax expense is the total of the current year income tax due, the change in deferred federal income taxes and benefit of available tax credits. Deferred federal income taxes represent the net tax effects of temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for federal income tax purposes. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.

**Net income per share of common stock**
Net income per share of common stock is computed by dividing net income by the weighted average number of shares of common stock outstanding during the year. Earnings and dividends per share are restated for all stock splits and stock dividends through the date of issuance of the consolidated financial statements.

**Comprehensive income**
Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available-for-sale which are also recognized as separate components of equity.

The following information discloses the reclassification adjustments for each component of accumulated other comprehensive income, including the consolidated statement of income items affected as of December 31, 2019:

| Accumulated Other Comprehensive Loss Components | Reclassification Amount | Affected Line Item in the Consolidated Statements of Income |
|---|---|---|
| Unrealized gains on securities available-for-sale | $ 783,512 | Net realized gain on sale of securities |
| | (164,538) | Federal income tax expense |
| Total reclassifications for the period | $ 618,974 | Reclassification adjustment, net of tax |

The following information discloses the reclassification adjustments for each component of accumulated other comprehensive income, including the consolidated statement of income items affected as of December 31, 2018:

| Accumulated Other Comprehensive Loss Components | Reclassification Amount | Affected Line Item in the Consolidated Statements of Income |
|---|---|---|
| Unrealized losses on securities available-for-sale | $ (96,586) | Net realized loss on sale of securities |
| | 20,283 | Federal income tax benefit |
| Total reclassifications for the period | $ (76,303) | Reclassification adjustment, net of tax |

**Dividend Restriction**
Banking regulations require maintaining certain capital levels and may limit the dividends paid by the Bank to the Company or by the Company to its shareholders.

**Advertising**
Advertising and marketing costs are expensed as incurred. Advertising and marketing expense was $397,297 and $294,170 for the years ended December 31, 2019 and 2018 respectively.

**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. Such financial instruments are recorded in the financial statements when they are funded.

**Subsequent events**
The Company has evaluated subsequent events for recognition and disclosure through February 10, 2019, which is the date the consolidated financial statements were available to be issued.

**Recent Accounting Pronouncements**
The FASB issued ASU 2016-02 “Leases (Topic 842)”, which requires lessees to recognize lease assets and liabilities on the balance sheet and requires expanded disclosure about leasing arrangements. The new standard is effective for the year ended December 31, 2020. Management has assessed the impact of the new standard, which will be immaterial to the consolidated financial statements.

The FASB issued ASU 2016-13, “Financial Instruments-Credit Losses: Measurement of Credit Losses on Financial Instruments (Topic 326)”, which changes the impairment model for most financial assets. This ASU is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the ASU is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management’s current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be affected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2022. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. The Company will be evaluating the impact of this ASU over the next several years.

**Adoption of a new accounting pronouncement**
On January 1, 2019, the Bank adopted ASU 2014-09 Revenue from Contracts with Customers and all subsequent amendments to the ASU (collectively, “ASC 606”), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Bank’s revenues come from interest income and other sources, including loans, and investment securities, which are outside the scope of ASC 606. The Bank’s services falling within the scope of ASC 606 are presented within other income (loss). Refer to Note 17 Revenue from Contracts with Customers for further discussion on the Bank’s accounting policies for revenue sources within the scope of ASC 606.

The Bank adopted ASC 606 using the modified retrospective method applied to all contracts not completed as of January 1, 2019. Results for reporting periods beginning after January 1, 2019 are presented under ASC 606 while prior period amounts continue to be reported in accordance with legacy GAAP. The adoption of ASC 606 did not result in a change to the accounting for any of the in-scope revenue streams; as such, no cumulative effect adjustment to retained earnings was required.

## 2. INVESTMENT SECURITIES:

The following tables provide information related to investment securities by category at December 31 (in thousands):

| | 2019 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale: | | | | |
| Mortgage-backed securities | $ 51,881 | 563 | 218 | 52,226 |
| State and political subdivisions | 63,125 | 1,466 | 341 | 64,250 |
| Other | 41 | 23 | - | 64 |
| Total | $ 115,047 | 2,052 | 559 | 116,540 |
| Held-to-maturity: | | | | |
| Corporate bonds | $ 1,000 | - | 11 | 989 |
| Qualified affordable housing | $ 479 | - | - | 479 |
| Total | $ 1,479 | - | 11 | 1,468 |

| | 2018 | | | |
|---|---|---|---|---|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale: | | | | |
| Mortgage-backed securities | $ 42,951 | 15 | 917 | 42,049 |
| U.S. Treasuries | 1,492 | - | 2 | 1,490 |
| State and political subdivisions | 55,304 | 91 | 2,041 | 53,354 |
| Other | 41 | 15 | - | 56 |
| Total | $ 99,788 | 121 | 2,960 | 96,949 |
| Held-to-maturity: | | | | |
| Qualified affordable housing | $ 498 | - | - | 498 |

The amortized cost and fair value of investment securities, by contractual maturity, are shown below (in thousands). Actual maturities may differ from contractual maturities when a right to call or prepay an obligation exists:

| | 2019 | | 2018 | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Available for sale: | | | | |
| Mortgage-backed securities: | | | | |
| Less than one year | $ 1,833 | 1,829 | 660 | 655 |
| One to five years | 24,411 | 24,427 | 32,972 | 32,393 |
| Five to ten years | 25,392 | 25,725 | 8,020 | 7,769 |
| Over ten years | 245 | 245 | 1,299 | 1,232 |
| U.S. Treasuries: | | | | |
| Less than one year | - | - | 1,492 | 1,490 |
| State and political subdivisions: | | | | |
| Less than one year | - | - | - | - |
| One to five years | 4,669 | 4,832 | 5,232 | 5,175 |
| Five to ten years | 43,729 | 44,893 | 42,665 | 41,672 |
| Over ten years | 14,727 | 14,525 | 7,407 | 6,507 |
| Other | 41 | 64 | 41 | 56 |
| Total | $ 115,047 | 116,540 | 99,788 | 96,949 |
| Held-to-maturity: | | | | |
| Corporate bonds: | | | | |
| Five to ten years | $ 1,000 | 989 | - | - |
| Qualified affordable housing: | 479 | 479 | 498 | 498 |
| Total | $ 1,479 | 1,468 | 498 | 498 |

At December 31, 2019 and 2018 investment securities with an amortized cost of $65,185,351 and $72,749,402, respectively, were pledged to secure public deposits, securities sold under repurchase agreements and for other purposes as required or permitted by law. These securities had fair values of $66,495,038 and $70,699,085 at December 31, 2019 and 2018, respectively.

