# Northumberland Bancorp

## Consolidated Financial Statements

December 31, 2019 and 2018

# Northumberland Bancorp

## Contents

# Northumberland Bancorp

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March 11, 2020

To Our Stockholders:

Last year was an exciting year for your company. Loans continued to grow, revenues increased and profits saw a healthy increase from 2018. In order to position your Bank to grow into the future, the defined benefit pension plan was terminated effective July 1, 2019, and a realignment of the Executive Team was announced in the fourth quarter designed to put in place future leadership of the Bank. Todd Troxell was appointed President and Chief Operating Officer and this is the first quarter where he and I collaborate on this message to shareholders. More recently, in January 2020, the Bank filed an application with the Comptroller of the Currency to open a full-service a branch office in Lewisburg, Pennsylvania. We look forward to opening this new site in 2021.

Total assets grew to $538,097,000. The growth continues to be driven by loan growth. Loans grew 6.8% to $373,633,000. The growth was funded through reduction in the investment portfolio, cash and due from banks and loans sales in the secondary market.

Net income increased to $3,441,000 or 17.4% from $2,931,000 in 2018. Factors impacting income included the following:

- Net interest income increased $1,038,000 or 7.0% from 2018. Interest margin for the year increased from 3.17% in 2018 to 3.30% in 2019
- The Provision for Loan Losses declined $103,000
- Trust income increased $76,000 or 9.9% from 2018
- Gains from sale of mortgages increased $107,000 or 23% from the prior year
- Service charges on deposit accounts increased to $1,318,000 or $153,000 in 2019

Offsetting the growth in income were increases in several specific operating expenses. Total non-interest expense increased $898,000 or 6.1%. Major factors contributing to the increase included the defined benefit pension plan termination costs and 401(K) plan enhancements totaling in excess of $340,000. A second major factor was legal costs related to both the lawsuit the Bank has filed against our former internal audit firm and the completion of the investigation into the activities of the former President of the Bank by the Office of the Comptroller of the Currency.

The Company and Bank continue to be well capitalized. Tier One Capital of the Bank was 10.37% compared to 10.09% in 2018. Common Equity Tier One Capital, Tier One Risk Based Capital and Total Risked Based Capital were 16.45%, 16.45% and 17.47% in 2019, compared to 17.03%, 17.03% and 18.04% in 2018, respectively. At December 31, 2019, past due loans decreased slightly to $4,037,000 or 1.08% of outstanding loans in 2019, as compared to $4,254,000 or 1.21% in 2018.

Always looking to enhance our electronic delivery of banking products and services, during 2019 we implemented Zelle (a person to person payment system), business bill pay, IDScan, and began the replacement of our ATMs which continues into 2020. In 2020, we plan to significantly increase the band width of our communications between offices; replace branch capture with teller capture and introduce contactless cards. These projects will enhance operational efficiency and provide better customer service.

We thank our stockholders, directors, officers and employees for your dedication, support and contributions to the Company's growth and success during the year.

J. Donald Steele, Jr.
Chairman & CEO

J. Todd Troxell
President & COO

Crowe LLP
Independent Member Crowe Global

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Stockholders
Northumberland Bancorp
Northumberland, Pennsylvania

**Report on the Financial Statements**

We have audited the accompanying financial statements of Northumberland Bancorp which comprise the consolidated statement of financial condition as of December 31, 2019, and the related statements of operations, stockholders' equity, and cash flows for the year then ended, and the related notes to the consolidated financial statements.

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

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

***Auditor's Responsibility***

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

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

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

***Opinion***

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

**Other Matter**

The consolidated financial statements of Northumberland Bancorp as of December 31, 2018, were audited by other auditors whose report dated April 23, 2019, expressed an unmodified opinion on those statements.

Crowe LLP

Crowe LLP

Washington, D.C.
March 11, 2020

# Consolidated Financial Statements

# Northumberland Bancorp

## Consolidated Balance Sheets

(amounts in thousands except share and per share data)

| *December 31,* | | 2019 | | 2018 |
|---|---|---|---|---|
| **Assets** | | | | |
| Cash and due from banks | $ | **4,659** | $ | 6,171 |
| Interest-bearing deposits in other banks | | **5,721** | | 5,733 |
| Total cash and cash equivalents | | **10,380** | | 11,904 |
| Investment securities available-for-sale | | **127,026** | | 142,921 |
| Investment securities held-to-maturity (fair value of $920 in 2019 and $1,851 in 2018) | | **906** | | 1,849 |
| Equity securities | | **229** | | 183 |
| Total investment securities | | **128,161** | | 144,953 |
| Restricted stock, at cost | | **3,425** | | 3,599 |
| Loans held for sale | | **969** | | 2,414 |
| Loans | | **373,633** | | 349,723 |
| Less allowance for loan losses | | **3,451** | | 3,163 |
| Net loans | | **370,182** | | 346,560 |
| Premises and equipment | | **9,319** | | 9,123 |
| Bank-owned life insurance | | **11,805** | | 11,523 |
| Accrued interest and other assets | | **3,856** | | 4,185 |
| **Total Assets** | **$** | **538,097** | $ | 534,261 |
| **Liabilities and Stockholders' Equity** | | | | |
| **Liabilities** | | | | |
| Deposits: | | | | |
| Noninterest-bearing demand | **$** | **96,251** | $ | 89,761 |
| Interest-bearing demand | | **141,816** | | 157,866 |
| Savings | | **85,093** | | 83,192 |
| Time deposits | | **152,700** | | 146,688 |
| Total deposits | | **475,860** | | 477,507 |
| Short-term borrowings | | **3,500** | | 3,175 |
| Accrued interest and other liabilities | | **2,053** | | 1,876 |
| **Total Liabilities** | | **481,413** | | 482,558 |
| **Stockholders' Equity** | | | | |
| Common stock, par value $0.10; 5,000,000 shares authorized, 1,502,500 shares issued and 1,327,858 shares outstanding in 2019 and 2018 | | **150** | | 150 |
| Capital surplus | | **3,832** | | 3,832 |
| Retained earnings | | **54,669** | | 52,304 |
| Accumulated other comprehensive income/(loss) | | **330** | | (2,269) |
| Treasury stock, at cost (174,642 shares in 2019 and 2018) | | **(2,265)** | | (2,265) |
| Total Northumberland Bancorp stockholders' equity | | **56,716** | | 51,752 |
| Non-controlling interest | | **(32)** | | (49) |
| **Total Stockholders' Equity** | | **56,684** | | 51,703 |
| **Total Liabilities and Stockholders' Equity** | **$** | **538,097** | $ | 534,261 |

*See accompanying notes to consolidated financial statements.*

# Northumberland Bancorp

## Consolidated Statements of Income

(amounts in thousands except share and per share data)

| *Years Ended December 31,* | **2019** | 2018 |
|---|---|---|
| **Interest and Dividend Income** | | |
| Interest and fees on loans: | | |
| Taxable | **$ 16,617** | $ 15,059 |
| Tax-exempt | **350** | 268 |
| Interest on interest-bearing deposits in other banks | **176** | 176 |
| Interest and dividends on investment securities: | | |
| Taxable | **2,174** | 2,121 |
| Tax-exempt | **772** | 879 |
| Dividends | **259** | 242 |
| **Total Interest and Dividend Income** | **20,348** | 18,745 |
| **Interest Expense** | | |
| Deposits | **4,418** | 3,855 |
| Short-term borrowings | **13** | 11 |
| **Total Interest Expense** | **4,431** | 3,866 |
| Net interest income | **15,917** | 14,879 |
| **Provision for Loan Losses** | **353** | 456 |
| **Net Interest Income After Provision for Loan Losses** | **15,564** | 14,423 |
| Noninterest Income | | |
| Service charges on deposit accounts | **1,318** | 1,165 |
| Trust services income | **846** | 770 |
| Investment securities losses, net | **69** | (14) |
| Gains on sales of loans | **571** | 464 |
| Earnings on bank-owned life insurance | **282** | 286 |
| Change in fair value of equity securities | **46** | (19) |
| Other income | **834** | 887 |
| **Total Noninterest Income** | **3,966** | 3,539 |
| **Noninterest Expense** | | |
| Salaries and employee benefits | **8,757** | 8,055 |
| Occupancy expense, net | **762** | 778 |
| Equipment expense | **932** | 982 |
| Professional fees | **1,093** | 961 |
| Data processing | **935** | 960 |
| Shares tax | **450** | 372 |
| Federal deposit insurance expense | **71** | 225 |
| Reimbursements to customers | **0** | 18 |
| Other expense | **2,504** | 2,255 |
| **Total Noninterest Expense** | **15,504** | 14,606 |
| Income before income taxes | **4,026** | 3,356 |
| **Income Taxes** | **568** | 422 |
| **Net Income** | **3,458** | 2,934 |
| Net income attributable to non-controlling interest | **17** | 3 |
| **Net Income Attributable to Northumberland Bancorp** | **$ 3,441** | $ 2,931 |
| **Earnings Per Share** | **$ 2.59** | $ 2.21 |
| **Weighted-Average Shares Outstanding** | **1,327,858** | 1,328,203 |

