Burke & Herbert Bank

At Your Service Since 1852®

2019 Audited Financial Statements

CONTENTS

BURKE & HERBERT BANK & TRUST COMPANY

BALANCE SHEETS
December 31, 2019 and 2018
In thousands, except share and per share data

ASSETS		**2019**		2018
Cash and due from banks	**$**	**83,747**	$	101,880
Securities available for sale, at fair value		**693,750**		847,776
Restricted stock, at cost		**5,944**		16,430
Loans held for sale		**1,969**		-
Loans, net of allowance for loan losses of **$24,201** in 2019 and $17,321 in 2018		**1,859,001**		1,835,545
Bank premises and equipment, net		**41,188**		42,460
Other real estate owned		**-**		338
Accrued interest receivable		**8,113**		9,867
Bank owned life insurance		**86,667**		74,748
Other assets		**85,560**		77,665
	$	**2,865,939**	$	3,006,709
LIABILITIES AND STOCKHOLDERS' EQUITY				
Liabilities				
Deposits:				
Demand deposits	**$**	**621,424**	$	618,527
Interest checking accounts		**386,617**		425,051
Savings deposits and money market accounts		**975,358**		927,350
Time deposits		**410,613**		336,143
		2,394,012		2,307,071
Other borrowed funds		**75,000**		320,000
Accrued interest and other liabilities		**43,399**		33,775
		2,512,411		2,660,846
Stockholders' Equity				
Common stock, $20 par value; 200,000 shares authorized; outstanding **186,958** in 2019 and 188,100 in 2018		**3,739**		3,762
Additional paid-in capital		**10,032**		10,000
Retained earnings		**338,331**		339,445
Accumulated other comprehensive income (loss)		**1,426**		(7,344)
		353,528		345,863
	$	**2,865,939**	$	3,006,709

See Notes to Financial Statements

BURKE & HERBERT BANK & TRUST COMPANY

STATEMENTS OF INCOME
Years Ended December 31, 2019 and 2018
In thousands, except per share data

	2019	2018
Interest income:		
Loans	**$ 84,496**	$ 82,576
Securities	**25,952**	28,594
	110,448	111,170
Interest expense:		
Deposits	**17,572**	8,612
Other borrowed funds	**3,884**	6,863
	21,456	15,475
Net interest income	**88,992**	95,695
Provision for loan losses	**6,243**	1,148
Net interest income after provision for loan losses	**82,749**	94,547
Noninterest income:		
Income from fiduciary & wealth management activities	**4,254**	4,223
Service charges and fees	**8,988**	8,792
Net gains on securities	**3,192**	397
Income from bank owned life insurance	**1,913**	4,053
Other	**41**	63
	18,388	17,528
Noninterest expenses:		
Salaries and wages	**43,274**	37,230
Pensions and other employee benefits	**9,655**	9,075
Occupancy expenses	**6,527**	5,797
Equipment rentals, depreciation and maintenance	**5,030**	4,799
Net (gains) on other real estate owned	**(78)**	(101)
Other operating expenses	**20,006**	18,707
	84,414	75,507
Income before income taxes	**16,723**	36,568
Income tax expense (benefit)	**(255)**	2,180
Net income	**$ 16,978**	$ 34,388
Basic earnings per common share	**$ 90.63**	$ 181.62
Diluted earnings per common share	**$ 90.60**	$ 181.62

See Notes to Financial Statements

BURKE & HERBERT BANK & TRUST COMPANY

STATEMENTS OF COMPREHENSIVE INCOME
Years Ended December 31, 2019 and 2018
In thousands

		2019		2018
Net income	**$**	**16,978**	$	34,388
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities:				
Unrealized holding gains (losses) arising during period, net of tax of **($2,740)** for 2019 and $2,537 for 2018		**10,308**		(9,544)
Reclassification adjustment for gain on securities, net of tax of **($670)** for 2019 and ($83) for 2018		**(2,522)**		(314)
Changes in pension plan benefits, net of tax of (**$261)** for 2019 and $7 for 2018		**984**		(27)
Total other comprehensive income (loss)		**8,770**		(9,885)
Comprehensive income	**$**	**25,748**	$	24,503

See Notes to Financial Statements

BURKE & HERBERT BANK & TRUST COMPANY

STATEMENTS OF STOCKHOLDERS' EQUITY
Years Ended December 31, 2019 and 2018
In thousands, except share data

	Common Stock			Additional Paid-in		Retained		Accumulated Other Comprehensive		Total Stockholders'
	Shares		Amount		Capital		Earnings		Income (Loss)		Equity
Balance, December 31, 2017	190,676	$	3,814	$	10,000	$	327,472	$	2,541	$	343,827
Net income							34,388				34,388
Cash dividends paid							(15,144)				(15,144)
Other comprehensive loss									(9,885)		(9,885)
Common stock transactions	(2,576)		(52)				(7,271)				(7,323)
Balance, December 31, 2018	188,100	$	3,762	$	10,000	$	339,445	$	(7,344)	$	345,863
Net income							**16,978**				**16,978**
Cash dividends paid							**(14,990)**				**(14,990)**
Other comprehensive income									**8,770**		**8,770**
Stock-based Compensation expense					**32**						**32**
Common stock Transactions	**(1,142)**		**(23)**				**(3,102)**				**(3,125)**
Balance, December 31, 2019	**186,958**	**$**	**3,739**	**$**	**10,032**	**$**	**338,331**	**$**	**1,426**	**$**	**353,528**

See Notes to Financial Statements

BURKE & HERBERT BANK & TRUST COMPANY

STATEMENTS OF CASH FLOWS
Years Ended December 31, 2019 and 2018
In thousands

		2019		2018
Cash flows from operating activities:				
Net income	**$**	**16,978**	$	34,388
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization		**3,041**		2,593
Realized (gain) on available for sale securities		**(3,192)**		(397)
(Gain) on sale of other real estate owned properties		**(78)**		(173)
Write-down on other real estate owned properties		**-**		72
Provision for loan losses		**6,243**		1,148
Income from Bank owned life insurance		**(1,913)**		(4,053)
Deferred tax (benefit)		**(5,092)**		(2,089)
Loss on disposal of fixed assets		**4**		8
Accretion of bond discount		**(975)**		(957)
Amortization of bond premium		**5,117**		6,902
Stock based compensation expense		**32**		-
(Gain) on loans held for sale		**(292)**		(160)
Proceeds from sale of loans held for sale		**14,859**		8,460
Originations of loans held for sale		**(16,536)**		(8,300)
Decrease in accrued interest receivable		**1,754**		615
(Increase) in other assets		**(5,135)**		(12,111)
Increase in accrued interest and other liabilities		**10,869**		8,752
Net cash provided by operating activities		**25,684**		34,698
Cash flows from investing activities:				
Proceeds from maturities of securities available for sale		**115,566**		148,337
Proceeds from sale of securities available for sale, net		**149,150**		13,602
Purchases of securities available for sale, net		**(101,784)**		(74,980)
Sales of restricted stock		**12,612**		8,288
Purchases of restricted stock		**(2,126)**		(3,941)
Purchases of property and equipment		**(1,772)**		(2,836)
Proceeds (purchases of) Bank owned life insurance		**(10,006)**		3,730
Proceeds from sale of other real estate owned properties		**416**		173
(Increase) decrease in loans made to customers, net		**(29,699)**		518
Net cash provided by investing activities	**$**	**132,357**	$	92,891

(continued)

BURKE & HERBERT BANK & TRUST COMPANY

STATEMENTS OF CASH FLOWS (continued)
Years Ended December 31, 2019 and 2018
In thousands

		2019		2018
Cash flows from financing activities:				
Net increase in demand deposits, NOW accounts, savings deposits and money market accounts	**$**	**12,471**	$	1,593
Increase in other time deposits		**74,470**		10,010
(Decrease) in other borrowed funds		**(245,000)**		(105,000)
Cash dividends paid		**(14,990)**		(15,144)
Common stock transactions		**(3,125)**		(7,323)
Net cash (used in) financing activities		**(176,174)**		(115,864)
Increase (decrease) in cash and cash equivalents		**(18,133)**		11,725
Cash and cash equivalents				
Beginning		**101,880**		90,155
Ending	**$**	**83,747**	$	101,880
Supplemental Disclosures of Cash Flow Information				
Cash payments for:				
Interest paid to depositors	**$**	**17,338**	$	8,413
Interest paid on securities sold under agreements to repurchase	**$**	**-**	$	-
Interest paid on other borrowed funds	**$**	**4,063**	$	6,879
Income taxes	**$**	**100**	$	1,750
Change in unrealized gains (losses) on available for sale Securities	**$**	**9,856**	$	(12,478)
Change in pension plan benefits	**$**	**1,245**	$	(34)
Loans transferred to other real estate owned	$	-	$	-

See Notes to Financial Statements

Note 1. Nature of Banking Activities and Significant Accounting Policies

Nature of banking activities: Burke & Herbert Bank & Trust Company (the Bank) conducts its banking business in northern Virginia. The Bank's 25 branch locations accept business and consumer deposits from a diverse clientele. The Bank's loan portfolio includes commercial and consumer loans, a substantial portion of which are secured by area real estate.

A summary of the Bank's significant accounting policies follows:

Estimates: The preparation of financial statements requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly sensitive to significant change relate to the determination of the allowance for loan losses, other-than-temporary impairment of securities, other real estate owned, deferred taxes and fair value measurements.

Cash, cash equivalents and cash flows: For purposes of reporting cash flows, cash and cash equivalents include cash on hand and amounts due from banks, including cash items in process of clearing. Cash flows from loans, federal funds purchased and sold, securities sold under agreements to repurchase and deposits are reported net.

