

**OAKWORTH CAPITAL, INC.
AND SUBSIDIARY**

CONSOLIDATED FINANCIAL REPORT

DECEMBER 31, 2020

**OAKWORTH CAPITAL, INC.
AND SUBSIDIARY**

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INDEPENDENT AUDITOR'S REPORT

**To the Board of Directors
Oakworth Capital, Inc.
Birmingham, Alabama**

We have audited the accompanying consolidated financial statements of **Oakworth Capital, Inc. and Subsidiary**, which comprise the consolidated balance sheets as of December 31, 2020 and 2019, and the related consolidated statements of income, comprehensive income, stockholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Oakworth Capital, Inc. and Subsidiary as of December 31, 2020 and 2019, and the results of their operations and their cash flows for the years then ended, in accordance with accounting principles generally accepted in the United States of America.

A handwritten signature in cursive script that reads 'Mauldin & Jenkins, LLC'.

Birmingham, Alabama
April 29, 2021

OAKWORTH CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS DECEMBER 31, 2020 AND 2019

<u>Assets</u>	<u>2020</u>	<u>2019</u>
Cash and due from banks	\$ 5,599,717	\$ 3,643,106
Interest-bearing deposits in banks	112,062,300	92,959,722
Federal funds sold	2,025,000	625,000
Securities available for sale	79,533,966	61,021,800
Restricted equity securities	646,000	552,500
 Loans	 695,232,426	 543,170,452
Less allowance for loan losses	8,284,034	6,063,376
Loans, net	686,948,392	537,107,076
 Premises and equipment	 3,277,258	 3,579,769
Accrued interest receivable	2,453,001	1,983,069
Goodwill	562,908	675,489
Bank-owned life insurance	10,791,324	10,489,901
Other assets	8,599,747	7,440,393
 Total assets	 \$ 912,499,613	 \$ 720,077,825
 <u>Liabilities and Stockholders' Equity</u>		
Liabilities:		
Deposits:		
Noninterest-bearing	\$ 209,602,203	\$ 146,803,523
Interest-bearing	600,706,053	480,011,946
Total deposits	810,308,256	626,815,469
Accrued interest payable	101,550	1,167,633
Other liabilities	7,990,934	7,546,341
Total liabilities	818,400,740	635,529,443
 Commitments and contingencies		
 Stockholders' equity:		
Common stock, \$5 par value, 10,000,000 shares authorized; 4,834,312 and 4,795,098 shares issued and 4,762,000 and 4,714,425 shares outstanding at December 31, 2020 and 2019, respectively	 24,171,560	 23,975,490
Capital surplus	31,949,983	30,017,597
Retained earnings	37,661,784	31,736,275
Accumulated other comprehensive income	2,369,089	885,881
Treasury stock, 66,963 and 62,010 shares at cost, respectively	(1,986,457)	(1,835,147)
Unvested restricted stock	(67,086)	(231,714)
 Total stockholders' equity	 94,098,873	 84,548,382
 Total liabilities and stockholders' equity	 \$ 912,499,613	 \$ 720,077,825

See Notes to Consolidated Financial Statements.

**OAKWORTH CAPITAL, INC.
AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF INCOME
YEARS ENDED DECEMBER 31, 2020 AND 2019**

	<u>2020</u>	<u>2019</u>
Interest income:		
Loans, including fees	\$ 26,124,651	\$ 26,643,881
Taxable securities	911,557	780,407
Non-taxable securities	1,021,620	908,270
Federal funds sold and interest-bearing deposits in banks	191,705	941,979
Total interest income	<u>28,249,533</u>	<u>29,274,537</u>
Interest expense:		
Deposits	3,129,817	6,817,329
Other borrowings	49,789	56,551
Total interest expense	<u>3,179,606</u>	<u>6,873,880</u>
Net interest income	25,069,927	22,400,657
Provision for loan losses	<u>1,262,867</u>	<u>850,424</u>
Net interest income after provision for loan losses	<u>23,807,060</u>	<u>21,550,233</u>
Other income:		
Service charges on deposit accounts	511,092	457,256
Wealth management and trust service fees	6,975,767	6,598,478
Gain (loss) on sales of securities available for sale, net	99,260	(3,845)
Other operating income	765,887	1,129,756
Total other income	<u>8,352,006</u>	<u>8,181,645</u>
Other expenses:		
Salaries and employee benefits	15,687,074	13,549,775
Equipment and occupancy expenses	1,827,203	1,673,360
Technology and processing expenses	2,454,228	2,089,568
Other operating expenses	2,718,801	2,545,916
Total other expenses	<u>22,687,306</u>	<u>19,858,619</u>
Income before income taxes	9,471,760	9,873,259
Income tax expense	<u>2,116,159</u>	<u>1,915,612</u>
Net income	<u>\$ 7,355,601</u>	<u>\$ 7,957,647</u>
Basic earnings per share	<u>\$ 1.55</u>	<u>\$ 1.69</u>
Diluted earnings per share	<u>\$ 1.51</u>	<u>\$ 1.62</u>

See Notes to Consolidated Financial Statements.

**OAKWORTH CAPITAL, INC.
AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
YEARS ENDED DECEMBER 31, 2020 AND 2019**

	<u>2020</u>	<u>2019</u>
Net income	\$ 7,355,601	\$ 7,957,647
Other comprehensive income:		
Unrealized holding gains on securities available for sale arising during the period, net of tax of \$550,732 and \$420,734, respectively	1,556,526	1,189,112
Reclassification adjustment for (gains) losses realized in net income net of tax (benefit) of \$25,942 and \$(1,005), respectively	<u>(73,318)</u>	<u>2,840</u>
Other comprehensive income	<u>1,483,208</u>	<u>1,191,952</u>
Comprehensive income	<u>\$ 8,838,809</u>	<u>\$ 9,149,599</u>

See Notes to Consolidated Financial Statements.

OAKWORTH CAPITAL, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY YEARS ENDED DECEMBER 31, 2020 AND 2019

	Common Stock		Capital	Retained	Accumulated	Unvested	Treasury	Total
	Shares	Par Value	Surplus	Earnings	Other Comprehensive Income (Loss)	Restricted Stock	Stock	Stockholders' Equity
Balance, December 31, 2018	4,771,852	\$ 23,859,260	\$ 28,630,651	\$ 24,961,901	\$ (306,071)	\$ (460,049)	\$ (1,628,887)	\$ 75,056,805
Net income	-	-	-	7,957,647	-	-	-	7,957,647
Dividends declared	-	-	-	(1,183,273)	-	-	-	(1,183,273)
Issuance of common stock	13,375	66,875	439,234	-	-	-	-	506,109
Exercise of stock options	5,307	26,535	67,620	-	-	-	-	94,155
Exercise of stock options - exchange	5,630	28,150	(28,150)	-	-	-	-	-
Stock-based compensation	-	-	929,935	-	-	-	-	929,935
Forfeiture of restricted stock	(1,066)	(5,330)	(21,693)	-	-	27,023	-	-
Restricted stock compensation	-	-	-	-	-	201,312	-	201,312
Purchase of treasury stock	-	-	-	-	-	-	(206,260)	(206,260)
Other comprehensive income	-	-	-	-	1,191,952	-	-	1,191,952
Balance, December 31, 2019	4,795,098	23,975,490	30,017,597	31,736,275	885,881	(231,714)	(1,835,147)	84,548,382
Net income	-	-	-	7,355,601	-	-	-	7,355,601
Dividends declared	-	-	-	(1,430,092)	-	-	-	(1,430,092)
Issuance of common stock	21,390	106,950	570,182	-	-	-	-	677,132
Exercise of stock options	15,188	75,940	158,607	-	-	-	-	234,547
Exercise of stock options - exchange	2,636	13,180	(13,180)	-	-	-	-	-
Stock-based compensation	-	-	1,216,777	-	-	-	-	1,216,777
Restricted stock compensation	-	-	-	-	-	164,628	-	164,628
Purchase of treasury stock	-	-	-	-	-	-	(151,310)	(151,310)
Other comprehensive income	-	-	-	-	1,483,208	-	-	1,483,208
Balance, December 31, 2020	<u>4,834,312</u>	<u>\$ 24,171,560</u>	<u>\$ 31,949,983</u>	<u>\$ 37,661,784</u>	<u>\$ 2,369,089</u>	<u>\$ (67,086)</u>	<u>\$ (1,986,457)</u>	<u>\$ 94,098,873</u>

See Notes to Consolidated Financial Statements.

**OAKWORTH CAPITAL, INC.
AND SUBSIDIARY**

**CONSOLIDATED STATEMENTS OF CASH FLOWS
YEARS ENDED DECEMBER 31, 2020 AND 2019**

	2020	2019
OPERATING ACTIVITIES		
Net income	\$ 7,355,601	\$ 7,957,647
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and software amortization	555,732	498,181
Net amortization and accretion of bond premiums and discounts	318,677	191,826
Amortization of low-income housing tax credit investment	237,840	237,798
Amortization of goodwill	112,581	112,581
Provision for loan losses	1,262,867	850,424
Stock-based compensation	1,216,777	929,935
Restricted stock compensation	164,628	201,312
(Gain) loss on sales of securities available for sale, net	(99,260)	3,845
Loss on disposal of premises, equipment and software	1,237	59,483
Increase in interest receivable	(469,932)	(166,671)
Increase (decrease) in interest payable	(1,066,083)	409,576
Increase (decrease) in income tax payable	(20,370)	602,557
Deferred income taxes	(1,216,077)	(505,387)
Increase in cash surrender value of life insurance contracts	(301,423)	(303,870)
Net other operating activities	(470,812)	(1,067,883)
Net cash provided by operating activities	7,581,983	10,011,354
INVESTING ACTIVITIES		
Net increase in interest-bearing deposits in banks	(19,102,578)	(24,111,280)
Net increase in federal funds sold	(1,400,000)	-
Purchase of securities available for sale	(31,716,997)	(18,868,349)
Proceeds from sales of investment securities available for sale	3,709,896	4,019,302
Proceeds from maturities, calls and paydowns of securities available for sale	11,283,516	5,802,717
Net purchase of restricted equity securities	(93,500)	(79,100)
Net increase in loans	(151,104,183)	(68,808,930)
Purchase of premises, equipment and software	(272,604)	(782,940)
Proceeds from sale of premises, equipment and software	1,195	9,000
Net cash used in investing activities	(188,695,255)	(102,819,580)
FINANCING ACTIVITIES		
Net increase in deposits	183,492,787	93,381,934
Issuance of common stock	677,132	506,109
Exercise of stock options	234,547	94,155
Purchase of treasury stock	(151,310)	(206,260)
Dividends paid	(1,183,273)	(942,827)
Net cash provided by financing activities	183,069,883	92,833,111
Net increase in cash and due from banks	1,956,611	24,885
Cash and due from banks at beginning of year	3,643,106	3,618,221
Cash and due from banks at end of year	\$ 5,599,717	\$ 3,643,106
SUPPLEMENTAL DISCLOSURE		
Cash paid during the year for:		
Interest	\$ 4,245,689	\$ 6,464,304
Income taxes	\$ 3,131,328	\$ 1,572,592
OTHER NONCASH TRANSACTIONS		
LGP funds moved into the allowance for loan loss	\$ 968,742	\$ -

See Notes to Consolidated Financial Statements.

