



Parkway Acquisition Corp.

ALWAYS OUR BEST



2020 ANNUAL REPORT

What we do here at Skyline National Bank is more than just meeting needs and growing businesses; doing good and being our best elevates community. We take on the challenges of our customers, craft solutions, and express kindness and enthusiasm in all that we do. The following values guide our every action.

Smart | Clever minds create change.

Kind | We're never wrong by doing right.

Young-at-Heart | We surprise and delight.

Local | We're from here. We own it.

Inspired | Extraordinary passion drives us.

Nonconforming | We don't do mediocre or status quo.

Energetic | This is contagious.



2020 Annual Report

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Financial Highlights¹

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Summary of Operations					
Interest income	\$ 31,744	\$ 30,802	\$ 26,186	\$ 22,274	\$ 17,562
Interest expense	<u>3,440</u>	<u>2,869</u>	<u>1,901</u>	<u>1,474</u>	<u>1,728</u>
Net interest income	28,304	27,933	24,285	20,800	15,834
Provision for (reduction of) loan losses	1,189	655	325	217	(5)
Other income	5,297	4,915	4,637	4,228	4,570
Other expense	25,098	23,258	22,857	19,280	16,816
Income taxes	<u>1,445</u>	<u>1,780</u>	<u>1,214</u>	<u>3,104</u>	<u>1,175</u>
Net income	<u>\$ 5,869</u>	<u>\$ 7,155</u>	<u>\$ 4,526</u>	<u>\$ 2,427</u>	<u>\$ 2,418</u>
Per Share Data					
Net income	\$.97	\$ 1.16	\$.81	\$.48	\$.60
Cash dividends declared	.26	.24	.20	.16	.12
Book value	14.08	13.27	12.17	11.39	11.05
Year-end Balance Sheet Summary					
Loans, net	\$ 659,195	\$ 566,460	\$ 532,970	\$ 421,418	\$ 408,548
Investment securities	33,507	32,881	45,428	50,675	62,540
Total assets	855,387	706,290	680,284	547,961	558,856
Deposits	755,528	611,211	601,868	488,441	499,387
Stockholders' equity	85,106	81,428	75,622	57,182	55,466
Selected Ratios					
Return on average assets	0.75%	1.05%	0.75%	0.44%	0.55%
Return on average equity	7.06%	9.10%	7.02%	4.28%	5.62%
Average equity to average assets	10.60%	11.51%	10.66%	10.32%	9.78%

¹ In thousands of dollars, except per share data.



Parkway Acquisition Corp.

Dear Fellow Stockholders:

It is our pleasure to present to you the year-end 2020 Financial Report for Parkway Acquisition Corp. and Skyline National Bank.

Parkway recorded net income of \$5.9 million, or \$0.97 per share for the year ended December 31, 2020 compared to net income of \$7.2 million or \$1.16 per share for 2019. Earnings for the year ended December 31, 2020 represented a return on average assets (“ROAA”) of 0.75% and a return on average equity (“ROAE”) of 7.06%, compared to 1.05% and 9.10%, respectively, for the year ended December 31, 2019. Net interest margin (“NIM”) was 3.95% for the fourth quarter 2020, compared to 4.40% in the fourth quarter of 2019. The NIM compression is a reflection of the exceptionally low interest rate environment as well as continual competitive pressure on loan rates.

Total assets were \$855.4 million at December 31, 2020, compared with \$706.3 million at December 31, 2019. Asset growth primarily reflected increased net loans, including Small Business Administration Paycheck Protection Program (“SBA-PPP”) loans, and higher liquid asset balances due to deposit growth.

Total loans were \$664.1 million at December 31, 2020, up \$93.7 million from \$570.4 million at December 31, 2019. Of the \$81.9 million in SBA-PPP loans originated in April through August 2020, approximately \$52.5 million with net deferred fees of \$1.4 million remained on the balance sheet at December 31, 2020. Organic growth in new and existing markets was \$44.6 million year-over-year.

Total deposits were \$755.5 million at December 31, 2020, an increase of \$144.3 million from \$611.2 million at December 31, 2019. The increase reflects core deposit growth (noninterest and interest-bearing demand, savings and money market accounts) primarily attributed to organic growth from the SBA-PPP loan program, government economic stimulus funds, as well as growth from recent branch expansions into North Carolina markets.

Stockholders’ equity increased to \$85.1 million at December 31, 2020 compared with \$81.4 million at December 31, 2019. Book value increased from \$13.27 per share at December 31, 2019 to \$14.08 per share at December 31, 2020.

We are pleased with our results for 2020 despite the negative economic impacts of the COVID-19 pandemic. Throughout our industry, net interest margins were negatively impacted due to the Federal Reserve’s swift reductions in short term interest rates, and noninterest income was also pressured as the pandemic response restrained economic activity and transaction volumes. While this has certainly been a challenging time for us all, it has also been a time that has only strengthened our pride in being a part of community banking. We have watched as our bank, and many community banks around us, stepped forward and led the nation in administering the SBA-PPP program. To date our bank alone has processed over 2,800 SBA-PPP applications for approximately \$125.0 million in funding which helped to preserve thousands of jobs throughout our communities. Also, many of these SBA-PPP loans were to customers who were new to Skyline. This helped us grow our customer base especially in our newer markets in North Carolina. Our staff worked day and night to make this happen and our bank was even recognized nationally in an article in Forbes magazine for the level of SBA-PPP loans we processed given the size of our bank.

For the near term, margin compression will continue to impact earnings as the Federal Reserve maintains its accommodative, near-zero interest rate policy, however we will remain focused on asset quality, cost containment, and building on the solid balance sheet growth that we experienced last year. We continue to believe we are well positioned for growth and success in the future despite the short-term impacts of COVID-19.

Again, we thank you for the opportunity to serve you as shareholders and customers. Please be sure to let us know if you have any questions or comments.

Always Our Best,

Blake M. Edwards, Jr.
President and CEO



Report of Independent Registered Public Accounting Firm

To the shareholders and the board of directors of Parkway Acquisition Corp. and Subsidiary

Opinion on the Financial Statements

We have audited the accompanying consolidated balance sheets of Parkway Acquisition Corp. and Subsidiary (the "Company") as of December 31, 2020 and 2019, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows, for each of the years then ended, and the related notes to the consolidated financial statements (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2020 and 2019, and the results of its operations and its cash flows for the years then ended, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on the Company's financial statements based on our audits. We are a public accounting firm registered with the Public Company Accounting Oversight Board (United States) ("PCAOB") and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. As part of our audits we are required to obtain an understanding of internal control over financial reporting but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion.

Our audits included performing procedures to assess the risks of material misstatement of the financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on a test basis, evidence regarding the amounts and disclosures in the financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as evaluating the overall presentation of the financial statements. We believe that our audits provide a reasonable basis for our opinion.

Critical Audit Matters

The critical audit matters communicated below are matters arising from the current period audit of the financial statements that were communicated or required to be communicated to the audit committee and that: (1) relate to accounts or disclosures that are material to the financial statements and (2) involved our especially challenging, subjective, or complex judgments. The communication of critical audit matters does not alter in any way our opinion on the financial statements, taken as a whole, and we are not, by communicating the critical audit matters below, providing separate opinions on the critical audit matters or on the accounts or disclosures to which they relate.

Allowance for Loan Losses

As described in Note 5 and Note 6 to the Company's financial statements, the Company's loan portfolio and associated allowance for loan losses (the "Allowance") totaled \$664.1 million and \$4.9 million, respectively, at December 31, 2020. As described in Note 1 and Note 6 to the financial statements, the Company's Allowance is an estimate of probable credit losses as of the balance sheet date and considers both unimpaired and impaired loans. Management's determination of the allowance for loan losses related to the Company's loan portfolio segment is generally based on the credit risk ratings and historical loss experience of individual borrowers, supplemented, as necessary, by credit judgment to address observed changes in trends and conditions, and other relevant

environmental and economic factors such as concentrations of credit risk (geographic, large borrower, and industry), economic trends and conditions, changes in underwriting standards, experience and depth of lending staff, trends in delinquencies, and the level of net charge-offs (qualitative factor adjustments).

Auditing the Company's Allowance involved a high degree of subjectivity due to the judgment involved in management's identification and measurement of qualitative factor adjustments included in the estimate of the allowance for loan losses.

The primary procedures we performed to address this critical audit matter included the following, among others:

- We evaluated the relevance and the reasonableness of assumptions related to evaluation of the loan portfolio, current economic conditions, and other risk factors used in development of the qualitative factors for collectively evaluated loans.
- We evaluated the reasonableness of assumptions and data used by the Company in developing the qualitative factors by comparing these data points to internally developed and third-party sources, and other audit evidence gathered.
- Analytical procedures were performed to evaluate changes that occurred in the allowance for loan losses for loans collectively evaluated for impairment.

Goodwill Impairment Evaluation

As described in Notes 1 and 7 to the consolidated financial statements, the Company's goodwill balance was \$3.3 million at December 31, 2020. The Company conducts periodic impairment analysis on goodwill at least annually or more often as conditions require. In conjunction with the Company's annual evaluation of goodwill impairment, management performed a quantitative evaluation of goodwill impairment. The Company used a third-party valuation specialist to assist management in performing the impairment evaluation, which includes a quantitative analysis evaluating the estimated fair value of the reporting unit.

We identified management's goodwill impairment evaluation as a critical audit matter because the methods and underlying assumptions in performing a quantitative test involves high levels of management judgment and in turn led to a high degree of auditor judgment and subjectivity in performing procedures and evaluating audit evidence related to management's valuation methods and significant assumptions.

The primary procedures we performed to address this critical audit matter included the following, among others:

- We validated completeness and accuracy of the inputs and historical data used in the analysis.
- We validated the accuracy of the inputs to peer data used in the analysis.
- We evaluated the reasonableness of the cash flow projections utilized in the discounted cash flow calculations by comparing the forecasts to historical results.
- We used an internal valuation specialist to evaluate the methodologies and assumptions used by the Company in the fair value analysis.
- We reviewed the sensitivity analysis of significant assumptions performed by the Company to evaluate changes in the fair value estimate resulting from changes in the assumptions.



We have served as the Company's auditor since 1995.

Charlotte, North Carolina
March 24, 2021

Consolidated Balance Sheets

December 31, 2020 and 2019

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Assets		
Cash and due from banks	\$ 10,009	\$ 8,388
Interest-bearing deposits with banks	84,863	34,861
Federal funds sold	817	1,138
Investment securities available for sale	33,507	32,881
Restricted equity securities	2,416	2,394
Loans, net of allowance for loan losses of \$4,900 at December 31, 2020 and \$3,893 at December 31, 2019	659,195	566,460
Cash value of life insurance	18,304	17,855
Properties and equipment, net	26,591	23,437
Accrued interest receivable	2,355	2,072
Core deposit intangible	2,359	3,070
Goodwill	3,257	3,257
Deferred tax assets, net	1,019	985
Other assets	10,695	9,492
	<u>\$ 855,387</u>	<u>\$ 706,290</u>
Liabilities and Stockholders' Equity		
Liabilities		
Deposits		
Noninterest-bearing	\$ 231,852	\$ 165,900
Interest-bearing	<u>523,676</u>	<u>445,311</u>
Total deposits	755,528	611,211
Federal Home Loan Bank Advances	10,000	10,000
Accrued interest payable	124	132
Other liabilities	<u>4,629</u>	<u>3,519</u>
	<u>770,281</u>	<u>624,862</u>
Commitments and contingencies (Note 18)		
Stockholders' Equity		
Preferred stock, no par value; 5,000,000 shares authorized, none issued	-	-
Common stock, no par value; 25,000,000 shares authorized, 6,045,775 and 6,137,275 issued and outstanding at December 31, 2020 and 2019, respectively	-	-
Surplus	39,740	40,752
Retained earnings	45,887	41,600
Accumulated other comprehensive loss	<u>(521)</u>	<u>(924)</u>
	<u>85,106</u>	<u>81,428</u>
	<u>\$ 855,387</u>	<u>\$ 706,290</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Income

Years ended December 31, 2020 and 2019

(dollars in thousands except share amounts)

	<u>2020</u>	<u>2019</u>
Interest income		
Loans and fees on loans	\$ 30,770	\$ 29,177
Interest-bearing deposits with banks	214	288
Federal funds sold	3	249
Interest on taxable securities	609	967
Interest on nontaxable securities	21	-
Dividends	<u>127</u>	<u>121</u>
	<u>31,744</u>	<u>30,802</u>
Interest expense		
Deposits	3,347	2,852
Interest on borrowings	<u>93</u>	<u>17</u>
	<u>3,440</u>	<u>2,869</u>
Net interest income	28,304	27,933
Provision for loan losses		
Net interest income after provision for loan losses	<u>1,189</u>	<u>655</u>
	<u>27,115</u>	<u>27,278</u>
Noninterest income		
Service charges on deposit accounts	1,441	1,652
Other service charges and fees	2,115	2,004
Net realized gains on securities	315	49
Mortgage origination fees	720	459
Increase in cash value of life insurance	449	442
Other income	<u>257</u>	<u>309</u>
	<u>5,297</u>	<u>4,915</u>
Noninterest expenses		
Salaries and employee benefits	14,603	13,245
Occupancy and equipment	3,240	2,953
Foreclosed asset expense, net	2	3
Data processing expense	1,765	1,546
FDIC Assessments	233	50
Advertising	683	603
Bank franchise tax	505	438
Director fees	361	356
Professional fees	462	667
Telephone expense	370	371
Core deposit intangible amortization	711	822
Other expense	<u>2,163</u>	<u>2,204</u>
	<u>25,098</u>	<u>23,258</u>
Income before income taxes	7,314	8,935
Income tax expense	<u>1,445</u>	<u>1,780</u>
Net income	<u>\$ 5,869</u>	<u>\$ 7,155</u>
Basic earnings per share	<u>\$ 0.97</u>	<u>\$ 1.16</u>
Weighted average shares outstanding	<u>6,075,819</u>	<u>6,184,133</u>
Dividends declared per share	<u>\$ 0.26</u>	<u>\$ 0.24</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Comprehensive Income

Years ended December 31, 2020 and 2019

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Net Income	\$ 5,869	\$ 7,155
Other comprehensive income		
Net change in pension reserve:		
Change in pension reserve during the year	(162)	79
Tax related to change in pension reserve	34	(16)
Unrealized gains on investment securities available for sale:		
Unrealized gains arising during the year	987	1,290
Tax related to unrealized gains	(207)	(271)
Reclassification of net realized gains during the year	(315)	(49)
Tax related to net realized gains	<u>66</u>	<u>10</u>
Total other comprehensive income	<u>403</u>	<u>1,043</u>
Total comprehensive income	<u>\$ 6,272</u>	<u>\$ 8,198</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Changes in Stockholders' Equity

Years ended December 31, 2020 and 2019

(dollars in thousands except share amounts)

	<u>Common Stock</u>		<u>Surplus</u>	<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>				
Balance, December 31, 2018	6,213,275	\$ -	\$ 41,660	\$ 35,929	\$ (1,967)	\$ 75,622
Net income	-	-	-	7,155	-	7,155
Other comprehensive income	-	-	-	-	1,043	1,043
Dividends paid (\$0.24 per share)	-	-	-	(1,484)	-	(1,484)
Common stock repurchased	(76,000)	-	(908)	-	-	(908)
Balance, December 31, 2019	<u>6,137,275</u>	<u>\$ -</u>	<u>\$ 40,752</u>	<u>\$ 41,600</u>	<u>\$ (924)</u>	<u>\$ 81,428</u>
Net income	-	-	-	5,869	-	5,869
Other comprehensive income	-	-	-	-	403	403
Dividends paid (\$0.26 per share)	-	-	-	(1,582)	-	(1,582)
Common stock repurchased	(91,500)	-	(1,012)	-	-	(1,012)
Balance, December 31, 2020	<u>6,045,775</u>	<u>\$ -</u>	<u>\$ 39,740</u>	<u>\$ 45,887</u>	<u>\$ (521)</u>	<u>\$ 85,106</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Years ended December 31, 2020 and 2019

(dollars in thousands)	<u>2020</u>	<u>2019</u>
<i>Cash flows from operating activities</i>		
Net income	\$ 5,869	\$ 7,155
Adjustments to reconcile net income to net cash provided by operations:		
Depreciation	1,364	1,224
Amortization of core deposit intangible	711	822
Accretion of loan discount and deposit premium, net	(1,388)	(2,175)
Provision for loan loss	1,189	655
Deferred income taxes	(141)	591
Net realized gains on securities	(315)	(49)
Accretion of discount on securities, net of amortization of premiums	268	411
Deferred compensation	(3)	(10)
Gains on sale of properties and equipment	-	(122)
Changes in assets and liabilities:		
Cash value of life insurance	(449)	(442)
Accrued interest receivable	(283)	12
Other assets	(1,413)	1,206
Accrued interest payable	(8)	43
Other liabilities	1,161	95
Net cash provided by operating activities	<u>6,562</u>	<u>9,416</u>
<i>Cash flows from investing activities</i>		
Activity in available for sale securities:		
Purchases	(17,990)	(1,037)
Sales	10,739	8,914
Maturities/calls/paydowns	7,344	5,548
Purchases of restricted equity securities	(22)	(341)
Net increase in loans	(92,725)	(32,354)
Proceeds from the sale of foreclosed assets	-	753
Purchases of property and equipment, net of sales	(4,518)	(3,854)
Net cash used in investing activities	<u>(97,172)</u>	<u>(22,371)</u>
<i>Cash flows from financing activities</i>		
Net increase in deposits	144,506	9,727
Net change in Federal Home Loan Bank advances	-	10,000
Common stock repurchased	(1,012)	(908)
Dividends paid	(1,582)	(1,484)
Net cash provided by financing activities	<u>141,912</u>	<u>17,335</u>
Net increase in cash and cash equivalents	<u>51,302</u>	<u>4,380</u>
<i>Cash and cash equivalents, beginning</i>	<u>44,387</u>	<u>40,007</u>
<i>Cash and cash equivalents, ending</i>	<u>\$ 95,689</u>	<u>\$ 44,387</u>

See Notes to Consolidated Financial Statements

Consolidated Statements of Cash Flows

Years ended December 31, 2020 and 2019

(dollars in thousands)	<u>2020</u>	<u>2019</u>
<i>Supplemental disclosure of cash flow information</i>		
Interest paid	<u>\$ 3,448</u>	<u>\$ 2,826</u>
Taxes paid	<u>\$ 1,873</u>	<u>\$ 850</u>
<i>Supplemental disclosure of noncash investing activities</i>		
Effect on equity of change in net unrealized gain on available for sale securities	<u>\$ 531</u>	<u>\$ 980</u>
Effect on equity of change in unfunded pension liability	<u>\$ (128)</u>	<u>\$ 63</u>
Right-of-use assets obtained in exchange for new operating lease liabilities	<u>\$ 68</u>	<u>\$ 729</u>
<i>Business combinations</i>		
Goodwill recorded	<u>\$ -</u>	<u>\$ 59</u>

See Notes to Consolidated Financial Statements

Notes to Consolidated Financial Statements

Note 1. Organization and Summary of Significant Accounting Policies

Organization

Parkway Acquisition Corp. (“Parkway” or the “Company”) was incorporated as a Virginia corporation on November 2, 2015. Parkway was formed as a business combination shell company for the purpose of completing a business combination transaction between Grayson Bankshares, Inc. (“Grayson”) and Cardinal Bankshares Corporation (“Cardinal”). On November 6, 2015, Grayson, Cardinal and Parkway entered into an agreement pursuant to which Grayson and Cardinal merged with and into Parkway, with Parkway as the surviving corporation (the “Cardinal merger”). The merger agreement established exchange ratios under which each share of Grayson common stock was converted to the right to receive 1.76 shares of common stock of Parkway, while each share of Cardinal common stock was converted to the right to receive 1.30 shares of common stock of Parkway. The exchange ratios resulted in Grayson shareholders receiving approximately 60% of the newly issued Parkway shares and Cardinal shareholders receiving approximately 40% of the newly issued Parkway shares. The Cardinal merger was completed on July 1, 2016. Grayson was considered the acquiror and Cardinal was considered the acquiree in the transaction for accounting purposes. Upon completion of the Cardinal merger, the Bank of Floyd, a wholly-owned subsidiary of Cardinal, was merged with and into Grayson National Bank (the “Bank”), a wholly-owned subsidiary of Grayson. Effective March 13, 2017, the Bank changed its name to Skyline National Bank.

On March 1, 2018, Parkway entered into a definitive agreement pursuant to which Parkway acquired Great State Bank (“Great State”), based in Wilkesboro, North Carolina. The agreement provided for the merger of Great State with and into the Bank, with the Bank as the surviving bank (the “Great State merger”). The transaction closed and the merger became effective on July 1, 2018. Each share of Great State common stock was converted into the right to receive 1.21 shares of Parkway common stock. The Company issued 1,191,899 shares and recognized \$15.5 million in surplus in the Great State merger. Parkway was considered the acquiror and Great State was considered the acquiree in the transaction for accounting purposes.

The Bank was organized under the laws of the United States in 1900 and now serves the Virginia counties of Grayson, Floyd, Carroll, Wythe, Pulaski, Montgomery and Roanoke, and the North Carolina counties of Alleghany, Ashe, Burke, Caldwell, Catawba, Cleveland, Davie, Watauga, Wilkes, and Yadkin, and the surrounding areas, through twenty-four full-service banking offices and two loan production offices. As an Federal Deposit Insurance Corporation (“FDIC”) insured national banking association, the Bank is subject to regulation by the Comptroller of the Currency and the FDIC. Parkway is regulated by the Board of Governors of the Federal Reserve System.