*See accompanying notes to consolidated financial statements.*

# Northumberland Bancorp

## Consolidated Statements of Comprehensive Income

(amounts in thousands)

| *Years Ended December 31,* | **2019** | 2018 |
|---|---|---|
| **Net Income** | **$ 3,458** | $ 2,934 |
| **Other Comprehensive Income / (Loss)** | | |
| Change in unrealized holding gains/(losses) on investment securities available-for-sale | **2,444** | (703) |
| Tax effect | **(513)** | 147 |
| Reclassification adjustment for investment securities (gains) /losses recognized in net income | **(69)** | 14 |
| Tax effect | **15** | (3) |
| Change in unrecognized pension costs | **572** | (110) |
| Tax effect | **(120)** | 23 |
| Reclassification adjustment for pension costs | **342** | 1,925 |
| Tax effect | **(72)** | (405) |
| **Other Comprehensive Income, Net of Tax** | **2,599** | 888 |
| Comprehensive income before non-controlling interest | **6,057** | 3,822 |
| Less: net income attributable to non-controlling interest | **17** | 3 |
| **Comprehensive Income** | **$ 6,040** | $ 3,819 |

*See accompanying notes to consolidated financial statements.*

# Northumberland Bancorp

## Consolidated Statements of Stockholders' Equity

(amounts in thousands excepts share and per share data)

| | Common Stock | Capital Surplus | Retained Earnings | Accumulated Other Comprehensive Loss | Treasury Stock | Non-controlling Interest | Total |
|---|---|---|---|---|---|---|---|
| **Balance, December 31, 2017** | $ 150 | $ 3,832 | $ 50,304 | $ (3,118) | $ (2,248) | $ (52) | $ 48,868 |
| Net income | - | - | 2,931 | - | - | 3 | 2,934 |
| Other comprehensive income | - | - | - | 888 | - | - | 888 |
| Cumulative adjustment for fair value of equity securities | - | - | 39 | (39) | - | - | - |
| Dividends declared ($0.73 per share) | - | - | (970) | - | - | - | (970) |
| Purchase of treasury stock shares (500 shares) | - | - | - | - | (17) | - | (17) |
| **Balance, December 31, 2018** | 150 | 3,832 | 52,304 | (2,269) | (2,265) | (49) | 51,703 |
| Net income | **-** | **-** | **3,441** | **-** | **-** | **17** | **3,458** |
| Other comprehensive income | **-** | **-** | **-** | **2,599** | **-** | **-** | **2,599** |
| Dividends declared ($0.81 per share) | **-** | **-** | **(1,076)** | **-** | **-** | **-** | **(1,076)** |
| **Balance, December 31, 2019** | **$ 150** | **$ 3,832** | **$ 54,669** | **$ 330** | **$ (2,265)** | **$ (32)** | **$ 56,684** |

*See accompanying notes to consolidated financial statements.*

# Northumberland Bancorp

## Consolidated Statements of Cash Flows
(amounts in thousands)

| *Years Ended December 31,* | | **2019** | | 2018 |
|---|---|---|---|---|
| **Cash Flows from Operating Activities** | | | | |
| Net income | $ | **3,458** | $ | 2,934 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | | | |
| Provision for loan losses | | **353** | | 456 |
| Depreciation, amortization, and accretion, net | | **1,448** | | 1,678 |
| Proceeds from sales of loans held for sale | | **20,845** | | 17,485 |
| Gains on sales of loans | | **(571)** | | (464) |
| Originations of residential loans held for sale | | **(18,830)** | | (18,081) |
| Investment securities losses, net | | **(69)** | | 14 |
| Deferred income tax (benefit)/expense | | **(79)** | | (48) |
| Earnings on bank-owned life insurance | | **(283)** | | (286) |
| Write-down of other real estate owned | | **59** | | 71 |
| Increase in accrued interest receivable | | **109** | | (107) |
| Decrease in accrued interest payable | | **13** | | 30 |
| Other, net | | **(96)** | | 1,340 |
| **Net Cash Provided by Operating Activities** | | **6,357** | | 5,022 |
| **Cash Flows from Investing Activities** | | | | |
| Investment securities available-for-sale: | | | | |
| Proceeds from sales | | **20,563** | | 3,192 |
| Proceeds from maturities or redemptions | | **25,996** | | 24,986 |
| Purchases | | **(29,103)** | | (27,875) |
| **Investment securities held-to-maturity:** | | | | |
| Proceeds from maturities or redemptions | | **925** | | 402 |
| Purchases | | **-** | | (1,612) |
| Increase in loans, net | | **(24,025)** | | (28,938) |
| Purchases of premises and equipment, net | | **(343)** | | (346) |
| Purchases of restricted stock | | **(703)** | | (515) |
| Redemptions of restricted stock | | **877** | | 722 |
| Proceeds from sale of real estate owned | | **330** | | - |
| **Net Cash Used in Investing Activities** | | **(5,483)** | | (29,984) |
| **Cash Flows from Financing Activities** | | | | |
| Net increase in deposits | | **(1,647)** | | 24,131 |
| Net increase in short-term borrowed funds | | **325** | | 175 |
| Cash dividends paid | | **(1,076)** | | (970) |
| Purchase of treasury stock | | **-** | | (17) |
| **Net Cash Provided by Financing Activities** | | **(2,398)** | | 23,319 |
| Decrease in cash and cash equivalents | | **(1,524)** | | (1,643) |
| **Cash and Cash Equivalents, Beginning Of Year** | | **11,904** | | 13,547 |
| **Cash and Cash Equivalents, End Of Year** | $ | **10,380** | $ | 11,904 |

*See accompanying notes to consolidated financial statements.*

## 1. Summary of Significant Accounting Policies

A summary of significant accounting and reporting policies applied in the presentation of the accompanying consolidated financial statements follows:

***Nature of Operations and Basis of Presentation***

Northumberland Bancorp (the "Company") is a Pennsylvania corporation and is registered under the Bank Holding Company Act. The Company was organized as the holding company of its wholly owned subsidiary, The Northumberland National Bank (the "Bank"). The Bank is a nationally chartered commercial bank located in Northumberland, Pennsylvania. The Bank's service area includes portions of Northumberland, Snyder, and Union counties in Pennsylvania. The Company and the Bank derive substantially all of their income from banking and bank-related services, which include interest earnings on commercial, commercial mortgage, residential real estate, and consumer loan financing as well as interest earnings on investment securities and deposit and trust services to their customers. The Bank has a subsidiary, NNB Financial Services, which sells financial and insurance products. The Company is supervised by the Federal Reserve Board, while the Bank is subject to regulation and supervision by the Office of the Comptroller of the Currency.

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary, the Bank. Intercompany activity has been eliminated in consolidation.

***Use of Estimates***

The consolidated financial statements have been prepared in conformity with U.S. generally accepted accounting principles and with general practice within the banking industry. In preparing the financial statements, management makes estimates and assumptions based upon available information. These estimates and assumptions affect the amounts reported in financial statements and the disclosures provided. Actual results could differ significantly from those estimates.

***Investment Securities***

Investment securities are classified at the time of purchase, based on management's intention and ability, as securities held-to-maturity or securities available-for-sale. Debt securities acquired with the intent and ability to hold to maturity are stated at cost adjusted for amortization of premium and accretion of discount that are computed using the level yield method and recognized as adjustments of interest income. Certain other debt securities have been classified as available-for-sale to serve principally as a source of liquidity. Equity securities are measured at fair value with changes in fair value recognized in current period earnings. Unrealized holding gains and losses for available- for-sale securities are reported as a separate component of stockholders' equity, net of tax, until realized. Realized securities gains and losses are computed using the specific identification method. Interest and dividends on investment securities are recognized as income when earned.

Debt securities are periodically reviewed for other-than-temporary impairment ("OTTI") based upon a number of factors including, but not limited to, the length of time and extent to which the market value has been less than cost, the financial condition of the underlying issuer, and the ability of the issuer to meet contractual obligations. Management also assesses whether it intends to sell, or is more likely than not that it will be required to sell, a debt security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: OTTI related to credit loss, which must be recognized in the income statement, and OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

In January 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) 2016-01, Recognition and measurement of Financial Assets and Liabilities. This standard requires several changes including that equity investments are to be measured at fair value, with changes in fair value measured in net income. This standard also requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes. The Company adopted ASU 2016-01 on January 1, 2018, and it had no material impact on the Consolidated Financial Statements. The Company reclassified the fair value of equity securities by increasing Retained Earnings by $39,000 and decreasing Accumulated Other Comprehensive Income by the same amount.

### *Federal Home Loan Bank Stock*

The Bank is a member of the Federal Home Loan Bank ("FHLB") of Pittsburgh and, as such, is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB, as well as a minimum level of mortgages in the Mortgage Partnership Finance ("MPF") program. FHLB Stock is carried at cost, classified as restricted securities, and periodically evaluated or impairment based on the ultimate recovery of par value. Both cash and stock dividends are reported as income.

### *Loans Held for Sale and Loans Serviced*

Loans held for sale are carried at the lower of cost or fair value, as determined on an aggregate basis. Gains and losses on sales of mortgage loans are determined by the difference between the sale proceeds and the carrying value of loans. All sales are made with limited recourse. Loans held for sale were $969,000 and $2,414,000 at December 31, 2019 and 2018, respectively. At December 31, 2019 and 2018, the amounts of loans serviced by the Company for the benefit of others were $126,980,000 and $126,403,000, respectively. These loans are not included in the Company's consolidated balance sheet.

### *Mortgage Servicing Rights ("MSRs")*

The Company has agreements for the express purpose of selling loans in the secondary market. The Company maintains servicing rights for certain loans. Originated MSRs are recorded by allocating total costs incurred between the loan and servicing rights based on their relative fair values. MSRs are amortized in proportion to the estimated servicing income over the estimated life of the servicing portfolio. Annually, the Company performs an impairment review of the MSRs and recognizes impairment through a valuation account. No impairment was recognized in 2019 or 2018. MSRs are a component of other assets on the consolidated balance sheets. The balance of loan servicing assets was $542,000 and $688,000 at December 31, 2019 and 2018, respectively.