Securities: Management determines the appropriate classification of securities at the time of purchase. Debt securities that the Bank has both the positive intent and ability to hold to maturity are classified as held to maturity and are reported at cost, adjusted for amortization of premiums and accretion of discounts. Debt securities that the Bank intends to hold for an indefinite period of time, but not necessarily to maturity, are classified as available for sale and are reported at fair value. Unrealized gains and losses on investments classified as available for sale have been accounted for as a separate component of accumulated other comprehensive income or loss, net of the related deferred tax effect. Amortization of premiums and accretion of discounts are recognized in interest income over the terms of the securities. Any decision to sell a security classified as available for sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Bank's assets and liabilities, liquidity needs, regulatory capital considerations, and other similar factors. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Equity Securities: Equity securities are carried at fair value, with changes in fair value reported in net income. Equity securities without readily determinable fair values are carried at cost, minus impairment, in any, plus or minus changes resulting from observable price changes in orderly transactions for the identical or a similar investment.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

The Bank follows applicable accounting guidance related to recognition and presentation of other-than-temporary impairment. The guidance specifies that (a) if the Bank does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss. When an entity does not intend to sell the security, and it is more likely than not the entity will not have to sell the security before recovery of its cost basis, it will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income.

The Bank's statement of income reflects the full impairment (that is, the difference between the security's amortized cost basis and fair value) on debt securities that the Bank intends to sell or would more-likely-than-not be required to sell before the expected recovery of the amortized cost basis. For available-for-sale and held-to-maturity debt securities that management has no intent to sell and believes that it more-likely-than-not will not be required to sell prior to recovery, only the credit loss component of the impairment is recognized in earnings, while the noncredit loss is recognized in accumulated other comprehensive income. The credit loss component recognized in earnings is identified as the amount of principal cash flows not expected to be received over the remaining term of the security as projected based on cash flow projections.

Due to the nature of, and restrictions placed upon, the equity securities of the Federal Home Loan Bank and Community Bankers' Bank, these securities have been classified as restricted stock and are carried at cost. These equity securities are not subject to the classifications above. The Bank has no other equity securities.

<u>Loans held for sale</u>: Loans held for sale are those loans the Bank has the intent to sell in the foreseeable future. They are carried at the lower of aggregate cost or fair value. Gains and losses on sales of loans are recognized at settlement dates and are determined by the difference between the sales proceeds and the carrying value of the loans. All sales are made without recourse, and are sold with servicing released.

<u>Derivatives</u>: The Bank enters into commitments to originate loans whereby the interest rate on the loan is determined prior to funding (rate lock commitments). Rate lock commitments on mortgage loans to be held for sale are considered to be derivatives. The period of time between issuance of a loan commitment and closing and sale of the loan generally ranges from 15 to 90 days. The Bank protects itself from changes in interest rates through the use of best efforts forward delivery commitments, whereby the Bank commits to sell a loan at the time the borrower commits to an interest rate with the intent that the buyer has assumed interest rate risk on the loan. As a result, the Bank is not exposed to significant losses nor will it realize significant gains related to rate lock commitments due to changes in interest rates. The Bank determined the fair value of the interest rate lock commitments were immaterial as of December 31, 2019 and 2018.

Financial derivatives are reported at fair value in other assets and other liabilities. The accounting for changes in fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. Refer to Note 15 – Commitment and Contingencies for additional information.

<u>Loans</u>: The Bank extends commercial and consumer loans, primarily in northern Virginia. Portfolio segments include (i) commercial real estate, (ii) single family residential (1-4 units), (iii) owner-occupied commercial real estate, (iv) acquisition, construction and development, (v) commercial non-real estate, and (vi) consumer non-real estate and other. As of December 31, 2019, 97.1% of the portfolio was secured with real estate. The Bank does not have a significant concentration of loans to any one customer.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

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

- Commercial real estate loans carry risk associated with either the net operating income generated from the lease of the real estate collateral or income generated from the sale of the collateral. Other risk factors include the credit-worthiness of the sponsor and the value of the collateral.
- Single family residential (1-4 units) loans for consumer purposes carry risks associated with the continued credit-worthiness of the borrower and the value of the collateral. Single family residential (1-4 units) loans for investment purposes carry risks associated with the continued credit-worthiness of the borrower, the value of the collateral, and either the net operating income generated from the lease of the real estate collateral or income generated from the sale of the collateral.
- Owner-occupied commercial real estate loans carry risk associated with the operations of the business that occupies the property and the value of the collateral.
- Acquisition, construction and development loans carry risk associated with the credit-worthiness of the borrower, project completion within budget, sale after completion and the value of the collateral.
- Commercial non-real estate loans represent a small portion of the portfolio and carry risk associated with the operations of the business and the value of the collateral, if any.
- Consumer non-real estate and other loans represent a small portion of the portfolio and carry risk associated with the credit-worthiness of the borrower and the value of the collateral, if any.

The Bank's recorded investment in loans that management has the intent and ability to hold for the foreseeable future, until maturity or until pay-off, generally are reported at their outstanding unpaid principal balances, adjusted for partial charge-offs, the allowance for loan losses, and any deferred fees and costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees and costs are deferred and recognized as an adjustment of the related loan yield using the interest method.

For all portfolio segments, the accrual of interest is discontinued at the time a loan becomes 90 days delinquent, unless the credit is well-secured and in process of collection. Loans also are placed on nonaccrual if collection of principal or interest is considered impaired. Interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. For all portfolio segments, loans are returned to accrual status when they are no longer 90 days past due, unless collection of future payments is considered impaired.

<u>Allowance for loan losses</u>: The allowance for loan losses is established to absorb probable losses inherent in outstanding loans through a provision for loan losses charged to earnings. Credit losses are charged against the allowance. Subsequent recoveries, if any, are credited to the allowance.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

The allowance for loan losses is evaluated on a quarterly basis by management and is based upon (i) historical loss norms for each portfolio segment as adjusted by environmental factors plus a risk adjustment based on the risk rating of the loan, (ii) a loan by loan analysis of all other loans which are rated as either substandard or worse or as troubled debt restructures. Loan ratings include:

- Pass rated loans include all loans which are considered to be either high quality, good quality or acceptable quality. Borrowers have an acceptable financial condition with demonstrated repayment ability.
- Special mention loans have potential developing weaknesses that deserve extra attention. If the developing weakness is not corrected or mitigated, there may be deterioration in the ability of the borrower to repay.
- Substandard is a regulatory classification. Loans rated substandard are considered to have well-defined weakness and there is a possibility that some future loss will be sustained by the Bank if such weakness is not corrected.
- Doubtful also is a regulatory classification. Loans rated doubtful have all of the weaknesses inherent in those rated substandard, with the added characteristic that the severity of the weaknesses makes collection or liquidation in full highly questionable. The probability of some loss is high.
- Loss represents a classification for loans which are considered uncollectable and are in the process of being charged off.

Historical credit losses for each portfolio segment are adjusted by environmental factors which include (i) changes in lending policies and procedures, including underwriting standards, and collection, charge-off, and recovery practices; (ii) changes in national and local economic and business conditions, including the conditions of various market segments; (iii) changes in the nature and volume of the portfolio; (iv) changes in the experience, ability, and depth of lending management and staff; (v) changes in the volume and severity of past due and classified loans and the volume of nonaccruals, troubled debt restructurings, and other loan modifications; (vi) changes in the quality of the Bank's loan review system and the degree of oversight by the Bank's Board of Directors; (vii) the existence and effect of any concentrations of credit and changes in the level of such concentrations; and (viii) the effect of external factors, such as competition and legal and regulatory requirements, on the level of estimated credit losses in the Bank's current portfolio. This evaluation is inherently subjective since it requires estimates that are susceptible to significant revision as additional information becomes available or as economic conditions change.

Impaired, collateral dependent loans may be charged down to the net realizable value of the collateral. Alternatively, a specific allowance may be established when the discounted cash flows (or collateral value of observable market price) of the impaired loan are lower than the carrying value of that loan.

For all portfolio segments, a loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

Bank premises and equipment: Land is carried at cost. Bank premises and equipment are carried at cost less accumulated depreciation. Depreciation is computed under the straight-line method. Maintenance and repairs are charged to expense as incurred and major improvements are capitalized.

Bank owned life insurance: The Bank has purchased life insurance policies on certain employees. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value.

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, or the ability to unilaterally cause the transferee to return specific assets.

Other real estate owned (OREO): Assets acquired through foreclosure or other proceedings are initially recorded at fair value at the date of foreclosure less estimated costs of disposal, which establishes a new cost. After foreclosure, valuations periodically are performed by management and the foreclosed assets held for sale are carried at the lower of cost or fair value less estimated costs of disposal. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for loan losses. All subsequent gains on sale, losses on sale, and additional write-downs are included in net gains/(losses) on other real estate owned. Revenue and expenses from the operations of foreclosed assets are included in other noninterest income and other operating expenses.

Income taxes: The Bank accounts for income taxes in accordance with income tax accounting guidance. The Bank has adopted the accounting guidance related to accounting for uncertainty in income taxes, which sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Bank determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

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

Employee benefits: The Bank has a noncontributory defined benefit pension plan that was frozen to new participants on June 1, 2005. The Bank also has a defined contribution plan (The Investment and Savings Plan) with a salary deferral provision, which covers all employees in the month following their date of hire if they have reached the age of 18. The Bank's funding policy for the defined benefit plan is to make annual contributions to the Plan in amounts that are determined based on actuarial valuations and recommendations and which meet the minimum funding requirements of the Employee Retirement Income Security Act of 1974.

Authoritative accounting literature requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or liability in its balance sheet and to recognize changes in the funded status in the year in which the changes occur through comprehensive income. The funded status of a benefit plan will be measured as the difference between plan assets at fair value and the benefit obligation. For a pension plan, the benefit obligation is the projected benefit obligation. For any other postretirement plan, the benefit obligation is the accumulated postretirement benefit obligation. Authoritative accounting literature also requires an employer to measure the funded status of a plan as of the date of its year-end balance sheet. The guidance also requires additional disclosure in the notes to financial statements about certain effects on net periodic benefit cost for the next fiscal year that arise from delayed recognition of the gains or losses, prior service costs or credits, and transition asset or obligation.