Critical Accounting Policies

Management believes the policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments involve a higher degree of complexity and require management to make difficult and subjective judgments, such as the recoverability of intangible assets and other-than-temporary impairment of investment securities, involve a higher degree of complexity and require management to make difficult and subjective judgments that often require assumptions or estimates about highly uncertain matters. Changes in these judgments, assumptions or estimates could cause reported results to differ materially. These critical policies and their application are periodically reviewed with the Audit Committee and the Board of Directors.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and the Bank, which is wholly owned. All significant, intercompany transactions and balances have been eliminated in consolidation.

Business Segments

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

Notes to Consolidated Financial Statements

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

Business Combinations

Generally, acquisitions are accounted for under the acquisition method of accounting in accordance with Financial Accounting Standards Board (“FASB”) Accounting Standards Codification (“ASC”) 805, Business Combinations. A business combination occurs when the Company acquires net assets that constitute a business, or acquires equity interests in one or more other entities that are businesses and obtains control over those entities. Business combinations are effected through the transfer of consideration consisting of cash and/or common stock and are accounted for using the acquisition method. Accordingly, the assets and liabilities of the acquired entity are recorded at their respective fair values as of the closing date of the acquisition. Determining the fair value of assets and liabilities, especially the loan portfolio, is a complicated process involving significant judgment regarding methods and assumptions used to calculate estimated fair values. Fair values are subject to refinement for up to one year after the closing date of the acquisition as information relative to closing date fair values becomes available. The results of operations of an acquired entity are included in our consolidated results from the closing date of the merger, and prior periods are not restated. No allowance for loan losses related to the acquired loans is recorded on the acquisition date because the fair value of the loans acquired incorporates assumptions regarding future credit losses. The fair value estimates associated with the acquired loans include estimates related to expected prepayments and the amount and timing of expected principal, interest and other cash flows.

Use of Estimates

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

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

Substantially all of the Bank’s loan portfolio consists of loans in its market area. Accordingly, the ultimate collectability of a substantial portion of the Bank’s loan portfolio and the recovery of a substantial portion of the carrying amount of foreclosed real estate are susceptible to changes in local market conditions. The regional economy is diverse, but influenced to an extent by the manufacturing and agricultural segments.

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

The Company seeks strategies that minimize the tax effect of implementing their business strategies. As such, judgments are made regarding the ultimate consequence of long-term tax planning strategies, including the likelihood of future recognition of deferred tax benefits. The Company’s tax returns are subject to examination by both Federal and State authorities. Such examinations may result in the assessment of additional taxes, interest and penalties. As a result, the ultimate outcome, and the corresponding financial statement impact, can be difficult to predict with accuracy.

Accounting for pension benefits, costs and related liabilities are developed using actuarial valuations. These valuations include key assumptions determined by management, including the discount rate and expected long-term rate of return on plan assets. Material changes in pension costs may occur in the future due to changes in these assumptions.

Notes to Consolidated Financial Statements

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

Cash and Cash Equivalents

For purposes of reporting cash flows, cash and cash equivalents includes cash and amounts due from banks (including cash items in process of collection), interest-bearing deposits with banks and federal funds sold.

Trading Securities

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

Securities Held to Maturity

Bonds, notes, and debentures for which the Company has the positive intent and ability to hold to maturity are reported at amortized cost. The Company does not currently hold any securities classified as held to maturity.

Securities Available for Sale

Available for sale securities are reported at fair value and consist of bonds, notes, debentures, and certain equity securities not classified as trading securities or as held to maturity securities.

Unrealized holding gains and losses, net of tax, on available for sale securities are reported as a net amount in a separate component of accumulated other comprehensive income. Realized gains and losses on the sale of available for sale securities are determined using the specific-identification method. The amortization of premiums and accretion of discounts are recognized in interest income using the effective interest method over the period to maturity for discounts and the earlier of call date or maturity for premiums.

Declines in the fair value of individual held to maturity and available for sale securities below cost that are other than temporary are reflected as write-downs of the individual securities to fair value. Related write-downs are included in earnings as realized losses.

Loans Receivable

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal amount adjusted for any charge-offs and the allowance for loan losses. Loan origination costs are capitalized and recognized as an adjustment to yield over the life of the related loan.

Interest is accrued and credited to income based on the principal amount outstanding. The accrual of interest on impaired loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Payments received are first applied to principal, and any remaining funds are then applied to interest. When facts and circumstances indicate the borrower has regained the ability to meet the required payments, the loan is returned to accrual status. Past due status of loans is determined based on contractual terms.

Notes to Consolidated Financial Statements

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

Loans Receivable, continued

Purchased Performing Loans – The Company accounts for performing loans acquired in business combinations using the contractual cash flows method of recognizing discount accretion based on the acquired loans' contractual cash flows. Purchased performing loans are recorded at fair value, including a credit discount. The fair value discount is accreted as an adjustment to yield over the estimated lives of the loans. There is no allowance for loan losses established at the acquisition date for purchased performing loans. A provision for loan losses is recorded for any further deterioration in these loans subsequent to the acquisition.

Purchased Credit-Impaired ("PCI") Loans – Loans purchased with evidence of credit deterioration since origination, and for which it is probable that all contractually required payments will not be collected, are considered credit impaired. Evidence of credit quality deterioration as of the purchase date may include statistics such as internal risk grade and past due and nonaccrual status. Purchased impaired loans generally meet the Company's definition for nonaccrual status. PCI loans are initially measured at fair value, which reflects estimated future credit losses expected to be incurred over the life of the loan. Accordingly, the associated allowance for credit losses related to these loans is not carried over at the acquisition date. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable yield and is recognized into interest income over the remaining life of the loan when there is a reasonable expectation about the amount and timing of such cash flows. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the nonaccretable difference, and is available to absorb credit losses on those loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent significant increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges, or a reclassification of the nonaccretable difference with a positive impact on future interest income.

Allowance for Loan Losses

The allowance for loan losses is established as losses are estimated to have occurred through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectability of a loan balance, or portion thereof, is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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

The allowance consists of specific, general and unallocated components. The specific component is calculated on an individual basis for larger-balance, non-homogeneous loans, which are considered impaired. A specific allowance is established when the discounted cash flows, collateral value (less disposal costs), or observable market price of the impaired loan is lower than its carrying value. The specific component of the allowance for smaller-balance loans whose terms have been modified in a troubled debt restructuring ("TDR") is calculated on a pooled basis considering historical experience adjusted for qualitative factors. The general component covers non-impaired loans and is based on historical loss experience adjusted for qualitative factors. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

Notes to Consolidated Financial Statements

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

Allowance for Loan Losses, continued

A loan is considered impaired when, based on current information and events, it is probable that we will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Impairment is measured on a loan by loan basis for all loans by either the present value of expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Bank does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement.

Troubled Debt Restructurings

Under GAAP, the Bank is required to account for certain loan modifications or restructurings as "troubled debt restructurings" or "troubled debt restructured loans." In general, the modification or restructuring of a debt constitutes a troubled debt restructuring if the Bank for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that the Bank would not otherwise consider. Debt restructuring or loan modifications for a borrower do not necessarily always constitute a troubled debt restructuring, however, and troubled debt restructurings do not necessarily result in non-accrual loans.

Operating, Accounting and Reporting Considerations related to COVID-19

The COVID-19 pandemic has negatively impacted the global economy, including our market area. In response to this crisis, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was passed by Congress and signed into law on March 27, 2020. The CARES Act provided an estimated \$2.2 trillion to fight the COVID-19 pandemic and stimulate the economy by supporting individuals and businesses through loans, grants, tax changes, and other types of relief. Some of the provisions applicable to the Company include, but are not limited to:

Accounting for Loan Modifications – Section 4013 of the CARES Act provides that a financial institution may elect to suspend (1) the requirements under GAAP for certain loan modifications that would otherwise be categorized as a TDR and (2) any determination that such loan modifications would be considered a TDR, including the related impairment for accounting purposes. See Note 5 Allowance for Loan Losses and Impaired Loans for more information.

Paycheck Protection Program - The CARES Act established the Small Business Administration Paycheck Protection Program ("SBA-PPP"), an expansion of the Small Business Administration's ("SBA") 7(a) loan program and the Economic Injury Disaster Loan Program ("EIDL"), administered directly by the SBA. On December 27, 2020 the Consolidated Appropriations Act ("CAA"), 2021 was signed into law. The CAA provides several amendments to the SBA-PPP, including additional funding for first and second draws of SBA-PPP loans up to March 31, 2021. The Company is a participant in the SBA-PPP. See Note 4 Loans Receivable for more information.

Notes to Consolidated Financial Statements

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

Operating, Accounting and Reporting Considerations related to COVID-19, continued

Also in response to the COVID-19 pandemic, the Board of Governors of the Federal Reserve System (“FRB”), the FDIC, the National Credit Union Administration, the Office of the Comptroller of the Currency (“OCC”), and the Consumer Financial Protection Bureau, in consultation with the state financial regulators (collectively, the “agencies”) issued a joint interagency statement (issued March 22, 2020; revised statement issued April 7, 2020). Some of the provisions applicable to the Company include, but are not limited to:

Accounting for Loan Modifications - Loan modifications that do not meet the conditions of the CARES Act may still qualify as a modification that does not need to be accounted for as a TDR. The agencies confirmed with FASB staff that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief are not TDRs. This includes short-term modifications such as payment deferrals, fee waivers, extensions of repayment terms, or insignificant delays in payment. See Note 5 Allowance for Loan Losses and Impaired Loans for more information.

Past Due Reporting - With regard to loans not otherwise reportable as past due, financial institutions are not expected to designate loans with deferrals granted due to COVID-19 as past due because of the deferrals. A loan’s payment date is governed by the due date stipulated in the legal agreement. If a financial institution agrees to a payment deferral, these loans would not be considered past due during the period of the deferral.

Nonaccrual Status and Charge-offs - During short-term COVID-19 modifications, these loans generally should not be reported as nonaccrual or as classified.

The Company began offering short-term loan modifications to assist borrowers during the COVID-19 pandemic. These modifications generally involve principal and/or interest payment deferrals for up to six months. These modifications generally meet the criteria of both Section 4013 of the CARES Act and the joint interagency statement, and therefore, the Company does not account for such loan modifications as TDRs. As the COVID-19 pandemic persists in negatively impacting the economy, the Company continues to offer additional loan modifications to borrowers struggling as a result of COVID-19. Similar to the initial modifications granted, the additional round of loan modifications are granted specifically under Section 4013 of the CARES Act and generally involve principal and/or interest payment deferrals for up to an additional six months for commercial and consumer loans, and principal-only deferrals for up to an additional 12 months for selected commercial loans. On August 3, 2020, the Federal Financial Institutions Examination Council on behalf of its members (collectively “the FFIEC members”) issued a joint statement on additional loan accommodations related to COVID-19. The joint statement clarifies that for loan modifications in which Section 4013 is being applied, subsequent modifications could also be eligible under Section 4013. To be eligible, each loan modification must be (1) related to the COVID-19 event; (2) executed on a loan that was not more than 30 days past due as of December 31, 2019; and (3) executed between March 1, 2020, and the earlier of (A) 60 days after the date of termination of the National Emergency or (B) December 31, 2020. The December 31, 2020 deadline was subsequently extended to January 1, 2022 by the Consolidated Appropriations Act (“CAA”), 2021, which was signed into law on December 27, 2020. Substantially all of the Company’s additional round of loan modifications granted under Section 4013 of the CARES Act are in compliance with the aforementioned FFIEC requirements. Accordingly, the Company does not account for such loan modifications as TDRs.

Notes to Consolidated Financial Statements

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

Small Business Administration Paycheck Protection Program

The SBA-PPP is one of the centerpieces of the CARES Act, which was passed on March 27, 2020 in response to the outbreak of COVID-19 and was supplemented with subsequent legislation. Overseen by the U.S. Treasury Department, the SBA-PPP offers cash-flow assistance to nonprofit and small business employers through guaranteed loans for expenses incurred between February 15, 2020, and August 8, 2020. Borrowers are eligible for forgiveness of principal and accrued interest on SBA-PPP loans to the extent that the proceeds are used to cover eligible payroll costs, interest costs, rent, and utility costs over a period between eight and 24-weeks after the loan is made as long as the borrower retains its employees and their compensation levels. The CARES Act authorized the SBA to temporarily guarantee these loans.

As a qualified SBA lender, we were automatically authorized to originate SBA-PPP loans and began taking applications on April 3, 2020. An eligible business can apply for a SBA-PPP loan up to the lesser of: (1) 2.5 times its average monthly “payroll costs;” or (2) \$10.0 million. SBA-PPP loans will have: (a) an interest rate of 1.0%, (b) a two-year or five-year term to maturity; and (c) principal and interest payments deferred for six months from the date of disbursement. The SBA will guarantee 100% of the SBA-PPP loans made to eligible borrowers. The entire principal amount of the borrower’s SBA-PPP loan, including any accrued interest, is eligible to be reduced by the loan forgiveness amount under the SBA-PPP, subject to certain eligibility requirements and conditions.

Due to the unique nature of these provisions, SBA-PPP loans have been disclosed as a separate loan class. Origination fees received by the SBA are capitalized into the carrying amount of the loans. The deferred fee income, net of origination costs, is recognized over the life of the loan as an adjustment to yield using the straight-line method.

The allowance for loan losses for SBA-PPP loans originated during 2020 were separately evaluated given the explicit government guarantee. This analysis, which incorporated historical experience with similar SBA guarantees and underwriting, concluded the likelihood of loss was remote and therefore these loans were assigned a zero expected credit loss in the allowance for loan losses.

Property and Equipment

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

	<u>Years</u>
Buildings and improvements	10-40
Furniture and equipment	5-12

Foreclosed Assets

Real estate properties acquired through, or in lieu of, loan foreclosure are to be sold and are initially recorded at fair value less anticipated cost to sell at the date of foreclosure, establishing a new cost basis. After foreclosure, valuations are periodically performed by management and the real estate is carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in foreclosure expense on the consolidated statements of income.

Notes to Consolidated Financial Statements

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

Pension Plan

Prior to the Cardinal merger, both Grayson National Bank (“Grayson”) and Bank of Floyd (“Floyd”) had qualified noncontributory defined benefit pension plans in place which covered substantially all of each bank’s employees. The benefits in each plan are primarily based on years of service and earnings. Both Grayson and Floyd plans were amended to freeze benefit accruals for all eligible employees prior to the effective date of the Cardinal merger. Grayson’s plan is a single-employer plan, the funded status of which is measured as the difference between the fair value of plan assets and the projected benefit obligation. Floyd’s plan is a multi-employer plan for accounting purposes and is a multiple-employer plan under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code.

Transfers of Financial Assets

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

Goodwill and Other Intangible Assets

Goodwill arises from business combinations and is generally determined as the excess of fair value of the consideration transferred, plus the fair value of any noncontrolling interests in the acquire, over the fair value of the nets assets acquired and liabilities assumed as of the acquisition date. Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually or more frequently in events and circumstances exists that indicate that a goodwill impairment test should be performed. The Company has selected July 1 as the date to perform the annual impairment test. The annual impairment test was performed for July 1, 2020, with no impairment found on the goodwill. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Other intangible assets consist of core deposit intangibles that represent the value of long-term deposit relationships acquired in a business combination. Core deposit intangibles are amortized over the estimated useful lives of the deposit accounts acquired. The core deposit intangible as a result of the Cardinal merger, is amortized over an estimated useful life of twenty years on an accelerated basis. For the core deposit intangible as a result of the Great State merger, we used an estimated useful life of seven years on an accelerated basis for the amortization.

Cash Value of Life Insurance

The Bank is owner and beneficiary of life insurance policies on certain current and former employees and directors. The Company records these policies in the consolidated balance sheets at cash surrender value, with changes recorded in noninterest income in the consolidated statements of income.

Notes to Consolidated Financial Statements

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

Revenue Recognition

Service Charges on Deposit Accounts - Service charges on deposit accounts consist of monthly service fees, overdraft and nonsufficient funds fees, ATM fees, wire transfer fees and other deposit account related fees. The Company's performance obligation for monthly service fees is generally satisfied, and the related revenue recognized, over the period in which the service is provided. Payment for service charges on deposit accounts is primarily received immediately or in the following month through a direct charge to customers' accounts. ATM fees are primarily generated when a Company cardholder uses a non-Company ATM or a non-Company cardholder uses a Company ATM. Wire transfer fees, overdraft and nonsufficient funds fees, and other deposit account related fees are transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time.

Other Service Charges and Fees - Other service charges include safety deposit box rental fees, check ordering charges, and other service charges. Safe deposit box rental fees are charged to the customer on an annual basis and recognized upon receipt of payment. The Company determined that since rentals and renewals occur fairly consistently over time, revenue is recognized on a basis consistent with the duration of the performance obligation. Check ordering charges are transactional based, and therefore, the Company's performance obligation is satisfied, and related revenue recognized, at a point in time. In addition, the following items are also included in other service charges and fees on the consolidated statements of income:

- **Credit and Debit Card Fees** - Credit and debit card fees are primarily comprised of interchange fee income and merchant services income. Interchange fees are earned whenever the Company's debit and credit cards are processed through card payment networks such as Visa or Mastercard. Merchant services income mainly represents fees charged to merchants to process their debit and credit card transactions, in addition to account management fees. The Company's performance obligation for interchange fee income and merchant services income are largely satisfied, and related revenue recognized, when the services are rendered or upon completion. Payment is typically received immediately or in the following month. Fees for these services for the years ended December 31, 2020 and 2019 amounted to \$377 thousand and \$386 thousand, respectively.
- **Insurance and Investment** - Insurance income primarily consists of commissions received on insurance product sales. The Company acts as an intermediary between the Company's customer and the insurance carrier. The Company's performance obligation is generally satisfied upon the issuance of the insurance policy. Shortly after the insurance policy is issued, the carrier remits the commission payment to the Company, and the Company recognizes the revenue. Investment income consists of recurring revenue streams such as commissions from sales of mutual funds and other investments. Commissions from the sale of mutual funds and other investments are recognized on trade date, which is when the Company has satisfied its performance obligation. The Company also receives periodic service fees (i.e., trailers) from mutual fund companies typically based on a percentage of net asset value. Trailer revenue is recorded over time, usually monthly or quarterly, as net asset value is determined. For the years ended December 31, 2020 and 2019 the Company received \$35 thousand and \$62 thousand, respectively in income from these services.

Mortgage Origination Fees - Mortgage origination fees consist of commissions received on mortgage loans closed in the secondary market. The Company acts as an intermediary between the Company's customer and companies that specialize in mortgage lending in the secondary market. The Company's performance obligation is generally satisfied when the mortgage loan is closed and funded and the Company receives its commission at that time.

Notes to Consolidated Financial Statements

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

Leases

In February 2016, the FASB amended the Leases topic of the ASC to revise certain aspects of recognition, measurement, presentation, and disclosure of leasing transactions. The amendments were effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

Effective January 1, 2019, we adopted the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow us to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. We have performed an evaluation of our leasing contracts and activities. We have developed our methodology to estimate the right-of use assets and lease liabilities, which is based on the present value of lease payments. There was not a material change to the timing of expense recognition. See additional discussion of leases in Note 8 to the consolidated financial statements.

Income Taxes

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

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

Advertising Expense

The Company expenses advertising costs as they are incurred. Advertising expense for the years ended December 31, 2020 and 2019 amounted to \$683 thousand and \$603 thousand, respectively.

Basic Earnings per Share

Basic earnings per share is computed by dividing income available to common stockholders by the weighted average number of common shares outstanding during the period, after giving retroactive effect to stock splits and dividends. For the years ended December 31, 2020 and 2019, there were no dilutive instruments.

Notes to Consolidated Financial Statements

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

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss). Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale and changes in the funded status of the pension plan which are also recognized as separate components of equity. The accumulated balances related to each component of other comprehensive income (loss) are as follows:

(dollars in thousands)	Unrealized Gains And Losses		
	On Available for Sale Securities	Defined Benefit Pension Items	Total
Balance, December 31, 2018	\$ (929)	\$ (1,038)	\$ (1,967)
Other comprehensive income before reclassifications	1,019	63	1,082
Amounts reclassified from accumulated other comprehensive loss	(39)	-	(39)
Balance, December 31, 2019	<u>\$ 51</u>	<u>\$ (975)</u>	<u>\$ (924)</u>
Balance, December 31, 2019	\$ 51	\$ (975)	\$ (924)
Other comprehensive income (loss) before Reclassifications	780	(128)	652
Amounts reclassified from accumulated other comprehensive loss	(249)	-	(249)
Balance, December 31, 2020	<u>\$ 582</u>	<u>\$ (1,103)</u>	<u>\$ (521)</u>

Off-Balance Sheet Credit Related Financial Instruments

In the ordinary course of business, the Company has entered into commitments to extend credit, including commitments under line of credit arrangements, commercial letters of credit, and standby letters of credit. Such financial instruments are recorded when they are funded.

Fair Value of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 12. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Reclassification

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

Notes to Consolidated Financial Statements

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

Recent Accounting Pronouncements

The following accounting standards may affect the future financial reporting by the Company:

In June 2016, the FASB issued ASU No. 2016-13 to change the accounting for credit losses and modify the impairment model for certain debt securities. The Company will apply the amendments to the ASU through a cumulative-effect adjustment to retained earnings as of the beginning of the year of adoption. We are currently evaluating the impact of the ASU on our consolidated financial statements. We expect the ASU will result in an increase in the recorded allowance for loan losses given the change to estimated losses over the contractual life of the loans adjusted for expected prepayments. The majority of the increase results from longer duration portfolios. In addition to our allowance for loan losses, we will also record an allowance for credit losses on debt securities instead of applying the impairment model currently utilized. The amount of the adjustments will be impacted by each portfolio's composition and credit quality at the adoption date as well as economic conditions and forecasts at that time. In July 2019, the FASB proposed changes to the effective date of the ASU for smaller reporting companies, as defined by the SEC, and other non-SEC reporting entities. The proposal delayed the effective date to fiscal years beginning after December 31, 2022, including interim periods within those fiscal periods. On October 16, 2019 the proposed changes were approved by the FASB. As the Company is a smaller reporting company, the delay is applicable to the Company.