### *Loans*

Loans originated with the intention to hold to maturity are reported at their principal amount, net of unearned income and the allowance for loan losses. Interest income on all loans is recognized on an accrual basis. Nonrefundable loan fees and certain direct costs are deferred and amortized over the life of the loans using the interest method. The amortization is reflected as an interest yield adjustment, and the deferred portion of the net fees and costs is reflected as part of the loan balance.

Accrual of interest is discontinued when, in the opinion of management, reasonable doubt exists as to the collectability of additional interest. Loans are returned to accrual status when past due interest is collected and the collection of principal is probable. Commercial and commercial real estate loans are considered for nonaccrual status upon 90 days delinquency, unless the loan is well- secured and in the process of collection. Residential mortgages are considered for nonaccrual when they are 180 days past due, unless they are well secured and in the process of collection. Consumer loans continue to accrue interest until they are charged off after they have reached 120 days past due. Past due status is based upon the contractual terms of the loan. In all cases, loans are placed on non-accrual or charged off at an earlier date if collection of principal or interest is considered doubtful. Nonaccrual loans and loans past due 90 days and still accruing may include smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

### *Allowance for Loan Losses*

The allowance for loan losses represents the amount that management estimates is adequate to provide for probable losses inherent in its loan portfolio. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance, and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses charged to operations. The provision for loan losses is based on management's periodic evaluation of individual loans, economic factors, past loan loss experience, changes in the composition and volume of the portfolio, and other relevant factors. The estimates used in determining the adequacy of the allowance for loan losses are particularly susceptible to changes in the near term.

Impaired loans are commercial and commercial real estate loans for which it is probable the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Company individually evaluates such loans for impairment and does not aggregate loans by major risk classifications. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of impaired loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loans. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans, are collectively evaluated for impairment, and accordingly, they are not included in the separate identified impairment disclosures. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed.

Loans whose terms are modified are classified as troubled debt restructurings if the Bank grants such borrowers concessions and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate or an extension of a loan's stated maturity date. Nonaccrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive months after modification. Loans classified as troubled debt restructurings are designated as impaired.

### *Premises and Equipment*

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on the straight-line method over the estimated useful lives of the assets, which range from 3 to 20 years for furniture, fixtures, and equipment and 15 to 50 years for buildings and building improvements. Expenditures for maintenance and repairs are charged against income as incurred. Costs of major additions and improvements are capitalized.

### *Real Estate Owned*

Real estate owned acquired in settlement of foreclosed loans is carried as a component of other assets at fair value minus estimated cost to sell. Prior to foreclosure, the estimated collectible value of the collateral is evaluated to determine whether a partial charge-off of the loan balance is necessary. After transfer to real estate owned, any subsequent write-downs are charged against other operating expenses. Direct costs incurred in the foreclosure process and subsequent holding costs incurred on such properties are recorded as expenses of current operations. The balance of real estate owned included in accrued interest and other assets was $0 and $389,000 at December 31, 2019 and 2018, respectively.

### *Bank Owned Life Insurance*

The Company invests in bank owned life insurance ("BOLI") as a source of funding for employee benefit expenses. BOLI involves the purchasing of life insurance by the bank on a select group of employees. The Company is the owner and beneficiary of the policies. This life insurance investment is carried at the cash surrender value of the underlying policies. Income from the increase in cash surrender value of the policies or from death benefits realized is included in other income on the consolidated statements of income.

### *Loan Commitments and Related Financial Instruments*

Financial instruments include off-balance sheet credit instruments, such as commitments to make loans and commercial letters of credit, issued to meet financing needs. The face amount for these items represents the exposure to loss, before considering customer ability to repay. Such financial instruments are recorded when they are funded.

### *Advertising Costs*

Advertising costs are expensed as the costs are incurred. Advertising expenses amounted to $110,000 and $118,000 for 2019 and 2018, respectively.

### *Income Taxes*

The Company and the Bank file a consolidated federal income tax return. Deferred tax assets or liabilities are computed based on the difference between the financial statement and income tax basis of assets and liabilities using the enacted marginal tax rates. Deferred income tax expenses or benefits are based on the changes in the deferred tax asset or liability from period to period.

A tax position is recognized as a benefit only if it is "more likely than not" that the tax position would be sustained in a tax examination, with a tax examination being presumed to occur. The amount recognized is the largest amount of tax benefit that is greater than 50% likely of being realized on examination. For tax positions not meeting the "more likely than not" test, no tax benefit is recorded.

### *Employee Benefit Plans*

The Bank had a noncontributory defined benefit pension plan that covered all eligible employees. Benefits are based upon years of service, the employee's compensation, and age at retirement. The plan was frozen effective December 31, 2018, at which time no new participants were added to the plan and service costs were no longer accrued. Effective July 1, 2019, the plan was terminated. See Note 11 for more details on this plan.

The Bank also has a defined contribution benefit plan in the form of a 401(k) plan, that covers all eligible employees. During 2019, the Bank amended the 401(k) plan to include Roth elective deferral contributions by employees. The amendment also included employer Safe Harbor Matching Contributions by the Bank for both traditional 401(k) employee contributions and Roth contributions. The Bank matches 100% of employee contributions up to 3%, and 50% of employee contributions that exceed 3% up to a maximum of 5%.

### *Trust Assets*

Assets held by the Bank in a fiduciary or agency capacity for its customers are not included in the accompanying financial statements, since such items are not assets of the Bank. The fair value of trust assets under administration were $115,217,000 and $121,495,000 as of December 31, 2019 and 2018, respectively.

### *Comprehensive Income*

The Company is required to present comprehensive income and its components in a full set of general-purpose financial statements for all periods presented. Other comprehensive income (loss) is comprised of net unrealized holding gains or losses on its available-for-sale investment securities as well as changes in unrecognized pension cost, net of tax.

### *Earnings Per Share*

The Company currently maintains a simple capital structure; therefore, there are no dilutive effects on earnings per share. As such, earnings per share are calculated using the weighted-average number of shares outstanding for the periods.

### *Loss contingencies*

Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated. Management does not believe there now are such matters that will have a material effect on the financial statements.

### *Cash Flow Information*

The Company has defined cash and cash equivalents as those amounts included in the consolidated balance sheet captions "cash and due from banks," and "interest-bearing deposits in other banks," with original maturities of 90 days or less. The following are supplemental disclosures for the consolidated statements of cash flows (in thousands):

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Cash paid during the year for: | | |
| Interest | $ 4,444 | $ 3,836 |
| Income taxes | 775 | 475 |
| Noncash investing transactions: | | |
| Transfer of loans to real estate owned | - | 460 |
| Lease Liabilities arising from obtaining right-of-use assets | 394 | - |

### *Reclassification of Comparative Amounts*

Certain comparative amounts for the prior year have been reclassified to conform to current-year classifications. Reclassifications had no effect on prior year stockholders' equity or net income.

## 2. Investment Securities

The amortized cost and fair values of investment securities are as follows (in thousands):

| *December 31, 2019* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Approximate Fair Value |
|---|---|---|---|---|
| Available-for-sale: | | | | |
| Obligations of states and political subdivisions | $ 46,127 | $ 576 | $ (80) | $ 46,623 |
| Mortgage-backed securities in government sponsored entities | 80,481 | 316 | (394) | 80,403 |
| **Total** | $ 126,608 | $ 892 | $ (474) | $ 127,026 |

| *December 31, 2018* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Approximate Fair Value |
|---|---|---|---|---|
| Available-for-sale: | | | | |
| Obligations of states and political subdivisions | $ 55,113 | $ 62 | $ (729) | $ 54,446 |
| Mortgage-backed securities in government sponsored entities | 89,766 | 116 | (1,407) | 88,475 |
| **Total** | $ 144,879 | $ 178 | $ (2,136) | $ 142,921 |

| *December 31, 2019* | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Approximate Fair Value |
|---|---|---|---|---|
| Held-to-maturity: | | | | |
| Obligations of states and political subdivisions | **$ 906** | **$ 14** | **$ -** | **$ 920** |
| **Total** | **$ 906** | **$ 14** | **$ -** | **$ 920** |
| *December 31, 2018* | | | | |
| Held-to-maturity: | | | | |
| Obligations of states and political subdivisions | $ 1,849 | $ 9 | $ (7) | $ 1,851 |
| **Total** | $ 1,849 | $ 9 | $ (7) | $ 1,851 |

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31, 2019 and 2018 (in thousands).

| | Less than 12 Months | | 12 months or Longer | | Total | |
|---|---|---|---|---|---|---|
| *2019* | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Available-for-sale: | | | | | | |
| Obligations of state and political subdivisions | $ 6,377 | $ (51) | $ 727 | $ (29) | $ 7,104 | $ (80) |
| Mortgage-backed securities in government sponsored entities | 14,490 | (94) | 30,514 | (300) | 45,004 | (394) |
| **Total** | $ 20,867 | $ (145) | $ 31,241 | $ (329) | $ 52,108 | $ (474) |
| Held-to-maturity: | | | | | | |
| Obligations of state and political subdivisions | $ - | $ - | $ - | $ - | $ - | $ - |
| **Total** | $ - | $ - | $ - | $ - | $ - | $ - |

| | Less than 12 Months | | 12 months or Longer | | Total | |
|---|---|---|---|---|---|---|
| *2018* | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses | Fair Value | Unrealized Losses |
| Available-for-sale: | | | | | | |
| Obligations of state and political subdivisions | $ 7,877 | $ (20) | $ 27,537 | $ (709) | $ 35,414 | $ (729) |
| Mortgage-backed securities in government sponsored entities | 24,003 | (175) | 48,933 | (1,232) | 72,936 | (1,407) |
| **Total** | $ 31,880 | (195) | $ 76,470 | $ (1,941) | $ 108,350 | $ (2,136) |
| Held-to-maturity: | | | | | | |
| Obligations of state and political subdivisions | $ 1,173 | $ (6) | $ 252 | $ (1) | $ 1,425 | $ (7) |
| **Total** | $ 1,173 | $ (6) | $ 252 | $ (1) | $ 1,425 | $ (7) |

The Company reviews its unrealized loss positions quarterly and has asserted that at December 31, 2019 and 2018, the declines outlined in the above tables represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. There were 109 and 220 positions that were temporarily impaired at December 31, 2019 and 2018, respectively. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, or issuer-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period. In each case, the issuers continue to make timely principal and interest payments. Fair value is expected to recover as the security approaches maturity.