Per share data: The Bank's capital structure includes a restricted stock unit (RSU) capital plan which is dilutive to earnings per share. Basic EPS is calculated by dividing net income by the weighted average number of shares outstanding during the year. The weighted average number of shares outstanding during 2019 and 2018, was 187,344 and 189,337 shares, respectively. Diluted EPS is calculated by assuming dilution of common shares and adjusting net income for compensation cost attributable to the RSU plan.

Trust assets and fees: Assets of the trust department, other than trust cash on deposit at the Bank, are not included in these financial statements because they are not assets of the Bank. Trust fees are recognized in income using the accrual method.

Advertising costs: Advertising costs are expensed as incurred. Advertising expense was $969 thousand and $967 thousand for the years ended December 31, 2019 and 2018, respectively.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

Comprehensive income: Comprehensive income consists of net income and other comprehensive income. Other comprehensive income (loss) includes unrealized gains (losses) on securities available for sale, unrealized losses related to factors other than credit on debt securities, and changes in the funded status of the pension plan which also are recognized as separate components of equity.

Fair value of financial instruments: Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 18. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Equity-based Compensation: The Bank recognizes in the income statement equity-based compensation. The Bank classifies stock awards as equity. Equity classified awards are valued as of the grant date using an observable market price.

During 2019, the Bank began granting restricted stock units which are granted at the fair market value of the Bank's common stock on the grant date. These restricted stock units vest at 33 1/3% on the third (3^{rd}) anniversary of the vesting commencement date. Fifty percent (50%) of the units then subject to the award shall vest on the 4^{th} anniversary of the vesting commencement date. The remaining units subject to award will vest of the fifth (5^{th}) anniversary of the vesting commencement date.

Discussion of New Pronouncement Adoption

In February 2016, the FASB issued ASU No. 2016-02, "Leases (Topic 842)." Among other things, the standard requires lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: (1) A lease liability, which is a lessee`s obligation to make lease payments arising from a lease, measured on a discounted basis; and (2) A right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. Under the new guidance, lessor accounting is largely unchanged. For financial reporting purposes, the standard provides for a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. Lessees and lessors may not apply a full retrospective transition approach.

Subsequent to the issuance of ASU 2016-02, the FASB issued targeted updates to clarify specific implementation issues including ASU No. 2018-01, "Leases (Topic 842): Land Easement Practical Expedient for Transition to Topic 842," ASU No. 2018-10, "Codification Improvements to Topic 842, Leases," ASU No. 2018-11, "Leases (Topic 842): Targeted Improvements," ASU No. 2018-20, "Leases (Topic 842): Narrow-Scope Improvements for Lessors," and ASU No. 2019-01 "Leases (Topic 842): Codification Improvements." One of the amendments in ASU 2018-11 provides an additional (and optional) transition method to adopt the standard. If elected, an entity initially applies the new leases standard at the adoption date and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Consequently, an entity's reporting for the comparative periods presented in the financial statements in which it adopts the new leases standard will continue to be in accordance with previous GAAP (Topic 840, Leases).

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

Upon adoption on January 1, 2019, the Bank elected the prospective application approach provided by ASU 2018-11. There was no cumulative effect adjustment at adoption. The Bank also elected certain practical expedients within the standard and did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases and did not reassess any initial direct costs for existing leases. The Bank evaluated its existing leases as of January 1, 2019 and recognized a right-of-use asset and lease liability for leases with a remaining term greater than 12 months. The Bank also recognized a right-of-use asset and lease liability for leases that commenced after January 1, 2019.

Recent Accounting Pronouncements

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

The Bank has formed a committee to address the compliance requirements, data gathering, archiving and analysis efforts. Additionally, the Bank has purchased a software solution that will assist in complying with this regulation. Historical data dating back to December 31, 2014 has been entered in the software for analysis. The Bank expects to begin operating in a parallel environment with the existing loss model in late 2020.

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

In August 2018, the FASB issued ASU 2018-14*: Compensation—Retirement Benefits—Defined Benefit Plans—General (Subtopic 715-20): Disclosure Framework—Changes to the Disclosure Requirements for Defined Benefit Plans*. These amendments modify the disclosure requirements for employers that sponsor defined benefit pension or other postretirement plans. Certain disclosure requirements have been deleted while the following disclosure requirements have been added: the weighted-average interest crediting rates for cash balance plans and other plans with promised interest crediting rates and an explanation of the reasons for significant gains and losses related to changes in the benefit obligation for the period.

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

The amendments also clarify the disclosure requirements in paragraph 715-20-50-3, which state that the following information for defined benefit pension plans should be disclosed: The projected benefit obligation (PBO) and fair value of plan assets for plans with PBOs in excess of plan assets and the accumulated benefit obligation (ABO) and fair value of plan assets for plans with ABOs in excess of plan assets. The amendments are effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Bank does not expect the adoption of ASU 2018-14 to have a material impact on its financial statements.

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

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

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

Note 1. Nature of Banking Activities and Significant Accounting Policies (continued)

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

Note 2. Restrictions on Cash and Due from Banks

No reserve balances were required at December 31, 2019 and December 31, 2018.

Note 3. Securities

Securities have been classified in the balance sheets according to management's intent. The carrying amount of securities and their approximate fair values at December 31, 2019 and 2018, are summarized as follows (in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities available for sale:				
December 31, 2019:				
U.S. Government & agency Securities	**$ 97,907**	**$ 573**	**$ 9**	**$ 98,471**
Mortgage backed securities	**374,774**	**2,087**	**2,485**	**374,376**
State & municipal securities	**211,146**	**10,190**	**433**	**220,903**
	$ 683,827	**$ 12,850**	**$ 2,927**	**$ 693,750**
December 31, 2018:				
U. S. Government & agency securities	$ 112,861	$ 36	$ 1,008	$ 111,889
Mortgage backed securities	434,403	4,375	9,101	429,677
State & municipal securities	300,445	7,435	1,670	306,210
	$ 847,709	$ 11,846	$ 11,779	$ 847,776

At December 31, 2019 and 2018, securities with amortized costs of $425.4 million and $537.2 million, respectively, and with estimated fair values of $433.0 million and $532.0 million, respectively, were pledged to secure public deposits, repurchase agreements and for other purposes required or permitted by law.

Note 3. Securities (continued)

The gross realized gains, realized losses, and proceeds from the sale of securities for the years ended December 31, 2019 and 2018 were as follows:

		2019		2018
Gross realized gains	$	3,668	$	472
Gross realized losses		(476)		(75)
Proceeds from sale of securities		149,249		13,602

The maturities of securities available for sale at December 31, 2019, were as follows: (Expected maturities may differ from contractual maturities because borrowers have the right to call or prepay some obligations with or without call or prepayment penalties.)

	Securities Available for Sale			
In thousands		Amortized Cost		Fair Value
Due in one year or less	$	96,006	$	96,531
Due in one to five years		161,212		168,258
Due in five to ten years		35,103		37,631
Due after ten years		16,732		16,954
Mortgage backed securities		374,774		374,376
	$	683,827	$	693,750

The following table shows the gross unrealized losses and fair value of the Bank's securities with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2019 and 2018.

Available for sale securities in a continuous unrealized loss position for less than 12 months and more than twelve months are as follows (in thousands):

	December 31, 2019									
	Less Than Twelve Months				More Than Twelve Months					
		Fair Value		Gross Unrealized Losses		Fair Value		Gross Unrealized Losses		Total Unrealized Losses
Securities available for sale:										
U.S. Government & agency securities	$	-	$	-	$	21,569	$	9	$	9
State & municipal securities		11,043		433		-		-		433
Mortgage backed securities		135,671		1,305		60,518		1,180		2,485
	$	146,714	$	1,738	$	82,087	$	1,189	$	2,927

Note 3. Securities (continued)

	December 31, 2018									
	Less Than Twelve Months				More Than Twelve Months					
	Fair Value		Gross Unrealized Losses		Fair Value		Gross Unrealized Losses		Total Unrealized Losses	
Securities available for sale:										
U.S. Government & agency Securities	$	4,990	$	2	$	89,388	$	1,006	$	1,008
State & municipal securities		5,804		24		49,991		1,646		1,670
Mortgage backed securities		79,742		574		206,761		8,527		9,101
	$	90,536	$	600	$	346,140	$	11,179	$	11,779

U.S. Government & agency securities: At December 31, 2019, the unrealized losses on 2 U.S. Government and agency securities were caused by interest rate increases and not the credit quality of the securities. The contractual cash flows of these investments are guaranteed by an agency of the U.S. government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost basis of the Bank's investments. Because the decline in fair value is attributable to changes in interest rates and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Bank does not consider these investments to be other-than-temporarily impaired.

State & municipal securities: At December 31, 2019, the unrealized losses associated with 7 state and municipal securities were primarily caused by changes in interest rates and not the credit quality of the securities. These investments are investment grade and were generally underwritten in accordance with our own investment standards prior to the decision to purchase, without relying on a bond insurer's guarantee in making the investment decision. These securities will continue to be monitored as part of our ongoing impairment analysis but are expected to perform, even if the rating agencies reduce the credit rating of the bond insurers. As a result, we expect to recover the entire amortized cost basis of these securities.

Mortgage backed securities: At December 31, 2019, the unrealized losses associated with 43 mortgage-backed securities are primarily driven by higher projected collateral losses, wider credit spreads and changes in interest rates. We assess for credit impairment using a cash flow model. Based on our assessment of the expected credit losses of the securities given the performance of the underlying collateral compared to our subordination-based credit enhancement, we expect to recover the entire amortized cost basis of these securities.