The tables below indicate the length of time individual investment securities and mortgage-backed securities have been in a continuous loss position at December 31 (in thousands):

| | 2019 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities | $ 12,711 | 90 | 7,371 | 128 | 20,082 | 218 |
| Number of Investments | 10 | | 13 | | 23 | |
| States and political subdivisions | 15,650 | 341 | - | - | 15,650 | 341 |
| Number of Investments | 11 | | - | | 11 | |
| Total | $ 28,361 | 431 | 7,371 | 128 | 35,732 | 559 |
| Number of Investments | 21 | | 13 | | 34 | |
| Held-to-maturity: Corporate bonds | $ 989 | 11 | - | - | 989 | 11 |
| Number of Investments | 1 | | - | | 1 | |

| | 2018 | | | | | |
|---|---|---|---|---|---|---|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Mortgage-backed securities | $ 6,520 | 72 | 29,832 | 845 | 36,352 | 917 |
| Number of Investments | 8 | | 34 | | 42 | |
| U.S. Treasuries | $ 1,490 | 2 | - | - | 1,490 | 2 |
| Number of Investments | 1 | | - | | 1 | |
| States and political subdivisions | 8,541 | 65 | 36,590 | 1,976 | 45,131 | 2,041 |
| Number of Investments | 9 | | 36 | | 45 | |
| Total | $ 16,551 | 139 | 66,422 | 2,821 | 82,973 | 2,960 |
| Number of Investments | 18 | | 70 | | 88 | |

Management does not intend to sell these securities, and it is more likely than not the Bank will retain, and not be required to sell, the securities in an unrealized loss position prior to the recovery of value. The decline in market value is due to fluctuations in market interest rates and not credit quality. The fair values are expected to recover as securities approach their maturity dates.

**Qualified Affordable Housing Project Investment**

The Bank invests in a qualified affordable housing project. The balance of the investment was $478,522 and $498,334 at December 31, 2019 and 2018, respectively. Total unfunded commitment at December 31, 2019 related to the investment in the qualified affordable housing project is $435,042. The Bank expects to fulfill these commitments as scheduled until 2029 as follows:

| | |
|---|---|
| 2020 | $ 218,570 |
| 2021 | 132,344 |
| 2022 | 13,537 |
| 2023 | 15,670 |
| 2024 | 12,308 |
| Thereafter | 42,613 |
| | $ 435,042 |

During 2019 and 2018, the Bank recognized amortization expense of $19,812 and $1,666, respectively. Additionally, during 2019 and 2018, the Bank recognized tax credits in connection with its investment in qualified affordable housing projects of $25,282 and $1,968, respectively.

## 3. LOANS RECEIVABLE:

Loans receivable consist of the following, net of unamortized loan fees (in thousands):

| | 2019 | 2018 |
|---|---|---|
| Residential real estate: | | |
| Construction | $ 4,549 | 4,220 |
| Owner occupied | 96,983 | 92,392 |
| Non-owner occupied | 43,442 | 41,989 |
| Commercial real estate: | | |
| Construction | 7,593 | 6,712 |
| Farmland | 24,133 | 21,123 |
| Nonfarm | 83,537 | 77,018 |
| Commercial and industrial | 22,743 | 26,034 |
| Consumer | 49,351 | 54,414 |
| Other | 373 | 302 |
| | 332,704 | 324,204 |
| Less allowance for loan losses | (4,487) | (4,047) |
| | $ 328,217 | 320,157 |

The risk characteristics applicable to each segment of the loan portfolio are described as follows:

Residential real estate loans are secured by 1 - 4 family residences and are generally owner-occupied. The Bank generally establishes a maximum loan-to-value ratio and requires private mortgage insurance if that ratio is exceeded. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market area, such as unemployment levels. Repayment can also be impacted by changes in property values of residential properties. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

Commercial real estate loans, including farmland and nonfarm loans, are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Commercial real estate lending typically involves larger loan principal amounts and the repayment of these loans is generally dependent on the successful operation of the property securing the loan or the business conducted on the property securing the loan. Commercial real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The characteristics of properties securing the Bank’s commercial real estate portfolio are diverse, but by geographic location are almost entirely in the Bank’s market area. Management monitors and evaluates commercial real estate loans based on cash flow, collateral, geography and risk grade criteria.

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

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

Consumer loans consist substantially of automobile loans. Automobile loans are generally secured by the automobile being financed or other personal assets. Repayment of these loans is primarily dependent on the personal income of the borrowers, which can be impacted by economic conditions in their market area, such as unemployment levels, and secondarily on the collateral securing the loan. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

**Allowance for Loan Losses and Recorded Investment in Financing Receivables (in thousands)**
**December 31, 2019**

| | Residential Real Estate | | | Commercial Real Estate | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Construction | Owner Occupied | Non-owner Occupied | Construction | Farmland | Nonfarm | Commercial and Industrial | Consumer | Other | Total |
| **Allowance for loan losses:** | | | | | | | | | | |
| Beginning balance | $ 40 | 1,209 | 397 | 59 | 179 | 786 | 291 | 1,082 | 4 | 4,047 |
| Provision | 11 | 219 | 67 | 14 | 52 | 91 | 175 | 346 | 100 | 1,075 |
| Charge-offs | - | (35) | - | - | - | (92) | (134) | (439) | (133) | (833) |
| Recoveries | - | 3 | 3 | - | - | 127 | - | 30 | 35 | 198 |
| Ending balance | $ 51 | 1,396 | 467 | 73 | 231 | 912 | 332 | 1,019 | 6 | 4,487 |
| Ending balance: Individually evaluated for impairment | $ - | 24 | - | - | - | 106 | 17 | - | - | 147 |
| Ending balance: Collectively evaluated for impairment | $ 51 | 1,372 | 467 | 73 | 231 | 806 | 315 | 1,019 | 6 | 4,340 |
| **Loans receivable:** | | | | | | | | | | |
| Ending balance | $ 4,549 | 96,983 | 43,442 | 7,593 | 24,133 | 83,537 | 22,743 | 49,351 | 373 | 332,704 |
| Ending balance: Individually evaluated for impairment | $ - | 65 | - | - | - | 211 | 2,304 | - | - | 2,580 |
| Ending balance: Collectively evaluated for impairment | $ 4,549 | 96,918 | 43,442 | 7,593 | 24,133 | 83,326 | 20,439 | 49,351 | 373 | 330,124 |

