



*2018 Annual Report*



**Independent Auditor's Report**

To the Board of Directors  
Bank of Botetourt  
Buchanan, Virginia

We have audited the accompanying consolidated financial statements of Bank of Botetourt and subsidiary which comprise the consolidated balance sheets as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements.

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

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

**Auditor's Responsibility**

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

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

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

**Opinion**

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

*Campbell & Lineberry, PC*

Roanoke, Virginia  
February 26, 2019

# Consolidated Balance Sheets

December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
<b>Assets</b>		
Cash and due from banks	\$ 7,385,958	\$ 6,535,297
Interest-bearing deposits with banks	5,533,852	314,101
Federal funds sold	486,000	-
Total cash and cash equivalents	13,405,810	6,849,398
Time deposits with banks	250,000	450,000
Investment securities available for sale	16,061,304	18,610,702
Restricted equity securities	399,801	617,501
Loans held for sale	316,721	453,287
Loans, net of allowance for loan losses of \$3,393,168 in 2018 and \$3,142,404 in 2017	380,403,793	337,665,197
Property and equipment, net	11,901,381	11,462,988
Accrued income	1,184,005	1,039,097
Foreclosed assets	4,230,724	3,634,555
Other assets	6,610,743	6,953,491
Total assets	<u>\$ 434,764,282</u>	<u>\$ 387,736,216</u>
<b>Liabilities and Stockholders' Equity</b>		
<b>Liabilities</b>		
Noninterest-bearing deposits	\$ 42,609,701	\$ 40,000,956
Interest-bearing deposits	342,704,290	300,999,123
Total deposits	385,313,991	341,000,079
Federal funds purchased	-	2,103,000
Other borrowings	-	6,000,000
Accrued interest payable	464,878	251,450
Other liabilities	2,720,425	3,365,467
Total liabilities	<u>388,499,294</u>	<u>352,719,996</u>
Commitments and contingencies	-	-
<b>Stockholders' equity</b>		
Common stock, \$1.50 par value; 2,500,000 shares authorized; 1,713,664 and 1,431,764 shares issued and outstanding in 2018 and 2017, respectively	2,570,496	2,147,646
Additional paid-in capital	11,168,057	3,791,803
Retained earnings	33,315,439	29,876,252
Accumulated other comprehensive loss	(789,004)	(799,481)
Total stockholders' equity	<u>46,264,988</u>	<u>35,016,220</u>
Total liabilities and stockholders' equity	<u>\$ 434,764,282</u>	<u>\$ 387,736,216</u>

# Consolidated Statements of Income

Years ended December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
<b>Interest income</b>		
Loans and fees on loans	\$ 17,859,600	\$ 15,354,813
Federal funds sold	4,676	2,263
Investment securities:		
Taxable	323,607	316,801
Exempt from federal income tax	33,312	41,154
Dividend income	26,673	17,289
Deposits with banks	192,806	115,653
Total interest income	<u>18,440,674</u>	<u>15,847,973</u>
<b>Interest expense</b>		
Deposits	3,173,883	2,235,751
Federal funds purchased	2,033	3,133
Other borrowings	12,817	13,421
Total interest expense	<u>3,188,733</u>	<u>2,252,305</u>
Net interest income	15,251,941	13,595,668
<b>Provision for loan losses</b>	470,000	450,000
Net interest income after provision for loan losses	<u>14,781,941</u>	<u>13,145,668</u>
<b>Noninterest income</b>		
Service charges on deposit accounts	743,183	628,389
ATM and debit card	935,269	865,995
Other service charges and fees	340,933	323,261
Mortgage origination fees	758,371	851,950
Commissions on title services	173,367	122,007
Net gain on sale of property and equipment	-	-
Other income	562,942	463,445
Total noninterest income	<u>3,514,065</u>	<u>3,255,047</u>
<b>Noninterest expense</b>		
Salaries and employee benefits	6,112,110	6,063,844
Occupancy	766,385	723,941
Equipment	760,069	708,127
Foreclosed assets, net	440,265	832,069
Outside services	1,236,527	1,187,291
FDIC insurance premiums and assessment	313,600	253,178
ATM and debit card	660,060	560,536
Franchise tax	232,712	226,585
Telephone and communication	260,875	233,484
Other professional fees	239,741	112,442
Marketing	375,686	396,049
Other operating expenses	1,649,794	1,612,776
Total noninterest expense	<u>13,047,824</u>	<u>12,910,322</u>
Income before income taxes	5,248,182	3,490,393
<b>Income tax expense</b>	948,668	1,212,218
Net income	<u>\$ 4,299,514</u>	<u>\$ 2,278,175</u>
<b>Basic earnings per share</b>	<u>\$ 2.98</u>	<u>\$ 1.60</u>
<b>Diluted earnings per share</b>	<u>\$ 2.98</u>	<u>\$ 1.60</u>
<b>Basic weighted average shares outstanding</b>	<u>1,445,176</u>	<u>1,428,547</u>
<b>Diluted weighted average shares outstanding</b>	<u>1,445,176</u>	<u>1,428,547</u>

See Notes to Consolidated Financial Statements

## Consolidated Statements of Comprehensive Income

Years ended December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
Net income	\$ 4,299,514	\$ 2,278,175
Other comprehensive income (loss):		
Unrealized losses on investment securities available for sale	(48,846)	(100,464)
Tax benefit related to unrealized losses on investment securities	10,258	21,097
Reclassification adjustment tax reform impact on available for sale securities	-	8,862
Pension plan adjustment	45,925	(211,414)
Tax benefit related to pension plan adjustment	(9,644)	(51,476)
Post-retirement health plan adjustment	16,182	10,631
Tax expense related to post-retirement health plan adjustment	(3,398)	(7,620)
Total other comprehensive income (loss)	<u>10,477</u>	<u>(330,384)</u>
Total comprehensive income	<u>\$ 4,309,991</u>	<u>\$ 1,947,791</u>

# Consolidated Statements of Changes in Stockholders' Equity

Years ended December 31, 2018 and 2017

	Common Stock		Paid-In	Retained	Accumulated Other Comprehensive Income	
	Shares	Amount	Capital	Earnings	(Loss)	Total
<b>Balance, December 31, 2016</b>	1,425,215	\$ 2,137,822	\$ 3,660,375	\$ 28,397,618	\$ (469,097)	\$ 33,726,718
Net income	-	-	-	2,278,175	-	2,278,175
Changes in other comprehensive loss					(330,384)	(330,384)
Total comprehensive income						1,947,791
Dividends declared	-	-	-	(799,541)	-	(799,541)
Stock issued under Dividend Reinvestment Plan	6,549	9,824	131,428	-	-	141,252
<b>Balance, December 31, 2017</b>	1,431,764	2,147,646	3,791,803	29,876,252	(799,481)	35,016,220
Net income	-	-	-	4,299,514	-	4,299,514
Changes in other comprehensive loss					10,477	10,477
Total comprehensive income						4,309,991
Dividends declared	-	-	-	(860,327)	-	(860,327)
Stock issued under Common Stock Offering	275,000	412,500	7,191,164	-	-	7,603,664
Stock issued under Dividend Reinvestment Plan	6,900	10,350	185,090	-	-	195,440
<b>Balance, December 31, 2018</b>	<u>1,713,664</u>	<u>\$ 2,570,496</u>	<u>\$ 11,168,057</u>	<u>\$ 33,315,439</u>	<u>\$ (789,004)</u>	<u>\$ 46,264,988</u>

# Consolidated Statements of Cash Flows

Years ended December 31, 2018 and 2017

	<u>2018</u>	<u>2017</u>
<b><i>Cash flows from operating activities</i></b>		
Net income	\$ 4,299,514	\$ 2,278,175
Adjustments to reconcile net income		
to net cash provided by operations:		
Depreciation and amortization	785,739	789,661
Net amortization of securities premiums	552	2,264
Provision for loan losses	470,000	450,000
Deferred income taxes	(5,136)	359,661
Net realized loss on sales of assets	76,714	14,415
Net write downs of foreclosed assets	283,751	803,749
Increase in cash surrender value of life insurance	(87,441)	(76,554)
Changes in assets and liabilities:		
Loans held for sale	136,566	(319,880)
Accrued income	(144,908)	(91,261)
Other assets	331,111	(1,090,208)
Accrued interest payable	213,428	6,479
Other liabilities	(572,677)	694,180
Net cash provided by operating activities	<u>5,787,213</u>	<u>3,820,681</u>
<b><i>Cash flows from investing activities</i></b>		
Purchases of investment securities – available for sale	(1,000,000)	(2,495,855)
Purchases of restricted equity securities	(37,300)	(277,000)
Maturities of investment securities – available for sale	3,500,000	1,960,000
Redemption of restricted equity securities	255,000	-
Purchase of bank owned life insurance	-	(1,000,000)
Net decrease in time deposits with banks	200,000	-
Net increase in loans	(44,510,941)	(51,121,592)
Purchases of property and equipment	(1,133,960)	(234,763)
Proceeds from sales of property and equipment	7,000	-
Proceeds from sales of foreclosed assets	339,711	1,637,894
Net cash used in investing activities	<u>(42,380,490)</u>	<u>(51,531,316)</u>
<b><i>Cash flows from financing activities</i></b>		
Net increase in noninterest-bearing deposits	2,608,745	6,951,460
Net increase in interest-bearing deposits	41,705,167	24,185,913
Net increase (decrease) in borrowings	(6,000,000)	6,000,000
Net increase (decrease) in federal funds purchased	(2,103,000)	2,103,000
Proceeds from common stock issued	7,799,104	141,252
Dividends paid	(860,327)	(799,541)
Net cash provided by financing activities	<u>43,149,689</u>	<u>38,582,084</u>
Net increase (decrease) in cash and cash equivalents	6,556,412	(9,128,551)
<b><i>Cash and cash equivalents, beginning</i></b>	<u>6,849,398</u>	<u>15,977,949</u>
<b><i>Cash and cash equivalents, ending</i></b>	<u>\$ 13,405,810</u>	<u>\$ 6,849,398</u>
<b><i>Supplemental disclosure of cash flow information:</i></b>		
Interest paid	<u>\$ 2,977,420</u>	<u>\$ 2,243,711</u>
Taxes paid	<u>\$ 1,247,000</u>	<u>\$ 972,000</u>
<b><i>Supplemental disclosure of noncash activities:</i></b>		
Foreclosed assets acquired in settlement of loans	<u>\$ 1,362,345</u>	<u>\$ 2,499,307</u>
Loans originated to finance the sale of foreclosed assets	<u>\$ 60,000</u>	<u>\$ 76,475</u>



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# Notes to Consolidated Financial Statements

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## **Note 1. Organization and Summary of Significant Accounting Policies**

### ***Organization***

Bank of Botetourt (the “Bank”) is a Virginia state-chartered bank subject to regulation by the Virginia Bureau of Financial Institutions and the Federal Deposit Insurance Corporation. The Bank provides full banking services through twelve branch offices in Botetourt, Roanoke, Rockbridge, and Franklin counties and the City of Salem, all in Virginia. The Bank uses two “trading as” names, registered with the State Corporation Commission, for market branding purposes. Virginia Mountain Mortgage is advertised for secondary market mortgage banking activities and Botetourt Wealth Management is advertised for non-FDIC insured investment products. The Bank has a wholly-owned subsidiary, Buchanan Service Corporation, which conducts its operations through an interest in an insurance company and two title insurance companies.