The amortized cost and fair value of debt securities at December 31, 2019, by contractual maturity, are shown below. Securities not due at a single maturity date are shown separately. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands).

| | Available-for-Sale | | Held-to-Maturity | |
|---|---|---|---|---|
| | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Due in one year or less | $ 7,500 | $ 7,521 | $ 241 | $ 241 |
| Due after one year through five years | 23,377 | 23,695 | 649 | 663 |
| Due after five years through ten years | 15,250 | 15,407 | - | - |
| Due after ten years | - | - | 16 | 16 |
| Mortgage Backed Securities | 80,481 | 80,403 | - | - |
| **Total** | $ 126,608 | $ 127,026 | $ 906 | $ 920 |

Proceeds from the sales of available-for-sale securities during 2019 amounted to $20,563,000 resulting in gross gains and gross losses of $82,000 and $13,000, respectively. Proceeds from the sales of available-for-sale securities during 2018 amounted to $3,192,000 resulting in gross gains and gross losses of $18,000 and $(32,000), respectively.

Investment securities with fair values of $70,558,000 and $77,314,000 at December 31, 2019 and 2018, respectively, were pledged to secure public deposits and other purposes as required by law.

## 3. Loans

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

| | December 31, 2019 | December 31, 2018 |
|---|---|---|
| Commercial | $ 87,293 | $ 75,335 |
| Commercial real estate | 84,969 | 76,636 |
| Residential real estate | 196,391 | 192,960 |
| Consumer | 4,980 | 4,792 |
| | 373,633 | 349,723 |
| Less allowance for loan losses | 3,451 | 3,163 |
| **Net Loans** | $ 370,182 | $ 346,560 |

The Company grants residential, commercial, and consumer loans to customers throughout its trade area, which is concentrated in North Central Pennsylvania. Although the Company has a diversified loan portfolio at December 31, 2019 and 2018, a substantial portion of its debtors' ability to honor their loan agreements is dependent upon the economic stability of its immediate trade area.

## 4. Allowance for Loan Losses

Changes in the allowance for loan losses by portfolio segment are as follows (in thousands):

| *December 31, 2019* | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| **Beginning Balance** | **$ 706** | **$ 544** | **$ 1,537** | **$ 63** | **$ 313** | **$ 3,163** |
| Charge-offs | **-** | **-** | **(58)** | **(8)** | **-** | **(66)** |
| Recoveries | **-** | **-** | **1** | **-** | **-** | **1** |
| Provision | **178** | **110** | **32** | **(1)** | **34** | **353** |
| **Ending Balance** | **$ 884** | **$ 654** | **$ 1,512** | **$ 54** | **$ 347** | **$ 3,451** |

| *December 31, 2018* | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| **Beginning Balance** | $ 574 | $ 499 | $ 1,465 | $ 45 | $ 327 | $ 2,910 |
| Charge-offs | - | - | (170) | (46) | - | (216) |
| Recoveries | - | - | 2 | 11 | - | 13 |
| Provision | 132 | 45 | 240 | 53 | (14) | 456 |
| **Ending Balance** | $ 706 | $ 544 | $ 1,537 | $ 63 | $ 313 | $ 3,163 |

Management has an established methodology to determine the adequacy of the allowance for loan losses that assesses the risks and losses inherent in the loan portfolio. For purposes of determining the allowance for loan losses, the Company has segmented certain loans in the portfolio by product type. Loans are segmented into the following pools: commercial, commercial real estate loans, residential real estate loans, and consumer loans. Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. These historical loss percentages are calculated over a two-year period during 2019 and a two-year period during 2018 for all portfolio segments. Certain qualitative factors are then added to the historical allocation percentage to apply the adjusted factor to non-classified loans. The following qualitative factors are analyzed for each portfolio segment and are adjusted based upon relevant changes within the portfolio:

- Levels of and trends in delinquencies
- Trends in volume and terms
- Trends in credit quality ratings
- Changes in management and lending staff
- Economic trends
- Concentrations of credit

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the consolidated balance sheet date. The following tables present the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment evaluation method as of December 31, 2019 and 2018 (in thousands):

| *December 31, 2019* | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Collectively evaluated for impairment | **884** | **654** | **1,512** | **54** | **347** | **3,451** |
| **Total** | **$ 884** | **$ 654** | **$ 1,512** | **$ 54** | **$ 347** | **$ 3,451** |
| Loans: | | | | | | |
| Individually evaluated for impairment | **$ 877** | $ - | **$ 344** | $ - | $ - | **$ 1,221** |
| Collectively evaluated for impairment | **86,416** | **84,969** | **196,047** | **4,980** | - | **372,412** |
| **Total** | **$ 87,293** | **$ 84,969** | **$ 196,391** | **$ 4,980** | $ - | **$ 373,633** |

| *December 31, 2018* | Commercial | Commercial Real Estate | Residential Real Estate | Consumer | Unallocated | Total |
|---|---|---|---|---|---|---|
| Allowance for loan losses: | | | | | | |
| Individually evaluated for impairment | $ - | $ - | $ - | $ - | $ - | $ - |
| Collectively evaluated for impairment | 706 | 544 | 1,537 | 63 | 313 | 3,163 |
| **Total** | $ 706 | $ 544 | $ 1,537 | $ 63 | $ 313 | $ 3,163 |
| Loans: | | | | | | |
| Individually evaluated for impairment | $ 926 | $ - | $ 335 | $ - | $ - | $ 1,261 |
| Collectively evaluated for impairment | 74,409 | 76,636 | 192,625 | 4,792 | - | 348,462 |
| **Total** | $ 75,335 | $ 76,636 | $ 192,960 | $ 4,792 | $ - | $ 349,723 |

### *Credit Quality Information*

The Company's internally assigned loan grades are as follows:

Pass loans are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral. There are five sub-grades within the pass category to further distinguish the loan.

Special Mention loans are loans for which a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard loans have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful loans have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

Loss loans are considered uncollectible, or of such value that continuance as an asset is not warranted.

The following tables represent credit exposures for commercial real estate and commercial and industrial loans by internally assigned grades for the years ended December 31, 2019 and 2018. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans (in thousands).

| *December 31, 2019* | Loans to States and Political Subdivisions | Other Commercial Loans | Loans for Investment Properties | Other Commercial Real Estate Loans | Total |
|---|---|---|---|---|---|
| Pass | **$ 10,930** | **$ 69,879** | **$ 30,724** | **$ 53,696** | **$ 165,229** |
| Special Mention | **-** | **1,967** | **-** | **436** | **2,403** |
| Substandard | **-** | **4,517** | **25** | **88** | **4,630** |
| Doubtful | **-** | **-** | **-** | **-** | **-** |
| Loss | **-** | **-** | **-** | **-** | **-** |
| **Ending Balance** | **$ 10,930** | **$ 76,363** | **$ 30,749** | **$ 54,220** | **$ 172,262** |

| *December 31, 2018* | Loans to States and Political Subdivisions | Other Commercial Loans | Loans for Investment Properties | Other Commercial Real Estate Loans | Total |
|---|---|---|---|---|---|
| Pass | $ 15,685 | $ 55,181 | $ 29,998 | $ 44,399 | $ 145,263 |
| Special Mention | - | 636 | - | 2,186 | 2,822 |
| Substandard | - | 3,833 | 29 | 24 | 3,886 |
| Doubtful | - | - | - | - | - |
| Loss | - | - | - | - | - |
| **Ending Balance** | $ 15,685 | $ 59,650 | $ 30,027 | $ 46,609 | $ 151,971 |

The Company evaluates credit quality for residential real estate and consumer loans based upon the aging status of the loan, which is presented below, and by payment activity. The following tables present performing and nonperforming residential real estate and consumer loans based on payment activity for the years ended December 31, 2019 and 2018 (in thousands):

| *December 31, 2019* | First Mortgages | Home Equity Loans | Consumer | Total |
|---|---|---|---|---|
| Performing | $ 164,770 | $ 30,445 | $ 4,980 | $ 200,195 |
| Nonperforming | 1,110 | 66 | - | 1,176 |
| **Total** | $ 165,880 | $ 30,511 | $ 4,980 | $ 201,371 |

| *December 31, 2018* | First Mortgages | Home Equity Loans | Consumer | Total |
|---|---|---|---|---|
| Performing | $ 164,852 | $ 27,481 | $ 4,792 | $ 197,125 |
| Nonperforming | 537 | 90 | - | 627 |
| **Total** | $ 165,389 | $ 27,571 | $ 4,792 | $ 197,752 |