**Allowance for Loan Losses and Recorded Investment in Financing Receivables (in thousands)**
**December 31, 2018**

| | Residential Real Estate | | | Commercial Real Estate | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Construction | Owner Occupied | Non-owner Occupied | Construction | Farmland | Nonfarm | Commercial and Industrial | Consumer | Other | Total |
| **Allowance for loan losses:** | | | | | | | | | | |
| Beginning balance | $ 55 | 1,025 | 431 | 32 | 165 | 874 | 319 | 919 | 5 | 3,825 |
| Provision | (15) | 269 | (34) | 27 | 14 | (88) | (26) | 451 | 66 | 664 |
| Charge-offs | - | (136) | - | - | - | - | (9) | (308) | (80) | (533) |
| Recoveries | - | 51 | - | - | - | - | 7 | 20 | 13 | 91 |
| Ending balance | $ 40 | 1,209 | 397 | 59 | 179 | 786 | 291 | 1,082 | 4 | 4,047 |
| Ending balance: Individually evaluated for impairment | $ - | 34 | - | - | - | 118 | - | - | - | 152 |
| Ending balance: Collectively evaluated for impairment | $ 40 | 1,175 | 397 | 59 | 179 | 668 | 291 | 1,082 | 4 | 3,895 |
| **Loans receivable:** | | | | | | | | | | |
| Ending balance | $ 4,220 | 92,392 | 41,989 | 6,712 | 21,123 | 77,018 | 26,034 | 54,414 | 302 | 324,204 |
| Ending balance: Individually evaluated for impairment | $ - | 67 | - | - | - | 551 | 1,656 | - | - | 2,274 |
| Ending balance: Collectively evaluated for impairment | $ 4,220 | 92,325 | 41,989 | 6,712 | 21,123 | 76,467 | 24,378 | 54,414 | 302 | 321,930 |

**Credit risk profile categories**

The Bank assigns credit risk grades to evaluated loans using grading standards employed by regulatory agencies. The following are the bank's internally assigned grades:

Pass – loans in this category are considered satisfactory or fair. Satisfactory loans represent the Bank's standard or average loans that require a normal amount of supervision. These credits should have orderly updated credit files with borrowers/guarantors that have an acceptable net worth and sufficient income to retire debt.

Special Mention – special mention loans that do not currently expose the Bank to a sufficient degree of risk to warrant a substandard classification. However, it does possess credit deficiencies or potential weaknesses deserving management's close attention. If not corrected, such weaknesses or deficiencies may expose the Bank to an increased risk of loss in the future.

Substandard – an asset classified as substandard is inadequately protected by the current net worth and paying capacity of the borrower or the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – an asset classified as doubtful has all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, based on currently existing facts, conditions, and values, highly questionable and improbable.

Loss – the portion of a loan classified as loss is considered uncollectible and of such little value that its continuance as an asset, without establishment of a specific valuation allowance or charge-off, is not warranted. This classification does not necessarily mean that an asset has absolutely no recovery or salvage value; but rather, it is not practical or desirable to defer reserving for a basically worthless asset even though a partial recovery may occur in the future.

**Credit Risk Profile by Internally Assigned Grade (in thousands)**
**December 31, 2019**

| | Residential Real Estate | | | Commercial Real Estate | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Construction | Owner Occupied | Non-owner Occupied | Construction | Farmland | Nonfarm | Commercial and Industrial | Consumer | Other | Total |
| **Grade:** | | | | | | | | | | |
| Pass | $ 4,136 | 95,830 | 43,283 | 7,593 | 22,967 | 77,147 | 22,528 | 48,618 | 373 | 322,474 |
| Special mention | - | 397 | 95 | - | 1,166 | 4,780 | 163 | 268 | - | 6,870 |
| Substandard | 413 | 719 | 64 | - | - | 1,610 | 52 | 465 | - | 3,323 |
| Doubtful | - | 37 | - | - | - | - | - | - | - | 37 |
| Loss | - | - | - | - | - | - | - | - | - | - |
| Total | $ 4,549 | 96,983 | 43,442 | 7,593 | 24,133 | 83,537 | 22,743 | 49,351 | 373 | 332,704 |

**Credit Risk Profile by Internally Assigned Grade (in thousands)**
**December 31, 2018**

| | Residential Real Estate | | | Commercial Real Estate | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Construction | Owner Occupied | Non-owner Occupied | Construction | Farmland | Nonfarm | Commercial and Industrial | Consumer | Other | Total |
| **Grade:** | | | | | | | | | | |
| Pass | $ 3,767 | 91,152 | 41,869 | 6,712 | 20,745 | 69,983 | 25,850 | 54,178 | 188 | 314,444 |
| Special mention | - | 487 | - | - | 216 | 4,721 | 184 | 207 | 98 | 5,913 |
| Substandard | 453 | 715 | 120 | - | 162 | 2,314 | - | 29 | - | 3,793 |
| Doubtful | - | 38 | - | - | - | - | - | - | 16 | 54 |
| Loss | - | - | - | - | - | - | - | - | - | - |
| Total | $ 4,220 | 92,392 | 41,989 | 6,712 | 21,123 | 77,018 | 26,034 | 54,414 | 302 | 324,204 |