The accounting and reporting policies of the Bank and Buchanan Service Corporation follow generally accepted accounting principles (“GAAP”) and general practices of the financial services industry, within the Financial Accounting Standards Board’s (“FASB”) Accounting Standards Codification (“ASC”) structure of authoritative literature. Following is a summary of the more significant policies.

### ***Critical Accounting Policy***

Management believes the policy with respect to the methodology for the determination of the allowance for loan losses involves a high degree of complexity. Management must make difficult and subjective judgments which often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. This critical policy and its application are periodically reviewed with the Audit Committee and Board of Directors.

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

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

### ***Business Segments***

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

### ***Cash and Cash Equivalents***

For the purpose of presentation in the Consolidated Statements of Cash Flows, cash and cash equivalents are defined as those amounts included in the balance sheet captions “Cash and due from banks”, “Interest-bearing deposits with banks”, and “Federal funds sold”.

### ***Use of Estimates***

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

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

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## Notes to Consolidated Financial Statements

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### **Note 1. Organization and Summary of Significant Accounting Policies, continued**

#### ***Use of Estimates, continued***

The majority of the Bank's loan portfolio consists of loans in Botetourt and the adjacent counties of Southwest Virginia. Accordingly, the ultimate collectability of a substantial portion of the Bank's loan portfolio and the recovery of a substantial portion of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions.

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

#### ***Interest-bearing Deposits with Banks***

Interest-bearing deposits with banks are carried at cost.

#### ***Trading Securities***

The Bank does not hold securities for short-term resale and therefore does not maintain a trading securities portfolio.

#### ***Investment Securities***

Debt securities that management has the positive intent and ability to hold to maturity are classified as "held to maturity" and recorded at amortized cost. Securities not classified as held to maturity or trading, including equity securities with readily determinable fair values, are classified as "available for sale" and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Realized gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses, management considers (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Bank to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value.

#### ***Bank Owned Life Insurance***

The cash surrender value of bank owned life insurance is a reasonable estimate of fair value and is included in other assets on the consolidated balance sheet. The cash surrender value of these policies was \$3,314,836 and \$3,227,395 as of December 31, 2018 and 2017, respectively. Any increase in cash surrender value is recorded as other income on the consolidated statement of income. In the event of the death of an insured individual, the Bank would receive the death benefit which would be recorded as other income.

#### ***Loans Held for Sale***

The carrying amount of loans originated and intended for sale in the secondary market are at fair value.

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## Notes to Consolidated Financial Statements

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### Note 1. Organization and Summary of Significant Accounting Policies, continued

#### *Loans Receivable*

Loans receivable that management has the intent and ability to hold for the foreseeable future, or until maturity or pay-off, are reported at their outstanding principal amount adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans.

Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment to the yield on the related loan.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. Management also considers the adequacy of collateral and the state of the collection process. When interest accrual is discontinued, all unpaid accrued interest is reversed. The Bank applies payments received on nonaccrual loans first to outstanding principal, and the residual amount, if any, is applied to interest. When facts, circumstances, and consistent performance indicate the borrower has regained the ability to meet required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

#### *Allowance for Loan Losses*

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio and is based on accounting standards for contingencies and receivables. The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the loan balance is uncollectible. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses consists of specific, general and unallocated components and is evaluated on a regular basis by management.

#### *Property and Equipment*

Land is carried at cost. Buildings and furniture and equipment are carried at cost, less accumulated depreciation and amortization computed principally by the straight-line method over the following estimated useful lives or lease terms:

	<u>Years</u>
Buildings and improvements	7-40
Furniture and equipment	3-10

#### *Foreclosed Assets*

Real estate properties acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at the lower of loan balance or fair value less the cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses during the holding period, gains and losses on sale, and changes in the valuation allowance are included in net expenses from foreclosed assets.

#### *Employee Benefit Plans*

A noncontributory cash balance pension plan (the "Plan") has been provided for all employees who met the eligibility requirements of 21 years of age and one year of service. The formulary contribution allocated annually to each participant's hypothetical cash balance account is based on the ages and years of service of the employee participants. Interest credit is indexed to the 10-year Treasury rate and is guaranteed not to be less than 3% on an annual basis. To maintain the Plan's funding adequacy, the Bank contributes an appropriate amount which is deductible for federal income tax purposes. Benefits under the Plan are accrued by periodic charges to income as determined by the Plan's actuaries. To the extent accumulated Plan assets, including current period cash contributions, are less than projected benefit obligations, the Bank accrues such obligations through either a charge to income or other comprehensive

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## Notes to Consolidated Financial Statements

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### **Note 1. Organization and Summary of Significant Accounting Policies, continued**

#### ***Employee Benefit Plans, continued***

income. To the extent accumulated Plan assets are greater than projected benefit obligations, the Bank records such benefits as a reduction of expense or as other comprehensive income.

The Bank also provides a qualified profit sharing/thrift plan. All eligible employees, age 18 and older, are automatically enrolled to participate, unless they choose to opt-out of the plan, after completing their first six months of service. The Bank expenses its matching portion to the employees' contributions each payroll period.

The Bank sponsors a post-retirement health care plan for certain retired employees. Expenses related to benefits under the plan are shared by the Bank and the retirees monthly. The Bank's monthly portion is expensed to income. To the extent accumulated plan assets, including periodic cash contributions from the Bank and the retirees, are less than the benefit obligations, the Bank accounts for such obligations through either a charge to income or other comprehensive income.

#### ***Marketing, Advertising and Public Relations Expense***

The Bank expenses marketing, advertising and public relations costs as they are incurred.

#### ***Transfers of Financial Assets***

Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Bank, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Bank does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

#### ***Income Taxes***

Provision for income taxes is based on amounts reported in the consolidated statements of income (after exclusion of non-taxable income such as interest on state and municipal securities and loans) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. Deferred tax assets and liabilities are included in the financial statements at currently enacted income tax rates applicable to the period in which the deferred tax assets or liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes.

Deferred income tax liabilities relating to unrealized appreciation (or the deferred tax asset in the case of unrealized depreciation) on investment securities available for sale and the pension plan and post-retirement benefits are recorded in other liabilities (assets). These items are recorded as an adjustment to equity and to other comprehensive income in the financial statements and not included in net income determination until realized. Accordingly, the resulting deferred income tax liabilities or assets are also recorded as an adjustment to equity and to other comprehensive income.

The Bank defers loan fees and costs for financial statement purposes. Current tax regulations suggest that loan fees also be deferred using the effective yield method for income tax purposes. These regulations also suggest that the associated costs, which are primarily employee salaries, be currently deducted. The Bank has chosen to accelerate revenue recognition by including these loan fees in current year income for income tax purposes. As a result of the implementation of disclosure guidance regarding Income Taxes, the Bank has not incurred a tax benefit because the payment of tax on these fees has been accelerated.

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## Notes to Consolidated Financial Statements

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### **Note 1. Organization and Summary of Significant Accounting Policies, continued**

#### ***Income Taxes, continued***

In the event that the Bank has an unrecognized tax benefit in future accounting periods, the Bank will recognize interest accrued related to the benefit in interest expense and penalties in operating expenses. There were no interest or penalties related to an unrecognized tax benefit for the years ended December 31, 2018 and 2017. Because of the impact of deferred tax accounting, other than interest and penalties, the reversal of the above treatment by taxing authorities would not affect the annual effective tax rate but would defer the payment of cash to the taxing authority to later periods.

#### ***Basic and Diluted Earnings per Share***

Basic and diluted earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period. At December 31, 2018 and 2017, the Bank had no potentially dilutive securities outstanding.

#### ***Comprehensive Income (Loss)***

Comprehensive income (loss) reflects the change in the Bank's equity during the year arising from transactions and events other than investments by, and distributions to, stockholders. It consists of net income plus certain other changes in assets and liabilities that are reported as separate components of stockholders' equity rather than as income or expense.

#### ***Financial Instruments***

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

#### ***Fair Value of Financial Instruments***

The Fair Value Measurements and Disclosures topic provides guidance and requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments.

#### ***Revenue Recognition***

The Bank adopted Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers (Topic 606)" as of January 1, 2018. The core principle of the new guidance is that an entity should recognize revenue to reflect the transfer of goods and services to customers in an amount equal to the consideration the entity receives or expects to receive. The scope of the guidance explicitly excludes revenue recognition from net interest income as well as many other revenue streams from financial assets and liabilities including loans, leases, and securities. Accordingly, the accounting policies for the majority of the Bank's revenues were not covered by this ASU. The Bank assessed its revenue contracts related to revenue streams that were within the scope of the standard and the principles of revenue recognition from the ASU are largely consistent with existing guidance and current practices already applied by the Bank. As a result, the adoption of the guidance did not have a material impact on the financial statements.

#### ***Reclassification***

Certain reclassifications have been made to the prior year's financial statements to place them on a comparable basis with the current year. Net income and stockholders' equity previously reported were not affected by these reclassifications.

## Notes to Consolidated Financial Statements

### Note 2. Restrictions on Cash

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. The daily average cash reserve requirement was approximately \$1,050,000 for the periods ending December 31, 2018 and 2017.

### Note 3. Investment Securities

Debt and equity securities have been classified in the consolidated balance sheets according to management's intent. The carrying amount of securities and their approximate fair values at December 31 follow:

	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
<b>2018</b>				
<i>Available for sale:</i>				
Government-sponsored enterprises	\$ 11,997,285	\$ 100	\$ 167,021	\$ 11,830,364
State and municipal securities	2,745,160	15,608	7,381	2,753,387
Corporate securities	1	77,552	-	77,553
Other	<u>1,400,000</u>	<u>-</u>	<u>-</u>	<u>1,400,000</u>
	<u>\$ 16,142,446</u>	<u>\$ 93,260</u>	<u>\$ 174,402</u>	<u>\$ 16,061,304</u>
<b>2017</b>				
<i>Available for sale:</i>				
Government-sponsored enterprises	\$ 14,496,458	\$ -	\$ 184,584	\$ 14,311,874
State and municipal securities	2,746,539	50,181	-	2,796,720
Corporate securities	1	102,107	-	102,108
Other	<u>1,400,000</u>	<u>-</u>	<u>-</u>	<u>1,400,000</u>
	<u>\$ 18,642,998</u>	<u>\$ 152,288</u>	<u>\$ 184,584</u>	<u>\$ 18,610,702</u>

Government-sponsored enterprises, commonly referred to as U.S. Government Agencies, include investments in Federal Farm Credit Banks, Federal Home Loan Banks, Federal Home Loan Mortgage Corporation, and Federal National Mortgage Association bonds.