**OAKWORTH CAPITAL, INC.
AND SUBSIDIARY
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Business

Oakworth Capital, Inc. (the “Company”) is a bank holding company whose business is conducted by its wholly-owned subsidiary, Oakworth Capital Bank (the “Bank”). The Bank is a commercial bank headquartered in Birmingham, Jefferson County, Alabama. The Bank also maintains a full-service branch and trust office in Mobile, Alabama. The Bank provides a full range of banking services in its primary market areas of Jefferson, Montgomery and Mobile Counties and the surrounding areas. Subsequent to the end of 2020, the Bank opened its first full-service branch and trust office outside the state of Alabama in the metropolitan area of Nashville, Tennessee.

Basis of Presentation and Accounting Estimates

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. Significant intercompany transactions and balances have been eliminated in consolidation.

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the balance sheet date 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 in the near term relate to the determination of the allowance for loan losses, the valuation of deferred taxes, other-than-temporary impairments of securities, and the fair value of financial instruments.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions.

The Company’s loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its borrowers’ ability to honor their contracts is dependent on local economic conditions.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary based on changes in local economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the estimated losses on loans. Such agencies may require the Company to recognize additional losses based on their judgments about information available to them at the time of their examination. Because of these factors, it is reasonably possible that the estimated losses on loans may change materially in the near term. However, the amount of the change that is reasonably possible cannot be estimated.

Cash, Due From Banks and Cash Flows

For purposes of reporting cash flows, cash and due from banks includes cash on hand, cash items in process of collection, and amounts due from banks. Cash flows from interest bearing deposits in banks, restricted equity securities, loans, federal funds sold, and deposits are reported net.

The Bank is required to maintain reserve balances in cash or on deposit with the Federal Reserve Bank. The total of those reserve requirements was approximately \$9,834,000 at December 31, 2019. On March 15, 2020, the Federal Reserve System Board announced an interim final rule amending Regulation D to lower all transaction account reserve requirement ratios to zero percent, thereby eliminating all reserve requirements as of December 31, 2020. During 2020, the Bank began using the deposit account with the Federal Reserve Bank for all domestic wire activity.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Securities

All securities are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income. Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company evaluates investment securities for other-than-temporary impairment (“OTTI”) using relevant accounting guidance on a regular basis. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near term prospects of the issuer including an evaluation of credit ratings, (3) the impact of changes in market interest rates, (4) the intent of the Company to sell a security, and (5) whether it is more likely than not the Company will have to sell the security before recovery of its cost basis. If the Company intends to sell an impaired security, or if it is more likely than not the Company will have to sell the security before recovery of its cost basis, the Company records an other-than-temporary loss in an amount equal to the entire difference between fair value and amortized cost in earnings. Otherwise, only the credit portion of the estimated loss is recognized in earnings, with the other portion of the loss recognized in other comprehensive income.

Restricted Equity Securities

The Company, as a member of the Federal Home Loan Bank (FHLB) system, is required to maintain an investment in capital stock of the FHLB based upon its assets or outstanding advances. The stock is carried at cost as no readily available market exists. Management reviews for impairment based on the ultimate recoverability of the cost basis in this stock.

Loans

Loans 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 balances less deferred fees and costs on originated loans and the allowance for loan losses. Interest income is accrued on the outstanding principal balance. Loan origination fees, net of certain direct origination costs, of consumer and installment loans are recognized at the time the loan is placed on the books. Loan origination fees for all other loans are deferred and recognized as an adjustment of the related loan yield over the life of the loan, using the straight-line method without anticipating prepayments.

The accrual of interest on loans is discontinued when, in management’s opinion, the borrower may be unable to meet payments as they become due, or at the time the loan is 90 days past due, unless the loan is well-secured and in process of collection. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income, unless management believes that the accrued interest is recoverable through the liquidation of collateral. Interest income on nonaccrual loans is recognized on the cash basis, until the loans are returned to accrual status. Loans are returned to accrual status when all the principal and interest amounts are brought current and the loan has been performing according to the contractual terms generally for a period of not less than six months.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

U.S. Small Business Administration Paycheck Protection Program

The Bank is participating in the Paycheck Protection Program (PPP), a loan program originated from the Coronavirus Aid, Relief, and Economic Security (CARES) Act and subsequently expanded by the Paycheck Protection Program and Health Care Enhancement Act (PPHCEA). The PPP provides loans of up to \$10 million to small businesses affected by economic conditions resulting from the COVID-19 pandemic to provide cash-flow assistance to employers for maintaining their payroll (including healthcare and certain related expenses), mortgage interest, rent, leases, utilities and interest on existing debt during the COVID-19 emergency. PPP loans carry an interest rate of 1% and a maturity of two or five years.

Under this program, the Bank provided approximately \$107.8 million in funding to 555 customers. The average PPP loan was approximately \$194,000. As compensation for originating the loans, the Bank received lender processing fees from the U.S. Small Business Administration (SBA) totaling approximately \$3.3 million. Processing fees per loan range from 1% to 5% based on the size of the loan, and are deferred and amortized into interest income over the loans' contractual lives. Upon forgiveness of a loan by the SBA, any unrecognized deferred fees related to the PPP loan are recognized as interest income in the period the SBA forgiveness payment is received.

If the borrower meets certain criteria and uses the proceeds toward eligible expenses in accordance with the requirements of the PPP, the borrower's obligation to repay the loan can be forgiven up to the full principal amount of the loan plus any accrued interest. Upon borrower forgiveness, the SBA pays the Bank for the principal and accrued interest owed on the loan. If the full principal of the loan is not forgiven, the loan will operate according to the original loan terms with the SBA guaranty remaining in place. Approximately \$76.6 million in PPP loans remain outstanding as of December 31, 2020, and are reported as commercial loans.

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 expense. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Confirmed losses are charged off immediately. Subsequent recoveries, if any, are credited to the allowance. The allowance for loan losses is comprised of specific valuation allowances for loans evaluated individually for impairment (if any), general allocations for pools of homogeneous loans with similar risk characteristics and trends, and an unallocated component that reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The allowance is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the uncollectibility of loans in light of historical experience, the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, current economic conditions that may affect the borrower's ability to pay, 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. This evaluation does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For impaired loans, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for other qualitative factors. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Allowance for Loan Losses (Continued)

A loan is considered impaired when it is probable, based on current information and events, the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Loans, for which the terms have been modified at the borrower's request, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest when due. Loans that experience insignificant payment delays and payment shortfalls are not generally classified as impaired. Impaired loans are measured 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. Interest on accruing impaired loans is recognized as long as such loans do not meet the criteria for nonaccrual status. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The Company's homogeneous loan pools include real estate construction and land development loans, 1-4 family first mortgage real estate loans, commercial real estate loans, other real estate loans, commercial loans, and consumer loans. The general allocations to these loan pools are based on the historical loss rates for specific loan types and the internal risk grade, if applicable, adjusted for both internal and external qualitative risk factors. The qualitative factors considered by management include, among other factors: (1) changes in local and national economic conditions; (2) levels and trends in delinquencies; (3) effects of changes in lending policies; (4) concentrations of credit; (5) experience, ability and depth of management; (6) documentation exceptions; (7) trends in housing starts; (8) loan portfolio diversification; and (9) quality of loan portfolio reviews. The total allowance established for each homogeneous loan pool represents the product of the historical loss ratio and the total dollar amount of the loans in the pool.

Troubled Debt Restructurings

A loan is considered a troubled debt restructuring ("TDR") based on individual facts and circumstances. The Company designates loan modifications as TDRs when for economic or legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. These concessions may include rate reductions, principal forgiveness, extension of maturity date and other actions intended to minimize potential losses.

In determining whether a borrower is experiencing financial difficulties, the Company considers if the borrower is in payment default or would be in payment default in the foreseeable future without the modification, the borrower declared or is in the process of declaring bankruptcy, the borrower's projected cash flows will not be sufficient to service any of its debt, or the borrower cannot obtain funds from sources other than the Company at a market rate for debt with similar risk characteristics.

In determining whether the Company has granted a concession, the Company assesses, if it does not expect to collect all amounts due, whether the current value of the collateral will satisfy the amounts owed, whether additional collateral or guarantees from the borrower will serve as adequate compensation for other terms of the restructuring, and whether the borrower otherwise has access to funds at a market rate for debt with similar risk characteristics.