The following tables summarize loans by delinquency, nonaccrual status and impaired loans:

**Age Analysis of Loans Receivable (in thousands)**
**December 31, 2019**

| | 30-59 days past due | 60-89 days past due | Greater than 90 days past due | Total past due | Total current and accruing | Total financing receivables | Nonaccrual | Recorded investment > 90 days and accruing |
|---|---|---|---|---|---|---|---|---|
| Residential real estate: | | | | | | | | |
| Construction | $ - | - | - | - | 4,549 | 4,549 | - | - |
| Owner occupied | 445 | 97 | 291 | 833 | 96,150 | 96,983 | 740 | - |
| Non-owner occupied | - | 20 | - | 20 | 43,422 | 43,442 | 84 | - |
| Commercial real estate: | | | | | | | | |
| Construction | - | - | - | - | 7,593 | 7,593 | - | - |
| Farmland | - | - | - | - | 24,133 | 24,133 | - | - |
| Nonfarm | - | 318 | 343 | 661 | 82,876 | 83,537 | 1,888 | - |
| Commercial and industrial | - | - | 126 | 126 | 22,617 | 22,743 | 52 | - |
| Consumer | 307 | 135 | 65 | 507 | 48,844 | 49,351 | 282 | - |
| Other | 52 | - | - | 52 | 321 | 373 | - | - |
| Total | $ 804 | 570 | 825 | 2,199 | 330,505 | 332,704 | 3,046 | - |

**Age Analysis of Loans Receivable (in thousands)**
**December 31, 2018**

| | 30-59 days past due | 60-89 days past due | Greater than 90 days past due | Total past due | Total current and accruing | Total financing receivables | Nonaccrual | Recorded investment > 90 days and accruing |
|---|---|---|---|---|---|---|---|---|
| Residential real estate: | | | | | | | | |
| Construction | $ - | - | - | - | 4,220 | 4,220 | - | - |
| Owner occupied | 577 | 43 | 243 | 863 | 91,529 | 92,392 | 561 | - |
| Non-owner occupied | 92 | - | - | 92 | 41,897 | 41,989 | 67 | - |
| Commercial real estate: | | | | | | | | |
| Construction | - | - | - | - | 6,712 | 6,712 | - | - |
| Farmland | - | - | - | - | 21,123 | 21,123 | - | - |
| Nonfarm | 190 | - | - | 190 | 76,828 | 77,018 | 1,206 | - |
| Commercial and industrial | 7 | - | - | 7 | 26,027 | 26,034 | - | - |
| Consumer | 510 | 61 | 114 | 685 | 53,729 | 54,414 | 120 | - |
| Other | 138 | - | - | 138 | 164 | 302 | - | - |
| Total | $ 1,514 | 104 | 357 | 1,975 | 322,229 | 324,204 | 1,954 | - |

**Impaired Loans (in thousands)**
**December 31, 2019**

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| Loans with no related allowance recorded: | | | | | |
| Residential real estate: | | | | | |
| Construction | $ - | - | - | - | - |
| Owner occupied | - | - | - | - | - |
| Non-owner occupied | - | - | - | - | - |
| Commercial real estate: | | | | | |
| Construction | - | - | - | - | - |
| Farmland | - | - | - | - | - |
| Nonfarm | - | - | - | 178 | - |
| Commercial and industrial | 2,062 | 2,062 | - | 1,730 | - |
| Consumer | - | - | - | - | - |
| Other | - | - | - | - | - |
| | $ 2,062 | 2,062 | - | | - |
| Loans with an allowance recorded: | | | | | |
| Residential real estate: | | | | | |
| Construction | $ - | - | - | - | - |
| Owner occupied | 65 | 89 | 24 | 66 | - |
| Non-owner occupied | - | - | - | - | - |
| Commercial real estate: | | | | | |
| Construction | - | - | - | - | - |
| Farmland | - | - | - | - | - |
| Nonfarm | 211 | 317 | 106 | 203 | - |
| Commercial and industrial | 242 | 259 | 17 | 251 | - |
| Consumer | - | - | - | - | - |
| Other | - | - | - | - | - |
| | $ 518 | 665 | 147 | | - |
| Total: | | | | | |
| Residential real estate: | | | | | |
| Construction | $ - | - | - | | - |
| Owner occupied | 65 | 89 | 24 | | - |
| Non-owner occupied | - | - | - | | - |
| Commercial real estate: | | | | | |
| Construction | - | - | - | | - |
| Farmland | - | - | - | | - |
| Nonfarm | 211 | 317 | 106 | | - |
| Commercial and industrial | 2,304 | 2,321 | 17 | | - |
| Consumer | - | - | - | | - |
| Other | - | - | - | | - |
| | $ 2,580 | 2,727 | 147 | | - |

**Impaired Loans (in thousands)**
**December 31, 2018**

| | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| Loans with no related allowance recorded: | | | | | |
| Residential real estate: | | | | | |
| Construction | $ - | - | - | - | - |
| Owner occupied | - | - | - | - | - |
| Non-owner occupied | - | - | - | - | - |
| Commercial real estate: | | | | | |
| Construction | - | - | - | - | - |
| Farmland | - | - | - | - | - |
| Nonfarm | 356 | 356 | - | 353 | - |
| Commercial and industrial | 1,656 | 1,656 | - | 828 | - |
| Consumer | - | - | - | - | - |
| Other | - | - | - | - | - |
| | $ 2,012 | 2,012 | - | | - |
| Loans with an allowance recorded: | | | | | |
| Residential real estate: | | | | | |
| Construction | $ - | - | - | - | - |
| Owner occupied | 67 | 101 | 34 | 69 | - |
| Non-owner occupied | - | - | - | - | - |
| Commercial real estate: | | | | | |
| Construction | - | - | - | - | - |
| Farmland | - | - | - | - | - |
| Nonfarm | 195 | 313 | 118 | 157 | - |
| Commercial and industrial | - | - | - | - | - |
| Consumer | - | - | - | - | - |
| Other | - | - | - | - | - |
| | $ 262 | 414 | 152 | | - |
| Total: | | | | | |
| Residential real estate: | | | | | |
| Construction | $ - | - | - | | - |
| Owner occupied | 67 | 101 | 34 | | - |
| Non-owner occupied | - | - | - | | - |
| Commercial real estate: | | | | | |
| Construction | - | - | - | | - |
| Farmland | - | - | - | | - |
| Nonfarm | 551 | 669 | 118 | | - |
| Commercial and industrial | 1,656 | 1,656 | - | | - |
| Consumer | - | - | - | | - |
| Other | - | - | - | | - |
| | $ 2,274 | 2,426 | 152 | | - |

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality. For purposes of this disclosure, the unpaid principal balance is not reduced for partial charge-offs. There were no outstanding commitments to lend additional amounts to borrowers who have impaired loans at December 31, 2019.