The Other category represents an investment in subordinated debt offerings of a 501(c)(3) non-profit, non-stock Community Development Financial Institution ("CDFI") dedicated to revitalizing communities, facilitating the creation of jobs, and increasing the amount of affordable housing throughout Virginia and an investment in a subordinated debt offering of a for-profit commercial financial institution.

No investment securities were pledged at December 31, 2018 and 2017.

There was no sale of investments in 2018 or 2017.

## Notes to Consolidated Financial Statements

### Note 3. Investment Securities, continued

The scheduled maturities of securities available for sale at December 31, 2018, are shown below. Actual expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations.

	<b>Available for Sale</b>	
	<b>Amortized Cost</b>	<b>Fair Value</b>
Due in one year or less	\$ 6,225,330	\$ 6,177,874
Due after one year through five years	8,917,115	8,805,878
Due after five years through ten years	1,000,000	1,000,000
Due after ten years	1	77,552
	<u>\$ 16,142,446</u>	<u>\$ 16,061,304</u>

The following tables detail unrealized losses and related fair values in the Bank's investment securities portfolio. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31.

	<b>Less Than 12 Months</b>		<b>12 Months or More</b>		<b>Total</b>	
	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>	<b>Fair Value</b>	<b>Unrealized Losses</b>
<b>2018</b>						
Government-sponsored enterprises	\$ 499,995	\$ 5	\$ 10,830,270	\$ 167,016	\$ 11,330,265	\$ 167,021
State and municipal securities	373,375	816	786,825	6,565	1,160,200	7,381
Corporate securities	-	-	-	-	-	-
Total temporarily impaired securities	<u>\$ 873,370</u>	<u>\$ 821</u>	<u>\$ 11,617,095</u>	<u>\$ 173,581</u>	<u>\$ 12,490,465</u>	<u>\$ 174,402</u>
<b>2017</b>						
Government-sponsored enterprises	\$ 5,915,509	\$ 80,949	\$ 8,396,365	\$ 103,635	\$ 14,311,874	\$ 184,584
State and municipal securities	-	-	-	-	-	-
Corporate securities	-	-	-	-	-	-
Total temporarily impaired securities	<u>\$ 5,915,509</u>	<u>\$ 80,949</u>	<u>\$ 8,396,365</u>	<u>\$ 103,635</u>	<u>\$ 14,311,874</u>	<u>\$ 184,584</u>

Management considers the nature of the investment, the underlying causes of the decline in market value, the severity and duration of the decline in market value and other evidence, on a security by security basis, in determining if the decline in market value is other than temporary. The Bank does not believe that gross unrealized losses as of December 31, 2018, which is comprised of twenty-seven investment securities, represent an other-than-temporary impairment. The gross unrealized losses reported relate to investment securities issued by Government-sponsored enterprises and state and municipal securities. Total gross unrealized losses, which represent 1.08% of the amortized cost basis of the Bank's total investment securities, were attributable to changes in interest rates due to market conditions and not due to the credit quality of the investment securities. The Bank has both the ability and the intent to hold all of these securities for a period of time necessary to recover amortized cost.

Restricted equity securities, which are carried at cost, consist of investments in stock of the Federal Home Loan Bank of Atlanta ("FHLB"), and CBB Financial Corp., which are upstream correspondents of the Bank. The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow from it. The Bank is required to hold that stock so long as it has borrowing capacity from the FHLB. Both the Bank's stock in CBB Financial Corp. and the FHLB are restricted in the fact that the stock may only be repurchased by the issuer. Management also considers these investments when testing for impairment. On a quarterly basis, management reviews both institutions' capital adequacy to ensure they meet regulatory minimum requirements. Bank management does not believe any unrealized losses associated with investments in these institutions to be anything other than temporary.

## Notes to Consolidated Financial Statements

### Note 4. Loans Receivable

The Bank segments its loan portfolio to capture the nature of credit risk inherent in its loans receivable. These segments allow management to monitor risk and performance. In reviewing risk, management has determined there to be several different risk categories within the loan portfolio. The allowance for loan losses consists of amounts applicable to portfolios of: (i) Commercial Loans; (ii) Commercial Real Estate Loans; (iii) Consumer Loans; (iv) Residential – Prime Loans; and (v) Agricultural and Raw Land Loans.

The Commercial segment consists of loans made for the purpose of financing the activities of commercial customers. The Commercial Real Estate portfolio includes owner occupied, non-owner occupied, and multi-family dwellings. The Residential – Prime Loan segment consists of fixed rate and adjustable rate single-family amortizing term loans, which are primarily first liens and home equity loans which are generally second liens. The Agricultural and Raw Land category is for farm loans and for undeveloped land. Consumer loans consist of motor vehicle loans, savings account loans, personal lines of credit, overdrafts, other types of secured consumer loans, and unsecured personal loans.

The major segmented components of loans at December 31 are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Commercial	\$ 26,000	\$ 25,226
Commercial Real Estate	132,437	112,165
Consumer	20,259	19,486
Residential - Prime	179,444	160,020
Agricultural & Raw Land	<u>25,657</u>	<u>23,911</u>
	383,797	340,808
Allowance for loan losses	<u>(3,393)</u>	<u>(3,142)</u>
	<u>\$ 380,404</u>	<u>\$ 337,666</u>

Loans receivable include \$67,000 and \$84,000 in overdraft deposit accounts at December 31, 2018 and 2017, respectively.

The Bank had no subprime residential loans at December 31, 2018 or 2017.

Construction loans are originated in the Commercial Real Estate and Residential – Prime segments of the loan portfolio, as reflected in the components in the table above. Construction lending is generally considered to involve a higher degree of credit risk than long-term permanent financing. If the estimate of construction cost proves to be inaccurate, the Bank may be compelled to advance additional funds to complete the construction with repayment dependent, in part, on the success of the ultimate project rather than the ability of a borrower or guarantor to repay the loan. If the Bank is forced to foreclose on a project prior to completion, there is no assurance that it will be able to recover all of the unpaid portion of the loan. In addition, the Bank may be required to fund additional amounts to complete a project and may have to hold the property for an indeterminate period of time. As of December 31, 2018, construction lending represents \$22,648,000, or 5.89% of the overall loan portfolio, compared to \$18,173,000, or 5.32%, the year prior.

### Note 5. Allowance for Loan Losses

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on three basic principles of accounting: (i) guidance for Contingencies, which requires that losses be accrued when they are probable of occurring and estimable, (ii) guidance for Receivables, which requires that losses be accrued based on the differences between the present value of future cash flows, value of collateral, or values that are observable in the market, and the loan balance, and (iii) guidance allowing a creditor to use existing methods for recognizing interest income on an impaired loan.



## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses, continued

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loans identified as losses and deemed uncollectible by management are charged to the allowance. Subsequent recoveries, if any, are credited to the allowance.

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

The allowance consists of specific, general, and unallocated components. The specific component relates to loans that are classified as impaired, for which an allowance is established when the discounted cash flows, collateral value, or observable market price of the loan is lower than its carrying value. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. Historical losses are categorized into risk-similar loan pools and a loss ratio factor is applied to each group's loan balances to determine the allocation. The loss ratio factor is based on average loss history for the current year and two prior years to ensure the most relevant data is being used in the model following the economic recession, anemic recovery, and current economic conditions.

An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio. Qualitative environmental factors include external risk factors that management believes affect the overall lending environment of the Bank. Environmental factors that management of the Bank routinely analyze include levels and trends in delinquencies and impaired loans, levels and trends in charge-offs and recoveries, trends in volume and terms of loans, effects of changes in risk selection and underwriting practices, experience, ability, and depth of lending management and staff, national and local economic trends and conditions such as unemployment rates, housing statistics, banking industry conditions, local economic forecasts, the effect of changes in credit concentrations, and an analysis of the probability of a recession.

The following table presents activity in the allowance for loan losses for the years-ended December 31, 2018 and 2017 on a portfolio segment basis. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories.

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Consumer</u>	<u>Residential- Prime</u>	<u>Agricultural &amp; Raw Land</u>	<u>Total</u>
<b>Allowance for loan losses:</b>						
Balance, January 1, 2018	\$ 657,900	\$ 791,318	\$ 284,056	\$ 1,325,030	\$ 84,100	\$ 3,142,404
Charge-offs	(8,596)	-	(172,996)	(174,550)	-	(356,142)
Recoveries	46,550	31,949	42,982	15,425	-	136,906
Provisions	(377,654)	203,576	141,483	439,895	62,700	470,000
Balance, December 31, 2018	<u>\$ 318,200</u>	<u>\$ 1,026,843</u>	<u>\$ 295,525</u>	<u>\$ 1,605,800</u>	<u>\$ 146,800</u>	<u>\$ 3,393,168</u>
Balance, January 1, 2017	\$ 768,200	\$ 699,401	\$ 247,759	\$ 1,050,101	\$ 137,901	\$ 2,903,362
Charge-offs	-	(12,588)	(161,954)	(83,696)	-	(258,238)
Recoveries	14,837	22	29,497	2,924	-	47,280
Provisions	(125,137)	104,483	168,754	355,701	(53,801)	450,000
Balance, December 31, 2017	<u>\$ 657,900</u>	<u>\$ 791,318</u>	<u>\$ 284,056</u>	<u>\$ 1,325,030</u>	<u>\$ 84,100</u>	<u>\$ 3,142,404</u>

## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses, continued

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Consumer</u>	<u>Residential- Prime</u>	<u>Agricultural &amp; Raw Land</u>	<u>Total</u>
<b><u>December 31, 2018</u></b>						
<b>Allowance for loan losses ending balances:</b>						
Individually evaluated for impairment	\$ -	\$ 3,743	\$ -	\$ -	\$ -	\$ 3,743
Collectively evaluated for impairment	\$ 318,200	\$ 1,023,100	\$ 295,525	\$ 1,605,800	\$ 146,800	\$ 3,389,425
<b>Loans receivable:</b>						
Ending balance - total	\$ 25,999,505	\$ 132,437,404	\$ 20,258,559	\$ 179,444,417	\$ 25,657,076	\$ 383,796,961
Ending balances:						
Individually evaluated for impairment	\$ 38,129	\$ 368,700	\$ -	\$ 839,224	\$ -	\$ 1,246,053
Collectively evaluated for impairment	\$ 25,961,376	\$ 132,068,704	\$ 20,258,559	\$ 178,605,193	\$ 25,657,076	\$ 382,550,908
<b><u>December 31, 2017</u></b>						
<b>Allowance for loan losses ending balances:</b>						
Individually evaluated for impairment	\$ -	\$ 5,018	\$ -	\$ 27,530	\$ -	\$ 32,548
Collectively evaluated for impairment	\$ 657,900	\$ 786,300	\$ 284,056	\$ 1,297,500	\$ 84,100	\$ 3,109,856
<b>Loans receivable:</b>						
Ending balance - total	\$ 25,226,093	\$ 112,165,100	\$ 19,485,784	\$ 160,019,666	\$ 23,910,958	\$ 340,807,601
Ending balances:						
Individually evaluated for impairment	\$ 31,089	\$ 373,808	\$ 14,737	\$ 2,914,240	\$ -	\$ 3,333,874
Collectively evaluated for impairment	\$ 25,195,004	\$ 111,791,292	\$ 19,471,047	\$ 157,105,426	\$ 23,910,958	\$ 337,473,727

## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses, continued

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Management assesses for possible loan impairment on a quarterly basis. The impairment review includes examining factors such as the loan balance, payment status, recent payment history, principal curtailment on lines of credit, extensions granted, risk rating, maturity date advancement, and the probability of collecting scheduled principal and interest payments when due. A loan may be considered impaired by management, and still be expected to have full repayment of both principal and interest, but not according to the contractual terms of the loan agreement. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for commercial and construction loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Large groups of smaller balance homogeneous loans are collectively evaluated for potential loss exposure. Accordingly, the Bank does not generally separately identify individual consumer and residential loans for impairment disclosures.