Premises and Equipment

Premises including leasehold improvements and equipment are carried at cost less accumulated depreciation. Depreciation is computed principally on the straight-line method over the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Goodwill

Goodwill represents the excess of cost over fair value of assets of businesses acquired. Prior to Accounting Standards Update (ASU) No. 2014-02, goodwill and other intangible assets acquired in a purchase business combination and determined to have an indefinite useful life were not amortized, but instead, tested for impairment at least annually or more often if conditions indicated a possible impairment. ASU No. 2014-02 allowed private companies to choose to adopt a goodwill accounting alternative prospectively under which goodwill existing at the beginning of the period of adoption could be amortized. The Company's subsidiary bank began amortizing goodwill, in accordance with ASU No. 2014-02, using the straight-line method and a seven-year amortization period beginning January 1, 2019.

Goodwill is subject to an annual evaluation of impairment. If desired, the Company can assess qualitative factors to determine if comparing the carrying value of the reporting unit to its fair value is necessary. Should the fair value be less than the carrying value, an impairment write-down would be recorded. Based on its assessment of qualitative factors, the Company determined that no impairment existed at December 31, 2020.

Changes in the carrying amount of goodwill is summarized as follows:

	Years Ended December 31,	
	2020	2019
Balance, beginning of year	\$ 675,489	\$ 788,070
Amortized during year	(112,581)	(112,581)
Balance, end of year	<u>\$ 562,908</u>	<u>\$ 675,489</u>

Future expected amortization of goodwill as of December 31, 2020 is as follows:

	Goodwill Amortization
2021	\$ 112,581
2022	112,581
2023	112,581
2024	112,581
2025	112,584
	<u>\$ 562,908</u>

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 Company - put presumptively beyond the reach of the transferor and its creditors, even in bankruptcy or other receivership, (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 Company 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.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Derivative Instruments

All derivative instruments are recorded on the balance sheet at their respective fair values. The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship and if so, on the reason for holding it. If the derivative instrument is not designated as a hedge, the gain or loss on the derivative instrument is recognized in earnings in the period of change. None of the derivative instruments utilized by the Company have been designated as a hedge. All derivative assets and liabilities are accounted for as trading assets or trading liabilities.

Income Taxes

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

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 may be reduced by deferred tax liabilities and 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.

Treasury Stock

The Company’s acquisition of shares of its common stock is recorded at cost as treasury stock and results in a reduction of stockholders’ equity. When treasury shares are reissued, the Company uses a first-in, first-out method and any difference in repurchase cost and reissuance price is recorded as an increase or reduction in capital surplus.

Earnings Per Share

Basic earnings per share (“EPS”) is computed by dividing income available to common shareholders by the weighted-average number of shares of common stock outstanding for the period. Diluted EPS reflects the potential dilution that could occur if dilutive stock options were exercised and resulted in the issuance of common stock. Unvested share-based payment awards, which include the right to receive non-forfeitable dividends, are considered participating securities and therefore considered to be outstanding in the computation of earnings per share. For the years ended December 31, 2020 and 2019, earnings per share is calculated using the two class method, under which calculations (1) exclude from the numerator any dividends paid or owed on participating securities and any undistributed earnings considered to be attributable to participating securities and (2) exclude from the denominator the dilutive impact of the participating securities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Earnings Per Share (Continued)

A reconciliation of the numerators and denominators of the earnings per common share and earnings per common share assuming dilution computations are presented below.

	Years Ended December 31,	
	2020	2019
Basic Earnings Per Share:		
Net income	\$ 7,355,601	\$ 7,957,647
Earnings allocated to participating securities	(12,648)	(36,589)
Net income allocated to common shareholders - basic	<u>\$ 7,342,953</u>	<u>\$ 7,921,058</u>
Weighted average common shares outstanding	4,728,988	4,698,522
Basic earnings per share	<u>\$ 1.55</u>	<u>\$ 1.69</u>
Diluted Earnings Per Share:		
Net income allocated to common shareholders	\$ 7,342,953	\$ 7,921,058
Earnings allocated to participating securities	272	1,146
Net income allocated to common shareholders - diluted	<u>7,343,225</u>	<u>7,922,204</u>
Weighted average common shares outstanding	4,728,988	4,698,522
Net dilutive effect of:		
Assumed exercises of potential common shares	<u>124,757</u>	<u>180,347</u>
Average shares and dilutive potential common shares	<u>4,853,745</u>	<u>4,878,869</u>
Diluted earnings per share	<u>\$ 1.51</u>	<u>\$ 1.62</u>

Stock Compensation Plans

At December 31, 2020 and 2019, the Company had options and warrants outstanding under three stock-based compensation plans (2007 Plan, 2011 Plan, 2016 Plan), and restricted stock outstanding under a separate restricted stock incentive plan, as well as the previously mentioned 2016 Plan, which are all described in more detail in Note 7. The plans have been accounted for under the accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) which requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options and warrants, restricted stock plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the estimated market price of the Company's common stock at the date of grant is used for restricted stock awards and stock grants.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Revenue from Contracts with Customers

On January 1, 2019, the Company adopted Accounting Standards Codification (ASC) Topic 606, *Revenue from Contracts with Customers* ("ASC 606"), which provides guidance for reporting revenue from the Company's contracts to provide goods or services to customers. The guidance requires recognition of revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration that it expects to be entitled to receive in exchange for those goods or services recognized as performance obligations are satisfied.

The majority of revenue-generating transactions are excluded from the scope of ASC 606, including revenue generated from financial instruments, such as securities, loans and income from bank owned life insurance contracts. Revenue-generating transactions that are within the scope of ASC 606, classified within other income, are described as follows:

Service Charges on Deposit Accounts – represent service fees for monthly activity and maintenance on customer accounts. Attributes can be transaction-based, item-based or time-based. Revenue is recognized when the Company's performance obligation is completed which is generally monthly for maintenance services or when a transaction is processed. Payments for such performance obligations are generally received at the time the performance obligations are satisfied.

Wealth Management and Trust Service Fees – represents non-interest income generated from recurring fee-based investment management and fiduciary services. Wealth management and trust service fees are based on an agreed upon percentage of account market value that fluctuates with contributions, distributions, and asset pricing. Revenue is typically realized on a monthly basis for services rendered the previous month. In addition to the Company's primary fee-based revenue, income may also include one-time consulting and fiduciary service fees.

Bank Card Fees – bank card related fees primarily include interchange income from client use of consumer and business debit cards. Interchange income is a fee paid by a merchant bank to the card-issuing bank through the interchange network. Interchange fees are set by the credit card associations and are based on cardholder purchase volumes. The Company records interchange income as transactions occur. This income is included in other operating income on the consolidated statements of income.

Other operating income primarily includes both transaction-based fees and account maintenance fees, along with the one-time payment in 2019 resulting from the termination of a Loan Guarantee Program operated by the State of Alabama. Transaction based fees are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Other account maintenance fees are recognized over time, usually on a monthly basis, as the Company's performance obligation for services is satisfied. The Company did not have an aggregate effect of modification resulting from adoption of ASC 606, and no financial statement line items were affected by this change in accounting standard.

Comprehensive Income

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available for sale securities, are reported as a separate component of the equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Fair Value of Financial Instruments

Fair values of financial instruments are estimates using relevant market information and other assumptions, as more fully disclosed in Note 13. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Assets Under Management

Property and funds held by the Company in a fiduciary or other capacity for the benefit of its clients are not included in the accompanying consolidated financial statements since such items are not assets of the Company. Income earned from fees charged against assets under management, including money management services, is recognized in the Company's consolidated statements of income.

Reclassification

Certain amounts reported in prior years have been reclassified to conform to the current year's presentation. These reclassifications had no effect on the Company's results of operations, financial position, or net cash flow.

Recent Accounting Pronouncements

ASU 2016-02, "*Leases (Topic 842)*." Issued in February 2016, ASU 2016-02 was issued by the FASB to increase transparency and comparability among organizations by recognizing lease assets and liabilities on the balance sheet and by disclosing key information about leasing arrangements. ASU 2016-02 will require organizations that lease assets (lessees) to recognize on the balance sheet the assets and liabilities for the rights and obligations created by the lease for all operating leases under current U.S. GAAP with a term of more than 12 months. The recognition, measurement and presentation of expenses and cash flows arising from a lease are not significantly changed under ASU 2016-02, and there will continue to be differentiation between finance leases and operating leases. The accounting applied by the lessor in a lease transaction remains largely unchanged from previous U.S. GAAP. ASU 2016-02 is effective for fiscal years beginning after December 15, 2021. Management is currently evaluating the impact that this ASU will have on the Company's consolidated financial statements and does not expect it to be material.

ASU 2016-13, "*Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments*." Issued in June 2016, ASU 2016-13 is essentially the final rule on use of the so-called CECL model, or current expected credit losses, and removes the thresholds that companies apply to measure credit losses on financial instruments measured at amortized cost, such as loans, receivables and held-to-maturity debt securities. Under current U.S. GAAP, companies generally recognize credit losses when it is probable that the loss has been incurred. The revised guidance will remove all current recognition thresholds and will require companies to recognize an allowance for lifetime expected credit losses. Credit losses will be immediately recognized through net income; the amount recognized will be based on the current estimate of contractual cash flows not expected to be collected over the financial asset's contractual term. ASU 2016-13 also amends the credit loss measurement guidance for available-for-sale debt securities. For non-public business entities, ASU 2016-13 is effective for financial statements issued for fiscal years and for interim periods within those fiscal years beginning after December 15, 2022. Institutions will be required to apply the changes through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. Management is currently evaluating the impact that this ASU will have on the Company's consolidated financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Subsequent Event

The Company has evaluated all transactions, events, and circumstances for consideration or disclosure through April 29, 2021, the date these financial statements were available to be issued and has reflected or disclosed those items within the consolidated financial statements and related footnotes as deemed appropriate. COVID-19 has not yet been contained and could affect significantly more households and businesses. Given the speed and unpredictable nature with which the pandemic is evolving, and the ongoing and fluid nature of the country's response to it, it is difficult for the Company to accurately estimate the length and severity of the economic disruption being caused by COVID-19 or when normal economic and operating conditions will resume. As a result, the extent to which results of operations, capital levels, liquidity ratios, and provision expense will be impacted is difficult to predict and depends on, among other things, new information that may emerge concerning the scope, duration and severity of the COVID-19 pandemic, actions taken by governmental authorities and other parties in response to the pandemic, the speed with which the vaccines for COVID-19 can be widely distributed, those vaccines' effectiveness against the virus and public acceptance of the vaccines. The adverse impact of COVID-19 on the markets in which the Company operates and on its business, financial condition and results of operations is expected to remain elevated until the pandemic subsides.