**Troubled Debt Restructurings**

If a borrower is experiencing financial difficulty, the Bank may consider, in certain circumstances, modifying the terms of their loan in a troubled debt restructuring (TDR) to maximize collection of amounts due. Within each of the Company's loan classes, TDRs typically involve either a reduction of the stated interest rate of the loan or an extension of the loan's maturity date(s) with a stated rate lower than the current market rate for a new loan with similar risk. Modifying the terms of loans may result in an increase or decrease to the allowance for loan loss (ALLL) depending upon the terms modified, the method used to measure the ALLL for a loan prior to modification, and whether any charge-offs were recorded on the loan before or at the time of modification.

The following table provides a summary of loans modified in a TDR during the year:

| | Number of Contracts | Pre-Modification Outstanding Recorded Investment | Post-Modification Outstanding Recorded Investment | Effect on ALLL upon Modification |
|---|---|---|---|---|
| | | (Dollars in thousands) | | |
| December 31, 2019: | | | | |
| Troubled Debt Restructurings | | | | |
| Residential real estate: | | | | |
| Owner occupied | 1 | $ 78 | 101 | - |
| December 31, 2018: | | | | |
| Troubled Debt Restructurings | | | | |
| Residential real estate: | | | | |
| Owner occupied | 2 | $ 96 | 93 | - |
| Commercial real estate: | | | | |
| Nonfarm | 1 | $ 259 | 259 | - |
| | | $ 355 | 352 | - |

The troubled debt restructured loan shown in the table was modified during 2019 with a lower interest rate and longer repayment terms.

At December 31, 2019 and 2018, the Bank had a recorded investment of $805,318 and $778,523 in TDRs, respectively. The Bank has not committed lend additional amounts to these borrowers. There were no troubled debt restructurings that subsequently defaulted as of December 31, 2019 and 2018, respectively.

At December 31, 2019 and 2018, $132,674 and $101,538, respectively, of overdrafts on deposit accounts have been reclassified and included in the loan receivable balance.

**Loan Servicing**

Mortgage loans the Bank services for others are not included in the accompanying consolidated financial statements. The Bank sells loans in the secondary market under terms of a Mortgage Purchase Program ("MPP") with the Federal Home Loan Bank ("FHLB") – Cincinnati and the Federal Home Loan Mortgage Corporation. The unpaid principal balance of loans serviced for others, including loan participations, as of December 31, 2019 and 2018 was $105,627,695 and $102,630,655, respectively. Custodial escrow balances maintained in connection with serviced loans (both sold and retained) were $839,102 and $838,791, respectively.

The following is an analysis of the activity of mortgage servicing rights for the years December 31, 2019 and 2018:

| | 2019 | 2018 |
|---|---|---|
| Balance, beginning of the year | $ 593,972 | 604,345 |
| Additions, net | 164,424 | 106,038 |
| Amortization | (146,062) | (116,411) |
| Balance, end of the year | $ 612,334 | 593,972 |

No impairment has been identified on the mortgage servicing assets and correspondingly, no valuation allowance has been recognized as of December 31, 2019 and 2018. The Bank recorded gains from sales of mortgage loans including associated servicing rights of $332,676 and $261,641 during 2019 and 2018, respectively. These gains are recorded in gain on sale of loans on the consolidated financial statements.

Under terms of the Mortgage Purchase Program, a fixed Lender Risk Account (LRA) is established and is maintained by the FHLB on behalf of the Bank and other members selling mortgages in an aggregated pool to the FHLB - Cincinnati. The Bank had on deposit in LRA with the FHLB - Cincinnati $483,921 and $502,329 at December 31, 2019 and 2018, respectively. These accounts are held by the FHLB and the Bank bears the risk of receiving less than 100% of its LRA contribution in the event of losses, either by the Bank or other members selling mortgages in the aggregated pool. If losses incurred in the pool are greater than the Bank's LRA contribution, such losses will be deducted from the LRA contribution of other members. Any portion of the LRA not used to pay losses will be released over a thirty-year period starting five years after the initial pool period. The Bank included income (expense) of $63,063 and $(6,759) in other income on the statements of operations during the fiscal years ended December 31, 2019 and 2018, respectively. The LRA balance included in other assets on the balance sheets is $306,000 and $284,000 estimated at December 31, 2019 and 2018, respectively. These amounts represent present values of the estimated future cash flows. Unless the Bank is required to repurchase a loan because it did not meet the criteria under the representations and warranties to be covered as part of the aggregated pool, the credit risk on these loans is limited to the amount provided in the LRA.

## 4. REAL ESTATE ACQUIRED THROUGH FORECLOSURE:

The Bank had $95,600 and $0 in real estate held for sale at December 31, 2019 and 2018, respectively. During 2019 and 2018, there were $59,582 and $46,825, respectively, in foreclosure losses charged-off to the allowance for loan losses. The Bank realized $10,074 of related losses and $8,131 of related gains on disposal of foreclosed real estate during 2019 and 2018, respectively. Other real estate owned expenses recognized in other expenses during 2019 and 2018 were immaterial to consolidated financial statements.