Cash payments received for individually evaluated impaired loans are recorded according to the accrual status of the loan. If the impaired loan is on nonaccrual status, payments are applied to the principal balance. Otherwise the payment is applied according to its contractual terms.

The recorded investment is defined as the original amount of the loan, net of any deferred costs and fees, less any principal reductions and direct charge-offs. Impaired loans with a balance at the end of the period are reflected in the recorded investment and unpaid principal balance columns. The average recorded investment represents the Bank's average investment in those same loans during the period. The following tables present impaired loans in the segmented portfolio categories as of December 31:

#### 2018:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Commercial	\$ -	\$ -	\$ -	\$ 27,647	\$ -
Commercial Real Estate	366,024	365,500	-	369,852	46,690
Residential - Prime	839,152	839,224	-	1,527,543	70,489
Consumer	-	-	-	3,508	-
Agricultural & Raw Land	38,678	38,129	-	3,223	140
With an allowance recorded:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial Real Estate	3,818	3,200	3,743	4,368	659
Residential - Prime	-	-	-	97,897	-
Consumer	-	-	-	3,508	-
Agricultural & Raw Land	-	-	-	-	-
Total:					
Commercial	\$ -	\$ -	\$ -	\$ 27,647	\$ -
Commercial Real Estate	369,842	368,700	3,743	374,220	47,349
Residential - Prime	839,152	839,224	-	1,625,440	70,489
Consumer	-	-	-	7,016	-
Agricultural & Raw Land	38,678	38,129	-	3,223	140

## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses, continued

#### 2017:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Commercial	\$ 31,440	\$ 31,089	\$ -	\$ 32,681	\$ 4,491
Commercial Real Estate	369,932	369,408	-	393,973	-
Residential - Prime	1,899,900	1,899,971	-	2,517,355	20,305
Consumer	14,776	14,737	-	16,494	-
Agricultural & Raw Land	-	-	-	-	-
With an allowance recorded:					
Commercial	\$ -	\$ -	\$ -	\$ -	\$ -
Commercial Real Estate	5,018	4,400	5,018	4,556	-
Residential - Prime	1,014,269	1,014,269	27,530	1,025,867	37,690
Consumer	-	-	-	-	-
Agricultural & Raw Land	-	-	-	-	-
Total:					
Commercial	\$ 31,440	\$ 31,089	\$ -	\$ 32,681	\$ 4,491
Commercial Real Estate	374,950	373,808	5,018	398,529	-
Residential - Prime	2,914,169	2,914,240	27,530	3,543,222	57,995
Consumer	14,776	14,737	-	16,494	-
Agricultural & Raw Land	-	-	-	-	-

Loans are considered past due if the required principal and interest payment have not been received as of the due date. The following schedule is an aging of past due loans receivable, including those on nonaccrual status, by portfolio segment as of December 31, 2018.

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater Than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Recorded Investment &gt; 90 Days and Accruing</u>
Commercial	\$ 283,727	\$ 83,180	\$ 107,692	\$ 474,599	\$ 25,524,906	\$ 25,999,505	\$ 107,692
Commercial Real Estate	-	325,784	365,500	691,284	131,746,120	132,437,404	-
Consumer	450,275	193,115	56,439	699,829	19,558,730	20,258,559	44,751
Residential - Prime	2,844,011	2,126,350	2,181,036	7,151,397	172,293,020	179,444,417	1,852,495
Agricultural & Raw Land	193,392	293,542	544,171	1,031,105	24,625,971	25,657,076	544,171
Total	<u>\$ 3,771,405</u>	<u>\$ 3,021,971</u>	<u>\$ 3,254,838</u>	<u>\$ 10,048,214</u>	<u>\$ 373,748,747</u>	<u>\$ 383,796,961</u>	<u>\$ 2,549,109</u>

The following schedule is an aging of past due loans receivable, including those on nonaccrual status, by portfolio segment as of December 31, 2017.

	<u>30-59 Days Past Due</u>	<u>60-89 Days Past Due</u>	<u>Greater Than 90 Days</u>	<u>Total Past Due</u>	<u>Current</u>	<u>Total Loans Receivable</u>	<u>Recorded Investment &gt; 90 Days and Accruing</u>
Commercial	\$ 921,913	\$ 72,554	\$ 31,089	\$ 1,025,556	\$ 24,200,537	\$ 25,226,093	\$ 31,440
Commercial Real Estate	272,199	284,170	518,054	1,074,423	111,090,677	112,165,100	-
Consumer	296,090	53,762	41,775	391,627	19,094,157	19,485,784	27,038
Residential - Prime	2,425,124	1,693,930	1,549,701	5,668,755	154,350,911	160,019,666	98,205
Agricultural & Raw Land	1,066,973	157,475	276,698	1,501,146	22,409,812	23,910,958	276,698
Total	<u>\$ 4,982,299</u>	<u>\$ 2,261,891</u>	<u>\$ 2,417,317</u>	<u>\$ 9,661,507</u>	<u>\$ 331,146,094</u>	<u>\$ 340,807,601</u>	<u>\$ 433,381</u>

## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses, continued

Loans are generally placed in nonaccrual status when, in management's opinion, the collection of principal and interest is 90 days or more past due, unless the obligation is both well-secured and in the process of collection. When interest accrual is discontinued, all unpaid accrued interest is reversed. Payments on nonaccrual loans are applied to the principal balance. No interest income was recognized on impaired loans subsequent to the nonaccrual status designation. A loan is returned to accrual status when the borrower makes consistent payments according to the contractual terms and the future payments are reasonably assured. The following is a schedule of loans receivable, by portfolio segment, on nonaccrual status as of December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
Commercial	\$ -	\$ -
Commercial Real Estate	368,701	522,454
Consumer	11,687	14,737
Residential - Prime	440,767	1,451,497
Agricultural & Raw Land	-	-
	<u>\$ 821,155</u>	<u>\$ 1,988,688</u>

The Bank uses several metrics as credit quality indicators of current or potential risks in the loan portfolio. These indicators include, but are not limited to, credit bureau reports, loan-to-value ratios, internal risk ratings, current financial information, historical payment experience, economic conditions, and trends in net charge-offs and nonperforming loans. As part of the ongoing monitoring of the credit quality of the Bank's loan portfolio, every loan is assigned a risk rating grade at the time of loan origination. The risk ratings are formally reviewed for appropriateness over the life of the loan on at least an annual basis. The formal external review occurs during the fourth quarter to correspond to the Bank's fiscal year-end. In addition, quarterly internal reviews occur for specific loans identified by loan administration to ensure loans with potential material impact are captured on an interim basis. These processes historically provide a predictive element to assist management in their efforts to quantify losses. The quarterly review is an important process to accurately identify impaired loans, a critical component in the allowance for loan losses calculation. The credit quality indicators are periodically reviewed and updated on a case-by-case basis.

Listed from the least risk to the highest risk, management uses a nine point internal risk rating system to monitor the credit quality of the non-consumer segments of the loan portfolio.

**Excellent:** The borrower is typically a long established, well-seasoned company with a significant market position. It possesses unquestioned asset quality, liquidity, and excellent sales and earnings trends. Leverage, if present, is well below industry norms. Borrower appears to have capacity to meet all of its obligations under almost any circumstances. If a business, the borrowing entity's management has extensive experience and depth.

**Good:** The borrower demonstrates a strong and liquid financial condition based upon current financial information and qualifies to borrow on an unsecured basis under most circumstances. If borrowing is secured, collateral is readily marketable and amply margined. Repayment sources are well defined and more than adequate. Credit checks and prior lending experiences with the company, if any, are fully satisfactory. The borrower's cash flow comfortably exceeds total current obligations.

**Satisfactory:** The borrower provides current financial information reflecting a satisfactory financial condition and reasonable debt service capacity. If borrowing is secured, collateral is marketable, adequately margined at the present time, and expected to afford coverage to maturity. Repayment understandings are documented, sources are considered adequate, and repayment terms are appropriate. Credit checks and prior experience, if any, are satisfactory. The borrower is usually established and is attractive to other financial institutions. If a business, the borrower's balance sheet is stable and sales and earnings are steady and predictable.

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## Notes to Consolidated Financial Statements

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### Note 5. Allowance for Loan Losses, continued

**Acceptable:** While an acceptable credit risk to the Bank, the borrower will generally demonstrate a higher leveraged, less liquid balance sheet and capacity to service debt, while steady, may be less well-defined. Repayment terms may not be appropriate for individual transactions. Borrower is generally acceptable to other financial institutions; however, secured borrowing is the norm. Collateral marketability and margin are acceptable at the present time but may not continue to be so. Credit checks or prior experience, if any, reveals some, but not serious, slowness in paying. If a business, its management experience may be limited or have less depth than a Satisfactory borrower. Sensitivity to economic or credit cycles exists, and staying power could be a problem.

**Pass/Watch:** Loan coverage is somewhat erratic, future coverage is uncertain, liquidity is strained and leverage capacity is considered minimal. Indicators of potential deterioration of repayment sources have resulted in uncertainty or unknown factors concerning the status of the credit. This risk rating is considered transitory in nature. When factors causing the uncertainty have been clearly defined, a risk rating will be assigned commensurate with the risk characteristics and circumstances that exist.

**Special Mention:** While loans to a borrower in this rating category are currently protected (no loss of principal or interest envisioned), they may pose undue or unwarranted credit risks if weaknesses are not checked or corrected. Weaknesses may be limited to one or several trends or developments. Weaknesses may include one or more of the following: a potentially over-extended financial condition, a questionable repayment program, an uncertain level of continuing employment or income, inadequate or deteriorating collateral, inadequate or untimely financial information, management competence or succession issues, and a high degree of vulnerability to outside forces.