In January 2017, the FASB amended the Goodwill and Other Topic of the Accounting Standards Codification to simplify the accounting for goodwill impairment for public business entities and other entities that have goodwill reported in their financial statements and have not elected the private company alternative for the subsequent measurement of goodwill. The amendment removes Step 2 of the goodwill impairment test. A goodwill impairment will now be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. The effective date and transition requirements for the technical corrections will be effective for the Company for reporting periods beginning after December 15, 2022. Early adoption is permitted for interim and annual goodwill impairment tests performed on testing dates after January 1, 2017.

In May 2019, the FASB issued guidance to provide entities with an option to irrevocably elect the fair value option, applied on an instrument-by-instrument basis for eligible instruments, upon adoption of ASU 2016-13, Measurement of Credit Losses on Financial Instruments. The amendments will be effective for the Company for reporting periods beginning after December 15, 2022. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2019, the FASB issued guidance that addresses issues raised by stakeholders during the implementation of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The amendments affect a variety of Topics in the Accounting Standards Codification. For entities that have not yet adopted the amendments in ASU 2016-13, the amendments are effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal. Early adoption is permitted in any interim period as long as an entity has adopted the amendments in ASU 2016-13. The Company does not expect these amendments to have a material effect on its financial statements.

In November 2019, the FASB issued guidance to defer the effective dates for private companies, not-for-profit organizations, and certain smaller reporting companies applying standards on current expected credit losses ("CECL"). Since the Company is a smaller reporting company, the new effect date for CECL will be fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

In December 2019, the FASB issued guidance to simplify accounting for income taxes by removing specific technical exceptions that often produce information investors have a hard time understanding. The amendments also improve consistent application of and simplify GAAP for other areas of Topic 740 by clarifying and amending existing guidance. The amendments are effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. Early adoption is permitted. The Company does not expect these amendments to have a material effect on its financial statements.

Notes to Consolidated Financial Statements

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

Recent Accounting Pronouncements, continued

In February 2020, the FASB issued guidance to add and amend SEC paragraphs in the ASC to reflect the issuance of SEC Staff Accounting Bulletin No. 119 related to the new credit losses standard and comments by the SEC staff related to the revised effective date of the new leases standard. The amendments were effective upon issuance. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2020, the FASB issued guidance that makes narrow-scope improvements to various aspects of the financial instrument guidance, including the CECL guidance issued in 2016. Since the Company is a smaller reporting company, it should adopt the amendments in ASU 2016-13 during 2023. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2020, the FASB issued guidance to provide temporary optional guidance to ease the potential burden in accounting for reference rate reform. The amendments are effective as of March 12, 2020 through December 31, 2022. The Company does not expect these amendments to have a material effect on its financial statements.

In August 2020, the FASB issued guidance to improve financial reporting associated with accounting for convertible instruments and contracts in an entity's own equity. The amendments are effective for fiscal years beginning after December 15, 2023, including interim periods within those fiscal years. Early adoption is permitted, but no earlier than fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. The Company does not expect these amendments to have a material effect on its financial statements.

In October 2020, the FASB updated various Topics of the ASC to align the guidance in various SEC sections of the Codification with the requirements of certain SEC final rules. The amendments were effective upon issuance and did not have a material effect on the financial statements.

In October 2020, the FASB issued amendments to clarify the ASC and make minor improvements that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. The amendments are effective for annual periods beginning after December 15, 2020. The Company does not expect these amendments to have a material effect on its financial statements.

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

Notes to Consolidated Financial Statements

Note 2. Restrictions on Cash

To comply with banking regulations, the Bank is required to maintain certain average cash reserve balances. At December 31, 2020 and 2019, the required reserve was met by the Bank's vault cash and no daily average cash reserve requirement was required.

Note 3. Investment Securities

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

(dollars in thousands)	<u>Amortized Cost</u>	<u>Unrealized Gains</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>
2020				
<i>Available for sale:</i>				
Mortgage-backed securities	\$ 15,212	\$ 472	\$ -	\$ 15,684
Corporate securities	1,500	-	-	1,500
State and municipal securities	<u>16,059</u>	<u>295</u>	<u>(31)</u>	<u>16,323</u>
	<u>\$ 32,771</u>	<u>\$ 767</u>	<u>\$ (31)</u>	<u>\$ 33,507</u>
2019				
<i>Available for sale:</i>				
Mortgage-backed securities	\$ 19,540	\$ 61	\$ (97)	\$ 19,504
Corporate securities	1,500	-	(67)	1,433
State and municipal securities	<u>11,777</u>	<u>168</u>	<u>(1)</u>	<u>11,944</u>
	<u>\$ 32,817</u>	<u>\$ 229</u>	<u>\$ (165)</u>	<u>\$ 32,881</u>

Restricted equity securities were \$2.4 million at December 31, 2020 and 2019. Restricted equity securities consist of investments in stock of the Federal Home Loan Bank of Atlanta ("FHLB"), CBB Financial Corp., Pacific Coast Bankers Bank, and the Federal Reserve Bank of Richmond, all of which are carried at cost. All of these entities are upstream correspondents of the Bank. The FHLB requires financial institutions to make equity investments in the FHLB in order to borrow money. The Bank is required to hold that stock so long as it borrows from the FHLB. The Federal Reserve requires Banks to purchase stock as a condition for membership in the Federal Reserve System. The Bank's stock in CBB Financial Corp. and Pacific Coast Bankers Bank is restricted only in the fact that the stock may only be repurchased by the respective banks.

The following tables details unrealized losses and related fair values in the Company's held to maturity and available for sale investment securities portfolios. This information is aggregated by the length of time that individual securities have been in a continuous unrealized loss position as of December 31, 2020 and 2019.

(dollars in thousands)	<u>Less Than 12 Months</u>		<u>12 Months or More</u>		<u>Total</u>	
	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>	<u>Fair Value</u>	<u>Unrealized Losses</u>
2020						
<i>Available for sale:</i>						
Mortgage-backed securities	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -
Corporate securities	-	-	-	-	-	-
State and municipal securities	<u>3,694</u>	<u>(31)</u>	<u>-</u>	<u>-</u>	<u>3,694</u>	<u>(31)</u>
Total securities available for sale	<u>\$ 3,694</u>	<u>\$ (31)</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 3,694</u>	<u>\$ (31)</u>
2019						
<i>Available for sale:</i>						
Mortgage-backed securities	\$ 8,625	\$ (97)	\$ -	\$ -	\$ 8,625	\$ (97)
Corporate securities	-	-	1,433	(67)	1,433	(67)
State and municipal securities	<u>1,010</u>	<u>(1)</u>	<u>-</u>	<u>-</u>	<u>1,010</u>	<u>(1)</u>
Total securities available for sale	<u>\$ 9,635</u>	<u>\$ (98)</u>	<u>\$ 1,433</u>	<u>\$ (67)</u>	<u>\$ 11,068</u>	<u>\$ (165)</u>

Notes to Consolidated Financial Statements

Note 3. Investment Securities, continued

At December 31, 2020, 3 debt securities with unrealized losses had depreciated 0.83 percent from their total amortized cost basis. Management evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to the length of time and the extent to which the fair value has been less than cost, and the financial condition and near-term prospects of the issuer. The relative significance of these and other factors will vary on a case by case basis. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, the results of reviews of the issuer's financial condition and the issuer's anticipated ability to pay the contractual cash flows of the investments. Since the Company intends to hold all of its investment securities until maturity, and it is more likely than not that the Company will not have to sell any of its investment securities before unrealized losses have been recovered, and the Company expects to recover the entire amount of the amortized cost basis of all its securities, none of the securities are deemed other than temporarily impaired at December 31, 2020. Management continues to monitor all of these securities with a high degree of scrutiny. There can be no assurance that the Company will not conclude in future periods that conditions existing at that time indicate some or all of these securities are other than temporarily impaired, which could require a charge to earnings in such periods.

Proceeds from the sales of investment securities available for sale were \$10.7 and \$8.9 million for the years ended December 31, 2020 and 2019, respectively. Proceeds from called securities totaled \$3.2 million and \$2.2 million for the years ended December 31, 2020 and 2019, respectively. Gross realized gains and losses for the years ended December 31 are as follows:

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Realized gains	\$ 315	\$ 92
Realized losses	-	(43)
	<u>\$ 315</u>	<u>\$ 49</u>

There were no securities transferred between the available for sale and held to maturity portfolios or other sales of held to maturity securities during the periods presented. In the future management may elect to classify securities as held to maturity based upon such considerations as the nature of the security, the Bank's ability to hold the security until maturity, and general economic conditions.

The scheduled maturities of securities available for sale at December 31, 2020, were as follows:

(dollars in thousands)	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 1,747	\$ 1,756
Due after one year through five years	6,358	6,457
Due after five years through ten years	10,243	10,554
Due after ten years	<u>14,423</u>	<u>14,740</u>
	<u>\$ 32,771</u>	<u>\$ 33,507</u>

Maturities of mortgage-backed securities are based on contractual amounts. Actual maturity will vary as loans underlying the securities are prepaid.

Investment securities with amortized cost of approximately \$14.1 million and \$15.5 million at December 31, 2020 and 2019, respectively, were pledged as collateral on public deposits and for other purposes as required or permitted by law.

Notes to Consolidated Financial Statements

Note 4. Loans Receivable

The major components of loans in the consolidated balance sheets at December 31, 2020 and December 31, 2019 are as follows:

(dollars in thousands)	2020	2019
Construction & development	\$ 46,053	\$ 39,649
Farmland	32,449	34,166
Residential	279,893	253,674
Commercial mortgage	203,886	190,817
Commercial & agricultural	33,663	32,426
SBA-PPP	51,118	-
Consumer & other	17,033	19,621
Total loans	664,095	570,353
Allowance for loan losses	(4,900)	(3,893)
Loans, net of allowance for loan losses	\$ 659,195	\$ 566,460

As of December 31, 2020 and 2019, substantially all of the Bank's residential 1-4 family loans were pledged as collateral toward borrowings with the Federal Home Loan Bank.

Small Business Administration Paycheck Protection Program

The Bank participated in the SBA-PPP and originated loans totaling \$81.9 million, with \$3.25 million of processing fees received from the SBA through December 31, 2020. These fees, net of direct costs relating to the origination of these loans, have been deferred and are being amortized over the life of the loans. As of December 31, 2020, \$29.3 million in SBA-PPP loan balances had been forgiven or paid off. Contractual interest earned on SBA-PPP loans totaled \$527 thousand, while net fees recognized totaled \$1.7 million. Gross SBA-PPP loans totaling \$52.5 million with net deferred fees of \$1.4 million remained on the balance sheet at December 31, 2020. Loan forgiveness payments will be treated as prepayments and recognized as they occur. A summary of our SBA-PPP loans as of December 31, 2020 by SBA tier is as follows:

(dollars in thousands)				
SBA Tier	# of SBA Approved	Mix	Balance Less Unearned Fees	Mix
\$2 million to \$10 million	2	0.20%	\$ 7,267	14.22%
Over \$350,000 to less than \$2 million	18	1.78%	11,693	22.87%
Up to \$350,000	988	98.02%	32,158	62.91%
Total	1,008	100.00%	\$ 51,118	100.00%

A summary of our SBA-PPP loans as of December 31, 2020 by industry is as follows:

(dollars in thousands)				
Industry	# of SBA Approved	Mix	Balance Less Unearned Fees	Mix
Manufacturing	74	7.34%	\$ 14,327	28.03%
Retail Trade	134	13.29%	5,247	10.26%
Construction	127	12.60%	3,577	7.00%
Health Care & Social Assistance	73	7.24%	3,550	6.94%
Accommodation & Retail Services	91	9.03%	3,705	7.25%
Educational Services	7	0.70%	4,825	9.44%
General & Other	502	49.80%	15,887	31.08%
Total	1,008	100.00%	\$ 51,118	100.00%

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans

Allowance for Loan Losses

The allowance for loan losses is maintained at a level believed to be sufficient to provide for estimated loan losses based on evaluating known and inherent risks in the loan portfolio. The allowance is provided based upon management's comprehensive analysis of the pertinent factors underlying the quality of the loan portfolio. These factors include changes in the amount and composition of the loan portfolio, delinquency levels, actual loss experience, current economic conditions, and detailed analysis of individual loans for which the full collectability may not be assured. The detailed analysis includes methods to estimate the fair value of loan collateral and the existence of potential alternative sources of repayment. The allowance consists of specific and general components. The specific component is calculated on an individual basis for larger-balance, non-homogeneous loans, which are considered impaired. A specific allowance is established when the discounted cash flows, collateral value (less disposal costs), or observable market price of the impaired loan is lower than its carrying value. The specific component of the allowance for smaller-balance loans whose terms have been modified in a TDR is calculated on a pooled basis considering historical experience adjusted for qualitative factors. These smaller-balance TDRs were collectively evaluated for impairment. The general component covers the remaining loan portfolio, and is based on historical loss experience adjusted for qualitative factors. The appropriateness of the allowance for loan losses on loans is estimated based upon these factors and trends identified by management at the time financial statements are prepared.

A provision for loan losses is charged against operations and is added to the allowance for loan losses based on quarterly comprehensive analyses of the loan portfolio. The allowance for loan losses is allocated to certain loan categories based on the relative risk characteristics, asset classifications and actual loss experience of the loan portfolio. While management has allocated the allowance for loan losses to various loan portfolio segments, the allowance is general in nature and is available for the loan portfolio in its entirety.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

As noted in Note 1, the Company determined that SBA-PPP loans have zero expected credit losses and as such are excluded from the disclosures included in the following table. The following table presents activity in the allowance by loan category and information on the loans evaluated individually for impairment and collectively evaluated for impairment as of December 31, 2020 and December 31, 2019:

Allowance for Loan Losses and Recorded Investment in Loans

(dollars in thousands)	<u>Construction & Development</u>	<u>Farmland</u>	<u>Residential</u>	<u>Commercial Mortgage</u>	<u>Commercial & Agricultural</u>	<u>Consumer & Other</u>	<u>Total</u>
December 31, 2020							
Allowance for loan losses:							
Beginning Balance	\$ 305	\$ 487	\$ 1,822	\$ 924	\$ 211	\$ 144	\$ 3,893
Charge-offs	(8)	-	(48)	(61)	(37)	(148)	(302)
Recoveries	4	-	11	65	6	34	120
Provision	198	(81)	382	493	113	84	1,189
Ending Balance	<u>\$ 499</u>	<u>\$ 406</u>	<u>\$ 2,167</u>	<u>\$ 1,421</u>	<u>\$ 293</u>	<u>\$ 114</u>	<u>\$ 4,900</u>
Ending balance: individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Ending balance: collectively evaluated for impairment	<u>\$ 499</u>	<u>\$ 406</u>	<u>\$ 2,167</u>	<u>\$ 1,421</u>	<u>\$ 293</u>	<u>\$ 114</u>	<u>\$ 4,900</u>
Loans outstanding:							
Ending Balance	<u>\$ 46,053</u>	<u>\$ 32,449</u>	<u>\$ 279,893</u>	<u>\$ 203,886</u>	<u>\$ 33,663</u>	<u>\$ 17,033</u>	<u>\$ 612,977</u>
Ending balance: individually evaluated for impairment	<u>\$ -</u>	<u>\$ 2,580</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 2,580</u>
Ending balance: collectively evaluated for impairment	<u>\$ 46,053</u>	<u>\$ 29,869</u>	<u>\$ 279,751</u>	<u>\$ 203,773</u>	<u>\$ 33,567</u>	<u>\$ 17,033</u>	<u>\$ 610,046</u>
Ending balance: purchased credit impaired loans	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 142</u>	<u>\$ 113</u>	<u>\$ 96</u>	<u>\$ -</u>	<u>\$ 351</u>
December 31, 2019							
Allowance for loan losses:							
Beginning Balance	\$ 246	\$ 385	\$ 1,807	\$ 682	\$ 281	\$ 94	\$ 3,495
Charge-offs	-	(13)	(55)	(41)	(77)	(212)	(398)
Recoveries	-	-	8	69	10	54	141
Provision	59	115	62	214	(3)	208	655
Ending Balance	<u>\$ 305</u>	<u>\$ 487</u>	<u>\$ 1,822</u>	<u>\$ 924</u>	<u>\$ 211</u>	<u>\$ 144</u>	<u>\$ 3,893</u>
Ending balance: individually evaluated for impairment	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>
Ending balance: collectively evaluated for impairment	<u>\$ 305</u>	<u>\$ 487</u>	<u>\$ 1,822</u>	<u>\$ 924</u>	<u>\$ 211</u>	<u>\$ 144</u>	<u>\$ 3,893</u>
Loans outstanding:							
Ending Balance	<u>\$ 39,649</u>	<u>\$ 34,166</u>	<u>\$ 253,674</u>	<u>\$ 190,817</u>	<u>\$ 32,426</u>	<u>\$ 19,621</u>	<u>\$ 570,353</u>
Ending balance: individually evaluated for impairment	<u>\$ -</u>	<u>\$ 3,240</u>	<u>\$ 909</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 4,149</u>
Ending balance: collectively evaluated for impairment	<u>\$ 39,649</u>	<u>\$ 30,926</u>	<u>\$ 252,615</u>	<u>\$ 190,496</u>	<u>\$ 32,280</u>	<u>\$ 19,621</u>	<u>\$ 565,587</u>
Ending balance: purchased credit impaired loans	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 150</u>	<u>\$ 321</u>	<u>\$ 146</u>	<u>\$ -</u>	<u>\$ 617</u>

As of December 31, 2020 and December 31, 2019, the Bank had no unallocated reserves included in the allowance for loan losses.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

Management closely monitors the quality of the loan portfolio and has established a loan review process designed to help grade the quality of the Bank's loan portfolio. The Bank's loan ratings coincide with the "Substandard," "Doubtful" and "Loss" classifications used by federal regulators in their examination of financial institutions. Generally, an asset is considered Substandard if it is inadequately protected by the current net worth and paying capacity of the obligors and/or the collateral pledged. Substandard assets include those characterized by the distinct possibility that the insured financial institution will sustain some loss if the deficiencies are not corrected. Assets classified as Doubtful have all the weaknesses inherent in assets classified Substandard with the added characteristic that the weaknesses present make collection or liquidation in full, on the basis of currently existing facts, highly questionable and improbable. Assets classified as Loss are those considered uncollectible, and of such little value that its continuance on the books is not warranted. Assets that do not currently expose the insured financial institutions to sufficient risk to warrant classification in one of the aforementioned categories but otherwise possess weaknesses are designated "Special Mention." Management also maintains a listing of loans designated "Watch". These loans represent borrowers with declining earnings, strained cash flow, increasing leverage and/or weakening market fundamentals that indicate above average risk. As of December 31, 2020 and December 31, 2019, respectively, the Bank had no loans graded "Doubtful" or "Loss" included in the balance of total loans outstanding.

During the first quarter of 2020, Management evaluated loan grades included in the "Watch" category and determined that loans associated with a certain grade should be classified as "Pass" credits. As a result of this reclassification, the loan grades previously reported as "Watch" & "Pass" of December 31, 2019 have been reclassified as follows:

(dollars in thousands)	Loan Grades		
	Watch		Watch
	As Reported	Reclass	Adjusted
December 31, 2019			
Real Estate Secured:			
Construction & development	\$ 4,801	\$ (4,244)	\$ 557
Farmland	4,059	(2,565)	1,494
Residential	19,887	(19,349)	538
Commercial mortgage	21,960	(19,557)	2,403
Non-Real Estate Secured:			
Commercial & agricultural	4,346	(3,805)	541
Consumer & other	300	(300)	-
Total	<u>\$ 55,353</u>	<u>\$ (49,820)</u>	<u>\$ 5,533</u>

(dollars in thousands)	Loan Grades		
	Pass		Pass
	As Reported	Reclass	Adjusted
December 31, 2019			
Real Estate Secured:			
Construction & development	\$ 34,701	\$ 4,244	\$ 38,945
Farmland	22,969	2,565	25,534
Residential	231,629	19,349	250,978
Commercial mortgage	163,584	19,557	183,141
Non-Real Estate Secured:			
Commercial & agricultural	27,503	3,805	31,308
Consumer & other	19,314	300	19,614
Total	<u>\$ 499,700</u>	<u>\$ 49,820</u>	<u>\$ 549,520</u>

These reclassifications did not have an impact on our calculation of the allowance for loan losses or our provision expense.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

The following table lists the loan grades utilized by the Bank and the corresponding total of outstanding loans in each category as of December 31, 2020 and December 31, 2019:

Credit Risk Profile by Internally Assigned Grades

(dollars in thousands)	Loan Grades				Total
	Pass	Watch	Special Mention	Substandard	
<u>December 31, 2020</u>					
Real Estate Secured:					
Construction & development	\$ 44,909	\$ 427	\$ 122	\$ 595	\$ 46,053
Farmland	25,607	419	496	5,927	32,449
Residential	277,811	659	-	1,423	279,893
Commercial mortgage	188,156	8,692	3,647	3,391	203,886
Non-Real Estate Secured:					
Commercial & agricultural	32,467	468	161	567	33,663
SBA-PPP	51,118	-	-	-	51,118
Consumer & other	17,028	-	-	5	17,033
Total	<u>\$ 637,096</u>	<u>\$ 10,665</u>	<u>\$ 4,426</u>	<u>\$ 11,908</u>	<u>\$ 664,095</u>
<u>December 31, 2019</u>					
Real Estate Secured:					
Construction & development	\$ 38,945	\$ 557	\$ -	\$ 147	\$ 39,649
Farmland	25,534	1,494	673	6,465	34,166
Residential	250,978	538	176	1,982	253,674
Commercial mortgage	183,141	2,403	930	4,343	190,817
Non-Real Estate Secured:					
Commercial & agricultural	31,308	541	103	474	32,426
Consumer & other	19,614	-	-	7	19,621
Total	<u>\$ 549,520</u>	<u>\$ 5,533</u>	<u>\$ 1,882</u>	<u>\$ 13,418</u>	<u>\$ 570,353</u>

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Allowance for Loan Losses, continued

Loans may be placed in nonaccrual status when, in management's opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Interest income is subsequently recognized only to the extent cash payments are received. Payments received are first applied to principal, and any remaining funds are then applied to interest. Loans are removed from nonaccrual status when they are deemed a loss and charged to the allowance, transferred to foreclosed assets, or returned to accrual status based upon performance consistent with the original terms of the loan or a subsequent restructuring thereof.