## 5. PREMISES AND EQUIPMENT:

Premises and equipment at December 31 consist of the following (in thousands):

| | 2019 | 2018 |
|---|---|---|
| Land | $ 2,918 | 2,918 |
| Buildings | 8,885 | 8,196 |
| Equipment | 4,978 | 4,493 |
| Total | 16,781 | 15,607 |
| Accumulated depreciation | (6,560) | (5,978) |
| | $ 10,221 | 9,629 |

## 6. DEPOSITS:

At December 31, 2019, the scheduled maturity of time deposits is as follows (in thousands):

| | |
|---|---|
| Under one year | $ 64,646 |
| One to three years | 40,939 |
| Three to five years | 23,334 |
| More than five years | 167 |
| | $ 129,086 |

Total non-interest bearing deposits were $66,229,680 and $59,426,401 at December 31, 2019 and 2018, respectively.

Time deposits of $250,000 or more were approximately $18,785,909 and $7,093,541 at December 31, 2019 and 2018, respectively.

## 7. BROKERED DEPOSITS:

The Bank is a network participant in the Certificate of Deposit Account Registry Service (CDARS) network. As part of this network and participation in the CDARS reciprocal program, the Bank can accept FDIC insured deposits as a broker for customers up to $500 million. This program allows the Bank to accept deposits on the customers' behalf, place them in the CDARS program, and receive matching reciprocal funds from the CDARS network. At December 31, 2019 and 2018, the Bank had received approximately $12,548,000 and $14,953,000, respectively, in deposits on behalf of customers and received matching reciprocal funds in the same amount under the CDARS program.

The Bank is a network participant in the Insured Cash Sweep (ICS) network. As part of this network and participation in the ICS reciprocal program, the Bank can accept FDIC insured deposits as a broker for customers with multi-million dollar savings accounts. This program allows the Bank to accept deposits on the customers' behalf, place them in the ICS program, and receive matching reciprocal funds from the ICS network. At December 31, 2019 and 2018, the Bank had received approximately $2,479,000 and $27,904,000, respectively, in deposits on behalf of customers and received matching reciprocal funds in the same amount under the ICS program.

## 9. FEDERAL HOME LOAN BANK ADVANCES:

The Bank has fixed-rate advances of $15,250,022 and $5,310,889 at December 31, 2019 and 2018, respectively. The advances mature in various years through 2038. At December 31, 2019 and 2018, interest rates on the fixed rate advances ranged from 1.60% to 2.82%, with a weighted average interest rate on fixed-rate debt of 2.03%.

During 2019, the Bank renewed a "Cash Management Advance" (CMA) credit line with the FHLB to a maximum of $15,000,000. Interest due on advances from the FHLB will be at either a variable rate set daily for 90 days, or a fixed rate for up to 30 days at the Bank's option. There were no amounts outstanding under this agreement at December 31, 2019 and 2018, respectively.

The Bank also holds a letter of credit with FHLB for $10,000,000. A commitment fee is charged as 1.25% of the average available balance each month. There were no draws on the line as of December 31, 2019.

The contractual maturities of the advances by year are as follows (in thousands):

| | |
|---|---|
| 2020 | $ 12 |
| 2021 | 13 |
| 2022 | 13 |
| 2023 | 13 |
| 2024 | 15,013 |
| Thereafter | 186 |
| | $ 15,250 |

As collateral for the FHLB advances and potential advances from the FHLB above, the Bank has pledged residential one-to-four family mortgages equal to 100% of the outstanding balance and its investment in FHLB stock.

## 10. FEDERAL INCOME TAXES:

Federal income tax expense (benefit) consists of the following (in thousands):

| | 2019 | 2018 |
|---|---|---|
| Current | $ 1,166 | 873 |
| Deferred | (98) | (60) |
| Total | $ 1,068 | 813 |

The effective tax rate varies from the federal statutory tax rate primarily due to the following (in thousands):

| | 2019 | 2018 |
|---|---|---|
| Federal income taxes computed at statutory rates | $ 1,346 | 1,197 |
| Increase (decrease) in taxes resulting from: | | |
| Tax exempt interest | (244) | (346) |
| Bank owned life insurance earnings | (31) | (33) |
| Other | (3) | (5) |
| Total | $ 1,068 | 813 |

The net deferred tax asset is recorded in other assets on the consolidated balance sheet at December 31, 2019 and 2018 and consists of the following (in thousands):

| | 2019 | 2018 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ 817 | 713 |
| Nonaccrual interest | 22 | 16 |
| Intangibles | 415 | 437 |
| Net unrealized holding losses on securities | - | 596 |
| Deferred tax assets | 1,254 | 1,762 |
| Deferred tax liabilities: | | |
| Net unrealized holding gains on securities | (314) | - |
| Property and equipment | (209) | (170) |
| FHLB stock dividends | (11) | (11) |
| Mortgage servicing rights | (154) | (139) |
| Other | (94) | (171) |
| Deferred tax liabilities | (782) | (491) |
| Net deferred tax asset | $ 472 | 1,271 |

## 11. RETIREMENT PLAN:

The Bank has a 401(k) plan that covers all employees who have completed one year of service and reached a minimum age of 21 years old. The Bank may make discretionary contributions, and contributed \$227,553 and \$206,208 to the plan during each of the years ended December 31, 2019 and 2018, respectively.

## 12. COMMITMENTS AND CONTINGENT LIABILITIES:

In the normal course of business, the Bank has outstanding various commitments to extend credit. At December 31, 2019 and 2018, the Bank had approximately \$33,827,000 and \$33,504,000, respectively, of such commitments, all of which were at variable rates of interest. Commitments to extend credit are agreements to lend. No material losses or liquidity demands are anticipated as a result of these commitments. The Bank had no standby letters of credit outstanding at December 31, 2019 and 2018. The Bank evaluates each customer's creditworthiness on a case-by-case basis in accordance with the Bank's credit policies. The amount of collateral obtained, if deemed necessary by the Bank upon extension of credit, is based upon management's credit evaluation of the customer. Collateral held varies but may include business assets of commercial borrowers as well as personal property and real estate of individual borrowers or guarantors.

The Bank grants agri-business, commercial, residential and installment loans to customers in the surrounding areas of its offices. Although the Bank has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their commitments is dependent upon the local economic sector. As of December 31, 2019, the Bank had \$26,858,986 of loans outstanding for agricultural purposes, or secured by agricultural property.