**Substandard:** Assets in this category are inadequately protected by the current creditworthiness and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Nonaccrual loans, reduced-earnings loans, and loans to borrowers engaged in bankruptcy proceedings are automatically rated Substandard or lower.

**Doubtful:** A loan rated Doubtful has all of the weaknesses inherent in one rated Substandard with the added characteristic that the weakness may make collection or liquidation in full, on the basis of currently existing facts, highly improbable. A Doubtful rating generally is used when the amount of loss can be projected and that projection exceeds one-third of the balance of outstanding debt but does not exceed two-thirds of that balance. A Doubtful rating is generally applied when the likelihood of significant loss is high.

**Loss:** A Loss rating should be applied when the borrower's outstanding debt is considered uncollectible or of such little value that its continuance as a bankable asset is not warranted. This rating does not suggest that there is absolutely no recovery or salvage value, but that it is not practical or desirable to defer writing off the debt even though a partial recovery may be affected in the future.

For the consumer segment of the loan portfolio, the Bank uses the following definitions:

**Nonperforming:** Loans on nonaccrual status plus loans greater than ninety days past due and still accruing interest.

**Performing:** All current loans plus loans less than ninety days past due.

## Notes to Consolidated Financial Statements

### Note 5. Allowance for Loan Losses, continued

The following is a schedule of the credit quality of loans receivable, by portfolio segment, as of December 31, 2018:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential- Prime</u>	<u>Agricultural &amp; Raw Land</u>
Internal Risk Rating Grades:				
Satisfactory or better	\$ 10,137,272	\$ 58,325,238	\$ 112,008,440	\$ 4,206,378
Acceptable	14,310,707	71,469,893	51,492,379	18,395,656
Pass/Watch	297,323	712,056	4,593,309	1,885,414
Special Mention	1,039,310	545,783	5,300,716	641,757
Substandard	214,893	1,384,434	6,049,573	527,871
Doubtful	-	-	-	-
Total	<u>\$ 25,999,505</u>	<u>\$ 132,437,404</u>	<u>\$ 179,444,417</u>	<u>\$ 25,657,076</u>
				<u>Consumer</u>
Internal Risk Rating Grades:				
Performing				\$ 20,202,120
Nonperforming				56,439
Total				<u>\$ 20,258,559</u>

The following is a schedule of the credit quality of loans receivable, by portfolio segment, as of December 31, 2017:

	<u>Commercial</u>	<u>Commercial Real Estate</u>	<u>Residential- Prime</u>	<u>Agricultural &amp; Raw Land</u>
Internal Risk Rating Grades:				
Satisfactory or better	\$ 11,122,331	\$ 51,898,584	\$ 98,108,633	\$ 4,696,870
Acceptable	13,456,167	54,667,068	48,111,427	15,181,161
Pass/Watch	251,951	1,638,451	2,319,047	3,718,774
Special Mention	63,068	2,372,899	5,437,753	141,049
Substandard	332,576	1,588,098	6,042,806	173,104
Doubtful	-	-	-	-
Total	<u>\$ 25,226,093</u>	<u>\$ 112,165,100</u>	<u>\$ 160,019,666</u>	<u>\$ 23,910,958</u>
				<u>Consumer</u>
Internal Risk Rating Grades:				
Performing				\$ 19,444,009
Nonperforming				41,775
Total				<u>\$ 19,485,784</u>

The Bank evaluated all loan restructurings to determine whether they are troubled debt restructurings (“TDRs”) under the guidance of ASU 2011-02. Upon identifying these loans as TDRs, the Bank identified and prospectively measured them as impaired under the guidance in ASC 310-10-35.

In the determination of the allowance for loan losses, management considers troubled debt restructurings and subsequent defaults in these restructurings. All troubled debt restructurings are considered impaired loans. Loss exposure related to these loans are determined by management on a quarterly basis. During 2018 and 2017, no loans were identified as TDRs.

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## Notes to Consolidated Financial Statements

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### Note 6. Property, Equipment and Foreclosed Assets

Components of property and equipment and total accumulated depreciation at December 31 are as follows:

	<u>2018</u>	<u>2017</u>
Land	\$ 3,388,953	\$ 3,388,953
Construction in process	936,405	4,821
Buildings and improvements	10,000,577	9,975,221
Furniture and equipment	<u>3,912,673</u>	<u>3,961,102</u>
	18,238,608	17,330,097
Less accumulated depreciation	<u>6,337,227</u>	<u>5,867,109</u>
	<u>\$ 11,901,381</u>	<u>\$ 11,462,988</u>

Depreciation expense for 2018 and 2017 was \$695,567 and \$717,850, respectively.

#### *Lessee Activities*

The Bank leased out a portion of its loan administration facility under an annually renewable lease and received rental income of \$9,000 in both 2018 and 2017.

The Bank leased out a portion of two branch facilities under a lease and received rental income of \$34,911 in both 2018 and 2017.

The Bank leases office space to Mountain Valley Title Insurance Agency, LLC and to Rockbridge Title Services, LLC each for an annual amount of \$6,200, totaling \$12,400 in rental income. Both of these companies are related party interests as subsidiaries of the Bank.

In 2018, the Bank subleased one of its rental properties, resulting in \$6,825 in rental income.

Aggregate rental income for 2018 and 2017 was \$63,136 and \$72,691, respectively.

#### *Lessor Activities*

The Bank leases locations for automated teller machines, equipment, and office space under various operating leases that call for annual payments as follows:

2019	\$ 23,673
2020	4,848
2021	3,940
2022	3,656
2023	-
Thereafter	-
	<u>\$ 36,117</u>

Aggregate rental expense for 2018 and 2017 was \$45,098 and \$53,068, respectively.



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## Notes to Consolidated Financial Statements

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### Note 6. Property, Equipment and Foreclosed Assets, continued

#### *Foreclosed Assets*

The following table summarizes the activity in foreclosed assets:

	<u>2018</u>	<u>2017</u>
Balance, beginning of year	\$ 3,634,555	\$ 3,667,782
Additions	1,356,845	2,499,306
Sales	(339,711)	(1,637,894)
Loans originated to finance the sale of foreclosed assets	(60,000)	(76,475)
Net loss on sale	(77,214)	(14,415)
Net write-downs	<u>(283,751)</u>	<u>(803,749)</u>
Balance, end of year	<u>\$ 4,230,724</u>	<u>\$ 3,634,555</u>

At December 31, 2018 and 2017, the Bank held foreclosed residential properties at a carrying value of \$309,250 and \$752,600 respectively.

### Note 7. Deposits

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2018 and 2017 was \$37,443,570 and \$22,007,041, respectively.

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

2019	\$ 67,509,605
2020	81,406,161
2021	26,474,094
2022	12,630,145
2023	4,100,480
Thereafter	<u>-</u>
	<u>\$ 192,120,485</u>

### Note 8. Federal Home Loan Bank Borrowings

The Bank had no outstanding debt with the Federal Home Loan Bank of Atlanta at December 31, 2018. There was outstanding debt as of December 31, 2017 in the amount of \$6.0 million, which matured and was paid off February 22, 2018.

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## Notes to Consolidated Financial Statements

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### **Note 9. Short-Term Debt**

The Bank has established various credit facilities to provide additional liquidity if and as needed. At December 31, 2018 and 2017, these facilities from correspondent banks included unsecured lines of credit, a secured line of credit and a repurchase agreement line of credit totaling \$29,500,000 and \$27,500,000, respectively. The Bank had no outstanding balance against these lines at December 31, 2018 and \$2,103,000 outstanding at December 31, 2017.

In addition, the Bank has a secured line of credit of approximately \$27,417,000 with the Federal Home Loan Bank of Atlanta as of December 31, 2018. Any borrowings from the Federal Home Loan Bank are secured by a blanket collateral agreement on a pledged portion of the Bank's 1-to-4 family residential real estate loans, multifamily mortgage loans, and commercial mortgage collateral. At December 31, 2018, a \$15,000,000 letter of credit in favor of the Commonwealth of Virginia-Treasury Board, to secure public deposits, was utilized from this line of credit. This pledging arrangement reduced the available credit for secondary liquidity needs to \$12,417,000. The Bank had no balance outstanding at December 31, 2018 and an outstanding balance of \$6,000,000 in borrowing from the Federal Home Loan Bank at December 31, 2017.

The Bank has established a Discount Window facility at the Federal Reserve Bank of Richmond as part of its Contingency Liquidity Plan. Collateral would have to be pledged in order to borrow from the facility. No balance was outstanding on this line at December 31, 2018 or 2017.

### **Note 10. Fair Values of Financial Instruments**

#### ***Financial Instruments Measured at Fair Value***

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

The fair value of net loans is based on estimated cash flows using the current rates at which similar loans would be made to borrowers with similar credit ratings and for the same remaining maturities. This does not include consideration of liquidity that market participants would use to value such loans. The estimated fair values of deposits are based on estimated cash flows discounted at market interest rates.

The fair value of off-balance sheet financial instruments is considered immaterial. These off-balance sheet financial instruments are commitments to extend credit and are either short-term in nature or subject to immediate repricing.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Bank's financial instruments as of December 31, 2018 and 2017. These tables exclude financial instruments for which the carrying amount approximates fair value and/or which would be classified as Level 1. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization.

## Notes to Consolidated Financial Statements

### Note 10. Fair Values of Financial Instruments, continued

#### *Financial Instruments Measured at Fair Value, continued*

			Fair Value Measurements	
	Carrying Amount	Fair Value	Significant Other Observable Inputs Level 2	Significant Other Unobservable Inputs Level 3
(In Thousands)				
December 31, 2018				
Financial assets				
Loans, net	\$ 380,404	\$ 370,123	\$ -	\$ 370,123
Financial liabilities				
Deposits	\$ 385,314	\$ 376,154	\$ 376,154	\$ -
(In Thousands)				
December 31, 2017				
Financial assets				
Loans, net	\$ 337,665	\$ 339,054	\$ -	\$ 339,054
Financial liabilities				
Deposits	\$ 341,000	\$ 335,547	\$ 335,547	\$ -

GAAP provides a framework for measuring and disclosing fair value which requires disclosures about the fair value of assets and liabilities recognized in the balance sheet, whether the measurements are made on a recurring basis (for example, available for sale investment securities) or on a nonrecurring basis (for example, impaired loans).

Fair value is defined as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy, which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value.

The Bank utilizes fair value measurements to record fair value adjustments to certain assets and to determine fair value disclosures. Securities available for sale are recorded at fair value on a recurring basis. Additionally, from time to time, the Bank may be required to record at fair value other assets on a nonrecurring basis, such as loans held for sale, loans held for investment and certain other assets. These nonrecurring fair value adjustments typically involve application of lower of cost or market accounting or write-downs of individual assets.

#### *Fair Value Hierarchy*

The Bank groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine the fair value. These levels are:

Level 1 – Valuation is based upon quoted prices for identical instruments traded in active markets.

Level 2 – Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.

Level 3 – Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include the use of option pricing models, discounted cash flow models and similar techniques.