Following are tables which include an aging analysis of the recorded investment of past-due loans as of December 31, 2019 and 2018 (in thousands):

| | Loans Past Due (Days) | | | | | Total |
|---|---|---|---|---|---|---|
| **2019** | **30-59** | **60-89** | **90+** | **Total** | **Current** | **Loans** |
| Commercial: | | | | | | |
| Obligations of states and political subdivisions | $ - | $ - | $ - | $ - | $ 10,930 | $ 10,930 |
| Other commercial loans | 8 | 50 | 73 | 131 | 76,232 | 76,363 |
| Commercial real estate: | | | | | | |
| Loans for investment property | 563 | - | - | 563 | 30,186 | 30,749 |
| Other commercial real estate loans | 29 | - | - | 29 | 54,191 | 54,220 |
| Residential mortgage loans: | | | | | | |
| First mortgages | 2,117 | 244 | 686 | 3,047 | 162,833 | 165,880 |
| Home equity loans | 140 | 49 | 20 | 209 | 30,302 | 30,511 |
| Consumer | 31 | 15 | 12 | 58 | 4,922 | 4,980 |
| **Total** | $ 2,888 | $ 358 | $ 791 | $ 4,037 | $ 369,596 | $ 373,633 |

| 2018 | Loans Past Due (Days) 30-59 | 60-89 | 90+ | Total | Current | Total Loans |
|---|---|---|---|---|---|---|
| Commercial: | | | | | | |
| Obligations of states and political subdivisions | $ - | $ - | $ - | $ - | $ 15,685 | $ 15,685 |
| Other commercial loans | 31 | - | 78 | 109 | 59,541 | 59,650 |
| Commercial real estate: | | | | | | |
| Loans for investment property | 232 | 156 | - | 388 | 29,639 | 30,027 |
| Other commercial real estate loans | - | - | - | - | 46,609 | 46,609 |
| Residential mortgage loans: | | | | | | |
| First mortgages | 2,026 | 729 | 732 | 3,487 | 161,902 | 165,389 |
| Home equity loans | 134 | 12 | 83 | 229 | 27,342 | 27,571 |
| Consumer | 19 | 17 | 5 | 41 | 4,751 | 4,792 |
| **Total** | $ 2,442 | $ 914 | $ 898 | $ 4,254 | $ 345,469 | $ 349,723 |

### *Impaired Loans*

Management evaluates commercial loans and commercial real estate loans which are 90 days or more past due and considers them to be impaired. Loans rated substandard or doubtful are also evaluated for impairment. These loans are analyzed to determine whether it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees, or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

The following tables include the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable, as of and for the years ending December 31 (in thousands):

| *December 31, 2019* | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial: | | | | | |
| Other commercial loans | **$ 877** | **$ 1,315** | **$ -** | **$ 895** | **$ -** |
| Commercial real estate: | | | | | |
| Loans for investment properties | - | - | - | - | - |
| Residential real estate: | | | | | |
| First mortgages | **344** | **379** | **-** | **333** | **18** |
| With an allowance recorded: | | | | | |
| Commercial: | | | | | |
| Other commercial loans | - | - | - | - | - |
| Commercial real estate: | | | | | |
| Loans for investment properties | - | - | - | - | - |
| Residential mortgage loans: | | | | | |
| First mortgages | - | - | - | - | - |
| **Total** | **$ 1,221** | **$ 1,694** | **$ -** | **$ 1,228** | **$ 18** |

| *December 31, 2018* | Recorded Investment | Unpaid Principal Balance | Related Allowance | Average Recorded Investment | Interest Income Recognized |
|---|---|---|---|---|---|
| With no related allowance recorded: | | | | | |
| Commercial: | | | | | |
| Other commercial loans | $ 926 | $ 1,295 | $ - | $ 965 | $ - |
| Commercial real estate: | | | | | |
| Loans for investment properties | - | - | - | - | - |
| Residential real estate: | | | | | |
| First mortgages | 335 | 368 | - | 218 | 11 |
| With an allowance recorded: | | | | | |
| Commercial: | | | | | |
| Other commercial loans | - | - | - | - | - |
| Commercial real estate: | | | | | |
| Loans for investment properties | - | - | - | - | - |
| Residential mortgage loans: | | | | | |
| First mortgages | - | - | - | - | - |
| **Total** | $ 1,261 | $ 1,663 | $ - | $ 1,183 | $ 11 |

### *Nonaccrual Loans*

Loans are considered for nonaccrual status upon 90 days delinquency. When a loan is placed in nonaccrual status, previously accrued but unpaid interest is deducted from interest income.

The following tables present loans that are on nonaccrual status and that are 90 days delinquent and still accruing interest by portfolio segment as of December 31 (in thousands):

| *December 31, 2019* | **Nonaccrual** | **Past Due 90 Days or More and Still Accruing** |
|---|---|---|
| Commercial: | | |
| Obligations of states and political subdivisions | **$ -** | **$ -** |
| Other commercial loans | **877** | **73** |
| Commercial real estate: | | |
| Loans for investment properties | **-** | **-** |
| Other commercial real estate loans | **-** | **-** |
| Residential mortgage loans: | | |
| First mortgages | **1,110** | **-** |
| Home equity loans | **66** | **25** |
| Consumer loans | **-** | **5** |
| | **$ 2,053** | **$ 103** |

| *December 31, 2018* | Nonaccrual | Past Due 90 Days or More and Still Accruing |
|---|---|---|
| Commercial: | | |
| Obligations of states and political subdivisions | $ - | $ - |
| Other commercial loans | 926 | 78 |
| Commercial real estate: | | |
| Loans for investment properties | - | - |
| Other commercial real estate loans | - | - |
| Residential mortgage loans: | | |
| First mortgages | 537 | 290 |
| Home equity loans | 90 | 76 |
| Consumer loans | - | - |
| | $ 1,553 | $ 444 |

Interest income on nonaccrual loans not recognized during 2019 and 2018 was $151,000 and $129,000, respectively.

The Bank identifies loans for potential restructure primarily through direct communication with the borrower and evaluation of the borrower's financial statements, revenue projections, tax returns, and credit reports. Even if the borrower is not presently in default, management will consider the likelihood that cash flow shortages, adverse economic conditions, and negative trends may result in a payment default in the near future.

Troubled debt restructurings (TDR) may be designated as performing or non-performing. A TDR may be designated as performing if the loan has demonstrated sustained performance under the modified terms. The period of sustained performance may include the periods prior to modification if prior performance met or exceeded the modified terms. For non-performing restructured loans, the loan will remain on non-accrual status until the borrower demonstrates a sustained period of performance, generally six consecutive months of payments. The Bank had $344,000 and $335,000 in total performing restructured loans as of December 31, 2019 and 2018, respectively. During the year ended December 31, 2019 and 2018, the Bank did not have any loans classified as troubled debt restructurings that subsequently defaulted.

The following table reflects the Bank's troubled debt restructuring activity during 2019 and 2018 (in thousands):

| | 2019 | | 2018 | |
|---|---|---|---|---|
| | Modification of Payment and Other Terms | | Modification of Payment and Other Terms | |
| *December 31, 2019* | Number of Contracts | Recorded Investment | Number of Contracts | Recorded Investment |
| Residential real estate | **1** | **$ 20** | 1 | $ 200 |
| **Total** | **1** | **$ 20** | 1 | $ 200 |

## 5. Premises and Equipment

Major classifications of premises and equipment are summarized as follows (in thousands):

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Land and improvements | **$ 1,458** | $ 1,458 |
| Buildings and improvements | **10,453** | 10,043 |
| Furniture, fixtures and equipment | **4,747** | 4,531 |
| | **16,658** | 16,032 |
| Less accumulated depreciation | **7,339** | 6,909 |
| **Total** | **$ 9,319** | $ 9,123 |

Depreciation expense for the years ended December 31, 2019 and 2018 was $543,000 and $584,000, respectively.

## 6. Leases

In the normal course of business, the Company leases a property for one of our branch locations. This lease has a remaining term of nine years with no renewal options remaining. This lease was classified as an operating lease as of the commencement date. Lease expense for operating leases is recognized on a straight line basis over the lease term. Right-of-use assets represent our right to use an underlying asset for the lease term, and lease liabilities represent our obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term.

The Company uses its incremental borrowing rate at lease commencement to calculate the present value of lease payments when the rate implicit in a lease is not known. The Company's incremental borrowing rate is based on the FHLB amortizing advance rate, adjusted for the lease term and other factors. The incremental borrowing rate used at lease commencement was 3.001%.

Right-of-use assets and lease liabilities by lease type and associated balance sheet captions are as follows (in thousands):

| | Balance Sheet Classification | December 31, 2019 |
|---|---|---|
| Right-of-use asset: | | |
| Operating Lease | Building | **$394** |
| Lease liability: | | |
| Operating Lease | Other Liabilities | **394** |

Future undiscounted lease payments for operating lease of branch as of December 31, 2019 are as follows (in thousands):

| *Year Ending December 31,* | |
|---|---|
| 2020 | $ 54 |
| 2021 | 54 |
| 2022 | 54 |
| 2023 | 54 |
| 2024 | 54 |
| Thereafter | 229 |
| Total undiscounted lease payments | 499 |
| Less: imputed interest | (105) |
| Net lease Liabilities | $ 394 |

## 7. Deposits

The components of deposits at December 31, 2019 and 2018 are as follows (in thousands):

| *December 31,* | **2019** | **2018** |
|---|---|---|
| Demand, noninterest-bearing | **$ 96,251** | $ 89,761 |
| Demand, interest-bearing | **68,472** | 71,417 |
| Savings | **85,093** | 83,192 |
| Money Market Accounts | **73,344** | 86,449 |
| Time, $250 and over | **30,945** | 30,097 |
| Time, other | **121,755** | 116,591 |
| **Total** | **$ 475,860** | $ 477,507 |

Time deposits and their remaining maturities at December 31, 2019 are as follows (in thousands):

| *Year Ending December 31,* | |
|---|---|
| 2020 | $ 83,573 |
| 2021 | 46,861 |
| 2022 | 8,396 |
| 2023 | 5,650 |
| 2024 | 8,153 |
| Thereafter | 67 |
| | $ 152,700 |

Time deposits $250,000 and greater were $30,945 and time deposits less than $250,000 were $121,755 as of December 31, 2019.