The following table presents an age analysis of nonaccrual and past due loans by category as of December 31, 2020 and December 31, 2019:

(dollars in thousands)	30-59 Days Past Due	60-89 Days Past Due	90 Days or More Past Due	Total Past Due	Current	Total Loans	90+ Days Past Due and Still Accruing	Nonaccrual Loans
December 31, 2020								
Real Estate Secured:								
Construction & development	\$ 71	\$ -	\$ -	\$ 71	\$ 45,982	\$ 46,053	\$ -	\$ 11
Farmland	100	-	914	1,014	31,435	32,449	-	3,937
Residential	386	29	240	655	279,238	279,893	-	557
Commercial mortgage	-	-	24	24	203,862	203,886	-	109
Non-Real Estate Secured:								
Commercial & agricultural	14	15	155	184	33,479	33,663	-	189
SBA-PPP	-	-	-	-	51,118	51,118	-	-
Consumer & other	7	-	-	7	17,026	17,033	-	-
Total	<u>\$ 578</u>	<u>\$ 44</u>	<u>\$ 1,333</u>	<u>\$ 1,955</u>	<u>\$ 662,140</u>	<u>\$ 664,095</u>	<u>\$ -</u>	<u>\$ 4,803</u>
December 31, 2019								
Real Estate Secured:								
Construction & development	\$ -	\$ -	\$ 10	\$ 10	\$ 39,639	\$ 39,649	\$ -	\$ 10
Farmland	893	-	971	1,864	32,302	34,166	-	4,192
Residential	292	48	365	705	252,969	253,674	-	412
Commercial mortgage	185	-	-	185	190,632	190,817	-	198
Non-Real Estate Secured:								
Commercial & agricultural	135	8	163	306	32,120	32,426	-	165
Consumer & other	2	6	2	10	19,611	19,621	-	2
Total	<u>\$ 1,507</u>	<u>\$ 62</u>	<u>\$ 1,511</u>	<u>\$ 3,080</u>	<u>\$ 567,273</u>	<u>\$ 570,353</u>	<u>\$ -</u>	<u>\$ 4,979</u>

Impaired Loans

A loan is considered impaired when it is probable that the Bank will be unable to collect all contractual principal and interest payments due in accordance with the original or modified terms of the loan agreement. Smaller balance homogenous loans may be collectively evaluated for impairment. Non-homogenous impaired loans are either measured based on the estimated fair value of the collateral less estimated cost to sell if the loan is considered collateral dependent, or measured based on the present value of expected future cash flows if not collateral dependent. The valuation of real estate collateral is subjective in nature and may be adjusted in future periods because of changes in economic conditions. Management considers third-party appraisals, as well as independent fair market value assessments in determining the estimated fair value of particular properties. In addition, as certain of these third-party appraisals and independent fair market value assessments are only updated periodically, changes in the values of specific properties may have occurred subsequent to the most recent appraisals. Accordingly, the amounts of any such potential changes and any related adjustments are generally recorded at the time such information is received. When the measurement of the impaired loan is less than the recorded investment in the loan, impairment is recognized by creating or adjusting an allocation of the allowance for loan losses and uncollected accrued interest is reversed against interest income. If ultimate collection of principal is in doubt, all cash receipts on impaired loans are applied to reduce the principal balance.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Impaired Loans, continued

As of December 31, 2020 and December 31, 2019, respectively, the recorded investment in impaired loans totaled \$6.2 million and \$7.8 million. The total amount of collateral-dependent impaired loans at December 31, 2020 and December 31, 2019, respectively, was \$2.6 million and \$2.9 million. As of December 31, 2020 and December 31, 2019, respectively, \$2.6 million and \$4.1 million of the recorded investment in impaired loans did not have a related allowance. The Bank had \$3.9 million and \$4.8 million in troubled debt restructured loans included in impaired loans at December 31, 2020 and December 31, 2019, respectively.

The categories of non-accrual loans and impaired loans overlap, although they are not coextensive. The Bank considers all circumstances regarding the loan and borrower on an individual basis when determining whether an impaired loan should be placed on non-accrual status, such as the financial strength of the borrower, the estimated collateral value, reasons for the delay, payment record, the amount past due and the number of days past due.

Management collectively evaluates performing TDRs with a loan balance of \$250,000 or less for impairment. As of December 31, 2020 and December 31, 2019, respectively, \$3.6 million and \$3.6 million of TDRs included in the following table were evaluated collectively for impairment and were deemed to have \$192 thousand and \$174 thousand of related allowance.

The following table is a summary of information related to impaired loans as of December 31, 2020 and December 31, 2019:

(dollars in thousands)	Impaired Loans				
	Recorded Investment¹	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
December 31, 2020					
With no related allowance recorded:					
Construction & development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	2,580	3,151	-	2,731	18
Residential	-	-	-	-	-
Commercial mortgage	-	-	-	-	-
Commercial & agricultural	-	-	-	-	-
Consumer & other	-	-	-	-	-
Subtotal	<u>2,580</u>	<u>3,151</u>	<u>-</u>	<u>2,731</u>	<u>18</u>
With an allowance recorded:					
Construction & development	501	501	27	522	31
Farmland	127	144	2	375	11
Residential	2,906	3,082	159	4,057	222
Commercial mortgage	8	53	1	10	3
Commercial & agricultural	46	46	3	49	3
Consumer & other	1	1	-	2	-
Subtotal	<u>3,589</u>	<u>3,827</u>	<u>192</u>	<u>5,015</u>	<u>270</u>
Totals:					
Construction & development	501	501	27	522	31
Farmland	2,707	3,295	2	3,106	29
Residential	2,906	3,082	159	4,057	222
Commercial mortgage	8	53	1	10	3
Commercial & agricultural	46	46	3	49	3
Consumer & other	1	1	-	2	-
Total	<u>\$ 6,169</u>	<u>\$ 6,978</u>	<u>\$ 192</u>	<u>\$ 7,746</u>	<u>\$ 288</u>

¹ Recorded investment is the loan balance, net of any charge-offs

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Impaired Loans, continued

(dollars in thousands)	<u>Recorded Investment¹</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
December 31, 2019					
With no related allowance recorded:					
Construction & development	\$ -	\$ -	\$ -	\$ -	\$ -
Farmland	3,240	3,240	-	3,505	25
Residential	909	909	-	921	40
Commercial mortgage	-	-	-	-	-
Commercial & agricultural	-	-	-	-	-
Consumer & other	-	-	-	-	-
Subtotal	<u>4,149</u>	<u>4,149</u>	<u>-</u>	<u>4,426</u>	<u>65</u>
With an allowance recorded:					
Construction & development	72	72	3	76	6
Farmland	150	150	2	1,545	70
Residential	3,345	3,495	166	4,161	225
Commercial mortgage	11	56	1	268	11
Commercial & agricultural	31	31	1	34	2
Consumer & other	3	3	1	4	-
Subtotal	<u>3,612</u>	<u>3,807</u>	<u>174</u>	<u>6,088</u>	<u>314</u>
Totals:					
Construction & development	72	72	3	76	6
Farmland	3,390	3,390	2	5,050	95
Residential	4,254	4,404	166	5,082	265
Commercial mortgage	11	56	1	268	11
Commercial & agricultural	31	31	1	34	2
Consumer & other	3	3	1	4	-
Total	<u>\$ 7,761</u>	<u>\$ 7,956</u>	<u>\$ 174</u>	<u>\$ 10,514</u>	<u>\$ 379</u>

¹ Recorded investment is the loan balance, net of any charge-offs

Troubled Debt Restructuring

A troubled debt restructured loan is a loan for which the Bank, for reasons related to the borrower's financial difficulties, grants a concession to the borrower that the Bank would not otherwise consider.

The loan terms which have been modified or restructured due to a borrower's financial difficulty, include but are not limited to: a reduction in the stated interest rate; an extension of the maturity at an interest rate below current market; a reduction in the face amount of the debt; a reduction in the accrued interest; or re-aging, extensions, deferrals and renewals.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Troubled Debt Restructuring, continued

The following table sets forth information with respect to the Bank's troubled debt restructurings as of December 31, 2020 and December 31, 2019:

(dollars in thousands)	TDRs identified during the period			TDRs identified in the last twelve months that subsequently defaulted ⁽¹⁾		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
December 31, 2020						
Construction & development	3	\$ 471	\$ 459	-	\$ -	\$ -
Farmland	-	-	-	-	-	-
Residential	1	46	50	-	-	-
Commercial mortgage	-	-	-	-	-	-
Commercial & agricultural	1	20	19	-	-	-
Consumer & other	-	-	-	-	-	-
Total	<u>5</u>	<u>\$ 537</u>	<u>\$ 528</u>	<u>-</u>	<u>\$ -</u>	<u>\$ -</u>

During the twelve months ended December 31, 2020, five loans were modified that were considered to be a TDRs. Term concessions were granted on all the loans and one loan had additional funds advanced for property taxes. No TDRs identified in the last twelve months subsequently defaulted in the year ended December 31, 2020.

⁽¹⁾ Loans past due 30 days or more are considered to be in default.

(dollars in thousands)	TDRs identified during the period			TDRs identified in the last twelve months that subsequently defaulted ⁽¹⁾		
	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment	Number of contracts	Pre-modification outstanding recorded investment	Post-modification outstanding recorded investment
December 31, 2019						
Construction & development	1	\$ 9	\$ 11	-	\$ -	\$ -
Farmland	1	38	37	-	-	-
Residential	1	117	128	-	-	-
Commercial mortgage	-	-	-	-	-	-
Commercial & agricultural	-	-	-	-	-	-
Consumer & other	-	-	-	-	-	-
Total	<u>3</u>	<u>\$ 164</u>	<u>\$ 176</u>	<u>-</u>	<u>\$ -</u>	<u>\$ -</u>

During the twelve months ended December 31, 2019, three loans were modified that were considered to be TDRs. Term concessions were granted on all the loans and two loans had additional funds advanced for legal expenses and property taxes. No TDRs identified in the last twelve months subsequently defaulted in the year ended December 31, 2019.

⁽¹⁾ Loans past due 30 days or more are considered to be in default.

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Modifications in response to COVID-19

The Company began offering short-term loan modifications to assist borrowers during the COVID-19 pandemic. These modifications generally involve principal and/or interest payment deferrals for up to six months. As the COVID-19 pandemic persists in negatively impacting the economy, the Company continues to offer additional loan modifications to borrowers struggling as a result of COVID-19. Similar to the initial modifications granted, the additional round of loan modifications generally involve principal and/or interest payment deferrals for up to an additional six months for commercial and consumer loans, and principal-only deferrals for up to an additional 12 months for selected commercial loans. The Company generally continues to accrue and recognize interest income during the forbearance period. The Company offers several repayment options such as immediate repayment, repayment over a designated time period or as a balloon payment at maturity, or by extending the loan term. These modifications generally do not involve forgiveness or interest rate reductions. The CARES Act, along with a joint agency statement issued by banking agencies, provide that modifications made in response to COVID-19 to borrowers who qualify are not required to be accounted for as a TDR. Accordingly, the Company does not account for such qualifying as TDRs. See Note 1 Organization and Summary of Significant Accounting Policies for more information.

The Bank began receiving requests for loan deferments on March 23, 2020. During 2020, the Bank approved approximately 250 requests for loan payment deferment of approximately \$64.9 million in loans. As of December 31, 2020, 18 loans with total outstanding balances of \$9.0 million remained in deferment status. A breakdown of the loans with deferments as of December 31, 2020 is as follows:

(dollars in thousands)

Classification	# of Loans	Balance
Commercial Loans w/ First Deferment Construction	1	\$ 47
Commercial Loans w/ Second Deferment		
Accommodation & Retail Services	1	752
Construction	1	36
Agriculture	2	603
Real Estate Rental	2	2,146
Commercial Loans w/ Third Deferment		
Accommodation & Retail Services	2	4,438
Manufacturing	1	153
Consumer Loans w/ First Deferment	7	782
Consumer Loans w/ Second Deferment	1	52
Total	<u>18</u>	<u>\$ 9,009</u>

Notes to Consolidated Financial Statements

Note 5. Allowance for Loan Losses and Impaired Loans, continued

Purchased Credit Impaired Loans

During 2018, the Company acquired loans as a result of the Great State merger, for which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans at December 31, 2020 and December 31, 2019 are as follows:

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Residential	\$ 142	\$ 150
Commercial mortgage	113	321
Commercial & agricultural	<u>96</u>	<u>146</u>
Outstanding balance	<u>\$ 351</u>	<u>\$ 617</u>
Carrying amount	<u>\$ 351</u>	<u>\$ 617</u>

There was no accretable yield on purchased credit impaired loans for the periods presented.

There were no purchased credit impaired loans acquired during the year ended December 31, 2020 and during the year ended December 31, 2019. Income is not recognized on purchased credit impaired loans if the Company cannot reasonably estimate cash flows expected to be collected.

Notes to Consolidated Financial Statements

Note 6. Property and Equipment

Components of property and equipment and total accumulated depreciation at December 31, 2020 and 2019, are as follows:

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Land	\$ 7,963	\$ 5,660
Buildings and improvements	20,620	19,439
Furniture and equipment	<u>13,516</u>	<u>12,482</u>
	42,099	37,581
Less accumulated depreciation	<u>(15,508)</u>	<u>(14,144)</u>
	<u>\$ 26,591</u>	<u>\$ 23,437</u>

Depreciation expense for the years ended December 31, 2020 and 2019 amounted to \$1.4 million and \$1.2 million, respectively.

Note 7. Goodwill and Intangible Assets

The change in goodwill during the years ended December 31, 2020 and 2019 is as follows:

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Beginning of year	\$ 3,257	\$ 3,198
Measurement period adjustment	-	59
Impairment	-	-
End of the period	<u>\$ 3,257</u>	<u>\$ 3,257</u>

Intangible Assets

The following table presents the activity for the Company's core deposit intangible assets, which are the only identifiable intangible assets subject to amortization. Core deposit intangibles at December 31, 2020 and 2019 are as follows:

(dollars in thousands)	<u>2020</u>	<u>2019</u>
Balance at beginning of year, net	\$ 3,070	\$ 3,892
Amortization expense	<u>(711)</u>	<u>(822)</u>
Net book value	<u>\$ 2,359</u>	<u>\$ 3,070</u>

Notes to Consolidated Financial Statements

Note 8. Leases

On January 1, 2019, the Company adopted ASU No. 2016-02 “Leases (Topic 842)” and all subsequent ASUs that modified Topic 842. We adopted the guidance using the modified retrospective method and practical expedients for transition. The practical expedients allow us to largely account for our existing leases consistent with current guidance except for the incremental balance sheet recognition for lessees. We have performed an evaluation of our leasing contracts and activities. We have developed our methodology to estimate the right-of use assets and lease liabilities, which is based on the present value of lease payments. Prior to adoption, all of the Company’s leases were classified as operating leases and remain operating leases at adoption.

Contracts that commence subsequent to adoption are evaluated to determine whether they are or contain a lease in accordance with Topic 842. The Company has elected the practical expedient provided by Topic 842 not to allocate consideration in a contract between lease and non-lease components. The Company also elected, as provided by the standard, not to recognize right-of-use assets and lease liabilities for short-term leases, defined by the standard as leases with terms of 12 months or less. Since adoption, the Company entered into a new operating lease during 2019 and a renewed an operating lease during 2020 and recognized right-of-use assets and lease liabilities.

Lease liabilities represent the Company’s obligation to make lease payments and are presented at each reporting date as the net present value of the remaining contractual cash flows. Cash flows are discounted at the Company’s incremental borrowing rate in effect at the commencement date of the lease. For our incremental borrowing rate, we used the Federal Home Loan Bank rate available at the time of lease inception. The right-of-use assets represent the Company’s right to use the underlying asset for the lease term and are calculated as the sum of the lease liability and if applicable, prepaid rent, initial direct costs and any incentives received from the lessor. The contracts in which the Company is lessee are with parties external to the Company and not related parties. The Company’s lease right-of-use assets are included in other assets and the lease liabilities are included in other liabilities. The following tables present information about leases:

(dollars in thousands)

	<u>2020</u>	<u>2019</u>
Lease liabilities	\$ 680	\$ 729
Right-of-use assets	\$ 680	\$ 729
Weighted average remaining lease term (years)	7.10	8.06
Weighted average discount rate	2.45%	2.39%

(dollars in thousands)

	<u>2020</u>	<u>2019</u>
Lease Expense		
Operating lease expense	\$ 147	\$ 73
Short-term lease expense	34	97
Total lease expense	<u>\$ 181</u>	<u>\$ 170</u>
Cash paid for amounts included in lease liabilities	<u>\$ 147</u>	<u>\$ 73</u>

The following table presents a maturity schedule of undiscounted cash flows that contribute to the lease liabilities:

(dollars in thousands)

Twelve months ending December 31, 2021	150
Twelve months ending December 31, 2022	119
Twelve months ending December 31, 2023	79
Twelve months ending December 31, 2024	68
Twelve months ending December 31, 2025	72
Thereafter	258
Total undiscounted cash flows	<u>\$ 746</u>
Less discount	<u>(66)</u>
Lease liabilities	<u>\$ 680</u>

Notes to Consolidated Financial Statements

Note 9. Deposits

The aggregate amount of time deposits in denominations of more than \$250 thousand at December 31, 2020 and 2019 was \$37.0 million, and \$38.7 million, respectively. At December 31, 2020, the scheduled maturities of all time deposits are as follows:

(dollars in thousands)

2021	\$	112,854
2022		36,784
2023		15,380
2024		10,782
2025		18,619
After Five Years		-
Total	\$	<u>194,419</u>

Note 10. Short-Term Debt

At December 31, 2020 and 2019 the Bank had no debt outstanding classified as short-term.

At December 31, 2020, the Bank had established unsecured lines of credit of approximately \$53.0 million with correspondent banks to provide additional liquidity if, and as needed. In addition, the Bank has the ability to borrow up to approximately \$194.2 million from the Federal Home Loan Bank, subject to the pledging of collateral.

Note 11. Long-Term Debt

At December 31, 2020 and 2019, the Bank's long-term debt consisted of a \$10.0 million advance from FHLB. The advance, which is secured by substantially all the Bank's 1-4 family loans, is scheduled to mature on December 6, 2029. Interest on the advance was fixed at 0.819 percent and the advance is convertible by FHLB to a variable rate quarterly on March 6, 2021. The Bank has the option to repay the advance amount in whole or in part on the conversion date.

Notes to Consolidated Financial Statements

Note 12. Financial Instruments

FASB ASC 825, “Financial Instruments”, requires disclosure of fair value information about financial instruments, whether or not recognized in the balance sheet. In cases where quoted market prices are not available, fair values are based on estimates using present value of future cash flows or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. In that regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in immediate settlement of the instruments. FASB ASC 825 excludes certain financial instruments and all nonfinancial instruments from its disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The following presents the carrying amount, fair value, and placement in the fair value hierarchy of the Company’s financial instruments as of December 31, 2020 and December 31, 2019. This table excludes financial instruments for which the carrying amount approximates fair value. For short-term financial assets such as cash and cash equivalents, the carrying amount is a reasonable estimate of fair value due to the relatively short time between the origination of the instrument and its expected realization. For non-marketable equity securities such as Federal Home Loan Bank and Federal Reserve Bank stock, the carrying amount is a reasonable estimate of the fair value as these securities can only be redeemed or sold at their par value and only to the respective issuing government supported institution or to another member institution. For financial liabilities such as noninterest-bearing demand, interest-bearing demand, and savings deposits, the carrying amount is a reasonable estimate of fair value due to these products having no stated maturity.

For loans, the carrying amount is net of unearned income and the allowance for loan losses. In accordance with the prospective adoption of ASU No. 2016-01, the fair value of loans as of December 31, 2020 and 2019 was measured using an exit price notion.

(dollars in thousands)	Carrying Amount	Fair Value	Fair Value Measurements		
			Quoted Prices in Active Markets for Identical Assets or Liabilities (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>December 31, 2020</u>					
Financial Instruments – Assets					
Net Loans	\$ 659,195	\$ 653,454	\$ -	\$ 653,255	\$ 199
Financial Instruments – Liabilities					
Time Deposits	194,419	196,522	-	196,522	-
FHLB Advances	10,000	9,765	9,765	-	-
<u>December 31, 2019</u>					
Financial Instruments – Assets					
Net Loans	\$ 566,460	\$ 557,054	\$ -	\$ 556,851	\$ 203
Financial Instruments – Liabilities					
Time Deposits	191,988	192,365	-	192,365	-
FHLB Advances	10,000	10,021	10,021	-	-

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

Notes to Consolidated Financial Statements

Note 12. Financial Instruments, continued

Fair Value Hierarchy

Under FASB ASC 820, “Fair Value Measurements and Disclosures”, the Company groups assets and liabilities at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value. These levels are:

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

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

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

Following is a description of valuation methodologies used for assets and liabilities recorded at fair value.