NOTE 2. SECURITIES

The amortized cost and fair value of securities are summarized as follows:

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Securities Available for Sale				
December 31, 2020:				
U.S. Government-sponsored enterprises (GSEs)	\$ 1,860,893	\$ 26,942	\$ (6,627)	\$ 1,881,208
Mortgage-backed GSE securities	11,290,947	567,675	-	11,858,622
State and municipal securities	63,174,803	2,628,851	(9,518)	65,794,136
	<u>\$ 76,326,643</u>	<u>\$ 3,223,468</u>	<u>\$ (16,145)</u>	<u>\$ 79,533,966</u>
December 31, 2019:				
U.S. Government-sponsored enterprises (GSEs)	\$ 1,686,480	\$ 13,826	\$ (6,664)	\$ 1,693,642
Mortgage-backed GSE securities	12,266,732	239,704	(6,923)	12,499,513
State and municipal securities	45,869,263	1,108,845	(149,463)	46,828,645
	<u>\$ 59,822,475</u>	<u>\$ 1,362,375</u>	<u>\$ (163,050)</u>	<u>\$ 61,021,800</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES (Continued)

The amortized cost and fair value of securities available for sale as of December 31, 2020 by contractual maturity are shown below. Actual maturities may differ from contractual maturities in mortgage-backed securities because the mortgages underlying the securities may be called or repaid with or without penalty. Therefore, these securities are not included in the maturity categories in the following summary:

	Securities Available for Sale	
	Amortized Cost	Fair Value
Due in less than one year	\$ 1,461,136	\$ 1,469,798
Due from one to five years	11,162,627	11,434,934
Due from five to ten years	16,130,274	16,756,097
Due after ten years	36,281,659	38,014,515
Mortgage-backed securities	11,290,947	11,858,622
	<u>\$ 76,326,643</u>	<u>\$ 79,533,966</u>

Gains and losses on sales of securities consist of the following:

	Years Ended December 31,	
	2020	2019
Gross gains	\$ 110,072	\$ 7,451
Gross losses	(10,812)	(11,296)
Net realized gains (losses)	<u>\$ 99,260</u>	<u>\$ (3,845)</u>

Securities with an approximate carrying value of \$3,142,000 and \$2,089,000 at December 31, 2020 and 2019, respectively, were pledged to secure certain derivative instruments or for other purposes required or permitted by law.

Temporarily Impaired Securities

The following tables show the gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2020 and 2019.

	<u>Less Than Twelve Months</u>		<u>Twelve Months or More</u>		Total Unrealized Loss
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
December 31, 2020:					
U.S. Government-sponsored enterprises (GSEs)	\$ (6,627)	\$ 523,274	\$ -	\$ -	\$ (6,627)
Mortgage-backed GSE securities	-	-	-	-	-
State and municipal securities	(9,518)	2,374,780	-	-	(9,518)
Total securities	<u>\$ (16,145)</u>	<u>\$ 2,898,054</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (16,145)</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 2. SECURITIES (Continued)

Temporarily Impaired Securities (Continued)

	<u>Less Than Twelve Months</u>		<u>Twelve Months or More</u>		
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Total Unrealized Loss
December 31, 2019:					
U.S. Government-sponsored enterprises (GSEs)	\$ (6,664)	\$ 692,815	\$ -	\$ -	\$ (6,664)
Mortgage-backed GSE securities	(6,923)	2,164,415	-	-	(6,923)
State and municipal securities	(149,463)	8,335,818	-	-	(149,463)
Total securities	<u>\$ (163,050)</u>	<u>\$ 11,193,048</u>	<u>\$ -</u>	<u>\$ -</u>	<u>\$ (163,050)</u>

The unrealized losses on five securities were caused by interest rate changes. Because the Company does not intend to sell the securities and it is not more likely than not that the Company will be required to sell the securities before recovery of the amortized cost bases, which may be maturity, the Company does not consider these securities to be other-than-temporarily impaired at December 31, 2020.

NOTE 3. LOANS

Portfolio Segments and Classes

The composition of loans is summarized as follows:

	December 31,	
	2020	2019
Real estate mortgages:		
Construction and land development	\$ 60,413,043	\$ 47,482,984
1-4 family first mortgage	17,726,110	15,181,310
Commercial	153,420,168	127,045,488
Other	25,771,715	26,517,744
Commercial	320,531,370	222,754,470
Consumer, HELOCS and other	119,728,317	104,965,323
	697,590,723	543,947,319
Net deferred loan fees	(2,358,297)	(776,867)
Allowance for loan losses	(8,284,034)	(6,063,376)
Loans, net	<u>\$ 686,948,392</u>	<u>\$ 537,107,076</u>

For purposes of the disclosures required pursuant to ASC 310, the loan portfolio was disaggregated into segments and then further disaggregated into classes for certain disclosures. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. There are three loan portfolio segments; real estate, commercial, and consumer. A class is generally determined based on the initial measurement attribute, risk characteristic of the loan, and an entity's method for monitoring and assessing credit risk. Classes within the real estate portfolio segment include construction and land development, 1-4 family first mortgage loans, commercial real estate loans, and other real estate loans. The portfolio segments of non-real estate commercial loans and consumer loans have not been further segregated by class.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Portfolio Segments and Classes (Continued)

The following describe risk characteristics relevant to each of the portfolio segments and classes:

Real Estate - As discussed below, the Company offers various types of real estate loan products. All loans within this portfolio segment are particularly sensitive to the valuation of real estate:

- Loans for real estate construction and land development are repaid through cash flow related to the operations, sale or refinance of the underlying property. This portfolio class includes extensions of credit to real estate developers or investors where repayment is dependent on the sale of the real estate or income generated from the real estate collateral.
- 1-4 family first mortgage loans are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.
- Commercial real estate mortgage loans include both owner-occupied commercial real estate loans and other commercial real estate loans such as commercial loans secured by income producing properties. Owner-occupied commercial real estate loans made to operating businesses are long-term financing of land and buildings and are repaid by cash flows generated from business operations. Real estate loans for income-producing properties such as apartment buildings, office and industrial buildings, and retail shopping centers are repaid from rent income derived from the properties.
- Other real estate mortgage loans include real estate loans secured by farmland, second liens, or multifamily residential properties. These are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.

Commercial - The commercial loan portfolio segment includes commercial and financial loans. These loans include loans to commercial customers for use in normal business operations to finance working capital needs, equipment purchases, or expansion projects. Loans are repaid by business cash flows. Collection risk in this portfolio is driven by the creditworthiness of the underlying borrower, particularly cash flows from the customers' business operations. Also included in the commercial portfolio segment are PPP loans originated during 2020.

Consumer - The consumer loan portfolio segment includes direct consumer installment loans and other revolving credit loans, overdrafts, automobile loans, and open end real estate loans, such as home equity lines. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

Credit Risk Management

The loan review function is involved in the credit risk management process and assesses the accuracy of risk ratings, the quality of the portfolio and the estimation of inherent credit losses in the loan portfolio. This comprehensive process also assists in the prompt identification of problem credits. The Company has taken a number of measures to manage the portfolios and reduce risk, particularly in the higher risk portfolios.

The Company employs a credit risk management process with defined policies, accountability and routine reporting to manage credit risk in the loan portfolio segments. Credit risk management is guided by a comprehensive Board approved Loan Policy that provides for a consistent and prudent approach to underwriting and approvals of credits. Within the Loan Policy, procedures exist that elevate the approval requirements as credits become larger and more complex. All loans are individually underwritten, risk-rated, approved, and monitored.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Credit Risk Management (Continued)

Responsibility and accountability for adherence to underwriting policies and accurate risk ratings lies in each portfolio segment. For the consumer portfolio segment, the risk management process focuses on managing customers who become delinquent in their payments. For the commercial and real estate portfolio segments, the risk management process focuses on underwriting new business and, on an ongoing basis, monitoring the credit of the portfolios. To ensure problem credits are identified on a timely basis, a specific portfolio review occurs at least once each year to assess the larger adversely rated credits for proper risk rating and accrual status.

Credit quality and trends in the loan portfolio segments are measured and monitored regularly. Detailed reports, by product, collateral, accrual status, etc., are reviewed by the Chief Credit Officer and the Directors Loan Committee.