The fair values of the Bank's investment securities could decline in the future if the underlying performance of the collateral for the residential mortgage backed securities or other securities deteriorates and our credit enhancement levels do not provide sufficient protection to our contractual principal and interest. As a result, there is a risk that significant other-than-temporary impairment may occur in the future given the current economic environment.

Note 3. Securities (continued)

Other-Than-Temporary Impairment

Periodic reviews are conducted to identify and evaluate each investment security to determine whether an other-than-temporary impairment has occurred. Financial models are used to determine whether an other-than-temporary impairment has occurred for these securities. While all securities are considered, the securities primarily impacted by other-than-temporary impairment testing are private-label mortgage-backed securities. For each private-label mortgage-backed security in the investment portfolio (including but not limited to those whose fair value is less than their amortized cost basis), an extensive, regular review is conducted to determine if an other-than-temporary impairment has occurred. Various inputs to the model are used to determine if an unrealized loss is other than temporary, including estimated default rates, prepayment speeds and severity of loss. Other inputs may include actual collateral attributes including geographic concentrations, credit ratings, and other performance indicators of the underlying assets.

To determine if the unrealized loss for private-label mortgage-backed securities is other-than-temporary, we project total estimated defaults of the underlying assets (mortgages) and multiply that calculated amount by an estimate of realizable value upon sale in the marketplace (severity) in order to determine the projected collateral loss. We also evaluate the current credit enhancement underlying the bond to determine the impact on cash flows. If we determine that a given mortgage-backed security position will be subject to a write-down or loss, we record the expected credit loss as a charge to earnings.

During 2019 and 2018, no securities were estimated to be other-than-temporarily impaired.

The Bank's investment in FHLB stock totaled $5.9 million and $16.4 million at December 31, 2019 and 2018, respectively. FHLB stock is generally viewed as a long-term investment and as a restricted investment security, which is carried at cost, because there is no market for the stock other than the FHLBs or member institutions. Therefore, when evaluating FHLB stock for impairment, its value is based on the ultimate recoverability of the par value rather than by recognizing temporary declines in value. The Bank does not consider this investment to be other-than-temporarily impaired at December 31, 2019 and no impairment has been recognized. FHLB stock is included in a separate line item on the balance sheet (Restricted stock, at cost) and is not part of the Bank's investment securities portfolio. The Bank's restricted securities also include an investment in Community Bankers Bank totaling $50 thousand at both December 31, 2019 and 2018, which is carried at cost.

Note 4. Loans

Major classifications of loans are as follows (in thousands):

	2019	2018
Commercial real estate	**$ 984,386**	$ 912,924
Owner-occupied commercial real estate	**189,710**	259,144
Acquisition, construction & development	**175,705**	157,377
Commercial non-real estate	**31,189**	40,088
Single family residential (1-4 units)	**477,765**	460,045
Consumer non-real estate and other	**24,447**	23,288
	1,883,202	1,852,866
Allowance for loan losses	**(24,201)**	(17,321)
	$ 1,859,001	$ 1,835,545

Net deferred loan fees included in the above loan categories totaled $**3,338** and $3,968 at December 31, 2019 and 2018, respectively.

The following tables present, as of December 31, 2019 and 2018, the total allowance for loan losses, the allowance by impairment methodology (individually evaluated or collectively evaluated for impairment), total loans and loans by impairment methodology (individually evaluated or collectively evaluated for impairment) (in thousands):

December 31, 2019	Commercial Real Estate	Owner-occupied Commercial Real Estate	Acquisition, Construction & Development	Commercial Non-Real Estate	Single Family Residential (1-4 units)	Consumer Non-Real Estate and Other	Total
Allowance for loan losses:							
Beginning balance	**$ 10,649**	**$ 3,097**	**$ 952**	**$ 253**	**$ 2,329**	**$ 41**	**$ 17,321**
Charge-offs	**-**	**-**	**-**	**-**	**-**	**(107)**	**(107)**
Recoveries	**12**	**311**	**-**	**52**	**333**	**36**	**744**
Provision	**735**	**(1,098)**	**745**	**5,647**	**129**	**85**	**6,243**
Ending balance	**$ 11,396**	**$ 2,310**	**$ 1,697**	**$ 5,952**	**$ 2,791**	**$ 55**	**$ 24,201**
Ending Balance:							
Individually evaluated for impairment	**$ -**	**$ 78**	**$ -**	**$ 5,834**	**$ 85**	**$ 2**	**$ 5,999**
Collectively evaluated for impairment	**11,396**	**2,232**	**1,697**	**118**	**2,706**	**53**	**18,202**
Loans:							
Ending balance	**$ 984,386**	**$ 189,710**	**$ 175,705**	**$ 31,189**	**$ 477,765**	**$ 24,447**	**$ 1,883,202**
Ending Balance:							
Individually evaluated for impairment	**$ -**	**$ 2,261**	**$ 120**	**$ 6,634**	**$ 5,356**	**$ 2**	**$ 14,373**
Collectively evaluated for impairment	**984,386**	**187,449**	**175,585**	**24,555**	**472,409**	**24,445**	**1,868,829**

Note 4. Loans (continued)

	December 31, 2018						
	Commercial Real Estate	Owner-occupied Commercial Real Estate	Acquisition, Construction & Development	Commercial Non-Real Estate	Single Family Residential (1-4 units)	Consumer Non-Real Estate and Other	Total
Allowance for loan losses:							
Beginning balance	$ 8,931	$ 3,592	$ 553	$ 250	$ 2,758	$ 155	$ 16,239
Charge-offs	-	(60)	-	(197)	(59)	(95)	(411)
Recoveries	21	-	108	44	115	57	345
Provision	1,697	(435)	291	156	(485)	(76)	1,148
Ending balance	$ 10,649	$ 3,097	$ 952	$ 253	$ 2,329	$ 41	$ 17,321
Ending Balance:							
Individually evaluated for impairment	$ 1,273	$ 48	$ -	$ -	$ -	$ -	$ 1,321
Collectively evaluated for impairment	9,376	3,049	952	253	2,329	41	16,000
Loans:							
Ending balance	$ 912,294	$ 259,144	$ 157,377	$ 40,088	$ 460,045	$ 23,288	$ 1,852,866
Ending Balance:							
Individually evaluated for impairment	$ 4,873	$ 10,013	$ 174	$ -	$ 3,377	$ -	$ 18,437
Collectively evaluated for impairment	908,051	249,131	157,203	40,088	456,668	23,288	1,834,429

Note 4. Loans (continued)

The past due status of loans as of December 31, 2019 and 2018 was as follows:

Aging and Nonaccrual Loans (in thousands)

	December 31, 2019							
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due & Still Accruing	Non-accrual Loans
Commercial real estate	**$ -**	**$ -**	**$ -**	**$ -**	**$ 984,386**	**$ 984,386**	**$ -**	**$ -**
Owner-occupied commercial real estate	**18**	**-**	**-**	**18**	**189,692**	**189,710**	**-**	**708**
Acquisition, construction & development	**39**	**-**	**120**	**159**	**175,546**	**175,705**	**-**	**120**
Commercial non-real estate	**49**	**-**	**-**	**49**	**31,140**	**31,189**	**-**	**5,920**
Single family residential (1-4 units)	**2,375**	**1,906**	**1,237**	**5,518**	**472,247**	**477,765**	**-**	**4,499**
Consumer non-real estate and other	**3**	**-**	**-**	**3**	**24,444**	**24,447**	**-**	**2**
Total	**$ 2,484**	**$ 1,906**	**$ 1,357**	**$ 5,747**	**$ 1,877,455**	**$ 1,883,202**	**$ -**	**$ 11,249**

Note 4. Loans (continued)

	December 31, 2018							
	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90 Days Past Due & Still Accruing	Non-accrual Loans
Commercial real estate	$ -	$ -	$ 3,693	$ 3,693	$ 909,231	$ 912,924	$ -	$ 4,123
Owner-occupied commercial real estate	-	-	578	578	258,566	259,144	578	6,011
Acquisition, construction & development	-	-	-	-	157,377	157,377	-	174
Commercial non-real estate	-	-	-	-	40,088	40,088	-	-
Single family residential (1-4 units)	4,953	-	1,654	6,607	453,438	460,045	-	3,142
Consumer non-real estate and other	1	-	-	1	23,287	23,288	-	-
Total	$ 4,954	$ -	$ 5,925	$ 10,879	$ 1,841,987	$ 1,852,866	$ 578	$ 13,450

Note 4. Loans (continued)

Impaired loans and the related allowance at December 31, 2019 and 2018 were as follows:

Impaired Loans (in thousands)

	December 31, 2019				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial real estate	$ -	$ -	$ -	$ -	$ -
Owner-occupied commercial real estate	**708**	**927**	**-**	**755**	**94**
Acquisition, construction & development	**120**	**123**	**-**	**147**	**2**
Commercial non-real estate	**-**	**-**	**-**	**-**	**-**
Single family residential (1-4 units)	**4,499**	**4,778**	**-**	**4,578**	**174**
Consumer non-real estate and other	**-**	**-**	**-**	**-**	**-**
With an allowance recorded:					
Commercial real estate	$ -	$ -	$ -	$ -	$ -
Owner-occupied commercial real estate	**1,553**	**1,553**	**78**	**1,579**	**82**
Acquisition, construction & development	**-**	**-**	**-**	**-**	**-**
Commercial non-real estate	**6,634**	**6,634**	**5,834**	**3,617**	**171**
Single family residential (1-4 units)	**857**	**857**	**85**	**868**	**42**
Consumer non-real estate and other	**2**	**3**	**2**	**1**	**-**

Note 4. Loans (continued)