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## Notes to Consolidated Financial Statements

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### **Note 10. Fair Values of Financial Instruments, continued**

The following is a description of valuation methodologies used for assets and liabilities recorded at fair value:

#### ***Investment Securities Available for Sale***

Investment securities available for sale are recorded at fair value on a recurring basis. Fair value measurement is based upon quoted prices, if available. If quoted prices are not available, fair values are measured using independent pricing models or other model-based valuation techniques such as the present value of future cash flows, adjusted for the security's credit rating, prepayment assumptions and other factors such as credit loss assumptions. Level 1 securities include those traded on an active exchange, such as the New York Stock Exchange, U.S. Treasury securities that are traded by dealers or brokers in active or over-the-counter markets, and money market funds. Level 2 securities include mortgage-backed securities issued by government sponsored entities, municipal bonds and corporate debt securities. Securities classified as Level 3 include asset-backed securities in less liquid markets.

#### ***Foreclosed Assets***

Foreclosed assets are recorded at the lower of investment in the loan or fair value at acquisition. During the holding phase, foreclosed assets are carried at the lower of the carrying value or fair value. Fair value is based on independent observable market prices or appraised values of the collateral, which the Bank considers to be level 2 inputs. When the appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the foreclosed asset as nonrecurring Level 3.

#### ***Loans, net***

Other than the loans held for sale portfolio, the Bank does not record loans at fair value on a recurring basis, however, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan are considered impaired. Once a loan is identified as individually impaired, management measures impairment. The fair value of impaired loans is estimated using one of several methods, including the collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring a specific allowance represent loans for which the fair value of expected repayments or collateral exceed the recorded investment in such loans. At December 31, 2018 and 2017, substantially all impaired loans were evaluated based upon the fair value of collateral. When the fair value of the collateral is based on an observable market price or a current appraised value, the Bank records the loan as nonrecurring Level 2. When an appraised value is not available or management determines the fair value of the collateral is further impaired below the appraised value and there is no observable market price, the Bank records the loan as nonrecurring Level 3. When management performs an in-house appraisal using data such as comparable sales analysis, analysis on tax assessments, and physical inspection to determine the fair value, the Bank records the loans as nonrecurring Level 3.

#### ***Deposits***

Deposits without a stated maturity, including demand, interest-bearing demand, and savings accounts, are reported at their carrying value in accordance with authoritative accounting guidance. No value has been assigned to the franchise value of these deposits. For other types of deposits with fixed maturities, fair value has been estimated by discounting future cash flows based on interest rates currently being offered on deposits with similar characteristics and maturities.

## Notes to Consolidated Financial Statements

### Note 10. Fair Values of Financial Instruments, continued

#### *Assets and Liabilities Recorded at Fair Value on a Recurring Basis*

The tables below present the recorded amount of assets and liabilities measured at fair value on a recurring basis.

<b>December 31, 2018</b> (In Thousands)	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Investment securities available for sale:				
Government-sponsored enterprises	\$ 11,830	\$ -	\$ 11,830	\$ -
State and municipal securities	2,753	-	2,753	-
Other investments	1,400	-	-	1,400
Corporate securities	78	78	-	-
Total assets at fair value	<u>\$ 16,061</u>	<u>\$ 78</u>	<u>\$ 14,583</u>	<u>\$ 1,400</u>

<b>December 31, 2017</b> (In Thousands)	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Investment securities available for sale:				
Government-sponsored enterprises	\$ 14,312	\$ -	\$ 14,312	\$ -
State and municipal securities	2,797	-	2,797	-
Other investments	1,400	-	-	1,400
Corporate securities	102	102	-	-
Total assets at fair value	<u>\$ 18,611</u>	<u>\$ 102</u>	<u>\$ 17,109</u>	<u>\$ 1,400</u>

#### *Assets and Liabilities Recorded at Fair Value on a Nonrecurring Basis*

The Bank may be required from time to time, to measure certain assets at fair value on a nonrecurring basis. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Balances are net of specific reserves. Assets measured at fair value on a nonrecurring basis are included in the table below.

<b>December 31, 2018</b> (In Thousands)	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Impaired loans:				
Commercial	\$ -	\$ -	\$ -	\$ -
Agricultural & Raw Land	-	-	-	-
Consumer	-	-	-	-
Residential - Prime	-	-	-	-
Total impaired loans	-	-	-	-
Foreclosed assets	4,231	-	4,231	-
Total assets at fair value	<u>\$ 4,231</u>	<u>\$ -</u>	<u>\$ 4,231</u>	<u>\$ -</u>

<b>December 31, 2017</b> (In Thousands)	<b>Total</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>
Impaired loans:				
Commercial	\$ -	\$ -	\$ -	\$ -
Agricultural & Raw Land	-	-	-	-
Consumer	-	-	-	-
Residential - Prime	986	-	-	986
Total impaired loans	986	-	-	986
Foreclosed assets	3,635	-	3,635	-
Total assets at fair value	<u>\$ 4,621</u>	<u>\$ -</u>	<u>\$ 3,635</u>	<u>\$ 986</u>

In 2017, one impaired loan was reclassified from Agricultural & Raw Land to Residential – Prime due to a change of the loan's purpose.

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## Notes to Consolidated Financial Statements

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### Note 10. Fair Values of Financial Instruments, continued

During 2018, the single loan was transferred out of Level 3. For the years ended December 31, 2018 and 2017, the changes in Level 3 assets measured at fair value on a nonrecurring basis are summarized as follows (dollars in thousands):

	<b>Year Ended December 31,</b>	
	<b>2018</b>	<b>2017</b>
	<b>Impaired Loans</b>	<b>Impaired Loans</b>
Balance, January 1	\$ 986	\$ 989
Included in earnings	-	(5)
Transfers into Level 3	-	3
Transfers out of Level 3	(986)	-
Principal reductions	-	(1)
Balance, December 31	<u>\$ -</u>	<u>\$ 986</u>

The Bank has no liabilities carried at fair value or measured at fair value on a recurring or nonrecurring basis.

### Note 11. Benefit Plans

#### *Pension Plan*

For the years ended December 31, 2018 and 2017, the Bank had a noncontributory cash balance pension plan ("Plan"). The Plan is sponsored by the Virginia Bankers Association and covers all eligible employees with at least one year of service who have attained the age of twenty-one. The Bank is permitted to make annual contributions to the Plan. Contribution credits are based on a tier for age and years of service. Interest is credited annually based on a rate tied to the 10-year Treasury rate and is guaranteed to meet the minimum threshold established by the IRS and not to be less than 3% on an annual basis. Upon retirement, the Plan permits lump sum, periodic installments, and monthly benefit payment options.

## Notes to Consolidated Financial Statements

### Note 11. Benefit Plans, continued

#### *Pension Plan, continued*

The Plan was underfunded at December 31, 2018 and 2017. The underfunded status at December 31, 2018 improved from December 31, 2017 primarily due to a favorable change in the discount rate assumption resulting in a decrease in the liability obligation, partially offset by market losses on plan assets. The following table is a summary of the plan's funded status for each year ended December 31:

	<u>2018</u>	<u>2017</u>
<b><i>Change in benefit obligation</i></b>		
Benefit obligation at beginning of year	\$ 4,880,637	\$ 4,092,015
Service cost	232,457	216,479
Interest cost	158,247	147,381
Actuarial loss (gain)	(560,867)	560,175
Benefits paid	(309,632)	(135,413)
Increase in obligation due to Plan amendment	33,472	-
Benefit obligation at end of year	<u>4,434,314</u>	<u>4,880,637</u>
<b><i>Change in plan assets</i></b>		
Fair value of plan assets at beginning of year	4,336,530	3,612,700
Actual return (loss) on plan assets	(210,377)	574,243
Employer contributions	300,000	285,000
Benefits paid	(309,632)	(135,413)
Fair value of plan assets at end of year	<u>4,116,521</u>	<u>4,336,530</u>
Funded status, over (under) at end of year	<u>\$ (317,793)</u>	<u>\$ (544,107)</u>
<b><i>Amounts recognized on the balance sheet</i></b>		
Other assets	\$ 189,625	\$ 199,269
Other liabilities	(317,793)	(544,107)
Net assets (liabilities)	<u>\$ (128,168)</u>	<u>\$ (344,838)</u>
<b><i>Amounts recognized in accumulated other comprehensive income:</i></b>		
Actuarial loss, net of tax	<u>\$ 713,349</u>	<u>\$ 749,630</u>
<b><i>Components of net periodic benefit cost and other amounts recognized in accumulated other comprehensive income:</i></b>		
<b><i>Net periodic benefit cost</i></b>		
Service cost	\$ 232,457	\$ 216,479
Interest cost	158,247	147,381
Expected return on plan assets	(304,147)	(249,184)
Amortization of prior service cost	6,628	4,397
Recognized net actuarial loss	26,426	19,305
Net periodic benefit cost	<u>119,611</u>	<u>138,378</u>
<b><i>Other changes in plan assets and benefit obligations recognized in other comprehensive income</i></b>		
Net actuarial (gain) loss	(45,925)	211,414
Tax expense on actuarial (gain) loss	9,644	51,476
Total recognized in other comprehensive (income) loss	<u>(36,281)</u>	<u>262,890</u>
Total recognized in net periodic benefit cost and other comprehensive loss	<u>\$ 83,330</u>	<u>\$ 401,268</u>

## Notes to Consolidated Financial Statements

### Note 11. Benefit Plans, continued

#### *Pension Plan, continued*

	<u>2018</u>	<u>2017</u>
<i>Assumptions</i>		
<i>Weighted-average assumptions at December 31</i>		
Discount rate used for net periodic pension cost	3.50%	4.00%
Discount rate used for disclosure	4.25%	3.50%
Expected return on plan assets	7.25%	7.25%
Rate of compensation increase	3.00%	3.00%
Rate of compensation increase for net periodic pension cost	3.00%	3.00%

Using the same fair value hierarchy described in Note 10, the fair values of the Bank's pension plan assets, by asset category, are as follows:

<u>December 31, 2018</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash equivalents and short term investments	\$ 1,910	\$ 1,910	\$ -	\$ -
Mutual funds – equities	2,374,242	2,374,242	-	-
Mutual funds – fixed income	1,740,369	1,740,369	-	-
Total assets at fair value	<u>\$ 4,116,521</u>	<u>\$ 4,116,521</u>	<u>\$ -</u>	<u>\$ -</u>
<u>December 31, 2017</u>	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
Cash equivalents and short term investments	\$ 1,585	\$ 1,585	\$ -	\$ -
Mutual funds – equities	2,634,032	2,634,032	-	-
Mutual funds – fixed income	1,700,913	1,700,913	-	-
Total assets at fair value	<u>\$ 4,336,530</u>	<u>\$ 4,336,530</u>	<u>\$ -</u>	<u>\$ -</u>

A contribution of \$325,000 is expected to be made in 2019.