Investment Securities Available for Sale

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

Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. If a loan is identified as individually impaired, management measures impairment in accordance with applicable accounting guidance. The fair value of impaired loans is estimated using one of several methods, including collateral value, market value of similar debt, enterprise value, liquidation value and discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2020, a small percentage of the total impaired loans were evaluated based on the fair value of the collateral. In accordance with accounting standards, impaired loans where an allowance is established based on the fair value of collateral require classification in the fair value hierarchy. When the fair value of the collateral is based on an observable market price the Company records the impaired loan as nonrecurring Level 2. When the fair value is based on either an external or internal appraisal and there is no observable market price, the Company records the impaired loan as nonrecurring Level 3.

Derivative Assets and Liabilities

Derivative instruments held or issued by the Company for risk management purposes are traded in over-the-counter markets where quoted market prices are not readily available. Management engages third-party intermediaries to determine the fair market value of these derivative instruments and classifies these instruments as Level 2. Examples of Level 2 derivatives are interest rate swaps, caps and floors. No derivative instruments were held during the years ended December 31, 2020 or 2019.

Notes to Consolidated Financial Statements

Note 12. Financial Instruments, continued

Foreclosed Assets

Foreclosed assets are adjusted to fair value upon transfer of the loans to foreclosed assets. Subsequently, foreclosed assets are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices, appraised values of the collateral or management's estimation of the value of the collateral. When the fair value of the collateral is based on an observable market price the Company records the foreclosed asset as nonrecurring Level 2. When the fair value of the collateral is based on either an external or internal appraisal and there is no observable market price, the Company records the foreclosed asset as nonrecurring Level 3. There were no foreclosed assets held as of December 31, 2020 or 2019.

Assets Recorded at Fair Value on a Recurring Basis

(dollars in thousands)	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
<u>December 31, 2020</u>				
<i>Investment securities available for sale</i>				
Mortgage-backed securities	\$ 15,684	\$ -	\$ 15,684	\$ -
Corporate securities	1,500	-	1,500	-
State and municipal securities	16,323	-	16,323	-
Total assets at fair value	<u>\$ 33,507</u>	<u>\$ -</u>	<u>\$ 33,507</u>	<u>\$ -</u>
<u>December 31, 2019</u>				
<i>Investment securities available for sale</i>				
Mortgage-backed securities	\$ 19,504	\$ -	\$ 19,504	\$ -
Corporate securities	1,433	-	1,433	-
State and municipal securities	11,944	-	11,944	-
Total assets at fair value	<u>\$ 32,881</u>	<u>\$ -</u>	<u>\$ 32,881</u>	<u>\$ -</u>

No liabilities were recorded at fair value on a recurring basis as of December 31, 2020 or 2019. There were no significant transfers between levels during the years ended December 31, 2020 or 2019.

Assets Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets and liabilities at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets and liabilities that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. No liabilities were recorded at fair value on a nonrecurring basis at December 31, 2020 or 2019. Assets measured at fair value on a nonrecurring basis are included in the table below.

(dollars in thousands)	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
<u>December 31, 2020</u>				
Impaired loans	\$ 199	\$ -	\$ -	\$ 199
Total assets at fair value	<u>\$ 199</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 199</u>
<u>December 31, 2019</u>				
Impaired loans	\$ 203	\$ -	\$ -	\$ 203
Total assets at fair value	<u>\$ 203</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ 203</u>

Notes to Consolidated Financial Statements

Note 12. Financial Instruments, continued

Assets Recorded at Fair Value on a Nonrecurring Basis, continued

For Level 3 assets measured at fair value on a recurring or non-recurring basis as of December 31, 2020 and 2019, the significant unobservable inputs used in the fair value measurements were as follows:

	Fair Value at December 31, 2020	Fair Value at December 31, 2019	Valuation Technique	Significant Unobservable Inputs	General Range of Significant Unobservable Input Values
Impaired Loans	\$ 199	\$ 203	Appraised Value/Discounted Cash Flows/Market Value of Note	Discounts to reflect current market conditions, ultimate collectability, and estimated costs to sell	0 – 10%
Foreclosed Assets	\$ -	\$ -	Appraised Value/Comparable Sales/Other Estimates from Independent Sources	Discounts to reflect current market conditions and estimated costs to sell	0 – 10%

Note 13. Employee Benefit Plans

Prior to the merger, both Grayson and Floyd had qualified noncontributory defined benefit pension plans in place which covered substantially all of each bank's employees. The benefits in each plan are primarily based on years of service and earnings. Both Grayson and Floyd plans were amended to freeze benefit accruals for all eligible employees prior to the effective date of the merger. A summary of each plan follows:

Grayson Plan

The following is a summary of the plan's funded status as of December 31:

(dollars in thousands)

	<u>2020</u>	<u>2019</u>
Change in benefit obligation		
Benefit obligation at beginning of year	\$ 5,222	\$ 4,493
Interest cost	163	182
Actuarial loss	723	827
Benefits paid	(25)	(267)
Settlement gain	-	(13)
Benefit obligation at end of year	<u>6,083</u>	<u>5,222</u>
Change in plan assets		
Fair value of plan assets at beginning of year	9,157	8,092
Actual return on plan assets	1,159	1,332
Benefits paid	(25)	(267)
Fair value of plan assets at end of year	<u>10,291</u>	<u>9,157</u>
Funded status at the end of the year	<u>\$ 4,208</u>	<u>\$ 3,935</u>

Notes to Consolidated Financial Statements

Note 13. Employee Benefit Plans, continued

Grayson Plan, continued

(dollars in thousands)

	<u>2020</u>	<u>2019</u>
Amounts recognized in the Balance Sheet		
Plan benefit cost	\$ 5,604	\$ 5,169
Unrecognized net actuarial loss	<u>(1,396)</u>	<u>(1,234)</u>
Amount recognized in other assets	<u>\$ 4,208</u>	<u>\$ 3,935</u>
Amounts recognized in accumulated comprehensive loss		
Unrecognized net actuarial loss	\$ (1,396)	\$ (1,234)
Deferred taxes	<u>293</u>	<u>259</u>
Amount recognized in accumulated comprehensive loss, net	<u>\$ (1,103)</u>	<u>\$ (975)</u>
Prepaid benefit detail		
Benefit obligation	\$ (6,083)	\$ (5,222)
Fair value of assets	10,291	9,157
Unrecognized net actuarial loss	<u>1,396</u>	<u>1,234</u>
Prepaid benefit cost	<u>\$ 5,604</u>	<u>\$ 5,169</u>
Components of net periodic pension cost		
Interest cost	\$ 163	\$ 182
Expected return on plan assets	(626)	(551)
Recognized net loss due to settlement	-	71
Recognized net actuarial loss	<u>28</u>	<u>41</u>
Net periodic benefit expense	<u>\$ (435)</u>	<u>\$ (257)</u>
Additional disclosure information		
Accumulated benefit obligation	\$ 6,083	\$ 5,222
Vested benefit obligation	\$ 6,083	\$ 5,222
Discount rate used for net periodic pension cost	3.25%	4.25%
Discount rate used for disclosure	2.50%	3.25%
Expected return on plan assets	7.00%	7.00%
Rate of compensation increase	N/A	N/A
Average remaining service (years)	10	11

Using the same fair value hierarchy described in Note 12, the fair values of the Company's pension plan assets, by asset category, are as follows:

(dollars in thousands)

	<u>Total</u>	<u>Level 1</u>	<u>Level 2</u>	<u>Level 3</u>
December 31, 2020				
Mutual funds – equities	\$ 5,454	\$ 5,454	\$ -	\$ -
Mutual funds – fixed income	<u>4,837</u>	<u>4,837</u>	<u>-</u>	<u>-</u>
Total assets at fair value	<u>\$ 10,291</u>	<u>\$ 10,291</u>	<u>\$ -</u>	<u>\$ -</u>
December 31, 2019				
Mutual funds – equities	\$ 4,749	\$ 4,749	\$ -	\$ -
Mutual funds – fixed income	<u>4,408</u>	<u>4,408</u>	<u>-</u>	<u>-</u>
Total assets at fair value	<u>\$ 9,157</u>	<u>\$ 9,157</u>	<u>\$ -</u>	<u>\$ -</u>

Notes to Consolidated Financial Statements

Note 13. Employee Benefit Plans, continued

Grayson Plan, continued

Estimated Future Benefit Payments

(dollars in thousands)	<u>Pension Benefits</u>
2021	\$ 767
2022	248
2023	1,299
2024	458
2025	69
2026 – 2030	1,973
	<u>\$ 4,814</u>

Funding Policy

It has been Bank practice to contribute the maximum tax-deductible amount each year as determined by the plan administrator. As a result of prior year contributions exceeding the minimum requirements, a Prefunding Balance existed as of December 31, 2020 and there is no required contribution for 2021. Based on this we do not anticipate making a contribution to the plan in 2021.

Long-Term Rate of Return

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

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

Asset Allocation

The pension plan's weighted-average asset allocations at December 31, 2020 and 2019, by asset category are as follows:

	<u>2020</u>	<u>2019</u>
Mutual funds – fixed income	47%	48%
Mutual funds – equity	53%	52%
Total	<u>100%</u>	<u>100%</u>

The trust fund is sufficiently diversified to maintain a reasonable level of risk without imprudently sacrificing return, with a targeted asset allocation of 50 percent fixed income and 50 percent equities. The Investment Manager selects investment fund managers with demonstrated experience and expertise, and funds with demonstrated historical performance, for the implementation of the Plan's investment strategy. The Investment Manager will consider both actively and passively managed investment strategies and will allocate funds across the asset classes to develop an efficient investment structure.

Notes to Consolidated Financial Statements

Note 13. Employee Benefit Plans, continued

Grayson Plan, continued

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

Floyd Plan

The Company participates in the Pentegra Defined Benefit Plan for Financial Institutions (“The Pentegra DB Plan”), a tax-qualified defined-benefit pension plan. The Pentegra DB Plan operates as a multi-employer plan for accounting purposes and is a multiple-employer plan under the Employee Retirement Income Security Act of 1974 and the Internal Revenue Code. There are no collective bargaining agreements in place that require contributions to the Pentegra DB Plan.

The Pentegra DB Plan is a single plan under Internal Revenue Code Section 413 (C) and, as a result, all of the assets stand behind all of the liabilities. Accordingly, under the Pentegra DB Plan, contributions made by a participating employer may be used to provide benefits to participants of other participating employers.

Funded Status (market value of plan assets divided by funding target) as of July 1,

<u>Source</u>	<u>2020 Valuation Report</u>	<u>2019 Valuation Report</u>
Bank of Floyd Plan	101.27%	103.97%

Employer Contributions

Plan expenses paid by the Company totaled approximately \$63 thousand and \$64 thousand for the years ended December 31, 2020 and 2019, respectively.

VBA Defined Contribution Plan for Skyline National Bank

The Bank has established a qualified defined contribution plan that covers all eligible employees of the Bank who have completed at least three months of service. The Bank makes a safe harbor matching contribution of 100% of the first 3% of compensation and 50% on the next 2% of compensation, up to a maximum of 5%. Additional amounts may be contributed at the discretion of the Bank. Participants are immediately vested in their contributions and the Bank’s safe harbor matching and discretionary contributions. The Bank expensed \$450 thousand and \$492 thousand related to the defined contribution plan for the years ended December 31, 2020 and 2019, respectively.

Notes to Consolidated Financial Statements

Note 14. Deferred Compensation and Supplemental Executive Retirement Plans

Deferred compensation plans have been adopted for certain executive officers and members of the Board of Directors for future compensation upon retirement. Under plan provisions aggregate annual payments ranging from \$1,992 to \$37,200 are payable for ten years certain, generally beginning at age 65. Reduced benefits apply in cases of early retirement or death prior to the benefit date, as defined. The liability accrued for compensation deferred under the plan amounts to \$162 thousand and \$209 thousand at December 31, 2020 and 2019, respectively. Expense charged against income and included in salary and benefits expense was \$14 thousand and \$18 thousand in 2020 and 2019, respectively. Charges to income are based on changes in present value of future cash payments, discounted at 8 percent, consistent with prior years.

Supplemental executive retirement plans for certain executive officers were adopted in 2017. The plans provide for annual payments ranging from \$12,875 to \$80,000, payable in monthly installments, and continuing for the life of the executive. Reduced benefits apply in cases of early retirement. The liability accrued for this obligation was \$307 thousand and \$222 thousand at December 31, 2020 and 2019, respectively. Expense charged against income and included in salary and benefits expense was \$85 thousand and \$79 thousand in 2020 and 2019, respectively, for these supplemental executive retirement plans.

Prior to the Cardinal merger, the Bank of Floyd had adopted supplemental executive plans to provide benefits for two former members of management. Aggregate annual payments of \$69 thousand are payable for 20 years, beginning subsequent to the executive's last day of employment. The liability is calculated by discounting the anticipated future cash flows at 4.00%. The liability accrued for this obligation was \$688 thousand and \$728 thousand at December 31, 2020 and 2019, respectively. Charges to income amounted to approximately \$28 thousand and \$29 thousand for 2020 and 2019, respectively. These plans are unfunded, however, life insurance has been acquired in amounts sufficient to discharge the obligations of the agreements.

Note 15. Share-Based Compensation

The Parkway Acquisition Corp. 2020 Equity Incentive Plan (the "Plan") was adopted by the Board of Directors of the Company on March 17, 2020 and approved by the Company's shareholders on August 18, 2020 (the "Effective Date"). The Plan permits the grant of Incentive Stock Options, Nonqualified Stock Options, Restricted Stock, Restricted Stock Units, Stock Appreciation Rights, and Stock Awards to Key Employees of the Company or its Subsidiaries and the grant of Nonqualified Stock Options, Restricted Stock, Restricted Stock Units, Stock Appreciation Rights, and Stock Awards to Non-Employee Directors of the Company or its Subsidiaries.

The purpose of the Plan is to promote the success of the Company and its subsidiaries by providing incentives to Key Employees and Non-Employee Directors that will promote the identification of their personal interests with the long-term financial success of the Company and with growth in shareholder value, consistent with the Company's risk management practices. The Plan is designed to provide flexibility to the Company, including its Subsidiaries, in its ability to attract, retain the services of, and motivate Key Employees and Non-Employee Directors upon whose judgment, interest, and special effort the successful conduct of its operation is largely dependent.

The Plan was effective on the Effective Date, and no Award may be granted under the plan after March 16, 2030. Awards outstanding on such date shall remain valid in accordance with their terms. The Board of Directors shall have the right to terminate the Plan at any time pursuant to the terms of the Plan. The Compensation Committee of the Board of Directors has been appointed to administer the Plan. The maximum aggregate number of shares that may be issued pursuant to Awards made under the Plan shall not exceed 300,000 shares of common stock. No Awards were issued or exercised in 2020 and there were no Awards outstanding at December 31, 2020.

Notes to Consolidated Financial Statements

Note 16. Income Taxes

Current and Deferred Income Tax Components

The components of income tax expense (substantially all Federal) are as follows:

(dollars in thousands)	2020	2019
Current	\$ 1,586	\$ 1,189
Deferred	(141)	591
	<u>\$ 1,445</u>	<u>\$ 1,780</u>

Rate Reconciliation

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

(dollars in thousands)	2020	2019
Tax at statutory federal rate	\$ 1,536	\$ 1,877
Tax exempt interest income	(47)	(52)
Tax exempt insurance income	(94)	(92)
State income tax, net of federal benefit	35	48
Other	15	(1)
	<u>\$ 1,445</u>	<u>\$ 1,780</u>

Deferred Income Tax Analysis

The significant components of net deferred tax assets (all Federal) at December 31, 2020 and 2019 are summarized as follows:

(dollars in thousands)	2020	2019
<i>Deferred tax assets</i>		
Allowance for loan losses	\$ 1,054	\$ 838
Acquired loan credit mark	425	684
Deferred compensation	302	315
Investment impairment charge recorded directly to stockholders' equity as a component of other comprehensive income	47	47
Minimum pension liability	293	259
Net operating loss carryforward	1,555	1,666
Nonaccrual interest income	484	445
Purchase accounting adjustments	1	1
Other	57	103
	<u>\$ 4,218</u>	<u>\$ 4,358</u>
<i>Deferred tax liabilities</i>		
Deferred loan origination costs	91	365
Core deposit intangible	507	661
Accrued pension costs	1,206	1,113
Depreciation	1,239	1,059
Merger expenses	-	161
Net unrealized gains on securities available for sale	155	14
Accretion of discount on investment securities, net	1	-
	<u>\$ 3,199</u>	<u>\$ 3,373</u>
Net deferred tax asset	<u>\$ 1,019</u>	<u>\$ 985</u>

Notes to Consolidated Financial Statements

Note 16. Income Taxes, continued

In March of 2020, the CARES Act was enacted and made significant changes to federal tax laws, including certain changes that were retroactive to the December 31, 2019 tax year. Changes in tax laws are accounted for in the period of enactment and the retroactive effects were recognized in these financial statements. There were no material income tax consequences of this enacted legislation on the reporting period of these financial statements.

The Bank has analyzed the tax positions taken or expected to be taken in its tax returns and concluded it has no liability related to uncertain tax positions in accordance with applicable regulations. Tax returns for the years subsequent to 2017 remain subject to examination by both federal and state tax authorities.

Deferred tax assets or liabilities are initially recognized for differences between the financial statement carrying amount and the tax basis of assets and liabilities which will result in future deductible or taxable amounts and operating loss and tax credit carry-forwards. A valuation allowance is then established, as applicable, to reduce the deferred tax asset to the level at which it is “more likely than not” that the tax benefits will be realized. Sources of taxable income that may allow for the realization of tax benefits include (1) taxable income in the current year or prior years that is available through carry-back, (2) future taxable income that will result from the reversal of existing taxable temporary differences, and (3) taxable income generated by future operations. There is no valuation allowance for deferred tax assets as of December 31, 2020 and 2019. The net operating loss of approximately \$7.4 million, if not utilized will begin to expire in 2031. It is management’s belief that realization of the deferred tax asset is more likely than not.

Note 17. Transactions with Related Parties

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

Aggregate 2020 and 2019 loan transactions with related parties were as follows:

(dollars in thousands)	<u>2020</u>	<u>2019</u>
<i>Balance, beginning</i>	\$ 6,969	\$ 7,549
New loans	10,501	2,053
Repayments	(5,043)	(2,735)
Change in relationship	-	102
<i>Balance, ending</i>	<u>\$ 12,427</u>	<u>\$ 6,969</u>

The Company has accepted deposits during the ordinary course of business from certain directors and executive officers of the Company and from their affiliates and associates. The total amount of these deposits outstanding was \$18.9 million, and \$8.6 million at December 31, 2020 and 2019, respectively.

Notes to Consolidated Financial Statements

Note 18. Commitments and Contingencies

Litigation

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

Financial Instruments with Off-Balance Sheet Risk

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments. A summary of the Bank's commitments at December 31, 2020 and 2019 is as follows:

(dollars in thousands)

	<u>2020</u>	<u>2019</u>
Commitments to extend credit	\$ 111,778	\$ 95,190
Standby letters of credit	<u>1,260</u>	<u>1,313</u>
	<u>\$ 113,038</u>	<u>\$ 96,503</u>

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

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

Concentrations of Credit Risk

Substantially all of the Bank's loans, commitments to extend credit, and standby letters of credit have been granted to customers in the Bank's market area and such customers are generally depositors of the Bank. Investments in state and municipal securities involve governmental entities within and outside the Bank's market area. The concentrations of credit by type of loan are set forth in Note 4. The distribution of commitments to extend credit approximates the distribution of loans outstanding. Standby letters of credit are granted primarily to commercial borrowers. The Bank's primary focus is toward small business and consumer transactions, and accordingly, it does not have a significant number of credits to any single borrower or group of related borrowers in excess of \$5,000,000. The Bank has cash and cash equivalents on deposit with financial institutions which exceed federally insured limits.

Notes to Consolidated Financial Statements

Note 19. Regulatory Restrictions

Dividends

The Company's dividend payments are generally made from dividends received from the Bank. Under applicable federal law, the Comptroller of the Currency restricts national bank total dividend payments in any calendar year to net profits of that year, as defined, combined with retained net profits for the two preceding years. The Comptroller also has authority under the Financial Institutions Supervisory Act to prohibit a national bank from engaging in an unsafe or unsound practice in conducting its business. It is possible, under certain circumstances, the Comptroller could assert that dividends or other payments would be an unsafe or unsound practice.

Intercompany Transactions

The Bank's legal lending limit on loans to the Company is governed by Federal Reserve Act 23A, and differs from legal lending limits on loans to external customers. Generally, a bank may lend up to 10 percent of its capital and surplus to its Parent, if the loan is secured. If collateral is in the form of stocks, bonds, debentures or similar obligations, it must have a market value when the loan is made of at least 20 percent more than the amount of the loan, and if obligations of a state or political subdivision or agency thereof, it must have a market value of at least 10 percent more than the amount of the loan. If such loans are secured by obligations of the United States or agencies thereof, or by notes, drafts, bills of exchange or bankers' acceptances eligible for rediscount or purchase by a Federal Reserve Bank, requirements for collateral in excess of the loan amount do not apply. Under this definition, the legal lending limit for the Bank on loans to the Company was approximately \$8.4 million at December 31, 2020. No 23A transactions were deemed to exist between the Company and the Bank at December 31, 2020.