	December 31, 2018				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance:					
Commercial real estate	$ 1,180	$ 1,294	$ -	$ 1,229	$ 82
Owner-occupied commercial real estate	6,011	10,774	-	6,392	530
Acquisition, construction & development	174	175	-	175	17
Commercial non-real estate	-	-	-	-	-
Single family residential (1-4 units)	3,377	3,683	-	3,422	107
Consumer non-real estate and other	-	-	-	-	-
With an allowance recorded:					
Commercial real estate	$ 3,693	$ 3,693	$ 1,273	$ 4,091	$ 114
Owner-occupied commercial real estate	4,002	4,002	48	4,030	242
Acquisition, construction & development	-	-	-	-	-
Commercial non-real estate	-	-	-	-	-
Single family residential (1-4 units)	-	-	-	-	-
Consumer non-real estate and other	-	-	-	-	-

Note 4. Loans (continued)

Loans by credit quality indicators as of December 31, 2019 and 2018 were as follows:

Loans by Credit Quality (in thousands)

	December 31, 2019				
	Internal Risk Rating Grades				
	Pass	Special Mention	Substandard	Doubtful	Loss
Commercial real estate	**$ 957,885**	**$ 26,372**	**$ 129**	**$ -**	**$ -**
Owner-occupied commercial real estate	**184,202**	**3,234**	**2,274**	**-**	**-**
Acquisition, construction & development	**143,528**	**31,764**	**413**	**-**	**-**
Commercial non-real estate	**24,416**	**89**	**6,684**	**-**	**-**
Single family residential (1-4 units)	**471,340**	**1,029**	**5,396**	**-**	**-**
Consumer non-real estate and other	**24,447**	**-**	**-**	**-**	**-**
Total	**$ 1,805,818**	**$ 62,488**	**$ 14,896**	**$ -**	**$ -**

	December 31, 2018				
	Internal Risk Rating Grades				
	Pass	Special Mention	Substandard	Doubtful	Loss
Commercial real estate	$ 901,054	$ 3,016	$ 8,854	$ -	$ -
Owner-occupied commercial real estate	245,863	2,549	10,732	-	-
Acquisition, construction & development	155,471	1,221	685	-	-
Commercial non-real estate	39,621	414	53	-	-
Single family residential (1-4 units)	450,933	1,552	7,454	106	-
Consumer non-real estate and other	23,079	-	209	-	-
Total	$ 1,816,021	$ 8,752	$ 27,987	$ 106	$ -

Note 4. Loans (continued)

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

	December 31, 2019		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	-	$ -	$ -
Owner-occupied commercial real estate	-	-	-
Acquisition, construction & development	-	-	-
Commercial non-real estate	-	-	-
Single family residential (1-4 units)	**3**	**1,162**	**1,135**
Consumer non-real estate and other	-	-	-
Total	**3**	**$ 1,162**	**$ 1,135**

	December 31, 2018		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	-	$ -	$ -
Owner-occupied commercial real estate	1	309	309
Acquisition, construction & development	-	-	-
Commercial non-real estate	-	-	-
Single family residential (1-4 units)	4	2,540	2,527
Consumer non-real estate and other	-	-	-
Total	5	$ 2,849	$ 2,836

Debt restructured during 2019 included two term extensions and one term extension with a rate reduction.

Information on Troubled Debt Restructurings that subsequently defaulted within twelve months of restructuring in the years ending, December 31, 2019 and December 31, 2018 are as follows (in thousands):

	December 31, 2019		December 31, 2018	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Commercial real estate	-	$ -	-	$ -
Owner-occupied commercial real estate	-	-	-	-
Acquisition, construction & development	-	-	-	-
Commercial non-real estate	-	-	-	-
Single family residential (1-4 units)	**1**	**187**	-	-
Consumer non-real estate	-	-	-	-
Total	**1**	**$ 187**	-	$ -

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

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

Note 5. Bank Premises and Equipment

Components of Bank premises and equipment included in the balance sheets at December 31, 2019 and 2018 were as follows (in thousands):

	Estimated Useful Lives		**2019**		2018
Cost:					
Land		$	**14,348**	$	14,348
Bank premises	10 – 39 years		**45,848**		45,767
Furniture and equipment	3 – 10 years		**23,528**		22,183
			83,724		82,298
Less accumulated depreciation			**(42,536)**		(39,838)
Net book value		$	**41,188**	$	42,460

Depreciation expense for the years ended December 31, 2019 was $3.0 million and 2018 was $2.6 million.

Note 6. Deposits

The aggregate amount of time deposits, each with a minimum denomination of $250,000, was approximately $86.3 million and $59.4 million in 2019 and 2018, respectively. There were no brokered time deposits at December 31, 2019 or December 31, 2018. Time deposits through the Certificate of Deposit Account Registry Service ("CDARS") program totaled $27.0 million at December 31, 2019, compared to $27.8 million at December 31, 2018. Deposits through the CDARS program are generated from major customers with substantial relationships with the Bank.

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

Years ending December 31,		
2020	$	335,215
2021		57,233
2022		13,530
2023		3,211
2024		1,424
	$	410,613

At December 31, 2019 and 2018, amounts included in time deposits for individual retirement accounts totaled $45.2 million and $46.8 million, respectively.

Overdrafts of $134 thousand for 2019 and $93 thousand for 2018 were reclassified to loans.

Note 7. Short Term Borrowings

Federal funds purchased: The Bank has unsecured federal fund lines of credit from correspondent banking relationships, which can provide up to $52.5 million in liquidity. There were no federal fund lines of credit borrowings outstanding at December 31, 2019 or 2018.

Note 8. Other Borrowed Funds

The Bank had fixed rate advances outstanding with the Federal Home Loan Bank of Atlanta of $75 million and $320 million at December 31, 2019 and 2018, respectively. At December 31, 2019, the interest rate on this debt ranged from 0.7725% to 2.618%. At December 31, 2018, the interest rate on this debt ranged from 1.44% to 3.44%. The weighted average interest rate at December 31, 2019 and 2018 was 2.003% and 2.112%, respectively. The average balance outstanding during 2019 and 2018 was $179 million and $371.3 million, respectively.

The Bank has available a $729 million line of credit with the Federal Home Loan Bank of Atlanta. Advances on the line are secured by securities and loans. The amount of securities and loans pledged against the line as of December 31, 2019 and December 31, 2018 were $832 million and $583 million, respectively.

The contractual maturities of this debt as of December 31, 2019 are as follows (in thousands):

Due in 2020	$	50,000
Thereafter		25,000
	$	75,000

Note 9. Income Taxes

The net deferred tax amounts in the accompanying balance sheets include the following components (in thousands):

	2019	2018
Deferred tax assets:		
Provision for loan losses	**$ 5,372**	$ 3,637
Deferred compensation and other accruals	**4,413**	2,044
Tax credit carryforward	**4,624**	1,840
	14,409	7,521
Deferred tax liabilities:		
Unrealized gains on securities available for sale	**(2,084)**	(14)
Tax over book depreciation	**(1,509)**	(1,546)
Pension accrual	**(980)**	(929)
Right of use asset	**(2,043)**	-
	(6,616)	(2,489)
Net deferred tax asset (liability)	**$ 7,793**	$ 5,032

The provision for income taxes consists of the following components (in thousands):

	2019	2018
Current expense	**$ 4,837**	$ 4,269
Deferred expense (benefit)	**(5,092)**	(2,089)
	$ (255)	$ 2,180

The following reconciles income taxes reported in the financial statements to taxes that would be obtained by applying statutory tax rates to income before taxes (in thousands):

	2019	2018
Expected taxes using statutory rates	**$ 3,512**	$ 7,679
Benefit of tax exempt income net of nondeductible interest	**(1,417)**	(1,805)
Nontaxable income from life insurance	**(414)**	(865)
Low income tax credits, net of amortization	**(1,095)**	(2,533)
Other adjustment, net	**(841)**	(296)
	$ (255)	$ 2,180

The Bank files income tax returns in the U.S. federal jurisdiction. With few exceptions, the Bank is no longer subject to tax examination by tax authorities for years prior to 2016.

Note 10. Defined Benefit Pension Plan

The Bank provides pension benefits for eligible employees through a defined benefit pension plan. Employees hired prior to June 1, 2005 participate in the retirement plan on a non-contributing basis and are fully vested after five years of service. The following tables set forth the Plan's status and related disclosures (in thousands):

	2019	2018
Changes in benefit obligation:		
Benefit obligation at beginning of year	**$ 30,855**	$ 33,823
Service cost	**746**	827
Interest cost	**1,273**	1,189
Actuarial (gain) loss	**4,964**	(3,198)
Distributions	**(1,170)**	(1,786)
Benefit obligation at end of year	**36,668**	30,855
Change in plan assets:		
Fair value of plan assets at beginning of year	**35,278**	35,696
Actual return on plan assets	**7,225**	(1,632)
Employer contribution	**-**	3,000
Distributions	**(1,170)**	(1,786)
Fair value of plan assets at end of year	**41,333**	35,278
Funded status recognized as accrued pension cost	**$ 4,665**	$ 4,423
Amounts recognized in accumulated other comprehensive (income) loss:		
Net loss	**$ 8,118**	$ 9,363
Deferred income tax benefit	**(1,706)**	(1,966)
Total amount recognized	**$ 6,412**	$ 7,397
Accumulated benefit obligation	**$ 33,183**	$ 27,804

At December 31, 2019 and 2018, the assumptions used to determine the benefit obligation were as follows:

	2019	2018
Discount rate	**3.17%**	4.19%
Rate of compensation increase	**3.00%**	4.00%

Note 10. Defined Benefit Pension Plan (continued)

		2019		2018
Components of net periodic pension cost:				
Service cost	**$**	**746**	$	827
Interest cost		**1,273**		1,189
Expected return on plan assets		**(1,668)**		(2,253)
Amortization of prior service cost		**-**		-
Amortization of net loss		**651**		564
Net periodic pension cost	**$**	**1,002**	$	327
Other changes recognized in other comprehensive (income) loss:				
Net (gain) loss	**$**	**(594)**	$	598
Amortization of net loss		**(651)**		(564)
Deferred tax expense (benefit)		**261**		(7)
Total recognized in accumulated other comprehensive (income) loss	**$**	**(984)**	$	27
Total recognized in net periodic pension cost and other comprehensive loss	**$**	**18**	$	354

For the years ended December 31, 2019 and 2018, the assumptions used to determine net periodic pension cost were as follows:

	2019	2018
Discount rate	**3.17%**	4.19%
Expected long-term rate of return on plan assets	**5.10%**	6.75%
Annual salary increase	**3.00%**	4.00%

The expected long-term return on plan assets assumption was developed as a weighted average rate based on the target asset allocation of the plan and the long-term capital market assumptions. The overall return for each asset class was developed by combining a long-term inflation component and the associated expected real rates. The development of the capital market assumptions utilized a variety of methodologies, including, but not limited to, historical analysis, stock valuation models such as dividend discount models and earnings yields' models, expected economic growth outlook, and market yields analysis.