## 8. Borrowings

Borrowings at December 31, 2019 and 2018 consisted of the following short-term notes with the Federal Home Loan Bank (dollars in thousands):

| Maturity Date | Interest Rate | December 31, 2019 | December 31, 2018 |
|---|---|---|---|
| January 2, 2019 | 2.62% | - | $ 3,175 |
| March 31, 2020 | 1.88% | $ 2,000 | - |
| June 30, 2020 | 1.88% | 1,500 | - |
| **Total** | | $ 3,500 | $ 3,175 |

Each advance is payable at its maturity date, with a prepayment penalty for fixed rate advances. The advances were collateralized by $244,491,000 and $263,791,000 on mortgage and non-mortgage loans under a blanket lien arrangement at December 31, 2019 and December 31, 2018. Based on this collateral, and the Company's holding of FHLB stock, the Company is eligible to borrow up to $214,939,000 at December 31, 2019. Additionally, the Company also had unused unsecured lines of credit with correspondent banks which provided another $14,708,000 of available credit at December 31, 2019.

## 9. Revenue Recognition

On January 1, 2018, the Company adopted ASC 606 "Revenue from Contracts with Customers" (ASC 606) using the modified retrospective approach. The accounting standard was applied to all contracts initiated on or after the effective date, and also for contracts which have remaining obligations after the effective date.

Results for the years ended December 31, 2019 and 2018 are presented under ASC 606. The accounting standard adoption did not have a material impact on any of the reported periods. The Company did not record a cumulative effect adjustment to the beginning retained earnings balance as of January 1, 2018 as it was determined that the transition adjustment, from the adoption of ASC 606, was immaterial to the Company's consolidated financial statements.

All of the revenue from contracts with customers, within the scope of ASC 606 is recognized in the non-interest income as presented in the Company's consolidated financial statements.

Sources of revenue for the Company which fall within the scope of ASC 606 are described as follows:

- Deposit Service Charges – The Bank earns fees from its deposit customers for various services transaction based services and periodic account maintenance. Transaction based services include but are not limited to stop payment fees, overdraft fees, check cashing fees, wire transfer fees, and early withdrawal penalties. Maintenance fees include account maintenance fees, minimum balance fees, and monthly service charge. Transaction based fees are only recognized when the transaction is complete, and maintenance fees are recognized when the period of the obligation is complete. Deposit service charges and fees amounted to $365,000 in 2019 and $394,000 in 2018, which are included in Service Charges on Deposit Accounts on the Consolidated Statements of Income.

- Trust Services Income
    - Asset Management - The Trust department receives fees for providing trust related services including Investment Management, Security Custody, and Other Trust Services. These fees are based upon the value of assets under management and are assessed using a tiered rate schedule. Fees are recognized on a monthly basis when the service obligation is complete. Trust asset management fees amounted to $819,000 in 2019 and $751,000 in 2018. These fees are included in Trust Services Income on the Consolidated Statements of Income.

    - Estate Settlement – The trust department provides estate settlement services. These fees are based on the estimated fair value of the estate according to a tiered rate schedule. Each estate is unique in the nature, size, and complexity, and may include many tasks or milestones to complete. Fees are recognized in proportion to the number of milestones completed which is a judgement made by the trust management team. Estate settlement fees amounted to $27,000 in 2019 and $19,000 in 2018. These fees are included in Trust Services Income on the Consolidated Statements of Income.

- Debit Card Income – The Bank provides electronic funds transfer processing services for the debit cards it offers to its customers. The Bank earns interchange fees from each cardholder transaction conducted through various networks. The fees are transaction based and are earned when the transaction is complete. Debit card income amounted to $829,000 in 2019 and $668,000 in 2018. These fees are included in Service Charges on Deposit Accounts on the Consolidated Statements of Income.

- Merchant Services Income - The Bank arranges for its business customers to contract with our credit card vendor for merchant (credit card) processing services. Customers are provided with a POS credit card terminal so they can take payment from retail sales customers. The fees are transaction based and are earned when the transaction is complete. Merchant Services Income amounted to $69,000 in 2019 and $68,000 in 2018. These fees are included in Other Income on the Consolidated Statements of Income.

- Insurance and Investment Service Fees – The Company sells investments and insurance through its Trust and Wealth Management division. Commissions from the sale of these products are recognized upon the completion of the transaction. These fees amounted to $79,000 in 2019 and $64,000 in 2018. These fees are included in Other Income on the Consolidated Statements of Income.

- ATM Service Charges – ATM service charges are earned when non customers use Bank ATM machines. These fees are recognized when the transaction is complete. These fees amounted to $49,000 in 2019 and $47,000 in 2018. These fees are included in Service Charges on Deposit Accounts on the Consolidated Statements of Income.

- Gains/ Losses on the Sale of Other Real Estate – these assets are de-recognized when control of the property transfers to the buyer. These gains/losses are included in Other Income on the Consolidated Statements of Income.

The Company expenses all contract acquisition costs as costs are incurred.

## 10. Income Taxes

The provision for Federal income taxes consists of (in thousands):

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Current | $ 647 | $ 470 |
| Deferred | (79) | (48) |
| **Total** | $ 568 | $ 422 |

The tax effects of deductible and taxable temporary differences that give rise to significant portions of the deferred tax assets and deferred tax liabilities, respectively, at December 31 are as follows (in thousands):

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Deferred tax assets: | | |
| Allowance for loan losses | $ 692 | $ 618 |
| Accrued pension obligation | - | 192 |
| Lease liability | 83 | - |
| Unrealized loss on investment securities | - | 411 |
| Other | 239 | 224 |
| Total gross deferred tax assets | 1,014 | 1,445 |
| Deferred tax liabilities: | | |
| Premises and equipment | 229 | 260 |
| Investment accretion | 5 | 3 |
| Prepaid pension costs | - | 104 |
| Loan origination fees and costs | 105 | 94 |
| Mortgage servicing rights | 114 | - |
| Right of use asset | 83 | - |
| Unrealized gain on investment securities | 99 | - |
| Other | 42 | 37 |
| Total gross deferred tax liabilities | 677 | 498 |
| **Net Deferred Tax Asset** | $ 337 | $ 947 |

No valuation allowance was established at December 31, 2019 and 2018, in view of the Company's ability to carryback to taxes paid in previous years and certain tax strategies, coupled with the anticipated future taxable income as evidenced by the Company's earnings potential. Net deferred tax assets are included in Accrued Interest and Other Assets on the balance sheet.

The following is a reconciliation of the federal statutory rate and the Company's effective income tax rate for the years ended December 31 (dollars in thousands):

| | 2019 | | 2018 | |
|---|---|---|---|---|
| | **Amount** | **Percent of Pretax Income** | **Amount** | **Percent of Pretax Income** |
| Provision at statutory rate | **$ 845** | **21.0 %** | $ 705 | 21.0 % |
| Effect of tax-exempt income | **(236)** | **(5.9)** | (241) | (7.2) |
| Earnings from bank owned insurance | **(59)** | **(1.5)** | (60) | (1.8) |
| Nondeductible interest expense | **16** | **0.4** | 26 | 0.8 |
| Other | **2** | **0.1** | (8) | (0.2) |
| **Actual Tax Expense and Effective Rate** | **$ 568** | **14.1 %** | $ 422 | 12.6 % |

The Company prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the consolidated statements of income. With few exceptions, the Company is no longer subject to U.S. federal or state income tax examinations by tax authorities for years before 2016.

## 11. Commitments and Contingencies

In the normal course of business, the Company makes various commitments that are not reflected in the accompanying consolidated financial statements. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The Company's exposure to credit loss in the event of nonperformance by the other parties to the financial instruments is represented by the contractual amounts as disclosed. Losses, if any, are charged to the allowance for loan losses. The Company minimizes its exposure to credit loss under these commitments by subjecting them to credit approval, review procedures, and collateral requirements as deemed necessary.

The off-balance sheet commitments consisted of the following (in thousands):

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Commitments to extend credit | **$ 82,639** | $ 76,570 |
| Standby letters of credit | **4,174** | 3,579 |

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the loan agreement. These commitments are composed primarily of available commercial lines of credit and mortgage loan commitments. The Company uses the same credit policies in making loan commitments and conditional obligations as it does for on-balance sheet instruments. The Company evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, as deemed necessary, is based upon management's credit evaluation in compliance with the Company's lending policy guidelines. Customers use credit commitments to ensure funds will be available for working capital purposes, for capital expenditures, and to ensure access to funds at specified terms and conditions.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Performance letters of credit represent conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid or performance-related contracts. The coverage period for these instruments is typically a one-year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized over the coverage period. For secured letters of credit, the collateral is typically company deposit instruments or customer business assets.

## 12. Pension Plan

The Bank sponsored a qualified, non-contributory defined benefit pension plan covering substantially all full time employees with at least one year of service and attaining 21 years of age. Employees would be fully vested upon completing five years of service. The Plan called for benefits to be paid to eligible employees at retirement, based primarily upon years of service with the Bank and compensation rates during employment.

Effective December 31, 2018 the Plan was frozen. At that time, no new employees were admitted to the Plan, and service costs for active employees participating in the plan no longer accrued benefits. The Bank's actuaries re-measured the Projected Benefit Obligation as of December 31, 2018. This re-measurement resulted in the recognition of a curtailment gain of $2,049,000 recognized as a credit to pension expense and a reduction of pension liability. The curtailment gain triggered recognition of $2,049,000 of unrecognized pension costs previously recorded in accumulated other comprehensive income, which were recognized as a charge to pension expense for $2,049,000.