Capital Requirements

The Bank is subject to various regulatory capital requirements administered by federal and state banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory - and possibly additional discretionary - actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of 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.

Effective January 1, 2015, the federal banking regulators adopted rules to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rules required the Bank to comply with the following minimum capital ratios: (i) a common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets; (iii) a total capital ratio of 8% of risk-weighted assets; and (iv) a leverage ratio of 4% of total assets. As fully phased in on January 1, 2019, the rules require the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7%), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio, effectively resulting in a minimum Tier 1 capital ratio of 8.5%), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio, effectively resulting in a minimum total capital ratio of 10.5%), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

Under Basel III Capital requirements, a capital conservation buffer of 0.625% became effective beginning on January 1, 2016. The capital conservation buffer was gradually increased through January 1, 2019 to 2.50%. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banks are now required to maintain levels that meet the required minimum plus the capital conservation buffer in order to make distributions, such as dividends, or discretionary bonus payments. The Banks's capital conservation buffer is 5.10% as of December 31, 2020.

Notes to Consolidated Financial Statements

Note 19. Regulatory Restrictions, continued

Capital Requirements, continued

The rules also revised the prompt corrective action framework, which is designed to place restrictions on insured depository institutions if their capital levels begin to show signs of weakness. Under the prompt corrective action requirements, which are designed to complement the capital conservation buffer, insured depository institutions are required to meet the following capital level requirements in order to qualify as “well capitalized:” a common equity Tier 1 capital ratio of 6.5%; a Tier 1 capital ratio of 8%; a total capital ratio of 10%; and a Tier 1 leverage ratio of 5%.

The Company meets eligibility criteria of a small bank holding company in accordance with the Federal Reserve Board’s Small Bank Holding Company Policy Statement, and is not obligated to report consolidated regulatory capital. The Bank’s actual capital amounts and ratios are presented in the following table as of December 31, 2020 and 2019. These ratios comply with Federal Reserve rules to align with the Basel III Capital requirements effective January 1, 2015.

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well-Capitalized</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
<u>December 31, 2020</u>						
Total Capital						
(to risk weighted assets)	\$ 84,176	13.10%	\$ 51,409	8.00%	\$ 64,261	10.00%
Tier 1 Capital						
(to risk weighted assets)	\$ 79,240	12.33%	\$ 38,557	6.00%	\$ 51,409	8.00%
Common Equity Tier 1						
(to risk weighted assets)	\$ 79,240	12.33%	\$ 28,918	4.50%	\$ 41,770	6.50%
Tier 1 Capital						
(to average total assets)	\$ 79,240	9.50%	\$ 33,354	4.00%	\$ 41,692	5.00%
<u>December 31, 2019</u>						
Total Capital						
(to risk weighted assets)	\$ 78,652	13.53%	\$ 46,499	8.00%	\$ 58,124	10.00%
Tier 1 Capital						
(to risk weighted assets)	\$ 74,726	12.86%	\$ 34,874	6.00%	\$ 46,499	8.00%
Common Equity Tier 1						
(to risk weighted assets)	\$ 74,726	12.86%	\$ 26,156	4.50%	\$ 37,780	6.50%
Tier 1 Capital						
(to average total assets)	\$ 74,726	10.80%	\$ 27,680	4.00%	\$ 34,599	5.00%

On September 17, 2019 the Federal Deposit Insurance Corporation finalized a rule that introduces an optional simplified measure of capital adequacy for qualifying community banking organizations (i.e., the community bank leverage ratio (“CBLR”) framework; as required by the Economic Growth, Regulatory Relief and Consumer Protection Act. The CBLR framework is designed to reduce burden by removing the requirements for calculating and reporting risk-based capital ratios for qualifying community banking organizations that opt into the framework.

In order to qualify for the CBLR framework, a community banking organization must have a Tier 1 leverage ratio of greater than 9.00%, less than \$10.0 billion in total consolidated assets, and limited amounts of off-balance sheet exposures and trading assets and liabilities. A qualifying community banking organization that opts into the CBLR framework and meets all requirements under the framework will be considered to have met the well-capitalized ratio requirements under the prompt corrective action regulations and will not be required to report or calculated risk-based capital. The CBLR rules were temporarily modified in response to COVID-19. See “Government Supervision and Regulation – CARES Act” in Item 1 of this Annual Report on Form 10-K.

The CBLR framework was available for banks to use in their December 31, 2020, Call Report. At this time the Company has elected not to opt into the CBLR framework for the Bank, but may opt into the CBLR framework in the future.

Notes to Consolidated Financial Statements

Note 20. Parent Company Financial Information

Condensed financial information of Parkway Acquisition Corp. is presented as follows:

Balance Sheets *December 31, 2020 and 2019*

(dollars in thousands)	<u>2020</u>	<u>2019</u>
<i>Assets</i>		
Cash and due from banks	\$ 31	\$ 52
Federal funds sold	-	532
Investment in affiliate bank	84,778	80,587
Other assets	<u>325</u>	<u>326</u>
Total assets	<u>\$ 85,134</u>	<u>\$ 81,497</u>
<i>Liabilities</i>		
Other liabilities	<u>\$ 28</u>	<u>\$ 69</u>
<i>Stockholders' Equity</i>		
Common stock	-	-
Surplus	39,740	40,752
Retained earnings	45,887	41,600
Accumulated other comprehensive loss	<u>(521)</u>	<u>(924)</u>
Total stockholders' equity	<u>85,106</u>	<u>81,428</u>
Total liabilities and stockholders' equity	<u>\$ 85,134</u>	<u>\$ 81,497</u>

Statements of Income *For the years ended December 31, 2020 and 2019*

(dollars in thousands)	<u>2020</u>	<u>2019</u>
<i>Income</i>		
Dividends from affiliate bank	\$ 2,133	\$ 1,484
Federal funds sold	<u>2</u>	<u>3</u>
	<u>2,135</u>	<u>1,487</u>
<i>Expenses</i>		
Management and professional fees	51	74
Other expenses	<u>17</u>	<u>5</u>
	<u>68</u>	<u>79</u>
Income before tax benefit and equity in undistributed income of affiliate	2,067	1,408
<i>Federal income tax benefit</i>	<u>14</u>	<u>16</u>
Income before equity in undistributed income of affiliate	2,081	1,424
<i>Equity in undistributed income of affiliate</i>	<u>3,788</u>	<u>5,731</u>
Net income	<u>\$ 5,869</u>	<u>\$ 7,155</u>

Notes to Consolidated Financial Statements

Note 20. Parent Company Financial Information, continued

Statements of Cash Flows
For the years ended December 31, 2020 and 2019

(dollars in thousands)	<u>2020</u>	<u>2019</u>
<i>Cash flows from operating activities</i>		
Net income	\$ 5,869	\$ 7,155
Adjustments to reconcile net income to net cash provided by operations:		
Equity in undistributed income of affiliate	(3,788)	(5,731)
Change in other assets	1	142
Change in other liabilities	(41)	1
Net cash provided by operating activities	<u>2,041</u>	<u>1,567</u>
<i>Cash flows from financing activities</i>		
Common stock repurchased	(1,012)	(908)
Dividends paid	<u>(1,582)</u>	<u>(1,484)</u>
Net cash used by financing activities	<u>(2,594)</u>	<u>(2,392)</u>
Net decrease in cash and cash equivalents	(553)	(825)
<i>Cash and cash equivalents, beginning</i>	<u>584</u>	<u>1,409</u>
<i>Cash and cash equivalents, ending</i>	<u>\$ 31</u>	<u>\$ 584</u>

Note 21. Subsequent Events

Subsequent events are events or transactions that occur after the balance sheet date but before financial statements are issued. Recognized subsequent events are events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements. Non-recognized subsequent events are events that provide evidence about conditions that did not exist at the date of the balance sheet but arose after that date. Management has reviewed the events occurring through the date the consolidated financial statements were issued and, other than what is disclosed below, no subsequent events occurred requiring accrual or disclosure.

The Bank is participating in the next round of SBA-PPP loans that began in 2021 and has received approval on approximately \$32.2 million in funding as of March 19, 2021.

Management's Discussion and Analysis

Management's Discussion and Analysis of Operations

Overview

Management's Discussion and Analysis is provided to assist in the understanding and evaluation of Parkway Acquisition Corp's. financial condition and its results of operations. The following discussion should be read in conjunction with the Company's consolidated financial statements.

Parkway Acquisition Corp. ("Parkway" or the "Company") was incorporated as a Virginia corporation on November 2, 2015. Parkway was formed as a business combination shell company for the purpose of completing a business combination transaction between Grayson Bankshares, Inc. ("Grayson") and Cardinal Bankshares Corporation ("Cardinal"). On November 6, 2015, Grayson, Cardinal and Parkway entered into an agreement pursuant to which Grayson and Cardinal merged with and into Parkway, with Parkway as the surviving corporation (the "Cardinal merger"). The merger agreement established exchange ratios under which each share of Grayson common stock was converted to the right to receive 1.76 shares of common stock of Parkway, while each share of Cardinal common stock was converted to the right to receive 1.30 shares of common stock of Parkway. The exchange ratios resulted in Grayson shareholders receiving approximately 60% of the newly issued Parkway shares and Cardinal shareholders receiving approximately 40% of the newly issued Parkway shares. The Cardinal merger was completed on July 1, 2016. Grayson was considered the acquiror and Cardinal was considered the acquiree in the transaction for accounting purposes. Upon completion of the Cardinal merger, the Bank of Floyd, a wholly-owned subsidiary of Cardinal, was merged with and into Grayson National Bank (the "Bank"), a wholly-owned subsidiary of Grayson. Effective March 13, 2017, the Bank changed its name to Skyline National Bank.

On March 1, 2018, Parkway entered into a definitive agreement pursuant to which Parkway acquired Great State Bank ("Great State"), based in Wilkesboro, North Carolina. The agreement provided for the merger of Great State with and into the Bank, with the Bank as the surviving bank (the "Great State merger"). The transaction closed and the merger became effective on July 1, 2018. Each share of Great State common stock was converted into the right to receive 1.21 shares of Parkway common stock. The Company issued 1,191,899 shares and recognized \$15.5 million in surplus in the Great State merger. Parkway was considered the acquiror and Great State was considered the acquiree in the transaction for accounting purposes.

The Bank was organized under the laws of the United States in 1900 and now serves the Virginia counties of Grayson, Floyd, Carroll, Wythe, Montgomery and Roanoke, and the North Carolina counties of Alleghany, Ashe, Burke, Caldwell, Catawba, Cleveland, Davie, Watauga, Wilkes, and Yadkin, and the surrounding areas, through twenty-four full-service banking offices and two loan production offices. As an Federal Deposit Insurance Corporation ("FDIC") insured national banking association, the Bank is subject to regulation by the Comptroller of the Currency and the FDIC. Parkway is regulated by the Board of Governors of the Federal Reserve System.

For purposes of this annual report, all information contained herein as of and for periods prior to July 1, 2016 reflects the operations of Grayson prior to the Cardinal merger. Unless this report otherwise indicates or the context otherwise requires, all references to "Parkway" or the "Company" as of and for periods subsequent to July 1, 2016 refer to the combined company and its subsidiary as a combined entity after the Cardinal merger, and all references to the "Company" as of and for periods prior to July 1, 2016 are references to Grayson and its subsidiary as a combined entity prior to the Cardinal merger. All information contained herein as of and for periods prior to July 1, 2018 reflects the operations of Parkway prior to the Great State merger. Unless this report otherwise indicates or the context otherwise requires, all references to "Parkway" or the "Company" as of and for periods subsequent to July 1, 2018 refer to the combined company and its subsidiary as a combined entity after the Great State merger, and all references to "Parkway" or the "Company" as of and for periods prior to July 1, 2018 are references to Parkway and its subsidiary as a combined entity prior to the merger.

Management's Discussion and Analysis

Parkway had net earnings of \$5.9 million for 2020 compared to \$7.2 million for 2019. Earnings in 2020 were impacted significantly by the COVID-19 pandemic and the branch expansion into North Carolina markets during 2020. Earnings for the year ended December 31, 2020 represented a return on average assets of 0.75% and a return on average equity of 7.06%, compared to 1.05% and 9.10%, respectively, for the year ended December 31, 2019. The net interest margin was 3.96% in 2020, compared to 4.51% in 2019. The net interest margin compression is a reflection of the exceptionally low interest rate environment due to swift reductions in short term interest rates late in the first quarter of 2020 as well as continual competitive pressure on loan rates.

Forward Looking Statements

From time to time, the Company and its senior managers have made and will make forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such statements may be contained in this report and in other documents that the Company files with the Securities and Exchange Commission. Such statements may also be made by the Company and its senior managers in oral or written presentations to analysts, investors, the media and others. Forward-looking statements can be identified by the fact that they do not relate strictly to historical or current facts. Also, forward-looking statements can generally be identified by words such as “may,” “could,” “should,” “would,” “believe,” “anticipate,” “estimate,” “seek,” “expect,” “intend,” “plan” and similar expressions.

Forward-looking statements provide management's expectations or predictions of future conditions, events or results. They are not guarantees of future performance. By their nature, forward-looking statements are subject to risks and uncertainties. These statements speak only as of the date they are made. The Company does not undertake to update forward-looking statements to reflect the impact of circumstances or events that arise after the date the forward-looking statements were made. There are a number of factors, many of which are beyond the Company's control that could cause actual conditions, events or results to differ significantly from those described in the forward-looking statements. These factors, some of which are discussed elsewhere in this report, include:

- any required increase in our regulatory capital ratios;
- inflation, interest rate levels and market and monetary fluctuations;
- the difficult market conditions in our industry;
- trade, monetary and fiscal policies and laws, including interest rate policies of the federal government;
- applicable laws and regulations and legislative or regulatory changes;
- the timely development and acceptance of new products and services of the Company;
- the willingness of customers to substitute competitors' products and services for the Company's products and services;
- the financial condition of the Company's borrowers and lenders;
- the Company's success in gaining regulatory approvals, when required;
- technological and management changes;
- growth and acquisition strategies;
- the Company's critical accounting policies and the implementation of such policies;
- lower-than-expected revenue or cost savings or other issues in connection with mergers and acquisitions and branch expansion;
- changes in consumer spending and saving habits;
- the strength of the United States economy in general and the strength of the local economies in which the Company conducts its operations;
- the effects of the COVID-19 pandemic, including the Company's credit quality and business operations, as well as its impact on general economic and financial market conditions; and,
- the Company's success at managing the risks involved in the foregoing.

Management's Discussion and Analysis

Critical Accounting Policies

The Company's financial statements are prepared in accordance with accounting principles generally accepted in the United States ("GAAP"). The notes to the audited consolidated financial statements included in the Annual Report for the year ended December 31, 2020 contain a summary of its significant accounting policies. Management believes the Company's policies with respect to the methodology for the determination of the allowance for loan losses, and asset impairment judgments, such as the recoverability of intangible assets and other-than-temporary impairment of investment securities, involve a higher degree of complexity and require management to make difficult and subjective judgments that often require assumptions or estimates about highly uncertain matters. Accordingly, management considers the policies related to those areas as critical.

The allowance for loan losses is an estimate of the losses that may be sustained in the loan portfolio. The allowance is based on two basic principles of accounting: the first of which requires that losses be accrued when they are probable of occurring and estimable, and the second, which requires that losses be accrued based on the differences between the value of collateral, present value of future cash flows or values that are observable in the secondary market, and the loan balance.

The allowance for loan losses has three basic components: (i) the formula allowance, (ii) the specific allowance, and (iii) the unallocated allowance. Each of these components is determined based upon estimates that can and do change when the actual events occur. The formula allowance uses a historical loss view as an indicator of future losses and, as a result, could differ from the loss incurred in the future. However, since this history is updated with the most recent loss information, the errors that might otherwise occur are mitigated. The specific allowance uses various techniques to arrive at an estimate of loss. Historical loss information, expected cash flows and fair market value of collateral are used to estimate these losses. The use of these techniques is inherently subjective and our actual losses could be greater or less than the estimates. The unallocated allowance captures losses that are attributable to various economic events, industry or geographic sectors whose impact on the portfolio have occurred but have yet to be recognized in either the formula or specific allowance.

Management's Discussion and Analysis

Table 1. Net Interest Income and Average Balances (dollars in thousands)

	2020			2019			2018		
	Average Balance	Interest Income/Expense	Yield/Cost	Average Balance	Interest Income/Expense	Yield/Cost	Average Balance	Interest Income/Expense	Yield/Cost
Interest-earning assets:									
Interest-bearing deposits	\$ 45,758	\$ 214	0.47%	\$ 19,082	\$ 288	1.51%	\$ 9,365	\$ 106	1.13%
Federal funds sold	639	3	0.47%	9,413	249	2.65%	10,584	228	2.15%
Investment securities	32,976	757	2.30%	42,915	1,088	2.54%	50,504	1,278	2.53%
Loans ^{1, 2}	634,755	30,770	4.85%	548,611	29,177	5.32%	476,900	24,574	5.15%
Total	714,128	31,744		620,021	30,802		547,353	26,186	
Yield on average interest-earning assets			4.45%			4.97%			4.78%
Non interest-earning assets:									
Cash and due from banks	10,211			8,364			8,218		
Premises and equipment	26,044			21,383			19,055		
Interest receivable and other	38,130			37,310			35,400		
Allowance for loan losses	(4,474)			(3,768)			(3,435)		
Unrealized gain/(loss) on securities	530			(263)			(1,283)		
Total	70,441			63,026			57,955		
Total assets	\$ 784,569			\$ 683,047			\$ 605,308		
Interest-bearing liabilities:									
Demand deposits	\$ 145,068	328	0.23%	\$ 128,645	301	0.23%	\$ 115,409	194	0.17%
Savings deposits	138,344	415	0.30%	124,441	389	0.31%	117,479	347	0.30%
Time deposits	192,519	2,604	1.35%	184,501	2,162	1.17%	163,932	1,326	0.81%
Borrowings	12,894	93	0.72%	3,077	17	0.55%	1,757	34	1.94%
Total	488,825	3,440		440,664	2,869		398,577	1,901	
Cost on average interest-bearing liabilities			0.70%			0.65%			0.48%
Non interest-bearing liabilities:									
Demand deposits	208,530			160,858			139,409		
Interest payable and other	4,038			2,913			2,826		
Total	212,568			163,771			142,235		
Total liabilities	701,393			604,435			540,812		
Stockholder's equity:	83,176			78,612			64,496		
Total liabilities and stockholder's equity	\$ 784,569			\$ 683,047			\$ 605,308		
Net interest income		\$ 28,304		\$ 27,933			\$ 24,285		
Net yield on interest-earning assets			3.96%			4.51%			4.44%

¹ Includes nonaccrual loans

² Interest income includes loan fees

Management's Discussion and Analysis

Table 2. Rate/Volume Variance Analysis (dollars in thousands)

	2020 Compared to 2019			2019 Compared to 2018		
	Interest Income/ Expense Variance	Variance Attributable To ⁽¹⁾		Interest Income/ Expense Variance	Variance Attributable To ⁽¹⁾	
		Rate	Volume		Rate	Volume
Interest-earning assets:						
Interest bearing deposits	\$ (74)	\$ 72	\$ (146)	\$ 182	\$ 44	\$ 138
Federal funds sold	(246)	(115)	(131)	21	40	(19)
Investment securities	(331)	(96)	(235)	(190)	2	(192)
Loans	1,593	(2,059)	3,652	4,603	810	3,793
Total	942	(2,198)	3,140	4,616	896	3,720
Interest-bearing liabilities:						
Demand deposits	27	(10)	37	107	83	24
Savings deposits	26	(15)	41	42	21	21
Time deposits	442	345	97	836	653	183
Borrowings	76	7	69	(17)	330	(347)
Total	571	327	244	968	1,087	(119)
Net interest income	\$ 371	\$ (2,525)	\$ 2,896	\$ 3,648	\$ (191)	\$ 3,839

(1) The variance in interest attributed to both volume and rate has been allocated to variance attributed to volume and variance attributed to rate in proportion to the absolute value of the change in each.

Net Interest Income

Net interest income, the principal source of Company earnings, is the amount of income generated by earning assets (primarily loans and investment securities) less the interest expense incurred on interest-bearing liabilities (primarily deposits used to fund earning assets). Table 1 summarizes the major components of net interest income for the past three years and also provides yields and average balances.

For the year ended December 31, 2020 total interest income increased by \$942 thousand compared to the year ended December 31, 2019. The increase in interest income in 2020 was primarily due to organic loan growth in new and existing markets of \$44.6 million and \$81.9 million of SBA-PPP loans originated in 2020; however, yields were negatively impacted by the exceptionally low interest rate environment due to swift reductions in short term interest rates late in the first quarter of 2020 as well as continual competitive pressure on loan rates. As a result interest income on loans increased by \$1.6 million in 2020 compared to \$4.6 million in 2019. Accretion of purchased loan discounts increased interest income by \$1.2 million in 2020 compared to \$1.8 million in 2019, representing a decrease of \$592 thousand. The decreases in interest income on federal funds sold, investment securities, and interest-bearing deposits in banks were due to the impact of short term interest rates decreases discussed above. Interest expense on deposits increased by \$495 thousand for the year ended December 31, 2020 compared to the same period last year due to the addition of \$78.4 million in interest-bearing deposits from 2019 to 2020. A significant portion of the growth in interest-bearing deposits year-over-year is attributed to increased balances held by customers during the pandemic, new relationships developed from the SBA-PPP program, as well as organic growth in new and existing markets.

Amortization of premiums on acquired time deposits, which reduces interest expense, totaled \$189 thousand in 2020, compared to \$384 thousand in 2019, representing a decrease of \$195 thousand. The effects of changes in volumes and rates on net interest income in 2020 compared to 2019, and 2019 compared to 2018 are shown in Table 2.