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows:

2019	\$ 444,189
2020	63,792
2021	404,591
2022	344,198
2023	1,534,994
2024-2028	1,222,330

#### *Long-term rate of return*

The plan sponsor selects the expected long-term rate-of-return-on-assets assumption in consultation with their investment advisors and actuary. This rate is intended to reflect the average rate of earnings expected to be earned on the funds invested or to be invested to provide plan benefits. Historical performance is reviewed – especially with respect to real rates of return (net of inflation) – for the major asset classes held or anticipated to be held by the trust, and for the trust itself. Undue weight is not given to recent experience – that may not continue over the measurement period – with higher significance placed on current forecasts of future long-term economic conditions.

Because assets are held in a qualified trust, anticipated returns are not reduced for taxes. Further – solely for this purpose – the plan is assumed to continue in force and not terminate during the period during which assets are invested. However, consideration is given to the potential impact of current and future investment policy, cash flow into and out of the trust, and expenses (both investment and non-investment) typically paid from plan assets (to the extent such expenses are not explicitly estimated within periodic cost).



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## Notes to Consolidated Financial Statements

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### Note 11. Benefit Plans, continued

#### *Pension Plan assumptions, continued*

##### *Discount Rate*

The process used to select the discount rate assumption under ASC 715 takes into account the benefit cash flow and the segmented yields on high quality corporate bonds that would be available to provide for the payment of the benefit cash flow. A single effective discount rate, rounded to the nearest 0.25%, is then established that produces an equivalent discounted present value.

##### *Asset allocation and investment strategies*

The pension plan's weighted-average asset allocations, by asset category, are as follows for the year-ended December 31:

Asset Category	2018	2017
Mutual funds – fixed income	42%	39%
Mutual funds – equity	58%	61%
Total	100%	100%

Bank management elects an asset allocation for the plan annually. The election is based on management's assessment of the fixed income and equities markets and the economic outlook when matching potential risk and return for employee participants. The trust fund is diversified to maintain a reasonable level of risk without imprudently sacrificing return. The targeted asset allocation was 40% fixed income and 60% equities in 2018 and 2017. The Investment Manager selects fund managers with demonstrated experience and expertise and funds with demonstrated historical performance for the implementation of the Plan's investment strategy. The Investment Manager considers both actively and passively managed investment strategies and allocates funds across the asset classes to develop an efficient investment structure.

It is the responsibility of the Trustee to administer the investments of the Trust within reasonable costs, being careful to avoid sacrificing quality. These costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administration costs chargeable to the Trust.

##### *Concentration of risk*

No concentration of risk was identified in the plan.

## Notes to Consolidated Financial Statements

### Note 11. Benefit Plans, continued

#### *Post-Retirement Health Insurance*

The Bank sponsors a post-retirement health care plan for certain retired employees. The health plan has an annual limitation (a “cap”) on the dollar amount of the employer’s share of the cost of covered benefits incurred by a plan participant. The retiree is responsible, therefore, for the amount by which the cost of the benefit coverage under the plan incurred during a year exceeds that cap. No health care cost increases have been factored into the health plan’s actuarial calculations due to this cap. The plan remains frozen with coverage continuing for four existing retiree participants. The following tables summarize the Bank’s post retirement plan obligations, assets, funded status, and the assumptions and components of net periodic benefit costs using a measurement date of December 31, 2018 and 2017:

	<u>2018</u>	<u>2017</u>
<b><i>Change in benefit obligation</i></b>		
Benefit obligation at beginning of year	\$ 100,826	\$ 104,511
Interest cost	3,084	3,382
Actuarial (gain) loss	(2,838)	2,533
Benefits paid	(9,600)	(9,600)
Benefit obligation at end of year	<u>91,472</u>	<u>100,826</u>
<b><i>Change in plan assets</i></b>		
Fair value of plan assets at beginning of year	-	-
Employer contribution	9,600	9,600
Benefits paid	(9,600)	(9,600)
Fair value of plan assets at end of year	<u>-</u>	<u>-</u>
Funded status, over (under) at end of year	<u>\$ (91,472)</u>	<u>\$ (100,826)</u>
<b><i>Amounts recognized on the balance sheet</i></b>		
Other assets (deferred tax)	\$ 3,071	\$ 6,469
Other liabilities	(91,472)	(100,826)
Net liabilities	<u>\$ (88,401)</u>	<u>\$ (94,357)</u>
<b><i>Amounts recognized in accumulated other comprehensive income:</i></b>		
Actuarial gain	\$ (29,536)	\$ (28,076)
Prior service cost	44,160	58,882
Deferred tax benefit	(3,071)	(6,469)
Net accumulated other comprehensive loss	<u>\$ 11,553</u>	<u>\$ 24,337</u>
<b><i>Components of net periodic postretirement cost and other amounts recognized in accumulated other comprehensive income:</i></b>		
<b><i>Net periodic benefit cost</i></b>		
Interest cost	\$ 3,084	\$ 3,382
Amortization of prior service cost	14,722	14,722
Amortization of net (gain) loss	(1,378)	(1,558)
Net periodic postretirement cost	<u>16,428</u>	<u>16,546</u>
<b><i>Other changes in plan assets and benefit obligations recognized in other comprehensive income</i></b>		
Actuarial (gain) loss	(1,460)	4,091
Amortization of prior service cost	(14,722)	(14,722)
Tax benefit on comprehensive income (loss)	3,398	7,620
Total recognized in other comprehensive loss	<u>(12,784)</u>	<u>(3,011)</u>
Total recognized in net periodic postretirement cost and other comprehensive (income) loss	<u>\$ 3,644</u>	<u>\$ 13,535</u>

# Notes to Consolidated Financial Statements

## Note 11. Benefit Plans, continued

### *Post-Retirement Health Insurance, continued*

The Bank expects to recognize amortization of transition obligation of \$14,722 in 2019.

The discount rate assumption in determining the benefit relating to the untrended post-retirement health care plan at December 31, 2018, was 4.00%. Since the post-retirement health insurance benefit plan is untrended, increases and decreases in health care cost trend rates, expected rate of return on plan assets, and the rate of compensation increase is not applicable.

Employer contributions are expected to be \$9,600 in 2019.

Estimated future benefit payments by the plan are as follows:

2019	\$	9,600
2020		9,315
2021		9,010
2022		8,683
2023		8,334
2024-2028		35,664

### *Deferred Compensation Plan*

Funded deferred compensation plans have been adopted for certain members of the Board of Directors and executive employees. The corresponding assets and liabilities of the plans are held by a third party through the Virginia Bankers Association and totaled \$728,166 and \$743,746 for the Director Plan at December 31, 2018 and 2017, respectively. The Executive Plan had no active participants and a zero balance at December 31, 2018 and 2017.

### *Profit Sharing/Thrift Plan*

The Bank provides a profit sharing/thrift plan for its employees to which contributions are made at the discretion of the Board of Directors. All full-time employees, age 18 and older, are eligible to participate and are automatically enrolled, unless they choose to opt-out of the plan, after completing their first six months of service. The plan allows for pretax employee contributions of up to the maximum allowed by the IRS. In 2018 and 2017, the first 1% of employee contributions was matched 100% by the Bank. The next 5% of employee contributions was matched 50% by the Bank. Employer contributions, including a 2% accrual for profit sharing, to the plan amounted to \$248,741 in 2018. Employer contributions were \$148,664 in 2017.

## Note 12. Income Taxes

### *Current and Deferred Income Tax Components*

The components of income tax expense (benefit) are as follows:

	<u>2018</u>	<u>2017</u>
<b><i>Current</i></b>		
Federal	\$ 928,593	\$ 1,559,922
State	14,939	11,957
	<u>943,532</u>	<u>1,571,879</u>
<b><i>Deferred</i></b>		
Federal	6,921	(360,251)
State	(1,785)	590
	<u>5,136</u>	<u>(359,661)</u>
<b><i>Income Tax Expense</i></b>	<u>\$ 948,668</u>	<u>\$ 1,212,218</u>

## Notes to Consolidated Financial Statements

### Note 12. Income Taxes, continued

#### *Rate Reconciliation*

A reconciliation of income tax expense computed at the statutory federal income tax rate to income tax expense included in the consolidated statements of income is as follows:

	<u>2018</u>	<u>2017</u>
Tax at statutory federal rate	\$ 1,102,118	\$ 1,186,733
Tax exempt interest income	(43,518)	(46,979)
Deferred tax adjustment due to enactment of reduced statutory federal rate of 21%	-	87,712
Other	(109,932)	(15,248)
Income tax expense	<u>\$ 948,668</u>	<u>\$ 1,212,218</u>

#### *Deferred Income Tax Analysis*

The significant components of net deferred tax assets at December 31 are summarized as follows:

	<u>2018</u>	<u>2017</u>
<b><i>Deferred tax assets</i></b>		
Allowance for loan losses	\$ 329,603	\$ 418,985
Deferred compensation	136,367	113,926
Pension plan	189,625	199,269
Post-retirement health benefits	3,071	6,469
Investment in pass-through entities	47,579	45,252
Foreclosed assets	162,566	96,443
Interest on nonaccrual loans	15,602	9,682
Accrued unpaid compensation	47,332	42,350
Net unrealized appreciation on securities available for sale	17,040	6,782
Other	67,115	62,218
Deferred tax assets	<u>1,015,900</u>	<u>1,001,376</u>
<b><i>Deferred tax liabilities</i></b>		
Depreciation	(412,709)	(451,804)
Accretion of discount on investment securities	(248)	(204)
Accrued pension costs	(191,138)	(148,006)
Other	(66,116)	(47,753)
Deferred tax liabilities	<u>(670,211)</u>	<u>(647,767)</u>
Net deferred tax asset	<u>\$ 345,689</u>	<u>\$ 353,609</u>

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with accounting guidance on Income Taxes.

The Bank has evaluated the need for a deferred tax valuation allowance for the years ended December 31, 2018 and 2017 in accordance with ASC 740, Income Taxes. Based on a three year taxable income projection and tax strategies which would result in recognition of potential securities gains and the effects of off-setting deferred tax liabilities, the Bank believes that it is more likely than not that the deferred tax assets are realizable. Therefore, no allowance is required.

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## Notes to Consolidated Financial Statements

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### Note 13. Low Income Housing Tax Credits

The Bank is an investor in a housing equity fund. The general purpose of this fund is to encourage and assist participants in investing in low-income residential rental properties located in the Commonwealth of Virginia, develop and implement strategies to maintain projects as low-income housing, deliver Federal Low Income Housing Credits to investors, allocate tax losses and other possible tax benefits to investors, and to preserve and protect project assets. The Bank accounts for this investment under the proportional amortization method and at December 31, 2018, the investment in this fund, recorded in other assets on the consolidated balance sheet, was \$454,452. Total projected tax credits to be received for 2018 are \$35,028 which is based on the most recent estimates received from the fund. Amortization expense for 2018 was \$31,339. Additional capital calls expected for the fund totals \$374,500 at December 31, 2018 and is included in other liabilities on the consolidated balance sheets.