## 13. RELATED PARTY TRANSACTIONS:

Directors, officers and certain related parties had loans outstanding during the years ended December 31, 2019 and 2018. This amount includes unused lines of credit. The directors and officers mentioned above were customers in the ordinary course of business. Additional transactions may be expected in the ordinary course of business in the future. All outstanding loans were made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with others and did not involve more than a normal risk of collectability or present other unfavorable features.

The following is an analysis of the activity of such loans for the years indicated (in thousands):

| | 2019 | 2018 |
|---|---|---|
| Balance, beginning of year | $ 3,284 | 3,093 |
| Origination of loan participation | - | 503 |
| Loans originated | 83 | 8 |
| Repayments | (515) | (320) |
| New Directors/Officers | 395 | - |
| Balance, end of year | $ 3,247 | 3,284 |

The Bank held deposits for directors, officers and certain related parties of $4,093,658 and $4,200,472 at December 31, 2019 and 2018, respectively.

## 14. FAIR VALUE:

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

- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities the Bank has the ability to access.

- Level 2 inputs are significant other observable inputs other than Level 1 prices such as quote prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

- Level 3 are unobservable inputs for the asset or liability and rely on management's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

The following methods and assumptions were used by the Bank in estimating the fair value disclosures for financial instruments:

**Investment securities**
The fair values of available-for-sale securities are determined by various valuation methodologies. Where quoted market prices are available in an active market, securities are classified within Level 1. Level 1 securities include U.S. Treasuries and exchange-traded equity securities. For securities traded in secondary markets for which quoted market prices are not available, the fair values are estimated by using pricing models or quoted prices of securities with similar characteristics. Level 2 securities include obligations of U.S. government corporations and agencies, mortgage-backed securities, certificates of deposit, collateralized mortgage obligations and other securities. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy.

**Loans held-for-sale**
These loans are carried at the lower of cost or fair value, which is evaluated on a pool-level basis. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors.

**Impaired loans**
Loans for which it is probable that the Bank will not collect all principal and interest due according to contractual terms are measured for impairment. Allowable methods for estimating fair value include using the fair value of the collateral for collateral dependent loans or, where a loan is determined not to be collateral dependent, using the discounted cash flow method.

**Mortgage servicing rights**
Mortgage servicing rights are evaluated annually for impairment based upon the fair value of the rights as compared to carrying amount. If the carrying amount of an individual tranche exceeds fair value, impairment is recorded on that tranche so that the servicing asset is carried at fair value. Fair value is determined at a tranche level, based on market prices for comparable mortgage servicing contracts (Level 2), when available, or alternatively based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model utilizes interest rate, prepayment speed, and default rate assumptions that market participants would use in estimating future net servicing income and that can be validated against available market data.

**Other real estate owned**
Real estate acquired through foreclosure assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price, the Bank records the foreclosed asset as nonrecurring Level 2.

Fair value measurements for certain assets and liabilities measured at fair value on a recurring basis (in thousands):

| | Total | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant other observable inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2019: | | | | |
| Mortgage-backed securities | $ 52,226 | - | 52,226 | - |
| State and political subdivisions | 64,250 | - | 64,250 | - |
| Other equity securities | 64 | - | 64 | - |
| December 31, 2018: | | | | |
| Mortgage-backed securities | $ 42,049 | - | 42,049 | - |
| U.S. Treasuries | 1,490 | 1,490 | - | - |
| State and political subdivisions | 53,354 | - | 53,354 | - |
| Other equity securities | 56 | - | 56 | - |

Fair value measurements for certain assets and liabilities measured at fair value on a non-recurring basis (in thousands):

| | Total | Quoted prices in active markets for identical assets (Level 1) | Significant other observable inputs (Level 2) | Significant other observable inputs (Level 3) |
|---|---|---|---|---|
| December 31, 2019: | | | | |
| Impaired loans | $ 2,580 | - | 2,580 | - |
| Real estate owned | 96 | - | 96 | - |
| Mortgage servicing rights | 612 | - | 612 | - |
| Fixed lender risk account | 306 | - | 306 | - |
| December 31, 2018: | | | | |
| Impaired loans | $ 2,274 | - | 2,274 | - |
| Loans held-for-sale | 986 | - | 986 | - |
| Mortgage servicing rights | 594 | - | 594 | - |
| Fixed lender risk account | 284 | - | 284 | - |

In accordance with accounting standards for financial instruments where quoted market prices are not available, fair values are estimated using present value or other valuation methods.

**16. REGULATORY MATTERS:**

Banks and holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. The net unrealized gain or loss on available for sale for securities is not included in computing regulatory capital. Management believes as of December 31, 2019, the Bank meets all capital adequacy requirements to which they are subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as in asset growth and expansion, and capital restoration plans are required. At year-end 2019 and 2018, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the institution’s category.

The Company's and the Bank's actual capital amounts and ratios as of December 31, 2019 and 2018 are presented in the table below (dollars in thousands):

| December 31, 2019: | Actual | | Minimum Capital Requirement | | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total capital to risk-weighted assets: | | | | | | |
| Consolidated | $ 55,531 | 16.9% | $ 26,221 | 8.0% | N/A | |
| Bank | 54,879 | 15.6% | 28,071 | 8.0% | $ 35,088 | 10.0% |
| Tier I (Core) capital to risk-weighted assets: | | | | | | |
| Consolidated | 51,144 | 15.6% | 19,665 | 6.0% | N/A | |
| Bank | 50,492 | 14.4% | 21,053 | 6.0% | 28,071 | 8.0% |
| Tier I capital (to average assets) | | | | | | |
| Consolidated | 51,144 | 10.1% | 20,185 | 4.0% | N/A | |
| Bank | 50,492 | 10.1% | 20,034 | 4.0% | 25,042 | 5.0% |
| Tangible capital (to risk-weighted assets) | | | | | | |
| Consolidated | 51,144 | 15.6% | 14,749 | 4.5% | N/A | |
| Bank | 50,492 | 14.4% | 15,790 | 4.5% | 22,807 | 6.5% |