Management's Discussion and Analysis

The aforementioned factors led to an increase in net interest income of \$371 thousand or 1.33% for 2020 as compared to 2019. The net yield on interest-earning assets decreased by 55 basis points to 3.96% in 2020 compared to 4.51% in 2019.

Provision for Credit Losses

The allowance for credit losses is established to provide for expected losses in the Company's loan portfolio. Management determines the provision for credit losses required to maintain an allowance adequate to provide for probable losses. Some of the factors considered in making this decision are the levels and collectability of past due loans, volume of new loans, composition of the loan portfolio, and general economic outlook.

The provision for loan losses was \$1.2 million for the year ended December 31, 2020, compared to \$655 thousand for the year ended December 31, 2019. The increase in loan loss provisions from 2019 to 2020 was due primarily to overall growth in the loan portfolio due to organic growth of \$44.6 million in new and existing markets, excluding SBA-PPP loans originated, as well as management's assessment of the impact of the COVID-19 pandemic on certain qualitative and environmental factors.

The allowance for loan losses for SBA-PPP loans originated during 2020 were separately evaluated given the explicit government guarantee. This analysis, which incorporated historical experience with similar SBA guarantees and underwriting, concluded the likelihood of loss was remote and therefore these loans were assigned a zero expected credit loss in the allowance for loan losses.

The reserve for loan losses at December 31, 2020 was approximately 0.74% of total loans, compared to 0.68% at December 31, 2019. Management's estimate of probable credit losses inherent in the acquired Great State and Cardinal loan portfolios was reflected as a purchase discount which will continue to be accreted into income over the remaining life of the acquired loans. As of December 31, 2020 and 2019, the remaining unaccreted discount on the acquired loan portfolios totaled \$2.0 million and \$3.2 million, respectively. Management believes the provision and the resulting allowance for loan losses are adequate. Additional information is contained in Tables 12 and 13, and is discussed in Nonperforming and Problem Assets.

Other Income

Noninterest income growth was a key factor in the Company's 2020 financial results as year-over-year net interest margins were negatively impacted by the low interest rate environment, and the Fed's lowering of rates paid on overnight funds. Noninterest income increased by \$382 thousand in 2020 compared to 2019, despite the decrease of \$211 thousand in service charges on deposit accounts, due to reduced consumer spending as well as increased balances held by our customers. Mortgage origination fees increased by \$261 thousand in 2020 compared to 2019. The mortgage department closed approximately \$43.5 million of mortgage loans for the secondary market during 2020 compared to \$24.0 million in 2019. Gains from sales of available-for-sale securities totaled \$315 thousand for the year ended December 31, 2020 compared to \$49 thousand for the year ended December 31, 2019. Noninterest income increased by \$278 thousand in 2019 compared to 2018. The increase was due to growth and expansion of fee-based products and a change in overdraft fees. Included in other income are nonrecurring gains from sale of bank premises and equipment totaling \$122 thousand in 2019. There were no nonrecurring gains from sale of bank premises and equipment in 2020 or 2018.

Management's Discussion and Analysis

Table 3. Sources of Noninterest Income (dollars in thousands)

	<u>2020</u>	<u>2019</u>	<u>2018</u>
Service charges on deposit accounts	\$ 1,441	\$ 1,652	\$ 1,538
Increase in cash value of life insurance	449	442	433
Life insurance income	-	-	303
Mortgage originations fees	720	459	396
Safe deposit box rental	90	91	93
Gain on securities	315	49	5
ATM income	1,613	1,465	1,324
Investment services income	35	62	126
Merchant services income	191	190	171
Interchange income	186	196	126
Other income	257	309	122
Total noninterest income	<u>\$ 5,297</u>	<u>\$ 4,915</u>	<u>\$ 4,637</u>

Other Expense

The major components of noninterest expense for the past three years are illustrated at Table 4.

Total noninterest expenses increased by \$1.8 million, or 7.91% for the year ended December 31, 2020, compared to the year ended December 31, 2019 reflecting additional costs associated with branching activities into new North Carolina markets. Salary and benefit cost increased by \$1.4 million due to the increase in full time equivalent employees from December 31, 2019 to December 31, 2020. Occupancy and equipment expenses increased by \$287 thousand and data processing expenses increased by \$219 thousand from 2019 to 2020, due to the addition of three branch facilities in 2020. FDIC/OCC assessments increased by \$171 thousand for the year ended December 31, 2020 compared to the year ended December 31, 2019 due to the Small Bank Assessment Credits received from the FDIC in 2019. This increase was offset by a decrease in amortization of core deposit intangibles of \$111 thousand for the year ended December 31, 2020, compared to same period in 2019.

Management's Discussion and Analysis

Table 4. Sources of Noninterest Expense (dollars in thousands)

	<u>2020</u>	<u>2019</u>	<u>2018</u>
Salaries & wages	\$ 11,347	\$ 10,277	\$ 9,034
Employee benefits	<u>3,256</u>	<u>2,968</u>	<u>2,768</u>
Total personnel expense	14,603	13,245	11,802
Director fees	361	356	370
Occupancy expense	1,596	1,389	1,260
Data processing expense	1,765	1,546	1,353
Other equipment expense	1,029	1,047	988
FDIC/OCC assessments	383	212	390
Insurance	138	131	121
Professional fees	462	667	452
Advertising	683	603	569
Postage & freight	429	396	362
Supplies	279	223	212
Franchise tax	505	438	438
Telephone	370	371	415
Travel, dues & meetings	418	509	490
ATM expense	615	517	423
Foreclosure expenses	2	3	32
Core deposit intangible amortization	711	822	578
Merger related expenses	-	-	1,978
Other expense	<u>749</u>	<u>783</u>	<u>624</u>
Total noninterest expense	<u>\$ 25,098</u>	<u>\$ 23,258</u>	<u>\$ 22,857</u>

The overhead efficiency ratio of noninterest expense to adjusted total revenue (net interest income plus noninterest income) was 74.69% in 2020, 70.80% in 2019, and 79.03% in 2018. The ratio for 2018, without the effect of nonrecurring merger related costs, would have been 72.19%.

Income Taxes

Income tax expense is based on amounts reported in the statements of income (after adjustments for non-taxable income and non-deductible expenses) and consists of taxes currently due plus deferred taxes on temporary differences in the recognition of income and expense for tax and financial statement purposes. The deferred tax assets and liabilities represent the future Federal income tax return consequences of those differences, which will either be taxable or deductible when the assets and liabilities are recovered or settled.

Income tax expense (substantially all Federal) was \$1.4 million in 2020 and \$1.8 million in 2019, resulting in effective tax rates of 19.8% and 19.9%, respectively. The decrease in income tax expense of \$335 thousand in 2020 was primarily due to the decreased in income before taxes of \$1.6 million in 2020 compared to 2019.

Net deferred tax assets of \$1.0 million, and \$985 thousand existed at December 31, 2020 and 2019 respectively. At December 31, 2020, net deferred tax assets included \$155 thousand of deferred tax assets applicable to unrealized gains on investment securities available for sale, and \$293 thousand of deferred tax assets applicable to unfunded projected pension benefit obligations. Accordingly, these amounts were not charged to income but recorded directly to the related stockholders' equity account.

Management's Discussion and Analysis

Analysis of Financial Condition

Average earning assets increased 15.18% from 2019 to 2020 due to asset growth primarily reflected in increased loans, including SBA-PPP loans, and higher liquid asset balances due to deposit growth. Total earning assets represented 91.02% of total average assets in 2020 and 90.77% in 2019. The mix of average earning assets changed from 2019 to 2020 as average loans increased by \$86.1 million, or 15.70%, average investment securities decreased by \$9.9 million, or 23.16%, average federal funds sold decreased by \$8.8 million, or 93.21%, and deposits in other banks increased by \$26.7 million of 139.80%.

Table 5. Average Asset Mix (dollars in thousands)

	2020		2019	
	Average Balance	%	Average Balance	%
Earning assets:				
Loans	\$ 634,755	80.91%	\$ 548,611	80.32%
Investment securities	32,976	4.20%	42,915	6.28%
Federal funds sold	639	0.08%	9,413	1.38%
Deposits in other banks	45,758	5.83%	19,082	2.79%
Total earning assets	714,128	91.02%	620,021	90.77%
Non earning assets:				
Cash and due from banks	10,211	1.30%	8,364	1.23%
Premises and equipment	26,044	3.32%	21,383	3.13%
Other assets	38,130	4.86%	37,310	5.46%
Allowance for loan losses	(4,474)	-0.57%	(3,768)	-0.55%
Unrealized gain (loss) on securities	530	0.07%	(263)	-0.04%
Total nonearning assets	70,441	8.98%	63,026	9.23%
Total assets	\$ 784,569	100.00%	\$ 683,047	100.00%

Average loans for 2020 represented 80.91% of total average assets compared to 80.32% in 2019. Average federal funds sold decreased from 1.38% to 0.08% of total average assets while deposits in other banks increased from 2.79% to 5.83% of total average assets over the same time period. Average investment securities decreased from 6.28% in 2019 to 4.20% of total average assets in 2020. The balances of nonearning assets to total average assets decreased from 9.23% to 8.98%.

Management's Discussion and Analysis

Table 7. Maturity Schedule of Loans, as of December 31, 2020 (dollars in thousands)

	Real Estate	Commercial, Agricultural & SBA-PPP	Consumer & Other	Total	
				Amount	%
Fixed rate loans:					
Three months or less	\$ 7,942	\$ 906	\$ 3,832	\$ 12,680	1.91%
Over three to twelve months	14,618	2,651	478	17,747	2.67%
Over one to five years	99,934	67,119	9,121	176,174	26.53%
Over five years	44,501	3,671	1,700	49,872	7.51%
Total fixed rate loans	<u>\$ 166,995</u>	<u>\$ 74,347</u>	<u>\$ 15,131</u>	<u>\$ 256,473</u>	<u>38.62%</u>
Variable rate loans:					
Three months or less	\$ 5,196	\$ 1,892	\$ 100	\$ 7,188	1.08%
Over three to twelve months	12,661	5,809	113	18,583	2.80%
Over one to five years	11,003	1,243	260	12,506	1.88%
Over five years	366,426	1,490	1,429	369,345	55.62%
Total variable rate loans	<u>\$ 395,286</u>	<u>\$ 10,434</u>	<u>\$ 1,902</u>	<u>\$ 407,622</u>	<u>61.38%</u>
Total loans:					
Three months or less	\$ 13,138	\$ 2,798	\$ 3,932	\$ 19,868	2.99%
Over three to twelve months	27,279	8,460	591	36,330	5.47%
Over one to five years	110,937	68,362	9,381	188,680	28.41%
Over five years	410,927	5,161	3,129	419,217	63.13%
Total loans	<u>\$ 562,281</u>	<u>\$ 84,781</u>	<u>\$ 17,033</u>	<u>\$ 664,095</u>	<u>100.00%</u>

Interest rates charged on loans vary with the degree of risk, maturity and amount of the loan. Competitive pressures, money market rates, availability of funds, and government regulations also influence interest rates. On average, loans yielded 4.85% in 2020 compared to an average yield of 5.32% in 2019. The decrease in loan yields was due to increasing competition in our markets for loans, in addition to a generally lower interest rate environment and the low rate of SBA-PPP loans, as well as a reduction in the overall impact of purchase accounting adjustment as the accretion of purchase loan discounts decreased by \$370 thousand during 2020.

Investment Securities

The Company uses its investment portfolio to provide liquidity for unexpected deposit decreases or loan generation, to meet the Bank's interest rate sensitivity goals, and to generate income.

Management of the investment portfolio has always been conservative with the majority of investments taking the form of purchases of U.S. Treasury, U.S. Government Agencies, U.S. Government Sponsored Enterprises and State and Municipal bonds, as well as investment grade corporate bond issues. Management views the investment portfolio as a source of income, and purchases securities with the intent of retaining them until maturity. However, adjustments are necessary in the portfolio to provide an adequate source of liquidity which can be used to meet funding requirements for loan demand and deposit fluctuations and to control interest rate risk. Therefore, from time to time, management may sell certain securities prior to their maturity. Table 8 presents the investment portfolio at the end of 2020 by major types of investments and contractual maturity ranges. Investment securities in Table 8 may have repricing or call options that are earlier than the contractual maturity date. Yields on tax exempt obligations are not computed on a tax-equivalent basis in Table 8.

The total amortized cost of investment securities decreased by approximately \$46 thousand from December 31, 2019 to December 31, 2020, while the average balance of investment securities carried throughout the year decreased by approximately \$9.9 million from 2019 to 2020. The average yield of the investment portfolio decreased to 2.30% for the year ended December 31, 2020 compared to 2.54% for 2019.

Management's Discussion and Analysis

Table 8. Investment Securities - Maturity/Yield Schedule (dollars in thousands)

	December 31, 2020							
	In One Year or Less	After One Through Five Years	After Five Through Ten Years	After Ten Years	Book Value 12/31/20	Market Value 12/31/20	Book Value 12/31/19	Book Value 12/31/18
Investment securities:								
U.S. Government agencies	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 244
Mortgage-backed securities	-	969	5,678	8,565	15,212	15,684	19,540	25,627
Corporate securities	-	1,500	-	-	1,500	1,500	1,500	2,970
State and municipal securities	1,747	3,889	4,565	5,858	16,059	16,323	11,777	17,764
Total	<u>\$ 1,747</u>	<u>\$ 6,358</u>	<u>\$ 10,243</u>	<u>\$ 14,423</u>	<u>\$ 32,771</u>	<u>\$ 33,507</u>	<u>\$ 32,817</u>	<u>\$ 46,605</u>
Weighted average yields:								
U.S. Government agencies	0.00%	0.00%	0.00%	0.00%	0.00%			
Mortgage-backed securities	0.00%	2.15%	2.12%	1.48%	1.76%			
Corporate securities	0.00%	0.88%	0.00%	0.00%	0.88%			
State and municipal securities	3.85%	3.02%	1.77%	2.15%	2.44%			
Total	<u>3.85%</u>	<u>2.38%</u>	<u>1.97%</u>	<u>1.75%</u>	<u>2.05%</u>			

Deposits

The Company relies on deposits generated in its market area to provide the majority of funds needed to support lending activities and for investments in liquid assets. More specifically, core deposits (total deposits less certificates of deposit in denominations of \$100,000 or more) are the primary funding source. The Company's balance sheet growth is largely determined by the availability of deposits in its markets, the cost of attracting the deposits, and the prospects of profitably utilizing the available deposits by increasing the loan or investment portfolios. We believe that recent market conditions have resulted in depositors shopping for deposit rates more than in the past. An increased customer awareness of interest rates adds to the importance of rate management. The Company's management must continuously monitor market pricing, competitor's rates, and the internal interest rate spreads to maintain the Company's growth and profitability. The Company attempts to structure rates so as to promote deposit and asset growth while at the same time increasing overall profitability of the Company.

Average total deposits for the year ended December 31, 2020 amounted to \$684.5 million, which was an increase of \$86.0 million, or 14.37% from 2019. A significant portion of the increase is attributed to increased balances held by customers during the pandemic, new relationships developed from the SBA-PPP program, as well as organic growth in new and existing markets. Average core deposits totaled \$595.8 million in 2020 representing a 15.43% increase over the \$516.2 million in 2019. The percentage of the Company's average deposits that are interest-bearing decreased to 69.5% in 2020 compared to 73.1% in 2019 and 74.0% in 2018. This decrease is due to the average demand deposits, which earn no interest, increasing 29.64% from \$160.9 million in 2019 to \$208.5 million in 2020. Average deposits for the periods ended December 31, 2020, 2019, and 2018 are summarized in Table 9.

Management's Discussion and Analysis

Table 9. Deposit Mix (dollars in thousands)

	December 31, 2020			December 31, 2019		
	Average Balance	% of Total Deposits	Average Rate Paid	Average Balance	% of Total Deposits	Average Rate Paid
Interest-bearing deposits:						
Interest-bearing DDA accounts	\$ 86,696	12.7%	0.12%	\$ 75,498	12.6%	0.12%
Money market	58,372	8.5%	0.39%	53,147	8.9%	0.40%
Savings	138,344	20.2%	0.30%	124,441	20.8%	0.31%
Individual retirement accounts	44,044	6.5%	1.19%	44,581	7.5%	1.13%
Small denomination certificates	59,841	8.7%	1.24%	57,657	9.6%	1.06%
Large denomination certificates	88,634	12.9%	1.51%	82,263	13.7%	1.27%
Total interest-bearing deposits	475,931	69.5%	0.70%	437,587	73.1%	0.65%
Noninterest-bearing deposits	208,530	30.5%	0.00%	160,858	26.9%	0.00%
Total deposits	\$ 684,461	100.0%	0.49%	\$ 598,445	100.0%	0.48%

	December 31, 2018		
	Average Balance	% of Total Deposits	Average Rate Paid
Interest-bearing deposits:			
Interest-bearing DDA accounts	\$ 66,984	12.5%	0.10%
Money market	48,425	9.0%	0.26%
Savings	117,479	21.9%	0.30%
Individual retirement accounts	45,598	8.5%	0.99%
Small denomination certificates	55,700	10.4%	0.57%
Large denomination certificates	62,634	11.7%	0.89%
Total interest-bearing deposits	396,820	74.0%	0.47%
Noninterest-bearing deposits	139,409	26.0%	0.00%
Total deposits	\$ 536,229	100.0%	0.35%

The average balance of certificates of deposit issued in denominations of \$100,000 or more increased by \$6.4 million, or 7.74%, for the year ended December 31, 2020 compared to December 31, 2019. The strategy of management has been to support loan and investment growth with core deposits and not to aggressively solicit the more volatile, large denomination certificates of deposit. Loan growth in 2020 was primarily funded through core deposit growth, in addition to reductions in investment securities, thus reducing management's reliance on large denomination certificates of deposit for funding purposes. Table 10 provides maturity information relating to certificates of deposit of \$100,000 or more at December 31, 2020.

Table 10. Large Denomination Certificate of Deposit Maturities (dollars in thousands)

Analysis of certificates of deposit of \$100,000 or more at December 31, 2020:

Remaining maturity of three months or less	\$ 15,698
Remaining maturity over three months through six months	15,006
Remaining maturity over six months through twelve months	33,197
Remaining maturity over twelve months	26,874
Total certificates of deposit of \$100,000 or more	\$ 90,775

Management's Discussion and Analysis

Equity

Stockholders' equity totaled \$85.1 million at December 31, 2020 compared to \$81.4 million at December 31, 2019. The increase of \$3.7 million was due to earnings of \$5.9 million, plus other comprehensive income of \$403 thousand, less common stock repurchases of \$1.0 million, and the payment of dividends of \$1.6 million. Book value increased from \$13.27 per share at December 31, 2019 to \$14.08 per share at December 31, 2020.

Effective January 1, 2015, the federal banking regulators adopted rules to implement the Basel III regulatory capital reforms from the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rules required the Bank to comply with the following minimum capital ratios: (i) a new common equity Tier 1 capital ratio of 4.5% of risk-weighted assets; (ii) a Tier 1 capital ratio of 6% of risk-weighted assets; (iii) a total capital ratio of 8% of risk-weighted assets; and (iv) a leverage ratio of 4% of total assets. As fully phased in on January 1, 2019, the rules require the Bank to maintain (i) a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 4.5%, plus a 2.5% "capital conservation buffer" (which is added to the 4.5% common equity Tier 1 ratio, effectively resulting in a minimum ratio of common equity Tier 1 to risk-weighted assets of at least 7%), (ii) a minimum ratio of Tier 1 capital to risk-weighted assets of at least 6.0%, plus the 2.5% capital conservation buffer (which is added to the 6.0% Tier 1 capital ratio, effectively resulting in a minimum Tier 1 capital ratio of 8.5%), (iii) a minimum ratio of total capital to risk-weighted assets of at least 8.0%, plus the 2.5% capital conservation buffer (which is added to the 8.0% total capital ratio, effectively resulting in a minimum total capital ratio of 10.5%), and (iv) a minimum leverage ratio of 4%, calculated as the ratio of Tier 1 capital to average assets.

Under Basel III Capital requirements, a capital conservation buffer of 0.625% became effective beginning on January 1, 2016. The capital conservation buffer was gradually increased through January 1, 2019 to 2.50%. The capital conservation buffer is designed to absorb losses during periods of economic stress. Banks are now required to maintain levels that meet the required minimum plus the capital conservation buffer in order to make distributions, such as dividends, or discretionary bonus payments. The Bank's capital conservation buffer is 5.10% as of December 31, 2020.

Table 11. Bank's Year-end Risk-Based Capital (dollars in thousands)

	<u>2020</u>	<u>2019</u>
Tier 1 Capital	\$ 79,240	\$ 74,726
Unrealized gains on AFS preferred stock	-	-
Qualifying allowance for loan losses (limited to 1.25% of risk-weighted assets)	<u>4,936</u>	<u>3,926</u>
Total regulatory capital	<u>\$ 84,176</u>	<u>\$ 78,652</u>
Total risk-weighted assets	<u>\$ 642,612</u>	<u>\$ 581,235</u>
Tier 1 capital as a percentage of risk-weighted assets	12.3%	12.9%
Common Equity Tier 1 capital as a percentage of risk-weighted assets	12.3%	12.9%
Total regulatory capital as a percentage of risk-weighted assets	13.1%	13.5%
Leverage ratio*	9.5%	10.8%

* Tier 1 capital divided by average total assets for the quarter ended December 31 of each year.