Effective July 1, 2019, the Bank terminated the defined benefit plan. As a result of the termination, those individuals employed and in the plan as of December 31, 2018 would become vested effective July 1, 2019. As a result of the termination, the plan offered annuities of similar benefit to all employees and retirees. In addition, the Bank offered a lump sum option to terminated vested and active employees.

As a result of the termination, effective July 1, 2019, the bank recognized an additional $342 thousand in pension costs previously recorded in accumulated other comprehensive income.

During 2019, the Bank contributed $73 thousand to the plan in order to fully fund the plan before the final distribution. As a result of the termination and distribution, the Bank has no remaining liability to the plan.

The following table sets forth the obligation and funded status as of December 31 (in thousands):

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Change in benefit obligation: | | |
| Benefit obligation at beginning of year | $ **10,467** | $ 12,782 |
| Service cost | **-** | 1,005 |
| Interest cost | **431** | 469 |
| Change in assumptions | **414** | (1,566) |
| Actuarial loss (gains) | **(59)** | 453 |
| Benefits paid | **(11,253)** | (627) |
| Effect of Curtailment | **-** | (2,049) |
| Benefit obligation at end of year | **-** | 10,467 |
| Change in plan assets: | | |
| Fair value of plan assets at beginning of year | **10,075** | 11,329 |
| Actual return on plan assets | **1,105** | (627) |
| Employer contribution | **73** | - |
| Benefits Paid | **(11,253)** | (627) |
| Fair value of plan assets at end of year | **-** | 10,075 |
| **Funded Status, included in Other Liabilities** | $ **-** | $ (392) |

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Amounts recognized in accumulated other comprehensive loss consist of: | | |
| Net loss | $ - | $ 914 |
| **Total** | $ - | $ 914 |

As a result of the termination and settlement of the defined benefit pension plan during 2019, the accumulated benefit obligation was zero at December 31, 2019. The accumulated benefit obligation was $10,467,000 at December 31, 2018.

***Components of Net Periodic Benefit Cost***

| *December 31,* | 2019 | 2018 |
|---|---|---|
| Net periodic pension cost: | | |
| Service cost | $ - | $ 1,005 |
| Interest cost | **431** | 469 |
| Expected return on plan assets | **(179)** | (844) |
| Amortization of net loss | - | 124 |
| **Net Periodic Benefit Cost** | $ **252** | $ 754 |

As a result of the freeze of the plan at December 31, 2018, there were no service costs accrued in 2019. Also due to the freeze, there was no amortization of accumulated other comprehensive loss into net periodic pension expense in 2019.

***Assumptions***

The weighted-average assumptions used to determine benefit obligations at December 31:

| | 2019 | 2018 |
|---|---|---|
| Discount rate | **3.43-4.88 %** | 4.21% |
| Rate of compensation increase | **N/A** | 4.00% |

Tiered discount rates were used for 2019 including 3.43%, 4.46%, and 4.88%, for participants electing a lump sum, insurance contract assumptions for those electing an annuity.

The weighted-average assumptions used to determine net periodic benefit cost for the years ended December 31:

| | 2019 | 2018 |
|---|---|---|
| Discount rate | **4.21%** | 3.59% |
| Expected long-term return on plan assets | **2.00%** | 8.00% |
| Rate of compensation increase | **N/A** | 4.00% |

The long-term rate of return on plan assets gives consideration to returns currently being earned on plan assets, as well as future rates expected to be returned.

### *Plan Assets*

The Bank's defined benefit pension plan weighted-average asset allocations at December 31 by asset category are as follows:

| | 2019 | 2018 |
|---|---|---|
| Asset category: | | |
| Mutual funds | n/a % | 71.9 % |
| Corporate bonds | n/a | 24.4 |
| U.S. Government agency securities | n/a | 2.3 |
| Cash and cash equivalents | n/a | 1.4 |
| **Total** | n/a % | 100.0 % |

Subsequent to the termination of the plan on July 1, 2019, but prior to December 31, 2019, all assets of the plan were distributed to the participants. As noted above, upon termination, the pension plan offered options to participants, including annuities of similar benefits, or a lump sum option to terminated vested and active employees. As of December 31, 2019, 100% of plan assets were distributed to participants.

The following table sets forth by level, within the fair value hierarchy, the plan's assets at fair value for 2018. At December 31, 2019 plan assets were zero as a result of the termination. A s of December 31, 2018, the plan’s assets at fair value were as follows(in thousands):

| | Fair Value Measurements at December 31, 2018 | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| Cash and cash equivalents | $ 143 | $ - | $ - | $ 143 |
| U.S. government agency securities | - | 234 | - | 234 |
| Corporate bonds | - | 2,451 | - | 2,451 |
| Mutual funds | 7,247 | - | - | 7,247 |
| **Total Assets at Fair Value** | $ 7,390 | $ 2,685 | $ - | $ 10,075 |

### *Cash Flows*

Due to the termination of the Plan, and full payment of all benefit obligations, the bank has no additional liability to the defined benefit pension plan. Accordingly, the bank is no longer obligated to make contributions.

## 13. Accumulated Other Comprehensive Loss

The following tables present the changes in accumulated other comprehensive loss by component net of tax for the years ended December 31, 2019 and 2018 (in thousands):

| | Unrealized Gains (Losses) on Available-for-Sale Securities | Unrecognized Pension Costs | Total |
|---|---|---|---|
| **Balance as of December 31, 2017** | $ (964) | $ (2,154) | $ (3,118) |
| Other comprehensive loss before reclassification | (555) | (88) | (643) |
| Amount reclassified from accumulated other comprehensive loss | 11 | 1,520 | 1,531 |
| Total other comprehensive loss | (544) | 1,432 | 888 |
| Cumulative adjustment for fair value of equity securities | (39) | - | (39) |
| **Balance as of December 31, 2018** | (1,547) | (722) | (2,269) |
| Other comprehensive loss before reclassification | **1,931** | **452** | **2,383** |
| Amount reclassified from accumulated other comprehensive loss | **(54)** | **270** | **216** |
| Total other comprehensive loss | **1,877** | **722** | **2,599** |
| **Balance as of December 31, 2019** | **$ 330** | **$ -** | **$ 330** |

The following table presents significant amounts reclassified out of each component of accumulated other comprehensive loss for the years ended December 31, 2019 and 2018 (in thousands):

| | Amount Reclassified from Accumulated Other Comprehensive Loss | | Affected Line Item in the Statement Where Net Income is Presented |
|---|---|---|---|
| | **2019** | **2018** | |
| Unrealized gains on available-for-sale securities: | | | |
| | $ **(69)** | $ 14 | Investment securities gains, net |
| | **15** | (3) | Income taxes |
| | $ **(54)** | $ 11 | Net of tax |
| Unrecognized pension costs: | | | |
| | $ **342** | $ 1,925 | Salaries and employee benefits |
| | **(72)** | (405) | Income taxes |
| | $ **270** | $ 1,520 | Net of tax |

## 14. Regulatory Matters

### *Cash and Due from Banks*

The Bank is required to maintain average cash reserve balances in vault cash or with the Federal Reserve Bank. The amount of these restricted cash reserve balances at December 31, 2019 and 2018 was $-0- and $-0-, respectively.

### *Loans*

Federal law prevents the Company from borrowing from the Bank unless the loans are secured by specific collateral. Further, such secured loans are limited in amount to 10 percent of the Bank's common stock and capital surplus.

### *Dividends*

The Bank is subject to a dividend restriction that generally limits the amount of dividends that can be paid by a national bank. Prior approval of the Office of the Comptroller of the Currency ("OCC") is required if the total of all dividends declared by a national bank in any calendar year exceeds net profits, as defined for the year, combined with its retained net profits for the two preceding calendar years less any required transfers to surplus. Using this formula, the amount available for payment of dividends by the Bank in 2019, without approval of the OCC, is approximately $4,039,000 plus 2019 net profits retained up to the date of the dividend declaration.

### *Capital Requirements*

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the 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 the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk-weightings and other factors.

Information presented for December 31, 2019 and 2018, reflects the Basel III capital requirements that became effective January 1, 2015 for the Bank. Prior to January 1, 2015, the Bank was subject to capital requirements under Basel I. Under these capital requirements and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk-weightings and other factors.

The risk-based capital rules adopted effective January 1, 2015 require that banks and holding companies maintain a "capital conservation buffer" of 250 basis points in excess of the "minimum capital ratio." The minimum capital ratio is equal to the prompt corrective action adequately capitalized threshold ratio. The capital conservation buffer is being phased in over a four-year period that began January 1, 2016, with a required buffer of 0.625% of risk weighted assets for 2016, 1.25% for 2017, 1.875% for 2018, and 2.5% for 2019 and thereafter. Failure to maintain the required capital conservation buffer will result in limitations on capital distributions and on discretionary bonuses to executive officers.

Effective January 1, 2019, the capital levels required for the Bank to avoid these limitations were as follows:

- Common Equity Tier 1 capital ratio of 7.00%
- Tier 1 risk based capital ratio of 8.50%
- Total risk based capital ratio of 10.50%

As of December 31, 2019, the Bank had a conservation buffer greater than 2.5%.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvement Act ("FDICIA") established five capital categories ranging from "well capitalized" to "critically undercapitalized." Should any institution fail to meet the requirements to be considered "adequately capitalized," it would become subject to a series of increasingly restrictive regulatory actions.