The Bank's pension plan asset allocations at December 31, 2019 and 2018, were as follows:

	2019	2018
Equity securities	**10%**	9%
Debt securities	**90%**	91%
Total	**100%**	100%

Note 10. Defined Benefit Pension Plan (continued)

As of December 31, 2019 and 2018, the fair value of plan assets was as follows (in thousands):

	December 31, 2019			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Assets at Fair Value
Cash and cash equivalents	**$ 74**	**$ -**	**$ -**	**$ 74**
Equity securities	**-**	**3,966**	**-**	**3,966**
Debt securities	**-**	**37,293**	**-**	**37,293**
Total pension assets	**$ 74**	**$ 41,259**	**$ -**	**$ 41,333**

	December 31, 2018			
	Fair Value Measurements Using			
	Level 1	Level 2	Level 3	Assets at Fair Value
Cash and cash equivalents	$ 73	$ -	$ -	$ 73
Equity securities	-	3,099	-	3,099
Debt securities	-	32,106	-	32,106
Total pension assets	$ 73	$ 35,205	$ -	$ 35,278

Assets are valued using a combination of methods including quoted prices for similar assets in active or non-active markets.

The fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 9% equities and 91% fixed income and cash. Investments are selected by officers experienced in financial matters and risk management and implementation of approved investment strategies is monitored on a regular basis. Both actively and passively managed investment strategies are considered and funds are allocated across asset classes to develop an efficient investment structure.

It is the responsibility of the trustee to consider costs in administering the portfolio while maintaining high quality investments. Costs include, but are not limited to, management and custodial fees, consulting fees, transaction costs and other administrative costs which may be charged to the trust.

The Bank does not expect to contribute to its pension plan in 2020.

Note 10. Defined Benefit Pension Plan (continued)

Estimated future benefit payments, which reflect expected future service, as appropriate, are as follows (in thousands):

Years Ending December 31,		
2020	$	932
2021		1,040
2022		1,289
2023		1,366
2024		1,392
2025-2029		7,774

Note 11. Investment and Savings Plan

The Bank has an investment and savings plan for its employees. In the month following date of hire, an employee is eligible to participate in the plan if he/she is at least 18 years old. A participant may elect to defer up to 90% of his/her annual compensation, not to exceed limitations established by the Internal Revenue Code. The Bank contributes on behalf of each participant who makes the election an amount up to 3.5% of the amount contributed by the participant. The Bank's contributions in 2019 and 2018 totaled $1.045 million and $933 thousand, respectively.

Note 12. Retirement Plans

The Bank has a deferred compensation plan for some of its directors and senior officers that provides benefits payable at age 65. Two of its officers and directors are currently receiving benefits under the plan. The deferred compensation is to be paid to the individual or beneficiary over a period of 15 years. Amounts deferred are invested in increasing whole life insurance policies on the participants' lives, with the Bank as owner and beneficiary. Amounts recognized for the increase in the cash surrender value of the policies are offset against the expense. The Bank recognized net income of $46 thousand in 2019 and 2018, related to this plan.

In 2010, the Bank adopted a Supplemental Executive Retirement Plan for a number of its executive officers. The plan is intended to be unfunded and maintained primarily for the purpose of providing deferred compensation to its participants. The benefits of the plan vest incrementally based on years of service. Plan expenses for the years ending December 31, 2019 and 2018, amounted to $608 thousand and $749 thousand, respectively.

Note 13. Leased Property

On January 1, 2019, the Bank adopted ASU No. 2016-02 “Leases (Topic 842)” and all subsequent ASUs that modified Topic 842. The Bank elected the prospective application approach provided by ASU 2018-11 and did not adjust prior periods for ASC 842. The Bank also elected certain practical expedients within the standard and consistent with such elections did not reassess whether any expired or existing contracts are or contain leases, did not reassess the lease classification for any expired or existing leases, and did not reassess any initial direct costs for existing leases. The right-of-use asset and lease liability are included in other assets and other liabilities, respectively, in the Balance Sheets.

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

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

The following tables present information about the Bank’s leases:

As of December 31, 2019 (dollars in thousands)		
Lease liabilities	$	9,893
Right-of-use assets		9,726
Weighted average remaining lease term		5.23 years
Weighted average discount rate		3.13%

For the Year Ended, December 31, 2019 (in thousands)		
Operating lease cost	$	2,401
Variable lease cost		-
Short-term lease cost		-
Total lease cost		-
	$	2,401

Cash paid for amounts included in the measurement of lease liabilities (in thousands) $ 2,235

Note 13. Leased Property (continued)

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

Lease payments due (in thousands)		
Twelve months ending December 31, 2020	$	2,304
Twelve months ending December 31, 2021		2,010
Twelve months ending December 31, 2022		1,958
Twelve months ending December 31, 2023		1,981
Twelve months ending December 31, 2024		1,666
Twelve months ending December 31, 2025		255
Thereafter		613
Total undiscounted cash flows	$	10,787
Discount		(894)
Lease Liabilities	$	9,893

Note 14. Regulatory Matters

As of December 31, 2019, the most recent notification from the FDIC categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based, Common Equity Tier 1 risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the table below. There are no conditions or events since that notification that management believes have changed the Bank's well capitalized category.

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of their assets, liabilities, and certain off-balance-sheet items as calculated under regulatory accounting practices. The capital amounts and classification are also subject to qualitative judgments by 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 of Total, Common Equity Tier 1, and Tier 1 Capital (as defined in the regulations) to risk weighted assets (as defined) and Tier 1 Capital (as defined) to average assets (as defined). Management believes, as of December 31, 2019 and 2018, the Bank met all capital adequacy requirements to which they were subject.

Note 14. Regulatory Matters (continued)

On January 1, 2015, the Bank applied changes to the regulatory capital framework that were approved on July 9, 2013 by the federal banking regulators (the Basel III Final Rule). The regulatory risk-based capital amounts presented below for December 31, 2019 and 2018 include: (1) common equity tier 1 capital (CET1) which consists principally of common stock (including surplus) and retained earnings with adjustments for goodwill, intangible assets and deferred taxes; (2) Tier 1 capital which consists principally of CET1; and (3) Tier 2 capital which consists principally of Tier 1 capital plus a limited amount of the allowance for loan losses. In addition, the Bank has made a one-time irrevocable election to continue treating accumulated other comprehensive income (AOCI) under regulatory standards that were in place prior to the Basel III Final Rule in order to eliminate volatility of regulatory capital that can result from fluctuations in AOCI and the inclusion of AOCI in regulatory capital, as would otherwise be required under the Basel III Capital Rule. The capital conservation buffer for 2019 was 2.50% and for 2018 was 1.875%.

The table below also reflects the minimum regulatory and certain prompt corrective action capital ratio requirements that began on January 1, 2015.

	Actual		Minimum Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2019:						
Total capital (to risk-weighted assets)	**$ 376,303**	**17.60%**	**$ 171,046**	**≥8%**	**$ 213,808**	**≥10%**
Tier I common equity (to risk-weighted assets)	**352,102**	**16.47**	**96,213**	**>4.5**	**138,975**	**>6.5**
Tier I capital (to risk-weighted assets)	**352,102**	**16.47**	**128,285**	**≥6**	**171,046**	**≥8**
Tier I capital (to average assets)	**352,102**	**12.28**	**114,664**	**≥4**	**143,330**	**≥5**
As of December 31, 2018:						
Total capital (to risk-weighted assets)	$ 370,528	16.78%	$ 176,633	≥8%	$ 220,791	≥10%
Tier I common equity (to risk-weighted assets)	353,207	16.00	99,356	>4.5	143,514	>6.5
Tier I capital (to risk-weighted assets)	353,207	16.00	132,475	≥6	176,633	≥8
Tier I capital (to average assets)	353,207	11.83	119,439	≥4	149,299	≥5

At December 31, 2019, approximately $151.8 million of retained earnings was available for dividend declaration without regulatory approval.

Note 15. Commitments and Contingencies

Credit extension commitments: The Bank's financial statements do not reflect various financial instruments which arise in the normal course of business and which involve elements of credit risk, interest rate risk and liquidity risk. These financial instruments include commitments to extend credit, commercial letters of credit and revolving lines of credit.

A summary of the contractual amounts of the Bank's financial instruments outstanding at December 31, 2019 and 2018, is as follows (in thousands):

	2019	2018
Commitments to extend credit	**$ 8,770**	$ 39,319
Commercial letters of credit	**7,334**	9,183
Undisbursed balance—revolving lines of credit	**239,827**	283,318

Commitments to extend credit, commercial letters of credit and revolving lines of credit all include exposure to some credit loss in the event of nonperformance of the customer. The Bank's credit policies and procedures for credit commitments and financial guarantees are the same as those for extensions of credit that are recorded on the balance sheets. Many of these instruments have fixed maturity dates, and many of them will expire without being drawn upon; accordingly, they do not generally present any significant liquidity risk to the Bank.