Management's Discussion and Analysis

Nonperforming and Problem Assets

Certain credit risks are inherent in making loans, particularly commercial and consumer loans. Management prudently assesses these risks and attempts to manage them effectively. The Bank attempts to use shorter-term loans and, although a portion of the loans have been made based upon the value of collateral, the underwriting decision is generally based on the cash flow of the borrower as the source of repayment rather than the value of the collateral. The Bank also attempts to reduce repayment risk by adhering to internal credit policies and procedures. These policies and procedures include officer and customer limits, periodic loan documentation review and follow up on exceptions to credit policies.

Nonperforming assets at December 31, 2020, 2019, 2018, 2017, and 2016 are analyzed in Table 12.

Table 12. Nonperforming Assets (dollars in thousands)

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Nonperforming loans:					
Nonaccrual loans	\$ 4,803	\$ 4,979	\$ 5,579	\$ 5,335	\$ 4,664
Restructured loans	3,844	4,695	6,961	7,743	9,239
Purchased credit-impaired loans on accrual status	116	128	-	-	-
Loans past due 90 days or more and still accruing	-	-	-	-	-
Total nonperforming loans	<u>8,763</u>	<u>9,802</u>	<u>12,540</u>	<u>13,078</u>	<u>13,903</u>
Foreclosed assets	-	-	753	-	70
Total nonperforming assets	<u>\$ 8,763</u>	<u>\$ 9,802</u>	<u>\$ 13,293</u>	<u>\$ 13,078</u>	<u>\$ 13,973</u>
Total nonperforming loans as a percentage to total loans	<u>1.3%</u>	<u>1.7%</u>	<u>2.3%</u>	<u>3.1%</u>	<u>3.4%</u>
Total nonperforming assets as a percentage to total assets	<u>1.0%</u>	<u>1.4%</u>	<u>2.0%</u>	<u>2.4%</u>	<u>2.5%</u>

Total nonperforming loans were 1.3% and 1.7% of total outstanding loans as of December 31, 2020 and 2019, respectively. The majority of the decrease in nonaccrual loans from 2020 to 2019 came in the “commercial mortgage and farmland” categories. Nonaccrual loans in these categories decreased by \$344 thousand. Loans are placed in nonaccrual status when, in management’s opinion, the borrower may be unable to meet payments as they become due. When interest accrual is discontinued, all unpaid accrued interest is reversed. Loans are removed from nonaccrual status when they are deemed a loss and charged to the allowance, transferred to foreclosed assets, or returned to accrual status based upon performance consistent with the original terms of the loan or a subsequent restructuring thereof. Management’s ability to ultimately resolve these loans either with or without significant loss will be determined, to a great extent, by general economic and real estate market conditions.

For the years ended December 31, 2020 and 2019, interest income recognized on loans in nonaccrual status was approximately \$46 thousand and \$47 thousand, respectively. Had these credits been current in accordance with their original terms, the gross interest income for these credits would have been approximately \$210 thousand and \$196 thousand, respectively for the years ended December 31, 2020 and 2019.

Restructured loans represent troubled debt restructurings (“TDRs”) that have returned to accrual status after a period of performance in accordance with their modified terms. The decrease in restructured loans from 2019 to 2020 came primarily in the form of principal reductions. A TDR is considered to be successful if the borrower maintains adequate payment performance under the modified terms and is financially stable.

There were no foreclosed assets in 2020 and 2019. More information on nonperforming assets and loan modifications in response to COVID-19 can be found in Note 5 of the “Notes to Consolidated Financial Statements” found in the company’s 2020 Annual Report.

Management's Discussion and Analysis

As of December 31, 2020 and 2019 we had loans with a current principal balance of \$15.1 million and \$7.4 million rated "Watch" or "Special Mention". The increase was due primarily to loan risk rating reclassifications as a result of loans that had a COVID-19 loan deferment. The "Watch" classification is utilized by us when we have an initial concern about the financial health of a borrower that indicate above average risk. We then gather current financial information about the borrower and evaluate our current risk in the credit. After this review we will either move the loan to a higher risk rating category or move it back to its original risk rating. Loans may be left rated "Watch" for a longer period of time if, in management's opinion, there are risks that cannot be fully evaluated without the passage of time, and we want to review it on a more regular basis. Assets that do not currently expose the Bank to sufficient risk to warrant a classification such as "Substandard" or "Doubtful" but otherwise possess weaknesses are designated "Special Mention". Loans rated as "Watch" or "Special Mention" are not considered "potential problem loans" until they are determined by management to be classified as "Substandard". As of December 31, 2020, potential problem loans classified as substandard totaled \$11.9 million compared to \$13.4 million at December 31, 2019. Past due loans are often regarded as a precursor to further credit problems which would lead to future increases in nonaccrual loans or other real estate owned. As of December 31, 2020 loans past due 30-89 days and still accruing totaled \$622 thousand compared to \$1.1 million at December 31, 2019.

Certain types of loans, such as option ARM products, subprime loans and loans with initial teaser rates, can have a greater risk of non-collection than other loans. The Bank has not offered these types of loans in the past and does not offer them currently. Junior-lien mortgages can also be considered higher risk loans. Our junior-lien portfolio at December 31, 2020 totaled \$4.0 million, or 0.61% of total loans. The charge-off rates in this category do not vary significantly from other real estate secured loans in the current year.

The allowance for loan losses is maintained at a level adequate to absorb potential losses. Some of the factors which management considers in determining the appropriate level of the allowance for loan losses are: past loss experience, an evaluation of the current loan portfolio, identified loan problems, the loan volume outstanding, the present and expected economic conditions in general, and in particular, how such conditions relate to the market area that the Bank serves. Bank regulators also periodically review the Bank's loans and other assets to assess their quality. Loans deemed uncollectible are charged to the allowance. Provisions for loan losses and recoveries on loans previously charged off are added to the allowance. The reserve for loan losses at December 31, 2020 was approximately 0.74% of total loans, compared to 0.68% at December 31, 2019. Management's estimate of probable credit losses inherent in the acquired Great State loan portfolio was reflected as a purchase discount which will continue to be accreted into income over the remaining life of the acquired loans in addition to the previously acquired loan portfolio from the merger with Cardinal Bankshares Corporation. As of December 31, 2020 and 2019, the remaining unaccreted discount on the acquired loan portfolios totaled \$2.0 million and \$3.2 million, respectively. This remaining discount can be used for credit losses if a loss occurs on individual loans in the purchased portfolios.

To quantify the specific elements of the allowance for loan losses, the Bank begins by establishing a specific reserve for larger-balance, non-homogeneous loans, which have been identified as being impaired. This reserve is determined by comparing the principal balance of the loan with the net present value of the future anticipated cash flows or the fair market value of the related collateral. If the impaired loan is collateral dependent, then any excess in the recorded investment in the loan over the fair value of the collateral that is identified as uncollectible in the near term is charged off against the allowance for loan losses at that time. The bank also collectively evaluates for impairment smaller-balance TDRs. The specific component of the allowance for smaller-balance TDR loans is calculated on a pooled basis considering historical experience adjusted for qualitative factors. The bank then reviews certain loans in the portfolio and assigns grades to loans which have been reviewed. Loans which are adversely classified are given a specific allowance based on the historical loss experience of similar type loans in each adverse grade with further adjustments for external factors. The remaining portfolio is segregated into loan pools consistent with regulatory guidelines. An allocation is then made to the reserve for these loan pools based on the bank's historical loss experience with further adjustments for external factors. The allowance is allocated according to the amount deemed to be reasonably necessary to provide for the possibility of losses being incurred within the respective categories of loans, although the entire allowance is available to absorb any actual charge-offs that may occur.

Management's Discussion and Analysis

The provision for loan losses, net charge-offs, and the resulting allowance for loan losses, are detailed in Table 13. The allocation of the reserve for loan losses is detailed in Table 14.

Table 13. Analysis of the Allowance for Loan Losses (dollars in thousands)

	<u>2020</u>	<u>2019</u>	<u>2018</u>	<u>2017</u>	<u>2016</u>
Allowance for loan losses, beginning	\$ 3,893	\$ 3,495	\$ 3,453	\$ 3,420	\$ 3,418
Provision for (reduction of) loan losses, added	1,189	655	325	217	(5)
Charge-offs:					
Commercial and agricultural	(37)	(77)	(23)	(27)	(19)
Real estate – construction	(8)	-	(20)	(33)	(20)
Real estate – mortgage	(109)	(109)	(259)	(182)	(105)
Consumer and other	(148)	(212)	(175)	(76)	(70)
Recoveries:					
Commercial and agricultural	6	10	9	33	8
Real estate – construction	4	-	-	56	98
Real estate – mortgage	76	77	147	23	81
Consumer and other	34	54	38	22	34
Net (charge-offs) recoveries	<u>(182)</u>	<u>(257)</u>	<u>(283)</u>	<u>(184)</u>	<u>7</u>
Allowance for loan losses, ending	<u>\$ 4,900</u>	<u>\$ 3,893</u>	<u>\$ 3,495</u>	<u>\$ 3,453</u>	<u>\$ 3,420</u>
Ratio of net charge-offs during the period to average loans outstanding during the period	<u>0.03%</u>	<u>0.05%</u>	<u>0.06%</u>	<u>0.04%</u>	<u>0.00%</u>

Table 14. Allocation of the Allowance for Loan Losses (dollars in thousands)

	<u>December 31, 2020</u>		<u>December 31, 2019</u>		<u>December 31, 2018</u>	
	% of		% of		% of	
	<u>Amount</u>	<u>Loans to Total Loans</u>	<u>Amount</u>	<u>Loans to Total Loans</u>	<u>Amount</u>	<u>Loans to Total Loans</u>
Balance at the end of the period applicable to:						
Commercial and agricultural	\$ 293	5.07%	\$ 211	5.69%	\$ 281	6.99%
SBA-PPP	-	7.70%	-	-	-	-
Real estate – construction	499	6.93%	305	6.95%	246	6.23%
Real estate – mortgage	3,994	77.74%	3,233	83.92%	2,874	82.99%
Consumer and other	114	2.56%	144	3.44%	94	3.79%
Total	<u>\$ 4,900</u>	<u>100.00%</u>	<u>\$ 3,893</u>	<u>100.00%</u>	<u>\$ 3,495</u>	<u>100.00%</u>
Balance at the end of the period applicable to:						
Commercial and agricultural	\$ 282	6.04%	\$ 210	6.33%		
SBA-PPP	-	-	-	-		
Real estate – construction	239	6.00%	319	6.42%		
Real estate – mortgage	2,852	84.29%	2,783	84.78%		
Consumer and other	80	3.67%	108	2.47%		
Total	<u>\$ 3,453</u>	<u>100.00%</u>	<u>\$ 3,420</u>	<u>100.00%</u>		

Management's Discussion and Analysis

Financial Instruments with Off-Balance Sheet Risk

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

The Bank's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as for on-balance sheet instruments. A summary of the Bank's commitments at December 31, 2020 and 2019 is as follows:

	<u>2020</u>	<u>2019</u>
Commitments to extend credit	\$ 111,778	\$ 95,190
Standby letters of credit	<u>1,260</u>	<u>1,313</u>
	<u>\$ 113,038</u>	<u>\$ 96,503</u>

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

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

Quantitative and Qualitative Disclosure about Market Risk

The principal goals of the Bank's asset and liability management strategy are the maintenance of adequate liquidity and the management of interest rate risk. Liquidity is the ability to convert assets to cash to fund depositors' withdrawals or borrowers' loans without significant loss. Interest rate risk management balances the effects of interest rate changes on assets that earn interest or liabilities on which interest is paid, to protect the Bank from wide fluctuations in its net interest income which could result from interest rate changes.

Management must insure that adequate funds are available at all times to meet the needs of its customers. On the asset side of the balance sheet, maturing investments, loan payments, maturing loans, federal funds sold, and unpledged investment securities are principal sources of liquidity. On the liability side of the balance sheet, liquidity sources include core deposits, the ability to increase large denomination certificates, federal fund lines from correspondent banks, borrowings from the Federal Home Loan Bank, as well as the ability to generate funds through the issuance of long-term debt and equity.

The liquidity ratio (the level of liquid assets divided by total deposits plus short-term liabilities) was 15.0% at December 31, 2020 compared to 9.9% at December 31, 2019. These ratios are considered to be adequate by management.

The Bank uses cash and federal funds sold to meet its daily funding needs. If funding needs are met through holdings of excess cash and federal funds, then profits might be sacrificed as higher-yielding investments are foregone in the interest of liquidity. Therefore management determines, based on such items as loan demand and deposit activity, an appropriate level of cash and federal funds and seeks to maintain that level.

Management's Discussion and Analysis

The primary goals of the investment portfolio are liquidity management and maturity gap management. As investment securities mature the proceeds are reinvested in federal funds sold if the federal funds level needs to be increased, otherwise the proceeds are reinvested in similar investment securities. The majority of investment security transactions consist of replacing securities that have been called or matured. The Bank keeps a portion of its investment portfolio in unpledged assets that are less than 60 months to maturity or next repricing date. These investments are a preferred source of funds in that they can be disposed of in most interest rate environments without causing significant damage to that quarter's profits.

Interest rate risk is the effect that changes in interest rates would have on interest income and interest expense as interest-sensitive assets and interest-sensitive liabilities either reprice or mature. Management attempts to maintain the portfolios of interest-earning assets and interest-bearing liabilities with maturities or repricing opportunities at levels that will afford protection from erosion of net interest margin, to the extent practical, from changes in interest rates. Table 15 shows the sensitivity of the Bank's balance sheet on December 31, 2020. This table reflects the sensitivity of the balance sheet as of that specific date and is not necessarily indicative of the position on other dates. At December 31, 2020 the Bank appeared to be cumulatively asset-sensitive (interest-earning assets subject to interest rate changes exceeding interest-bearing liabilities subject to changes in interest rates). However, in the one year window liabilities subject to changes in interest rates exceed assets subject to interest rate changes (non asset-sensitive).

Matching sensitive positions alone does not ensure the Bank has no interest rate risk. The repricing characteristics of assets are different from the repricing characteristics of funding sources. Thus, net interest income can be impacted by changes in interest rates even if the repricing opportunities of assets and liabilities are perfectly matched.

Table 15. Interest Rate Sensitivity (dollars in thousands)

	December 31, 2020				
	Maturities/Repricing				
	1 to 3 Months	4 to 12 Months	13 to 60 Months	Over 60 Months	Total
Interest-Earning Assets:					
Interest bearing deposits	\$ 84,863	\$ -	\$ -	\$ -	\$ 84,863
Federal funds sold	817	-	-	-	817
Investments	1,987	1,322	4,957	25,241	33,507
Loans	111,875	52,275	380,248	119,697	664,095
Total	<u>\$ 199,542</u>	<u>\$ 53,597</u>	<u>\$ 385,205</u>	<u>\$ 144,938</u>	<u>\$ 783,282</u>
Interest-Bearing Liabilities:					
Interest-bearing DDA accounts	\$ 106,333	\$ -	\$ -	\$ -	\$ 106,333
Money market	65,040	-	-	-	65,040
Savings	157,884	-	-	-	157,884
Time deposits	27,537	85,317	81,565	-	194,419
Borrowings	-	-	-	10,000	10,000
Total	<u>\$ 356,794</u>	<u>\$ 85,317</u>	<u>\$ 81,565</u>	<u>\$ 10,000</u>	<u>\$ 533,676</u>
Interest sensitivity gap	\$ (157,252)	\$ (31,720)	\$ 303,640	\$ 134,938	\$ 249,606
Cumulative interest sensitivity gap	\$ (157,252)	\$ (188,972)	\$ 114,668	\$ 249,606	\$ 249,606
Ratio of sensitivity gap to total earning assets	-20.1%	-4.0%	38.8%	17.2%	31.9%
Cumulative ratio of sensitivity gap to total earning assets	-20.1%	-24.1%	14.6%	31.9%	31.9%

Management's Discussion and Analysis

The Company uses a number of tools to monitor its interest rate risk, including simulating net interest income under various scenarios, monitoring the present value change in equity under the same scenarios, and monitoring the difference or gap between rate sensitive assets and rate sensitive liabilities over various time periods (as displayed in Table 15).

The earnings simulation model forecasts annual net income under a variety of scenarios that incorporate changes in the absolute level of interest rates, changes in the shape of the yield curve, and changes in interest rate relationships. Management evaluates the effect on net interest income and present value equity from gradual changes in rates of up to 400 basis points up or down over a 12-month period. Table 16 presents the Bank's twelve-month forecasts for changes in net interest income and market value of equity resulting from changes in rates of up to 300 basis points up or down, as of December 31, 2020.

Table 16. Interest Rate Risk (dollars in thousands)

Rate Shocked Net Interest Income and Market Value of Equity							
Rate Change	-300bp	-200bp	-100bp	0bp	+100bp	+200bp	+300bp
Net Interest Income:							
Net interest income	\$ 27,450	\$ 27,344	\$ 27,257	\$ 27,428	\$ 27,750	\$ 28,225	\$ 28,789
Change	\$ 22	\$ (84)	\$ (171)	\$ -	\$ 322	\$ 797	\$ 1,361
Change percentage	0.08%	-0.31%	-0.62%		1.17%	2.91%	4.96%
Market Value of Equity	\$ 143,221	\$ 120,322	\$ 100,699	\$ 103,395	\$ 107,985	\$ 113,365	\$ 117,768

Impact of Inflation and Changing Prices

The consolidated financial statements and the accompanying notes presented elsewhere in this document have been prepared in accordance with generally accepted accounting principles which require the measurement of financial position and operating results in terms of historical dollars without considering the change in the relative purchasing power of money over time due to inflation. Unlike most industrial companies, virtually all Company assets and liabilities are monetary in nature, therefore the impact of inflation is reflected primarily in the increased cost of operations. As a result, interest rates have a greater impact on performance than do the effects of general levels of inflation. Interest rates do not necessarily move in the same direction or to the same extent as the prices of goods and services.

Table 17. Key Financial Ratios

	2020	2019	2018
Return on average assets	0.75%	1.05%	0.75%
Return on average equity	7.06%	9.10%	7.02%
Dividend payout ratio	26.96%	20.74%	24.81%
Average equity to average assets	10.60%	11.51%	10.66%

Stockholder Information

Requests for Information

Requests for information should be directed to Mrs. Suzanne S. Yearout, Corporate Secretary, at Parkway Acquisition Corp, 101 Jacksonville Circle, P.O. Box 215, Floyd, Virginia 24091; telephone (540) 745-4191.

Independent Registered Public Accounting Firm

Elliott Davis, PLLC
500 East Morehead Street, Ste. 700
Charlotte, North Carolina, 28202

Stock Transfer Agent

Computershare
250 Royal Street
Canton, Massachusetts, 02021

Federal Deposit Insurance Corporation

The Bank is a member of the FDIC. This statement has not been reviewed, or confirmed for accuracy or relevance by the Federal Deposit Insurance Corporation.

Banking Offices

Boone} 189 Boone Heights Drive, Boone, NC 28607 P} 828/264-4260
Carroll} 8351 Carrollton Pike, Galax, VA 24333 P} 276/238-8112
Christiansburg} 2145 Roanoke Street, Christiansburg, VA 24073 P} 540/381-8121
East Independence} 802 East Main Street, Independence, VA 24348 P} 276/773-2821
Elk Creek} 60 Comers Rock Road, Elk Creek, VA 24326 P} 276/655-4011
Floyd} 101 Jacksonville Circle, Floyd, VA 24091 P} 540/745-4191
Galax} 209 West Grayson Street, Galax, VA 24333 P} 276/238-2411
Hickory} 2900 HWY 127 South, Hickory, NC 28602 P} 828/578-7400
Hillsville} 419 South Main Street, Hillsville, VA 24343 P} 276/728-2810
Hudson} 537 Main Street, Hudson, NC 28638 P} 828/750-6076
Independence Main Office & Operations Ctr} 113 West Main Street, Independence, VA 24348 P} 276/773-2811
Lenoir} 509 Wilkesboro Blvd. NE, Lenoir, NC 28645 P} 828/750-6100
Mocksville} 119 Gaither Street, Mocksville, NC 27028 P} 336/477-7010
Radford} 7349 Peppers Ferry Boulevard, Radford, VA 24141 P} 540/633-1680
Roanoke} 4094 Postal Drive, Roanoke, VA 24018 P} 540/774-1111
Roanoke} 3850 Keagy Road, Roanoke, VA 24018 P} 540/387-4533
Sparta} 98 South Grayson Street, Sparta, NC 28675 P} 336/372-2811
Troutdale} 101 Ripshin Road, Troutdale, VA 24378 P} 276/677-3722
West Jefferson} 1055 Mount Jefferson Road, West Jefferson, NC 28694 P} 336-489-7811
Whitetop} 16303 Highlands Parkway, Whitetop, VA 24292 P} 276/388-3811
Wilkesboro} 1422 US Highway 421, Wilkesboro, NC 28697 P} 336/903-4948
Willis} 5598 Floyd Highway South, Willis, VA 24380 P} 540/745-4191
Wytheville} 420 North 4th Street, Wytheville, VA 24382 P} 276/228-6050
Yadkinville} 516 Hawthorne Drive, Yadkinville, NC 27055 P} 336/849-4194
Blacksburg Loan Production Office} 902 South Main Street, Blacksburg, VA 24060 P} 540/250-0280
Shelby Loan Production Office} 809 Lafayette Street, Shelby, NC 28150 P} 704/466-3674

Skyline Support Call Center} 1-866-773-2811

Growing Our Best

Skyline is pleased to announce that work has begun on a two-story, 7,000 square-foot centrally located branch within the Christiansburg Marketplace in Montgomery County, VA. Located at the intersection of Peppers Ferry Road and North Franklin Street in Christiansburg, the branch will feature a unique and modern aesthetic incorporating our brand. We look forward to bringing hometown, community banking to this thriving community.



BREAKING GROUND



FUTURE CHRISTIANSBURG BRANCH



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