As of December 31, 2019 and 2018, the OCC categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. To be classified as a well-capitalized financial institution, Common equity Tier 1, Total risk-based, Tier I risk-based, and Tier I leverage capital ratios must be at least 6.5 percent, 10 percent, 6 percent, and 5 percent, respectively.

The Company's actual capital ratios are presented in the following table that shows the Company met all regulatory capital requirements. The capital position of the Bank does not differ significantly from the Company's capital position (dollars in thousands).

| | Actual | | To be Adequately Capitalized under Prompt Corrective Action Provisions | | To be Well Capitalized under Prompt Corrective Action Provisions | |
|---|---|---|---|---|---|---|
| **2019** | **Amount** | **Ratio** | **Amount** | **Ratio** | **Amount** | **Ratio** |
| Common equity Tier 1 (total risk-weighted assets) | $ 55,906 | 16.45% | $ 15,290 | ≥4.5% | $ ≥22,085 | ≥6.5% |
| Total capital (to risk-weighted assets) | 59,357 | 17.47% | 27,182 | ≥8.0% | ≥33,977 | ≥10.0% |
| Tier I capital (to risk-weighted assets) | 55,906 | 16.45% | 20,386 | ≥6.0% | ≥27,182 | ≥8.0% |
| Tier I capital (to average assets) | 55,906 | 10.37% | 21,561 | ≥4.0% | ≥26,951 | ≥5.0% |
| **2018** | | | | | | |
| Common equity Tier 1 (total risk-weighted assets) | $ 53,762 | 17.03% | $ ≥14,202 | ≥4.5% | $ ≥20,514 | ≥ 6.5% |
| Total capital (to risk-weighted assets) | 56,925 | 18.04% | ≥25,248 | ≥8.0% | ≥31,560 | ≥10.0% |
| Tier I capital (to risk-weighted assets) | 53,762 | 17.03% | ≥18,936 | ≥6.0% | ≥25,248 | ≥ 8.0% |
| Tier I capital (to average assets) | 53,762 | 10.09% | ≥21,316 | ≥4.0% | ≥26,645 | ≥ 5.0% |

## 15. Fair Value Measurements

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value. The three broad levels of pricing observations are as follows:

***Level 1:*** Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

***Level 2***: Pricing inputs are other than the quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities includes items for which quoted prices are available but traded less frequently and items that are fair-valued using other financial instruments, the parameters of which can be directly observed.

***Level 3***: Valuations derived from valuation techniques in which one or more significant inputs or significant value drivers are unobservable.

This hierarchy requires the use of observable market data when available.

The following tables present the assets measured on a recurring basis on the consolidated balance sheets at their fair value as of December 31, 2019 and 2018, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement (in thousands).

| *December 31, 2019* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets measured on a recurring basis: | | | | |
| Investment securities available-for-sale: | | | | |
| Obligations of states and political subdivisions | $ - | $ 46,623 | $ - | $ 46,623 |
| Mortgage-backed securities in government-sponsored entities | - | 80,403 | - | 80,403 |
| Equity securities in financial institutions | 229 | - | - | 229 |
| **Total** | $ 229 | $ 127,026 | $ - | $ 127,255 |

| *December 31, 2018* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Assets measured on a recurring basis: | | | | |
| Investment securities available-for-sale: | | | | |
| Obligations of states and political subdivisions | $ - | $ 54,446 | $ - | $ 54,446 |
| Mortgage-backed securities in government-sponsored entities | - | 88,475 | - | 88,475 |
| Equity securities in financial institutions | 183 | - | - | 183 |
| **Total** | $ 183 | $ 142,921 | $ - | $ 143,104 |

Other real estate owned ("OREO") is measured at fair value, less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value, less cost to sell.

| *December 31, 2019* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Fair value measurements on nonrecurring basis: | | | | |
| Other real estate owned | $ - | $ - | $ - | $ - |
| **Total** | $ - | $ - | $ - | $ - |

| *December 31, 2018* | Level 1 | Level 2 | Level 3 | Total |
|---|---|---|---|---|
| Fair value measurements on nonrecurring basis: | | | | |
| Other real estate owned | $ - | $ - | $ 389 | $ 389 |
| **Total** | $ - | $ - | $ 389 | $ 389 |

The following table provides information describing the valuation processes used to determine nonrecurring fair value measurements categorized within Level III of the fair value hierarchy:

| *December 31, 2018* | Quantitative Information About Level 3 Fair Value Measurements | | | |
|---|---|---|---|---|
| | Fair Value | Valuation Techniques | Unobservable Input | Range (Weighted Average) |
| Other real estate owned | $ 389 | Appraisal of collateral (1) (3) | Appraisal adjustments (2) | 10% - 59% (29%) |

(1) Fair value is generally determined through independent appraisals of the underlying collateral, which include various level III inputs which are not identifiable.
(2) Appraisals may be adjusted by management for qualitative factors such as economic conditions, aging, and/or estimated liquidation expenses incurred when selling the collateral. The range and weighted average of appraisal adjustments and liquidation expenses are presented as a percentage of the appraisal.
(3) Includes qualitative adjustments by management and estimated liquidation expenses.

## 16. Fair Value of Financial Instruments

The fair values at December 31 of the Company's financial instruments are as follows (in thousands):

| *December 31, 2019* | Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|---|
| **Financial Assets:** | | | | | |
| Cash and cash equivalents | **$ 10,380** | **$ 10,380** | **$ 10,380** | **$ -** | **$ -** |
| Investment securities: | | | | | |
| Available-for-sale | **127,026** | **127,026** | **-** | **127,026** | **-** |
| Held-to-maturity | **906** | **920** | **-** | **920** | **-** |
| Equity securities | **229** | **229** | **229** | **-** | **-** |
| Loans held for sale | **969** | **969** | **969** | **-** | **-** |
| Net loans | **370,060** | **372,847** | **-** | **372,847** | **-** |
| Restricted stock | **3,425** | **N/A** | **N/A** | **N/A** | **N/A** |
| Mortgage servicing rights | **542** | **1,008** | **-** | **1,008** | **-** |
| Accrued interest receivable | **1,591** | **1,591** | **-** | **1,591** | **-** |
| **Financial Liabilities:** | | | | | |
| Deposits | **475,860** | **459,262** | **-** | **459,262** | **-** |
| Borrowings | **3,500** | **3,525** | **-** | **3,525** | **-** |
| Accrued interest payable | **154** | **154** | **-** | **154** | **-** |

| *December 31, 2018* | Carrying Value | Fair Value | Level 1 | Level 2 | Level 3 |
|---|---|---|---|---|---|
| **Financial Assets:** | | | | | |
| Cash and cash equivalents | $ 11,904 | $ 11,904 | $ 11,904 | $ - | $ - |
| Investment securities: | | | | | |
| Available-for-sale | 142,921 | 142,921 | - | 142,921 | - |
| Held-to-maturity | 1,849 | 1,851 | - | 1,851 | - |
| Equity securities | 183 | 183 | 183 | - | - |
| Loans held for sale | 2,414 | 2,414 | 2,414 | - | - |
| Net loans | 346,560 | 341,519 | - | 341,519 | - |
| Restricted stock | 3,599 | N/A | N/A | N/A | N/A |
| Mortgage servicing rights | 688 | 1,225 | - | 1,225 | - |
| Accrued interest receivable | 1,700 | 1,700 | - | 1,700 | - |
| **Financial Liabilities:** | | | | | |
| Deposits | 477,507 | 457,444 | - | 457,444 | - |
| Borrowings | 3,175 | 3,175 | - | 3,175 | - |
| Accrued interest payable | 141 | 141 | - | 141 | - |

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract that creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses, and other factors as determined through various option pricing formulas. As many of these assumptions result from judgments made by management based upon estimates that are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

In accordance with Accounting Standards Update (ASU) 2016-01, *Recognition and Measurement of Financial Assets and Liabilities*, the Company has considered the exit price notion when measuring the fair value of financial instruments.

The Company employed simulation modeling in determining the estimated fair value of financial instruments for which quoted market prices were not available based upon the following assumptions:

***Investment Securities***

The fair market value of investment securities is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities. Fair values for certain corporate bonds were determined utilizing discounted cash flow models, due to the absence of a current market to provide reliable market quotes for the instruments.

***Mortgage Servicing Rights***

The fair value for mortgage servicing rights is estimated by discounting contractual cash flows and adjusting for prepayment estimates. Discount rates are based upon rates generally charged for such loans with similar characteristics.

***Commitments to Extend Credit and Commercial Letters of Credit***

These financial instruments are generally not subject to sale, and estimated fair values are not readily available.

The carrying value, represented by the net deferred fee arising from the unrecognized commitment or letter of credit, and the fair value, determined by discounting the remaining contractual fee over the term of the commitment using fees currently charged to enter into similar agreements with similar credit risk, are not considered material for disclosure. The contractual amounts of unfunded commitments and letters of credit are presented in Note 11.

## 17. Related Party Transactions

Certain officers, directors and other related parties have loans and conduct other transactions with the Bank. Deposits of related parties totaled $1,928,000 and $1,914,000 at December 31, 2019 and 2018, respectively. The aggregate dollar amount of loans to related parties, along with an analysis of the activity for December 31, 2019 and 2018 are as follows (in thousands):

| *December 31,* | **2019** | 2018 |
|---|---|---|
| Balance, beginning | **$ 1,940** | $ 1,585 |
| Additions | **829** | 960 |
| Repayments | **(463)** | (605) |
| Reclassify | **(1)** | - |
| Balance, ending | **$ 2,305** | $ 1,940 |

## 18. Subsequent Events

Management has reviewed events occurring through March 11, 2020, the date the financial statements were available to be issued for items that should potentially be recognized or disclosed in these consolidated financial statements.