### Note 14. Commitments and Contingencies

#### *Litigation*

In the normal course of business the Bank is involved in various legal proceedings. After consultation with legal counsel, management believes that any liability resulting from such proceedings will not be material to the consolidated financial statements.

#### *Financial Instruments with Off-Balance-Sheet Risk*

The Bank is party to financial instruments with off-balance-sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. These instruments involve, to varying degrees, credit risk in excess of the amounts recognized in the consolidated balance sheets.

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance-sheet instruments. A summary of commitments at December 31 is as follows:

	<u>2018</u>	<u>2017</u>
Commitments to extend credit	\$ 71,564,000	\$ 66,854,000
Standby letters of credit	<u>3,323,000</u>	<u>2,825,000</u>
	<u>\$ 74,887,000</u>	<u>\$ 69,679,000</u>

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## Notes to Consolidated Financial Statements

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### **Note 14. Commitments and Contingencies, continued**

#### ***Financial Instruments with Off-Balance-Sheet Risk, continued***

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate and income-producing commercial properties.

Standby letters of credit are conditional commitments issued by the Bank to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. Collateral held varies as specified above and is required in instances which the Bank deems necessary.

In the normal course of business, the Bank extends commitment letters to fund loans at a future date. The Bank had issued approximately \$17,164,000 in such commitments at December 31, 2018. However, there is no assurance that the loans will be originated and funded due to uncertainty of customer acceptance of the terms and conditions of the agreement.

#### ***Concentrations of Credit Risk***

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers. Although the Bank has a reasonably diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent upon economic conditions in and around the counties of Botetourt, Roanoke, Rockbridge and Franklin and the City of Salem, Virginia. At December 31, 2018 the Bank had an approximate \$44,640,000 in secured loan concentration balances in 1-4 family residential construction, other construction, land and development, and lots. This amount represents 88% of total risk based capital, complying with the Federal Deposit Insurance Corporation's ("FDIC") suggested guideline of less than 100%.

The Bank also monitors loan concentrations for non-owner occupied commercial real estate, construction, and lot loans. Combined with the categories above, the Bank had approximately \$102,650,000 in concentration balances or 203% of total risk based capital, below the FDIC's suggested guideline of less than 300%. Large individual credit relationships are also monitored to mitigate risk and ensure compliance with applicable laws.

Certain cash deposits maintained by the Bank with other financial institutions are secured by federal depository insurance. At times during the year these accounts are in excess of the FDIC insured limit of \$250,000. The Bank has not experienced losses in such accounts and believes it is not exposed to significant credit risk on cash and cash equivalents.

### **Note 15. Regulatory Restrictions**

Investments in state and municipal securities involve governmental entities within and outside the Bank's market area. The Bank from time to time has cash and cash equivalents on deposit with financial institutions which exceed federally-insured limits.

#### ***Dividends***

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

## Notes to Consolidated Financial Statements

### Note 15. Regulatory Restrictions, continued

#### Capital Requirements

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

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table below) of Total Capital, Tier 1 Capital and Tier 1 Common Equity Capital to risk-weighted assets, and of Tier 1 Leverage Capital to average assets, as all those terms are defined in the regulations. Management believes, as of December 31, 2018, that the Bank met all capital adequacy requirements to which they are subject.

As of December 31, 2018 and 2017, the Bank was categorized as "well capitalized" as defined by applicable regulations. To be categorized as "well capitalized", the Bank must maintain minimum total risk-based, Tier 1 risk-based, Tier 1 Common Equity, and Tier 1 Leverage ratios as set forth in the table below. BASEL III regulatory capital guidance established the capital conservation buffer phase-in schedule which began January 1, 2016. The capital conservation buffer requirement is being gradually phased in starting with 0.625% in 2016 and increased each year until it is fully implemented at 2.5% in 2019. The Bank must maintain the required capital conservation buffer to avoid restrictions on payments of dividends, discretionary bonuses, and capital repurchases. At December 31, 2018, the Bank met the capital conservation buffer requirement.

There are no conditions or events since that date that management believes have changed the Bank's category. The Bank's actual capital amounts and ratios are presented in the table below (in thousands except for percentages):

	<u>Actual</u>		<u>Regulatory Minimum With Capital Conservation Buffer</u>		<u>Capital Required To Be Considered Well Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<b>December 31, 2018:</b>						
Total Capital (to Risk-Weighted Assets)	\$ 50,447	14.2%	\$ 35,076	9.875%	\$ 35,520	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 47,054	13.3%	\$ 27,972	7.875%	\$ 28,416	8.0%
Tier 1 Common Equity Capital (to Risk-Weighted Assets)	\$ 47,054	13.3%	\$ 22,644	6.375%	\$ 23,088	6.5%
Tier 1 Capital - Leverage (to Average Assets)	\$ 47,054	10.9%	\$ 17,270	4.000%	\$ 21,588	5.0%
<b>December 31, 2017:</b>						
Total Capital (to Risk-Weighted Assets)	\$ 38,958	11.9%	\$ 30,305	9.250%	\$ 32,762	10.0%
Tier 1 Capital (to Risk-Weighted Assets)	\$ 35,816	10.9%	\$ 23,753	7.250%	\$ 26,210	8.0%
Tier 1 Common Equity Capital (to Risk-Weighted Assets)	\$ 35,816	10.9%	\$ 18,838	5.750%	\$ 21,296	6.5%
Tier 1 Capital - Leverage (to Average Assets)	\$ 35,816	9.4%	\$ 15,311	4.000%	\$ 19,139	5.0%

## Notes to Consolidated Financial Statements

### Note 16. Transactions with Related Parties

The Bank has entered into transactions with its directors, significant shareholders and their affiliates (related parties). Such transactions were made in the ordinary course of business on substantially the same terms and conditions, including interest rates and collateral, as those prevailing at the same time for comparable transactions with other customers, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

Aggregate loan transactions with related parties were as follows for the year-ended December 31:

	<u>2018</u>	<u>2017</u>
<i>Balance, beginning</i>	\$ 3,774,408	\$ 3,843,603
New loans or credit line advances	2,508,242	4,377,920
Repayments	<u>(3,642,670)</u>	<u>(4,447,115)</u>
<i>Balance, ending</i>	<u>\$ 2,639,980</u>	<u>\$ 3,774,408</u>

Deposit transactions with related parties at December 31, 2018 and 2017 were insignificant.

As discussed in Note 6 Property, Equipment and Foreclosed Assets, the Bank had lessee activities with companies of related party interests in both 2018 and 2017.

### Note 17. Stockholders' Equity

#### *Dividend Reinvestment and Stock Purchase Plan*

The Bank's Dividend Reinvestment and Stock Purchase Plan ("DRIP") provides for the issuance of up to 200,000 shares of common stock. Common shares may be acquired on a quarterly basis via full or partial dividend reinvestment, systematic quarterly purchases, or a one-time purchase. The purchase price of shares acquired through the DRIP is recommended by the Dividend Reinvestment Plan Committee ("Committee") of the Bank and approved by the Board of Directors. In determining the purchase price per share, the Committee considers book value of the common stock, the relationship between traded price and book value, known recent trades, bid price, and any additional information the Committee deems appropriate.

The following is a summary of the shares of common stock issued from dividends reinvested and optional cash purchases in 2018 and 2017.

	<u>2018</u>	
	<u>Shares</u>	<u>Purchase Price</u>
First Quarter	1,474	\$ 25.80
Second Quarter	1,363	27.25
Third Quarter	1,313	28.75
Fourth Quarter	<u>2,750</u>	30.00
Total Shares Issued	<u>6,900</u>	
	<u>2017</u>	
	<u>Shares</u>	<u>Purchase Price</u>
First Quarter	1,715	\$ 20.25
Second Quarter	1,690	20.75
Third Quarter	1,619	22.00
Fourth Quarter	<u>1,525</u>	23.50
Total Shares Issued	<u>6,549</u>	



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## Notes to Consolidated Financial Statements

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### **Note 17. Stockholders' Equity, continued**

#### ***Common Stock Offering***

On December 17, 2018, the Bank completed its stock offering to existing shareholders, institutional investors, and other accredited investors. The Bank sold the offering's maximum of 275,000 shares of common stock at an offering price of \$30.00 per share, or \$8,250,000 in gross proceeds. Net proceeds from the offering were \$7,603,664. The Bank intends to use the net proceeds from the offering to support future growth and for general corporate purposes.

### **Note 18. Subsequent Events**

#### ***Declaration of Cash Dividend***

On January 30, 2019, the Bank declared a first quarter \$0.16 dividend per common share paid on February 19, 2019 to shareholders of record on February 11, 2019. These financial statements have not been updated for subsequent events occurring after February 26, 2019 which is the date these financial statements were available to be issued.

### **Note 19. Accounting Standards Updates**

In January 2016, the FASB amended the Financial Instruments topics of the Accounting Standards Codification to address certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. The amendment was effective for the Bank January 1, 2019. The Bank applied the guidance by means of a cumulative-effect adjustment to the balance sheet as of the beginning of the fiscal year adoption. The Bank had one equity instrument with a readily determined fair value in its portfolio. The cumulative-effect adjustment resulted in a reclassification of approximately \$61,000 from accumulated other comprehensive income to retained earnings. The deferred income tax payable initially recorded was approximately \$16,000.

In February 2016, the FASB amended the Leases topic of the Accounting Standards Codification to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendment requires all leases with lease terms over twelve months to be capitalized as a right-of-use asset and lease liability on the balance sheet at the date of lease commencement. Leases are classified as either finance leases or operating leases. The Bank evaluated the existing leasing contracts and activities as the amendment was effective January 1, 2019. The Bank adopted the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow the Bank to largely account for the existing leases consistent with current guidance except for the balance sheet recognition for any qualifying lessees. The timing of expense recognition was immaterial to the Bank's financial statements.

In June 2016, the FASB issued ASU No. 2016-13, "*Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*," Under this ASU, the current incurred loss credit impairment methodology will be replaced with the CECL model, a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. Accordingly, the implementation of the CECL model will change the Bank's current method of providing an allowance for loan losses and may result in material changes in the Bank's accounting for credit losses on financial instruments. The CECL model may create more volatility in the Bank's estimate. If the Bank is required to materially increase its level of allowance for loan losses for any reason, such increase could adversely affect its business, financial condition, and results of operations. As a non-SEC registrant, the amendment is effective for the Bank January 1, 2021. The Bank is currently assessing the requirements and necessary changes to the existing credit loss estimation methods and identifying a complete set of data requirements and sources as well as currently evaluating the impact the ASU will have on its consolidated financial statements.

In March 2017, the FASB amended the requirements in the Compensation – Retirement Benefits Topic of the Accounting Standards Codification related to the income statement presentation of the components of net periodic benefit cost for an entity's sponsored defined benefit pension plan and other postretirement plans. The amendments will be effective for the Bank on January 1, 2020. The Bank does not expect these amendments to have a material effect on its financial statements.

## NOTES

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