| December 31, 2018: | Actual | | Minimum Capital Requirement | | Minimum to Be Well Capitalized Under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| Total capital (to risk-weighted assets: | | | | | | |
| Consolidated | $ 50,667 | 16.1% | $ 25,112 | 8.0% | N/A | |
| Bank | 50,006 | 15.0% | 26,616 | 8.0% | $ 33,270 | 10.0% |
| Tier I (Core) capital to risk-weighted assets: | | | | | | |
| Consolidated | 42,134 | 13.4% | 18,834 | 6.0% | N/A | |
| Bank | 45,959 | 13.8% | 19,962 | 6.0% | 26,616 | 8.0% |
| Tier I capital (to average assets) | | | | | | |
| Consolidated | 42,134 | 8.9% | 18,857 | 4.0% | N/A | |
| Bank | 45,959 | 9.8% | 18,683 | 4.0% | 23,353 | 5.0% |
| Tangible capital (to risk-weighted assets) | | | | | | |
| Consolidated | 42,134 | 13.4% | 14,126 | 4.5% | N/A | |
| Bank | 45,959 | 13.8% | 14,972 | 4.5% | 21,626 | 6.5% |

**Dividend restrictions**
All State of Ohio Chartered Banks are subject to the dividend restrictions set forth by the State of Ohio. Under such restrictions, the Bank may not, without the prior approval of the Superintendent of Banks of the State of Ohio, declare dividends in excess of the sum of the current year's earnings (as defined) plus the retained earnings (as defined) from the prior two years. The dividends, as of December 31, 2019 and 2018, that the Bank could declare, without the approval of the Superintendent of Banks of the State of Ohio, amounted to approximately $17,640,000 and $16,164,000, respectively.

## 17. REVENUE FROM CONTRACTS WITH CUSTOMERS:

The Bank's revenue from contracts with customers in the scope of ASC 606 is recognized within Other income (loss). The following table presents the Bank's sources of non-interest income for the twelve months ended December 31, 2019 and 2018. Items outside the scope of ASC 606 are noted as such.

| | 2019 | 2018 |
|---|---|---|
| Other income (loss): | | |
| (Loss) gain on sale of other real estate owned | $ (10,074) | 8,131 |
| Service charges on deposit accounts | 1,328,104 | 1,235,214 |
| ATM service charges and other fees, net | 1,108,989 | 952,028 |
| | $ 2,427,019 | 2,195,373 |

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

(Loss) gain on sale of other real estate owned - the Bank 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 Bank finances the sale of other real estate owned to the buyer, the Bank 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 or loss on the sale is recorded upon transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Bank adjusts the transaction price and related gain or loss on sale if a significant financing component is present.

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

ATM Service charges and other fees, net - The Bank earns fees from cardholder transactions conducted through debit cards and the ATM network. Fees from cardholder transactions are recognized concurrent with the transaction processing services provided to the cardholder. Income is presented on the Consolidated Statements of Income net of expenses. Other income (loss) includes other recurring revenue streams such as wire transaction fees, safe deposit rental income, insurance commissions, and merchant referral income. Transaction fees primarily include check printing sales commissions, collection fees and wire transfer fees which arise from in-branch transactions. Safe deposit rental income arises from fees charged to the customer on an annual basis and recognized upon receipt of payment. Insurance commissions are agent commissions earned by the Bank upon the effective date of the coverage. Revenue is recognized at the point in time when the transaction occurs.

## 18. CONDENSED FINANCIAL STATEMENTS OF FIRST STATE BANCORP (PARENT COMPANY ONLY):

The following condensed financial information comprising the financial position, results of operations and cash of flows of First State Bancorp, Inc. as of and for years ended, December 31, 2019 and 2018, respectively:

**Condensed Balance Sheets**

| | 2019 | 2018 |
|---|---|---|
| Assets: | | |
| Cash and cash equivalents | $ 586,709 | 595,700 |
| Investment in First State Bank | 52,355,145 | 48,112,928 |
| Other assets | 65,000 | 65,000 |
| Total assets | $ 53,006,854 | 48,773,628 |
| Shareholders' Equity: | | |
| Capital stock | $ 5,178,533 | 5,178,533 |
| Additional paid-in capital | 1,800,000 | 1,800,000 |
| Retained earnings | 46,028,321 | 41,795,095 |
| Total shareholders' equity | 53,006,854 | 48,773,628 |
| Total liabilities and shareholders' equity | $ 53,006,854 | 48,773,628 |

**Condensed Statements of Income**

| | 2019 | 2018 |
|---|---|---|
| Interest and dividend income | $ 1,108,741 | 982,049 |
| General and administrative expenses | (8,991) | (10,250) |
| | 1,099,750 | 971,799 |
| Equity in earnings of First State Bank | 4,242,217 | 3,913,759 |
| Net income | $ 5,341,967 | 4,885,558 |

**Condensed Statements of Cash Flows**

| | 2019 | 2018 |
|---|---|---|
| Operating activities: | | |
| Net income | $ 5,341,967 | 4,885,558 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Equity in undistributed earnings of subsidiary | (4,242,217) | (3,913,759) |
| Change in assets and liabilities: | | |
| Accrued expenses | - | (2,500) |
| | 1,099,750 | 969,299 |
| Financing activities: | | |
| Cash dividends paid | (1,108,741) | (982,049) |
| Net change in cash | (8,991) | (12,750) |
| Cash – beginning of year | 595,700 | 608,450 |
| Cash – end of year | $ 586,709 | 595,700 |

First State BANK You're at home with us!

# Banking Center Locations

**Fayetteville**
513.875.8151

**Georgetown**
937.378.2595

**Hillsboro**
937.393.9170

**Manchester**
937.549.2621

**Mt. Orab**
937.444.2380

**Peebles**
937.587.6191

**Ripley**
937.392.4349

**Seaman**
937.386.2525

**St. Bernard**
513.641.1765

**Washington Court House**
740.335.3771

**West Union**
937.544.5252

**Wilmington**
937.382.1057

**Winchester**
937.695.0331



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