A description of the general characteristics of the risk grades used by the Company is as follows:

- **“Pass”:** There are five risk grades that are considered “pass”. Risk grade 1 is reserved for loans secured by cash collateral on deposit with no risk of principal deterioration. Risk grade 2 is reserved for loans secured by readily marketable collateral, or loans within guidelines to clients with liquid financial statements. A liquid financial statement is generally a financial statement with substantial liquid assets, particularly relative to the debts. These loans have excellent sources of repayment, with no significant identifiable risk of collection, and conform in all respects to Company policy, guidelines, underwriting standards, and Federal and State regulations. Risk grade 3 is reserved for the Company’s high quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection and conform to Company policy, underwriting standards and product guidelines. Risk grade 4 is given to acceptable loans that have adequate sources of repayment, with little identifiable risk of collection. Risk grade 5 is given to acceptable loans that show signs of weakness in either adequate sources of repayment or collateral but have demonstrated mitigating factors that minimize the risk of delinquency or loss.
- **“Watch” or “Special Mention”:** Watch or special mention loans include the following characteristics: 1) loans within guideline tolerances or with exceptions of any kind that have not been mitigated by other economic or credit factors; 2) loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Company’s position at some future date (potential weaknesses can be the result of deviations from prudent lending practices); 3) loans where adverse economic conditions that develop subsequent to the loan origination that don’t jeopardize liquidation of the debt but do substantially increase the level of risk may also warrant this rating.
- **“Substandard”:** A substandard loan is inadequately protected by the current sound net worth and paying capacity of the borrower or the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.
- **“Doubtful”:** Loans classified doubtful have all the weaknesses inherent in the loans classified substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. However, these loans are not yet rated as loss because certain events may occur which could salvage the debt. The ability of the client to service the debt is extremely weak, overdue status is constant, the debt has been placed on nonaccrual status, and no definite repayment schedule exists. Doubtful is a temporary grade where a loss is expected but is not presently quantified with any degree of accuracy. Once the loss position is determined, the amount is charged off. There are no loans with a doubtful rating in the Company’s portfolio as of December 31, 2020 or 2019.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Credit Risk Management (Continued)

- **“Loss”:** Loans classified loss are considered uncollectable and of such little value that their continuance as active assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off the loan even though partial recovery may be realized in the future. Probable loss portions of the doubtful assets are to be charged against the allowance for loan losses. There are no loans with a loss rating in the Company’s portfolio as of December 31, 2020 or 2019.

The following tables summarize the risk category of the Company’s loan portfolio based upon the most recent analysis performed as of December 31, 2020 and 2019:

	<u>Pass</u>	<u>Watch or Special Mention</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
December 31, 2020					
Real estate mortgages:					
Construction and land development	\$ 57,633,169	\$ 2,779,874	\$ -	\$ -	\$ 60,413,043
1-4 family first mortgage	17,122,500	603,610	-	-	17,726,110
Commercial	151,882,160	1,538,008	-	-	153,420,168
Other	25,771,715	-	-	-	25,771,715
Commercial	307,488,532	13,042,838	-	-	320,531,370
Consumer, HELOCS and other	119,728,317	-	-	-	119,728,317
Total	\$ 679,626,393	\$ 17,964,330	\$ -	\$ -	\$ 697,590,723
December 31, 2019					
Real estate mortgages:					
Construction and land development	\$ 47,482,984	\$ -	\$ -	\$ -	\$ 47,482,984
1-4 family first mortgage	15,181,310	-	-	-	15,181,310
Commercial	126,718,855	326,633	-	-	127,045,488
Other	26,517,744	-	-	-	26,517,744
Commercial	219,360,911	3,393,559	-	-	222,754,470
Consumer, HELOCS and other	104,965,323	-	-	-	104,965,323
Total	\$ 540,227,127	\$ 3,720,192	\$ -	\$ -	\$ 543,947,319

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Allowance for Loan Losses

The following tables detail activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2020 and 2019. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. During the first quarter of 2020, the Company evaluated changes in the economic environment specifically related to COVID-19 and transferred the remaining balance of funds received from the State of Alabama, resulting from the termination of a Loan Guarantee Program, to the allowance for loan losses.

	Real Estate	Commercial	Consumer	Unallocated	Total
December 31, 2020					
Allowance for loan losses:					
Balance, beginning of year	\$ 1,671,956	\$ 1,874,835	\$ 829,656	\$ 1,686,929	\$ 6,063,376
Provision (credit) for loan losses	1,391,129	1,137,432	584,962	(1,850,656)	1,262,867
Loan Guarantee Program	-		-	968,742	968,742
Loans charged off	-	-	(14,451)	-	(14,451)
Recoveries of loans previously charged off	-	-	3,500	-	3,500
Balance, end of year	<u>\$ 3,063,085</u>	<u>\$ 3,012,267</u>	<u>\$ 1,403,667</u>	<u>\$ 805,015</u>	<u>\$ 8,284,034</u>
Ending balance – individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -
Ending balance – collectively evaluated for impairment	<u>3,063,085</u>	<u>3,012,267</u>	<u>1,403,667</u>	<u>805,015</u>	<u>8,284,034</u>
Total ending balance	<u>\$ 3,063,085</u>	<u>\$ 3,012,267</u>	<u>\$ 1,403,667</u>	<u>\$ 805,015</u>	<u>\$ 8,284,034</u>
Loans:					
Ending balance – individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -
Ending balance – collectively evaluated for impairment	<u>257,331,036</u>	<u>320,531,370</u>	<u>119,728,317</u>	<u>-</u>	<u>697,590,723</u>
Total ending balance	<u>\$ 257,331,036</u>	<u>\$ 320,531,370</u>	<u>\$ 119,728,317</u>	<u>\$ -</u>	<u>\$ 697,590,723</u>
December 31, 2019					
Allowance for loan losses:					
Balance, beginning of year	\$ 1,622,884	\$ 1,776,462	\$ 871,547	\$ 1,042,746	\$ 5,313,639
Provision (credit) for loan losses	49,072	211,544	(54,375)	644,183	850,424
Loans charged off	-	(119,650)	-	-	(119,650)
Recoveries of loans previously charged off	-	6,479	12,484	-	18,963
Balance, end of year	<u>\$ 1,671,956</u>	<u>\$ 1,874,835</u>	<u>\$ 829,656</u>	<u>\$ 1,686,929</u>	<u>\$ 6,063,376</u>
Ending balance – individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -
Ending balance – collectively evaluated for impairment	<u>1,671,956</u>	<u>1,874,835</u>	<u>829,656</u>	<u>1,686,929</u>	<u>6,063,376</u>
Total ending balance	<u>\$ 1,671,956</u>	<u>\$ 1,874,835</u>	<u>\$ 829,656</u>	<u>\$ 1,686,929</u>	<u>\$ 6,063,376</u>
Loans:					
Ending balance – individually evaluated for impairment	\$ -	\$ -	\$ -	\$ -	\$ -
Ending balance – collectively evaluated for impairment	<u>216,227,526</u>	<u>222,754,470</u>	<u>104,965,323</u>	<u>-</u>	<u>543,947,319</u>
Total ending balance	<u>\$ 216,227,526</u>	<u>\$ 222,754,470</u>	<u>\$ 104,965,323</u>	<u>\$ -</u>	<u>\$ 543,947,319</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 3. LOANS (Continued)

Past Due Loans

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. Generally, loans are placed on non-accrual when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. The following tables present the aging of the recorded investment in loans as of December 31, 2020 and 2019:

		Past Due Status (Accruing Loans)						
		Current	30-59 Days	60-89 Days	90+ Days	Total Past Due	Non-accrual	Total
December 31, 2020								
Real estate mortgages:								
Construction and land development	\$	60,413,043	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 60,413,043
1-4 family first mortgage		17,726,110	-	-	-	-	-	17,726,110
Commercial		153,420,168	-	-	-	-	-	153,420,168
Other		25,771,715	-	-	-	-	-	25,771,715
Commercial		320,531,370	-	-	-	-	-	320,531,370
Consumer, HELOC and other		119,728,317	-	-	-	-	-	119,728,317
Total	\$	697,590,723	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 697,590,723
December 31, 2019								
Real estate mortgages:								
Construction and land development	\$	47,482,984	\$ -	\$ -	\$ -	\$ -	\$ -	\$ 47,482,984
1-4 family first mortgage		15,181,310	-	-	-	-	-	15,181,310
Commercial		126,718,855	326,633	-	-	326,633	-	127,045,488
Other		26,517,744	-	-	-	-	-	26,517,744
Commercial		219,360,911	3,393,559	-	-	3,393,559	-	222,754,470
Consumer, HELOC and other		104,965,323	-	-	-	-	-	104,965,323
Total	\$	540,227,127	\$ 3,720,192	\$ -	\$ -	\$ 3,720,192	\$ -	\$ 543,947,319

Impaired Loans

A loan held for investment is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement. Management has identified no impaired loans as of December 31, 2020 or 2019.

The Company did not have any loans classified as Troubled Debt Restructurings as of December 31, 2020 or 2019.

Related Party Loans

In the ordinary course of business, the Company has granted loans to certain related parties, including directors, executive officers, and their affiliates. The interest rates on these loans were substantially the same as rates prevailing at the time of the transaction and repayment terms are customary for the type of loan. Changes in related party loans are as follows:

	Years Ended December 31,	
	2020	2019
Balance, beginning of year	\$ 14,393,500	\$ 8,659,409
Advances	15,870,124	16,865,645
Repayments	(16,811,515)	(12,447,192)
Change in directors	-	1,315,638
Balance, end of year	<u>\$ 13,452,109</u>	<u>\$ 14,393,500</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4. PREMISES AND EQUIPMENT

Premises and equipment is summarized as follows:

	December 31,	
	2020	2019
Leasehold improvements	\$ 2,937,629	\$ 2,813,468
Furniture and equipment	2,474,664	2,375,579
	<u>5,412,293</u>	<u>5,189,047</u>
Accumulated depreciation	(2,135,035)	(1,609,278)
	<u>\$ 3,277,258</u>	<u>\$ 3,579,769</u>

Depreciation expense for the years ended December 31, 2020 and 2019 totaled \$525,884 and \$481,261, respectively.

Leases

850 Shades Cahaba, LLC

During 2015 the Company invested in 850 Shades Cahaba, LLC (“Shades Cahaba”). Shades Cahaba was organized as a limited liability company under the laws of the State of Alabama. Shades Cahaba was formed for the purpose of acquiring and operating the property located at 850 Shades Creek Parkway in Birmingham, Alabama. The Company invested \$1,138,000 into Shades Cahaba during 2015 giving the Company 25% ownership.

A company that holds a variable interest in an entity is required to consolidate the entity if the company’s interest in the variable interest entity (VIE) is such that the company will absorb a majority of the VIE’s expected losses and/or receive a majority of the VIE’s expected residual returns, if they occur. In such cases, the company is the primary beneficiary of the VIE.

The Company has determined that it is not the primary beneficiary of Shades Cahaba, and thus this entity is not subject to consolidation. The Company uses the equity method of accounting to account for its investment in Shades Cahaba. The investment in Shades Cahaba is included in other assets in the consolidated balance sheets.