Financial derivatives: Financial derivatives are reported at fair value in other assets and other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings. The Bank has entered into interest rate swaps to facilitate customer transactions in connection with their financing needs. Upon entering into swaps with the borrowers, the Bank entered into offsetting positions with counterparties to minimize risk to the Bank. The back-to-back swaps qualify as derivatives, but are not designated as hedging instruments. Interest rate swap contracts involve the risk of dealing with borrowers and counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counterparty or customer owes the Bank, and results in credit risk to the Bank. When the fair value of a derivative instrument contract is negative, the Bank owes the customer or counterparty and, therefore, has no risk.

Note 15. Commitments and Contingencies (continued)

A summary of the Bank's interest rate swaps at December 31, 2019 and 2018, is as follows (in thousands):

	December 31, 2019	
Interest rate swap agreements:	Notional Amount	Estimated Fair Value
Pay fixed/receive variable swaps	**$ 39,312**	**$ (1,628)**
Pay variable/receive fixed swaps	**39,312**	**1,628**

	December 31, 2018	
Interest rate swap agreements:	Notional Amount	Estimated Fair Value
Pay fixed/receive variable swaps	$ 40,217	$ (564)
Pay variable/receive fixed swaps	40,217	564

Litigation: The Bank is a party to litigation and claims arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the Bank's financial position.

Note 16. Transactions with Related Parties

The Bank has had, and may be expected to have in the future, banking transactions in the ordinary course of business with directors and principal officers, their immediate families and affiliated companies in which they are principal stockholders (commonly referred to as related parties). Management believes these loans do not involve more than normal credit risk or present other unfavorable features.

Aggregate loan balances with related parties were as follows (in thousands):

(Dollars In Thousands)	**2019**	2018
Balance, beginning	**$ 41,332**	$ 32,779
New loans	**5,351**	29,318
Repayments	**(7,382)**	(20,765)
Balance, December 31	**$ 39,301**	$ 41,332

Deposits from related parties held were as follows (in thousands):

	2019	2018
Balance, December 31	**$ 68,406**	$ 67,370

Note 17. Concentrations of Credit

Substantially all of the Bank's loans, commitments, and standby letters of credit have been granted to customers in the Bank's market area. Such customers are generally depositors of the Bank. Some investments in state and municipal securities also involve governmental entities within the Bank's market area. 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 were granted primarily to commercial borrowers.

Note 18. Fair Value Measurements

Determination of Fair Value

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 and most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. U.S. GAAP requires that valuation techniques maximize the use of observable inputs and minimize the use of unobservable inputs. U.S. GAAP also established a fair value hierarchy which prioritizes the valuation inputs into three broad levels. These levels are as follows:

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

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

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

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

		Fair Value Measurements			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance
At December 31, 2019:					
Financial assets:					
Cash and due from banks	$ **83,747**	$ **83,747**	$ **-**	$ **-**	$ **83,747**
Securities	**693,750**	**25,012**	**668,738**	**-**	**693,750**
Restricted stock	**5,944**	**-**	**-**	**5,944**	**5,944**
Loans held for sale	**1,969**	**-**	**1,969**	**-**	**1,969**
Loans, net	**1,859,001**	**-**	**-**	**1,824,916**	**1,824,916**
Bank owned life insurance	**86,667**	**-**	**86,667**	**-**	**86,667**
Accrued interest	**8,113**	**-**	**8,113**	**-**	**8,113**
Financial derivatives	**1,628**	**-**	**1,628**	**-**	**1,628**
Financial liabilities:					
Demand deposits	$ **621,424**	$ **-**	$ **621,424**	$ **-**	$ **621,424**
NOW accounts	**386,617**	**-**	**386,617**	**-**	**386,617**
Savings deposits and money market accounts	**975,358**	**-**	**975,358**	**-**	**975,358**
Time deposits	**410,613**	**-**	**410,641**	**-**	**410,641**
Other borrowed funds	**75,000**	**-**	**75,085**	**-**	**75,085**
Accrued interest	**792**	**-**	**792**	**-**	**792**
Financial derivatives	**1,628**	**-**	**1,628**	**-**	**1,628**

Note 18. Fair Value Measurements (continued)

		Fair Value Measurements			
	Carrying Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	Balance
At December 31, 2018:					
Financial assets:					
Cash and due from banks	$ 101,880	$ 101,880	$ -	$ -	$ 101,880
Securities	847,776	-	847,776	-	847,776
Restricted stock	16,430	-	-	16,430	16,430
Loans held for sale	-	-	-	-	-
Loans, net	1,835,545	-	-	1,786,833	1,786,833
Bank owned life insurance	74,748	-	74,748	-	74,748
Accrued interest	9,867	-	9,867	-	9,867
Financial derivatives	564	-	564	-	564
Financial liabilities:					
Demand deposits	$ 618,527	$ -	$ 618,527	$ -	$ 618,527
NOW accounts	425,051	-	425,051	-	425,051
Savings deposits and money market accounts	927,350	-	927,350	-	927,350
Time deposits	336,143	-	332,733	-	332,733
Other borrowed funds	320,000	-	319,281	-	319,281
Accrued interest	737	-	737	-	737
Financial derivatives	564	-	564	-	564

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

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

<u>Financial derivatives</u>: The Bank has contracted with a third party vendor to provide valuations for interest rate swaps using standard swap valuation techniques and, therefore, classifies such valuations as Level 2. The Bank has considered counterparty credit risk in the valuation of its interest rate swap assets and has considered its own credit risk in the valuation of its interest rate swap liabilities.

Note 18. Fair Value Measurements (continued)

The following table presents the balances of financial assets measured at fair value on a recurring basis (in thousands):

		Fair Value Measurements at December 31 Using		
Description	Balance as of December 31	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Assets				
2019:				
Securities available for sale:				
U.S. Government & agency securities	**$ 98,471**	**$ 25,012**	**$ 73,459**	**$ -**
Mortgage backed securities	**374,376**	**-**	**374,376**	**-**
State & municipal securities	**220,903**	**-**	**220,903**	**-**
Financial derivatives	**1,628**	**-**	**1,628**	**-**
	$ 695,378	**$ 25,012**	**$ 670,366**	**$ -**
2018:				
Securities available for sale:				
U.S. Government & agency Securities	$ 111,889	$ -	$ 111,889	$ -
Mortgage backed securities	429,677	-	429,677	-
State & municipal securities	306,210	-	306,210	-
Financial derivatives	564	-	564	-
	$ 848,340	$ -	$ 848,340	$ -

Certain assets are measured at fair value on a nonrecurring basis in accordance with GAAP. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets.

The following describes the valuation techniques used by the Bank to measure certain assets recorded at fair value on a nonrecurring basis in the financial statements:

Loans held for sale: Loans held for sale are carried at the lower of cost or fair value. These loans currently consist of one-to-four family residential loans originated for sale in the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale (Level 2). As such, the Bank records any fair value adjustments on a nonrecurring basis. No nonrecurring fair value adjustments were recorded on loans held for sale during the year ended December 31, 2019 or 2018. Gains and losses on the sale of loans are recorded within noninterest income on the Statements of Income. Loans held for sale were $2.0 million at December 31, 2019. There were no loans held for sale at December 31, 2018.

Note 18. Fair Value Measurements (continued)

Impaired loans: Loans are designated as impaired, when, in the judgment of management based on current information and events, it is probable that all amounts due according to the contractual terms of the loan agreement will not be collected when due. The measurement of loss associated with impaired loans can be based on either the observable market price of the loan or the fair value of the collateral. Fair value is measured based on the value of the collateral securing the loans, less estimated costs of disposal. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The vast majority of the collateral is real estate. The value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraisal of the real estate property is over two years old or uses an income valuation approach, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impairment measured utilizing discounted cash flows is considered Level 3. Impaired loans allocated to the allowance for loan loss are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the Statements of Income.

Other real estate owned: Assets acquired through foreclosure or other proceedings are initially recorded at fair value at the date of the foreclosure less estimated costs of disposal, which establishes a new cost. After foreclosure, valuations periodically are performed by management and the foreclosed assets held for sale are carried at the lower of cost or fair value less estimated costs of disposal. If there is a contract for the sale of a property, and management reasonably believes the contract will be executed, fair value is based on the sale price in that contract (Level 1). Lacking such a contract, the value of real estate collateral is determined utilizing a market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Bank using observable market data (Level 2). However, if the collateral is a house or building in the process of construction or if an appraiser of other real estate owned is over two years old or uses an income valuation approach, then the fair value is considered Level 3. Any fair value adjustments are recorded in the period incurred and expensed against current earnings.

Note 18. Fair Value Measurements (continued)

The following table summarizes the Bank's financial assets that were measured at fair value on a nonrecurring basis during the period (in thousands):

		Carrying value		
Description	Balance	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
As of December 31, 2019:				
Assets				
Impaired loans:				
Commercial real estate	**$ -**	**$ -**	**$ -**	**$ -**
Owner-occupied commercial real estate	**1,475**	**-**	**-**	**1,475**
Acquisition, construction & development	**-**	**-**	**-**	**-**
Commercial non-real estate	**800**	**-**	**-**	**800**
Single family residential	**772**	**-**	**-**	**772**
Consumer non-real estate and other	**-**	**-**	**-**	**-**
Loans held for sale	**1,969**	**-**	**1,969**	**-**
Other real estate owned	**-**	**-**	**-**	**-**
As of December 31, 2018:				
Assets				
Impaired loans:				
Commercial real estate	$ 2,420	$ -	$ -	$ 2,420
Owner-occupied commercial real estate	3,954	-	-	3,954
Acquisition, construction & development	-	-	-	-
Commercial non-real estate	-	-	-	-
Single family residential	-	-	-	-
Consumer non-real estate and other	-	-	-	-
Loans held for sale	-	-	-	-
Other real estate owned	338	-	-	338

Note 18. Fair Value Measurements (continued)

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

Description		Fair Value	Valuation Techniques	Unobservable Inputs	Range	Weighted Average
As of December 31, 2019:						
Assets						
Impaired loans	**$**	**3,047**	Discounted appraised value	Estimated selling cost	6% - 9%	8%
			Discounted cash flow analysis	Market rate for borrower	5.62% - 7.5%	6.7%
As of December 31, 2018:						
Assets						
Impaired loans	$	6,374	Discounted appraised value	Estimated selling cost	6% - 9%	6%
				Discount for lack of marketability and age of appraisal	0% - 5%	2%
			Discounted cash flow analysis	Market rate for borrower	6.25% - 7.5%	7%
Other real estate owned		338	Discounted appraised value	Estimated selling cost	6%	6%

Note 19. Common Stock Transactions

During 2019, the Bank purchased shares of its own common stock on the open market in arms-length transactions. It acquired 1,142 shares at an aggregate cost of $3.125 million at prices ranging from $2,140 to $2,960 per share. In 2018, the Bank acquired 2,591 shares at an aggregate cost of $7.37 million at prices ranging from $2,725 to $2,975 per share.