The property owned by 850 Shades Cahaba, LLC became the Company’s headquarters in January 2018.

The Company leases their banking facility in Birmingham, Alabama under an operating lease agreement from Shades Cahaba. The lease term expires in 2032 and requires a fixed monthly payment for the designated square footage. The Company has evaluated the lease and determined it to be an operating lease.

The Company leases a banking facility in Montgomery, Alabama under an operating lease agreement from an unrelated entity. The lease term expired through a buyout of the lease in early 2021. The Company has evaluated the lease and determined it to be an operating lease.

The Company leases office space in Mobile, Alabama under an operating lease agreement from an unrelated entity. The lease term expires in 2025. The lease requires a fixed monthly payment for the designated square footage. The Company has evaluated the lease and determined it to be an operating lease.

The Company leases office space in Brentwood, Tennessee under an operating lease agreement from an unrelated entity. The lease term expires in 2028. The lease requires a fixed monthly payment which starts in July 2021, after a six-month rent abatement from the start of the lease on December 15, 2020. The lease payment is based on the designated square footage. The Company has evaluated the lease and determined it to be an operating lease.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 4. PREMISES AND EQUIPMENT (Continued)

Leases (Continued)

Rental expense for all leases totaled approximately \$1,159,000 and \$1,104,000 for the periods ended December 31, 2020 and 2019, respectively.

Future minimum lease payments, including the new Middle Tennessee location, on the leases described above are summarized as follows:

2021	\$ 1,297,344
2022	1,299,433
2023	1,348,554
2024	1,385,649
2025	1,329,557
Thereafter	8,835,416
	<u>\$ 15,495,953</u>

NOTE 5. DEPOSITS

The major classifications of deposits are as follows:

	December 31,	
	<u>2020</u>	<u>2019</u>
Noninterest-bearing demand	\$ 209,602,203	\$ 146,803,523
Interest-bearing demand	469,050,095	327,972,483
Savings	71,312,773	8,311,336
Certificates of deposit of \$250,000 or more	45,463,028	113,294,565
Other certificates of deposit	14,880,157	30,433,562
	<u>\$ 810,308,256</u>	<u>\$ 626,815,469</u>

The scheduled maturities of time deposits at December 31, 2020 are as follows:

2021	\$ 57,771,974
2022	2,245,646
2023	231,784
2024	42,934
2025	50,847
	<u>\$ 60,343,185</u>

Deposits from related parties held by the Company at December 31, 2020 and 2019 amounted to approximately \$30,076,000 and \$35,668,000, respectively.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 6. AVAILABLE FUNDING

Federal Home Loan Bank advances are secured by a blanket floating lien on qualifying 1-4 family multifamily residential mortgages, home equity lines of credit, and commercial real estate loans. As of December 31, 2020, the Company had qualifying loans available to pledge totaling approximately \$63,901,000. As of December 31, 2020, the amount that was available to be borrowed from the Federal Home Loan Bank was approximately \$41,937,000. As of December 31, 2020 and 2019, no advances from the Federal Home Loan Bank were outstanding.

The Company also has accommodations which allow the purchase of federal funds from several correspondent banks on an overnight basis at prevailing overnight market rates. These accommodations are subject to various restrictions as to their term and availability, and in most cases, must be repaid in less than a month. At December 31, 2020 and 2019, the Company had no amounts outstanding under these arrangements. The Company may borrow up to \$70,000,000 under these arrangements as of December 31, 2020.

NOTE 7. EMPLOYEE AND DIRECTOR BENEFITS

Profit Sharing Plan

The Company sponsors a 401(k) profit sharing plan covering substantially all full-time employees subject to certain age and minimum service requirements. Contributions to the plan charged to expense totaled \$314,588 and \$340,486 for the years ended December 31, 2020 and 2019, respectively.

Stock Options

The Company issues and has outstanding stock options from three plans: the 2007 Stock Option Plan (2007 Plan), the 2011 Stock Option Plan (2011 Plan), and the 2016 Equity Incentive Plan (2016 Plan). The 2007 and 2011 Plans were frozen as of December 31, 2019 and no further options will be granted from either plan; however, options remain outstanding from both plans. Both plans allow for grants to grant directors, key employees and others of options to purchase shares of common stock of the Company. Options were granted as incentive stock options or nonqualified stock options depending on the eligibility of the recipient. Option prices and terms were determined by a committee appointed by the Board of Directors. The 2007 Plan provided for a total of 366,187 stock options to purchase common shares of the Company. The 2011 Plan provided for a total of 240,000 stock options to purchase common shares of the Company.

The 2016 Equity Incentive Plan (2016 Plan) may grant directors, key employees and others options to purchase shares of common stock of the Company. Options may be granted as incentive stock options or nonqualified stock options depending on the eligibility of the recipient. The 2016 Plan may also grant restricted stock, restricted stock units, stock appreciation rights, or any other right determined by a committee appointed by the Board of Directors subject to a limit of no more than 100,000 restricted shares and/or restricted share units in aggregate. Option and grant prices and terms are determined by a committee appointed by the Board of Directors. The 2016 Plan provides for a total of 1,000,000 shares of common stock be available for grant. As of December 31, 2020, there are 299,873 awards under this plan available to be granted.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. EMPLOYEE AND DIRECTOR BENEFITS (Continued)

Stock Options (Continued)

Other pertinent information related to the options is as follows:

	Number	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term (Years)	Aggregate Intrinsic Value
Year Ended December 31, 2020:				
Outstanding at beginning of year	773,831	\$ 31.32		
Granted	157,167	38.19		
Exercised	(19,418)	14.85		
Forfeited	(1,095)	40.68		
Outstanding at end of year	<u>910,485</u>	<u>\$ 32.84</u>	<u>7.05</u>	<u>\$ 4,948,807</u>
Exercisable at December 31, 2020	<u>424,028</u>	<u>\$ 27.17</u>	<u>5.10</u>	<u>\$ 4,115,636</u>
Year Ended December 31, 2019:				
Outstanding at beginning of year	669,199	\$ 28.05		
Granted	130,445	47.61		
Exercised	(19,473)	25.99		
Forfeited	(6,340)	39.94		
Outstanding at end of year	<u>773,831</u>	<u>\$ 31.32</u>	<u>7.50</u>	<u>\$ 7,176,768</u>
Exercisable at December 31, 2019	<u>310,950</u>	<u>\$ 23.56</u>	<u>5.21</u>	<u>\$ 4,844,059</u>

The fair market value of options vested during the year ended December 31, 2020 and 2019 totaled \$1,008,600 and \$843,700, respectively.

Restricted Stock

The Company may issue restricted stock from two plans, the 2011 Restricted Stock Incentive Plan (2011 RS Inc Plan) and the 2016 Plan (discussed in this note under “Stock Options”). The 2011 RS Inc Plan allows the Company to grant up to 120,000 shares of restricted stock. As of December 31, 2020, there are 34,808 shares under the 2011 RS Inc Plan available to be granted. As of December 31, 2020, there are 89,367 restricted shares under the 2016 Plan available to be granted (which are included in the 299,873 total awards available to be granted as disclosed in this note under “Stock Options”). Recipients of restricted stock do not pay any cash consideration to the Company for the shares. The restriction is based upon continuous service.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. EMPLOYEE AND DIRECTOR BENEFITS (Continued)

Restricted Stock (Continued)

Restricted stock consists of the following:

	Restricted Shares	Weighted- Average Grant Date Fair Value
Year Ended December 31, 2020:		
Balance, at beginning of year	18,663	\$ 21.11
Granted	-	-
Vested	(13,314)	18.75
Forfeited	-	-
Unvested balance, at end of year	<u>5,349</u>	<u>\$ 27.01</u>
 Year Ended December 31, 2019:		
Balance, at beginning of year	33,040	\$ 20.30
Granted	-	-
Vested	(13,311)	18.75
Forfeited	(1,066)	25.35
Unvested balance, at end of year	<u>18,663</u>	<u>\$ 21.11</u>

Stock-Based Compensation

The fair value of each stock option award is estimated on the date of grant using a Black-Scholes-Merton valuation model that uses the assumptions noted in the following table. Expected volatilities are based on an average of traded community banks. The Company considers historical data and peer group data to estimate option exercise and employee termination within the valuation model; separate groups of employees that have similar historical exercise behavior are considered separately for valuation purposes. The expected term of options granted is based on the short-cut method and represents the period of time that the options granted are expected to be outstanding. The risk-free rate for periods within the contractual life of the option is based on the U.S. Treasury yield curve in effect at the time of grant.

The fair value of stock options were based upon the following weighted-average assumptions for grants during the years ended December 31, 2020 and 2019:

	2020	2019
Dividend yield	2.00%	2.00%
Weighted-average stock price volatility	21.50%	20.10%
Expected life in years	6.58 years	8.1 years
Annual rate of forfeiture for stock options	3.19%	4.24%
Weighted-average risk-free interest rate	1.59%	2.62%
Weighted-average grant-date fair value	\$6.84	\$9.98

For the years ended December 31, 2020 and 2019, the Company recognized \$1,216,777 and \$929,935, respectively, in stock-based compensation expense related to stock option awards. As of December 31, 2020 and 2019, there was \$2,731,086 and \$2,810,701, respectively, of total unrecognized compensation cost related to nonvested share-based compensation arrangements granted. That cost is expected to be recognized over a weighted-average period of 2.98 years.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 7. EMPLOYEE AND DIRECTOR BENEFITS (Continued)

Restricted Stock Compensation

Compensation expense for restricted stock is based on the estimated market price of the Company stock at the time of the grant and amortized on a straight-line basis over the vesting period. Unvested restricted stock is shown as a reduction of stockholder's equity until earned. As of December 31, 2020, unvested restricted stock totaled \$67,086 and is expected to be recognized over a weighted-average period of 2.16 years. Total compensation expense recognized for the restricted stock granted to employees and directors for the year ended December 31, 2020 and 2019, was \$164,628 and \$201,312, respectively.