In 2018, the Bank sold 15 shares at prices ranging from $2,850 to $2,925 per share for a total of $43,225.

During 2019 and 2018, the Bank declared and paid cash dividends of $80 per share.

Note 20. Accumulated Other Comprehensive Income

Changes in each component of accumulated other comprehensive income are as follows (in thousands):

	Net Unrealized Gains (Losses) on Securities	Adjustments Related to Pension and Other Post Retirement Benefits	Accumulated Other Comprehensive Income (Loss)
Balance at December 31, 2017	$ 9,910	$ (7,369)	$ 2,541
Unrealized holding losses, net of tax of $2,537	(9,544)	-	(9,544)
Reclassification adjustment for gains on securities, net of tax of ($83)	(314)	-	(314)
Changes in pension plan benefits, net of tax of $7	-	(27)	(27)
Balance at December 31, 2018	$ 52	$ (7,396)	$ (7,344)
Unrealized holding gains, net of tax of ($2,740)	**10,308**	**-**	**10,308**
Reclassification adjustment for gains on securities, net of tax of ($670)	**(2,522)**	**-**	**(2,522)**
Changes in pension plan benefits, net of tax of ($261)	**-**	**984**	**984**
Balance at December 31, 2019	$ **7,838**	**$ (6,412)**	**$ 1,426**

Note 21. Reclassifications Out of Accumulated Other Comprehensive Income

Details about Accumulated Other Comprehensive Income Components	Amounts Reclassified from Accumulated Other Comprehensive Income (Loss) 2019	2018	Affected Line Item in the Statement of Income
Available for sale securities:			
Realized gain on sales	**$ 3,192**	$ 397	Net gain on securities
	3,192	397	Income before income taxes
	(670)	(83)	Provision for income taxes
	2,522	314	Net income
Defined benefit pension plan items:			
Amortization of actuarial gain/(loss)	**1,245**	(34)	Other operating expenses
	1,245	(34)	Income before income taxes
	(261)	7	Provision for income taxes
	984	(27)	Net income
Total reclassifications	**$ 3,506**	$ 287	Net income

Note: The Defined benefit pension plan items are included in the computation of net periodic pension cost. See Note 10, *Defined Benefit Pension Plan*, for additional information.

Note 22. Other Operating Expense

Other Operating Expense from the Statements of Income for years ended December 31, 2019 and 2018 is as follows (in thousands):

	2019	**2018**
Directors Fees	**$ 1,310**	$ 1,088
Consultant fees	**1,281**	1,216
Advertising expense	**969**	967
Historic tax credit amortization	**2,718**	2,772
Virginia franchise tax	**2,289**	2,192
Provision for Off-balance sheet exposure	**1,380**	-
Network Expense	**1,437**	1,337
Other	**8,622**	9,135
Total	**$ 20,006**	$ 18,707

Note 23. Qualified Affordable Housing Project and Historic Tax Investments

The Bank invests in qualified affordable housing projects. At December 31, 2019 and 2018, the balance of the investment for qualified affordable housing projects was $37.5 million and $36.2 million. These balances are reflected in the other assets line on the balance sheet. Total unfunded commitments related to the investments in qualified affordable housing projects totaled $7.8 million and $12 million at December 31, 2019 and 2018. The Bank expects to fulfill the majority of these commitments during 2020.

During the year ended December, 31, 2019 and 2018, the Bank recognized total amortization expense of $6.8 million and $5.4 million, respectively. In 2019 and 2018, $2.7 million was included in noninterest expense on the statement of income related to historic tax credit investments that do not qualify for the proportional method. The remainder was recorded as income tax expense.

Note 24. Revenue Recognition

On January 1, 2018, the Bank adopted ASU No. 2016-10 "Revenue from Contracts with Customers" (Topic 606) and all subsequent ASUs that modified Topic 606. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

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

Income from Fiduciary & Wealth Management Activities
Fiduciary and asset management income is primarily comprised of fees earned from the management and administration of trusts and other customer assets. The Bank's performance obligation is generally satisfied over time and the resulting fees are recognized monthly, based upon the month-end market value of the assets under management and the applicable fee rate. Payment is generally received a few days after month end through a direct charge to customers' accounts. The Bank does not earn performance-based incentives. Optional services such as real estate sales and tax return preparation services are also available to existing trust and asset management customers. The Bank's performance obligation for these transactional-based services is generally satisfied, and related revenue recognized, at a point in time (i.e., as incurred). Payment is received shortly after services are rendered.

Annuity and insurance income primarily consists of commissions received on annuity product sales. The Bank acts as an intermediary between the Bank's customer and the insurance carrier. The Bank's performance obligation is generally satisfied upon the issuance of the annuity policy. Shortly after the policy is issued, the carrier remits the commission payment to the Bank, and the Bank recognizes the revenue. The Bank does not earn a significant amount of trailer fees on annuity sales. The majority of the trailer fees relates to variable annuity products and are calculated based on a percentage of market value at period end. Revenue is not recognized until the annuity's market value can be determined.

Other noninterest income consists of other recurring revenue streams such as commissions from sales of mutual funds and other investments, investment advisor fees from the Bank's wealth management product, safety deposit box rental fees, and other miscellaneous revenue streams. Commissions from the sale of mutual funds and other investments are payable on the trade date and are received in the following month, which is when the Bank has satisfied its performance obligation. The Bank also receives periodic service fees (i.e., trailers) from mutual fund companies typically based on a percentage of net asset value. Trailer revenue is recorded over time, usually monthly or quarterly, as net asset value is determined. Investment advisor fees from the wealth management product are earned over time and based on an annual percentage rate of the net asset value. The investment advisor fees are charged to the customer's account in advance on the first month of the quarter, and the revenue is recognized over the following three-month period.

Note 24. Revenue Recognition (continued)

Service Charges and Fees

Service charges and fees on deposit accounts consist of monthly service fees, check orders, and other deposit account related fees. Check orders and other deposit account related fees are largely transactional based, and therefore, the Bank's performance obligation is satisfied, and related revenue recognized, at a point in time. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts.

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

Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Bank determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation.

Note 25. Earnings Per Share

In June of 2019, the Bank granted its first block of equity compensation under its 2019 Stock Incentive Plan. The Plan permits issuance of shares of the Bank in the form of Restricted Stock Units.

The first block under the 2019 Stock Incentive Plan consists of 100 restricted stock units. The recipient of the restricted stock units does not receive shares of the Bank's stock immediately, but instead receives shares upon satisfying the requisite service period specified by the terms and conditions of the grant. Additionally, the recipient of the restricted stock units does not enjoy the rights of holder of the Bank's common stock until the units have vested and as such, they do not have voting rights or rights to non-forfeitable dividends. The shares vest over a five-year period with 33 1/3% of the Units vesting on the third anniversary date. Fifty percent (50%) of the Units will vest on the fourth anniversary date with the remaining Units vesting on the fifth anniversary date. The total expense recognized as of December 31, 2019, in connection with the restricted stock unit awards was approximately $32,000.

Basic earnings per share excludes dilution and is computed by dividing net income by weighted average number of common shares outstanding for the period. Diluted earnings per share reflects the potential dilution that could occur if contracts to issue common stock were exercised or converted into common stock, resulting in the issuance of stock which then shared in the earnings of the Bank.

The following shows the weighted average number of shares used in computing earnings per share and the effect of weighted average number of shares dilutive potential common stock. Dilutive potential common stock has no effect on income available to common shareholders.

Note 25. Earnings Per Share (continued)

		2019
Net Income	$	16,978
Weighted average number of shares		187,344
Options effect of dilutive shares		62
Weighted average dilutive shares		187,406
Basic EPS	$	90.63
Diluted EPS	$	90.60

Note 26. Subsequent Events

In accordance with FASB ASC Topic 855-10, the Bank evaluates subsequent events that have occurred after the balance sheet date but before the financial statements are issued. There are two types of subsequent events: (1) recognized, or those that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements, and (2) non-recognized, or those that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. The Bank evaluated subsequent events through March 16, 2020.

Based on the evaluation, the Bank did not identify any recognized or non-recognized subsequent events that would have required adjustment to or disclosure in the financial statements.

YHB CPAs & Consultants

INDEPENDENT AUDITOR'S REPORT

To the Board of Directors
Burke & Herbert Bank & Trust Company
Alexandria, Virginia

Report on the Financial Statements

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

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

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

Opinion

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

Other Matter

We have also audited, in accordance with auditing standards generally accepted in the United States of America, Burke & Herbert Bank & Trust Company's internal control over financial reporting as of December 31, 2019, based on criteria established in *Internal Control—Integrated Framework* issued by the Committee of Sponsoring Organizations of the Treadway Commission in 2013, and our report dated March 16, 2020 expressed an unqualified opinion on the effectiveness of Burke & Herbert Bank & Trust Company's internal control over financial reporting.

Yount, Hyde & Barbour, P.C.

Roanoke, Virginia
March 16, 2020