Bank-Owned Life Insurance

Investments in bank-owned life insurance programs are recorded at their respective cash surrender values. The cash surrender value and net interest earned on the related policies amounted to \$10,791,324 and \$301,423, respectively, as of and for the year ended December 31, 2020 and \$10,489,901 and \$303,870, respectively, as of and for the year ended December 31, 2019.

Loans Receivable

During 2019 the Company entered into loan agreements with certain members of the management team. Upon the formation of the Bank in 2008, the initial management team was granted ten-year stock options, and these loans were made in connection with the exercise of those stock options. The loans have a ten-year term and a stated interest rate based on the applicable Federal long-term rate in effect at inception, of 2.89% from inception through May 31, 2020. On June 1, 2020, a change in terms agreement adjusted the stated rate to 0.58% to reflect the then-current interest rate environment. Principal and interest are due annually. The carrying value of the loans was \$1,950,612 and \$2,179,113 at December 31, 2020 and 2019, respectively, and is included in other assets on the consolidated balance sheets.

NOTE 8. INCOME TAXES

Income tax expense consists of the following:

	Years Ended December 31,	
	2020	2019
Current	\$ 3,094,396	\$ 2,183,201
Deferred	(1,216,077)	(505,387)
Federal tax credit investment amortization	237,840	237,798
Income tax expense	<u>\$ 2,116,159</u>	<u>\$ 1,915,612</u>

The Company's income tax differs from the amounts computed by applying the federal income tax statutory rates to income before income taxes. A reconciliation of the differences is as follows:

	Years Ended December 31,	
	2020	2019
Income tax at federal statutory rate	\$ 1,989,070	\$ 2,073,384
Tax-exempt interest	(267,555)	(239,724)
State tax	348,071	368,868
Stock-based compensation	97,589	(14,697)
Federal tax credits	(96,050)	(96,083)
Other	45,034	(176,136)
Income tax expense	<u>\$ 2,116,159</u>	<u>\$ 1,915,612</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 8. INCOME TAXES (Continued)

The components of deferred income taxes are as follows:

	December 31,	
	2020	2019
Deferred income tax assets:		
Allowance for loan losses	\$ 2,165,032	\$ 1,570,385
Pre-opening and organization expenses	71,492	101,885
Stock-based compensation	392,653	262,573
Net operating loss carryforward	165,352	179,738
Deferred compensation	38,959	18,310
Federal tax credits	751	-
Goodwill	58,846	29,423
Other	639,968	206,358
	<u>3,533,053</u>	<u>2,368,672</u>
Deferred income tax liabilities:		
Depreciation	(659,693)	(712,153)
Federal tax credits	-	(17,538)
Investment in Shades Cahaba	(170,834)	(152,533)
Unrealized gain on securities available for sale	(838,234)	(313,444)
	<u>(1,668,761)</u>	<u>(1,195,668)</u>
Net deferred income tax assets	<u>\$ 1,864,292</u>	<u>\$ 1,173,004</u>

At December 31, 2020, the Company has available net operating loss carryforwards of approximately \$1,162,000 for federal tax purposes. If unused, the federal net operating loss carryforwards will begin to expire in 2027.

The federal and state income tax returns of the Company for 2017, 2018, and 2019 are subject to examination, generally for three years after they were filed.

The Company is invested in a partnership that generates federal low-income housing tax credits. The investment is being amortized into income tax expense over ten years, the expected term of the tax credits, using a proportional amortization method as allowed under ASU No. 2014-01, *Accounting for Investments in Qualified Affordable Housing Projects*. The remaining unamortized investment totaled \$713,470 and \$951,310 as of December 31, 2020 and 2019, respectively, and is included in other assets in the consolidated balance sheets. The resulting tax benefit of the amortization is recorded in deferred income taxes and totaled \$49,946 and \$49,937 for the years ended December 31, 2020 and 2019, respectively. Federal low-income housing tax credits generated from the partnership totaled \$283,944 and \$283,944 for the years ended December 31, 2020 and 2019, respectively, and are recorded as a reduction of current income tax expense. The following table summarizes the Company's net benefit from the investment in this tax credit.

	Years Ended December 31,	
	2020	2019
Federal low-income housing tax credit	\$ 283,944	\$ 283,944
Amortization of federal tax credit investment	(237,840)	(237,798)
Tax benefit of amortization included in deferred income taxes	49,946	49,937
Total federal tax credit benefit, net	<u>\$ 96,050</u>	<u>\$ 96,083</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 9. COMMITMENTS AND CONTINGENCIES

Loan Commitments

The Company is a 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. They involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized in the balance sheets. The majority of all commitments to extend credit are variable rate instruments.

The Company's exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments. A summary of the Company's commitments is as follows:

	December 31,	
	2020	2019
Commitments to extend credit	\$ 272,990,000	\$ 239,701,000
Standby letters of credit	6,315,000	4,617,000
	<u>\$ 279,305,000</u>	<u>\$ 244,318,000</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 amount of collateral obtained, if deemed necessary by the Company 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.

Letters of credit are conditional commitments issued by the Company 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 loans to customers. Collateral held varies as specified above and is required in instances which the Company deems necessary.

At December 31, 2020 and 2019, the carrying amount of liabilities related to the Company's obligation to perform under letters of credit was insignificant. The Company has not been required to perform on any letters of credit, and the Company has not incurred any losses on letters of credit for the years ended December 31, 2020 and 2019.

Contingencies

In the normal course of business, the Company is involved in various legal proceedings. In the opinion of management, any liability resulting from such proceedings would not have a material adverse effect on the Company's financial statements.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 10. CONCENTRATIONS

The Company originates primarily commercial, commercial real estate, residential real estate, and consumer loans to customers in Jefferson, Montgomery, and Mobile Alabama Counties, as well as, Williamson County Tennessee and surrounding areas. The ability of the majority of the Company's customers to honor their contractual loan obligations is dependent on the economy in these areas. Thirty-seven percent of the Company's outstanding loan portfolio is composed of real estate type loans, of which a substantial portion is secured by real estate in the Company's market area. Forty-six percent of the Company's loan portfolio consists of commercial and industrial type loans.

The Company does not extend credit to any single borrower or group of related borrowers on a secured basis in excess of 20% of capital, as defined, or approximately \$17,936,000, or on an unsecured basis in excess of 10% of capital, as defined, or approximately \$8,968,000. In addition, internal Company policies may further limit the extension of credit to any single borrower or group of related borrowers.

NOTE 11. REGULATORY MATTERS

The Bank is subject to certain restrictions on the amount of dividends that may be declared without prior regulatory approval. At December 31, 2020, approximately \$18,111,000 of retained earnings was available for dividend declaration without regulatory approval.

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

On September 17, 2019, the federal banking agencies issued a final rule providing simplified capital requirements for certain community banking organizations (banks and holding companies) with less than \$10 billion in total consolidated assets, implementing provisions of The Economic Growth, Regulatory Relief, and Consumer Protection Act ("EGRRCPA"). Under the rule, a qualifying community banking organization would be eligible to elect the community bank leverage ratio ("CBLR") framework, or continue to measure capital under the existing Basel III requirements. The new rule was effective beginning January 1, 2020, and qualifying community banking organizations could elect to opt into the new community bank leverage ratio ("CBLR") in their call report beginning in the first quarter of 2020. A banking organization meets the definition of a qualifying community banking organization ("QCBO") if the organization has:

- A leverage ratio of greater than 9%;
- Total consolidated assets of less than \$10 billion;
- Total off-balance sheet exposures (excluding derivatives other than sold credit derivatives and unconditionally cancellable commitments) of 25% or less of total consolidated assets; and
- Total trading assets plus trading liabilities of 5% or less of total consolidated assets.

A banking organization that opts into the CBLR framework and meets the QCBO definition, including maintaining a leverage ratio in excess of 9%, is considered to be well capitalized.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 11. REGULATORY MATTERS (Continued)

On April 6, 2020, the federal banking regulators, implementing the applicable provisions of the CARES Act, issued rules which modified the CBLR framework so that: (i) beginning in the second quarter 2020 and until the end of the year, a banking organization that has a leverage ratio of 8% or greater and meets certain other criteria may elect to use the CBLR framework; and (ii) community banking organizations will have until January 1, 2022, before the CBLR requirement is reestablished at greater than 9%. Under the rules, the minimum CBLR is 8% beginning in the second quarter and for the remainder of calendar year 2020, 8.5% for calendar year 2021, and 9% thereafter. The numerator of the CBLR is Tier 1 capital, as calculated under present rules. The denominator of the CBLR is the Bank's average assets, calculated in accordance with the call report instructions less assets deducted from Tier 1 capital.

The Bank has opted into the CBLR as of December 31, 2020, and therefore the Bank is not required to comply with the Basel III capital requirements.

Under the Basel III capital requirements in effect as of December 31, 2019, quantitative measures established by regulation to ensure capital adequacy required the Bank to maintain minimum amounts and ratios of total common equity Tier 1, Tier 1 and total capital to risk-weighted assets, and of Tier 1 capital to average assets. In addition, the Bank was subject to an institution-specific capital buffer which had to exceed 2.50% to avoid limitations on distributions and discretionary bonus payments.

As of December 31, 2020 and 2019, the most recent notifications from the Bank's primary regulator categorized the Bank as well-capitalized under the regulatory framework for prompt corrective action. There are no conditions or events that management believes have changed the Bank's category.

The Bank's actual capital amounts and ratios are presented in the following table.

	Actual		For Capital Adequacy Purposes ¹		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<i>(Dollars in Thousands)</i>						
December 31, 2020:						
CBLR	\$ 80,653	9.343%	\$ 69,060	8.00%	\$ 69,060	8.00%
December 31, 2019:						
Total Capital to Risk Weighted Assets	\$ 79,767	13.200%	\$ 63,453	10.500%	\$ 60,432	10.000%
Tier I Capital to Risk Weighted Assets	\$ 73,705	12.196%	\$ 51,367	8.500%	\$ 48,345	8.000%
CET1 Capital to Risk Weighted Assets	\$ 73,705	12.196%	\$ 42,302	7.000%	\$ 39,281	6.500%
Tier I Capital to Average Total Assets	\$ 73,705	10.990%	\$ 26,827	4.000%	\$ 33,533	5.000%

¹ Includes the capital conservation buffer.

NOTE 12. DERIVATIVE INSTRUMENTS

Derivative instruments are reported at fair value in other assets and other liabilities in the accompanying consolidated balance sheets. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current earnings. The Company has entered into interest rate swaps ("swaps") to facilitate customer transactions in connection with their financing needs. Upon entering into swaps with borrowers, the Company enters into offsetting positions with counterparties to minimize risk to the Company. These back-to-back swaps qualify as derivatives, but are not designated as hedging instruments. As a result, these instruments are classified as trading assets and liabilities.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 12. DERIVATIVE INSTRUMENTS (Continued)

Interest rate swap contracts involve the risk of dealing with borrowers and counterparties and their ability to meet contractual terms. When the fair value of a derivative instrument contract is positive, this generally indicates that the counterparty or customer owes the Company, and results in credit risk to the Company.

When the fair value of a derivative instrument contract is negative, the Company owes the customer or counterparty and therefore, has no credit risk.

A summary of the Company's interest rate swaps is included in the following table:

	December 31, 2020		December 31, 2019	
	Notional Amount	Estimated Fair Value	Notional Amount	Estimated Fair Value
Interest rate swap agreements:				
Pay variable/receive fixed swaps	\$ 20,121,190	\$ 2,188,989	\$ 21,620,589	\$ 1,198,867
Pay fixed/receive variable swaps	20,121,190	(2,188,989)	21,620,589	(1,198,867)
	<u>\$ 40,242,380</u>	<u>\$ -</u>	<u>\$ 43,241,178</u>	<u>\$ -</u>

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES

Determination of Fair Value

The Company uses fair value measurements to record fair value adjustments to certain assets and liabilities and to determine fair value disclosures. In accordance with the *Fair Value Measurements and Disclosures* topic (FASB ASC 820), the fair value of a financial instrument is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Accordingly, the fair value estimates may not be realized in an immediate settlement of the instrument.

The fair value guidance provides a consistent definition of fair value, which focuses on exit price in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. If there has been a significant decrease in the volume and level of activity for the asset or liability, a change in valuation technique or the use of multiple valuation techniques may be appropriate. In such instances, determining the price at which willing market participants would transact at the measurement date under current market conditions depends on the facts and circumstances and requires the use of significant judgment. The fair value is a reasonable point within the range that is most representative of fair value under current market conditions.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value Hierarchy

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured 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.

Level 1 - Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.

Level 2 - Valuation is based on inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.

Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

A financial instrument's categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

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

Cash and Due From Banks, Federal Funds Sold and Interest-Bearing Deposits in Banks: The carrying amounts of these short-term instruments approximate fair values based on the short-term nature of the assets.

Securities: Where quoted prices are available in an active market, management classifies the securities within level 1 of the valuation hierarchy. Securities are defined as both long and short positions. Level 1 securities include highly liquid government bonds and exchange-traded equities.

If quoted market prices are not available, management estimates fair values using pricing models and discounted cash flows that consider standard input factors such as observable market data, benchmark yields, interest rate volatilities, broker/dealer quotes, and credit spreads. Examples of such instruments, which would generally be classified within level 2 of the valuation hierarchy, include GSE obligations, and municipal securities. Mortgage-backed securities are included in level 2 if observable inputs are available. In certain cases where there is limited activity or less transparency around inputs to the valuation, those securities are classified in level 3.

Restricted Equity Securities: The carrying amount of restricted equity securities with no readily determinable fair value approximates fair value based on the redemption provisions of the issuers which is cost.

Loans: For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair value for other loans (for example, commercial real estate, mortgage loans, commercial and industrial loans) are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value Hierarchy (Continued)

Deposits: The fair values disclosed for demand deposits (for example, interest and noninterest checking, savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (that is, their carrying amounts). Fair values for fixed-rate certificates of deposit are estimated using a discounted cash flow calculation that applies market interest rates on comparable instruments to a schedule of aggregated expected monthly maturities on time deposits.

Accrued Interest: The carrying amount of accrued interest approximates fair value.

Bank-Owned Life Insurance: The carrying amount of bank-owned life insurance approximates fair value.

Trading Assets and Liabilities: The Company has derivative instruments in the form of interest rate swap agreements accounted for as trading assets and liabilities and carried at fair value. The fair value of these instruments is based on information obtained from a third party financial institution. The Company reflects these instruments within level 3 of the valuation hierarchy.

Off-Balance Sheet Credit-Related Instruments: Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing.

Assets and Liabilities Measured at Fair Value on a Recurring Basis

The following table presents financial assets and liabilities measured at fair value on a recurring basis:

	Assets/Liabilities Measured at Fair Value	Fair Value Measurements Using			
		Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
At December 31, 2020:					
Securities available for sale	\$ 79,533,966	\$ -	\$ 79,533,966	\$ -	
Trading assets	2,188,989	-	-	2,188,989	
Trading liabilities	(2,188,989)	-	-	(2,188,989)	
At December 31, 2019:					
Securities available for sale	\$ 61,021,800	\$ -	\$ 61,021,800	\$ -	
Trading assets	1,198,867	-	-	1,198,867	
Trading liabilities	(1,198,867)	-	-	(1,198,867)	

Assets Measured at Fair Value on a Nonrecurring Basis

There were no instruments measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets as of December 31, 2020 and 2019.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 13. FAIR VALUE OF ASSETS AND LIABILITIES (Continued)

Fair Value of Financial Instruments

The carrying amount and estimated fair value of the Company's financial instruments as of December 31, 2020 and 2019 were as follows:

	December 31, 2020		December 31, 2019	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and due from banks, interest-bearing deposits in banks, and federal funds sold	\$ 119,687,017	\$ 119,687,017	\$ 97,227,828	\$ 97,227,828
Securities	79,533,966	79,533,966	61,021,800	61,021,800
Restricted equity securities	646,000	646,000	552,500	552,500
Loans, net	686,948,392	691,400,034	537,107,076	537,902,327
Accrued interest receivable	2,453,001	2,453,001	1,983,069	1,983,069
Bank-owned life insurance	10,791,324	10,791,324	10,489,901	10,489,901
Trading assets	2,188,989	2,188,989	1,198,867	1,198,867
Financial liabilities:				
Deposits	810,308,256	810,291,215	626,815,469	626,498,155
Accrued interest payable	101,550	101,550	1,167,633	1,167,633
Trading liabilities	2,188,989	2,188,989	1,198,867	1,198,867

NOTE 14. PARENT COMPANY ONLY FINANCIAL STATEMENTS

The following information presents the condensed balance sheets of Oakworth Capital, Inc. as of December 31, 2020 and 2019 and the condensed statements of income and cash flows for the years then ended.

CONDENSED BALANCE SHEETS

	2020	2019
Assets		
Cash	\$ 9,693,474	\$ 7,969,136
Investment in subsidiary	83,764,599	75,446,420
Loans receivable	1,950,612	2,179,113
Other assets	198,152	160,281
Total assets	<u>\$ 95,606,837</u>	<u>\$ 85,754,950</u>
Liabilities and stockholders' equity		
Dividends declared	\$ 1,430,092	\$ 1,183,272
Other liabilities	77,872	23,296
Total liabilities	<u>1,507,964</u>	<u>1,206,568</u>
Stockholders' equity	<u>94,098,873</u>	<u>84,548,382</u>
Total liabilities and stockholders' equity	<u>\$ 95,606,837</u>	<u>\$ 85,754,950</u>

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 14. PARENT COMPANY ONLY FINANCIAL STATEMENTS (Continued)

CONDENSED STATEMENTS OF INCOME

	2020	2019
Income		
Dividend income	\$ 2,000,000	\$ 3,000,000
Miscellaneous income	29,571	44,685
Total income	<u>2,029,571</u>	<u>3,044,685</u>
Expense		
Equipment expense	10,865	10,865
Restricted stock compensation	29,360	20,627
Other operating expense	163,571	101,961
Total expense	<u>203,796</u>	<u>133,453</u>
Income before income tax benefit and undistributed earnings of subsidiary	1,825,775	2,911,232
Income tax benefit	<u>(46,900)</u>	<u>(34,763)</u>
Income before undistributed earnings of subsidiary	1,872,675	2,945,995
Undistributed earnings of subsidiary	<u>5,482,926</u>	<u>5,011,652</u>
Net income	<u>\$ 7,355,601</u>	<u>\$ 7,957,647</u>

CONDENSED STATEMENTS OF CASH FLOWS

	2020	2019
OPERATING ACTIVITIES		
Net income	\$ 7,355,601	\$ 7,957,647
Adjustments to reconcile net income to net cash provided by operating activities:		
Undistributed earnings of subsidiary	(5,482,926)	(5,011,652)
Increase (decrease) in loans receivable	228,501	(2,179,113)
Restricted stock compensation	29,360	20,627
Net other operating activities	16,706	28,076
Net cash provided by operating activities	<u>2,147,242</u>	<u>815,585</u>
FINANCING ACTIVITIES		
Issuance of common stock	677,132	506,109
Exercise of stock options	234,547	94,155
Purchase of treasury stock	(151,310)	(206,260)
Dividends paid	(1,183,273)	(942,827)
Net cash used in financing activities	<u>(422,904)</u>	<u>(548,823)</u>
Increase in cash	1,724,338	266,762
Cash at beginning of year	<u>7,969,136</u>	<u>7,702,374</u>
Cash at end of year	<u>\$ 9,693,474</u>	<u>\$ 7,969,136</u>