

Section 1: 10-Q (10-Q)

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period June 30, 2018

or

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File Number: 000-52598

KENTUCKY BANCSHARES, INC.

(Exact name of registrant as specified in its charter)

Kentucky

(State or other jurisdiction of
incorporation or organization)

61-0993464

(I.R.S. Employer Identification No.)

P.O. Box 157, Paris, Kentucky

(Address of principal executive offices)

40362-0157

(Zip Code)

Registrant's telephone number, including area code: **(859) 987-1795**

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or an emerging growth company. See the definitions of "large accelerated filer," "accelerated filer," "smaller reporting company," and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer

Accelerated filer

Non-accelerated filer

(Do not check if a smaller reporting company)

Smaller reporting company

Emerging growth company

If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

Number of shares of Common Stock outstanding as of July 31, 2018: 2,978,344.

KENTUCKY BANCSHARES, INC.

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Item 1 – Financial Statements

KENTUCKY BANCSHARES, INC.
CONSOLIDATED BALANCE SHEETS (unaudited)
(Dollar amounts in thousands except per share data)

	<u>6/30/2018</u>	<u>12/31/2017</u>
ASSETS		
Cash and due from banks	\$ 28,765	\$ 38,851
Federal funds sold	5	321
Cash and cash equivalents	28,770	39,172
Interest bearing time deposits	1,785	1,830
Securities available for sale	290,504	318,177
Loans held for sale	2,005	1,231
Loans	668,778	648,535
Allowance for loan losses	(8,184)	(7,720)
Net loans	660,594	640,815
Federal Home Loan Bank stock	7,034	7,034
Real estate owned, net	1,404	2,404
Bank premises and equipment, net	17,728	16,539
Interest receivable	3,733	3,951
Mortgage servicing rights	1,606	1,511
Goodwill	14,001	14,001
Other intangible assets	298	369
Bank owned life insurance	10,075	—
Other assets	7,570	6,159
Total assets	<u>\$ 1,047,107</u>	<u>\$ 1,053,193</u>
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits		
Non-interest bearing	\$ 238,033	\$ 230,241
Time deposits, \$250,000 and over	49,198	79,578
Other interest bearing	515,251	505,454
Total deposits	802,482	815,273
Repurchase agreements	9,120	19,900
Federal funds purchased	15,717	—
Short-term Federal Home Loan Bank advances	16,000	8,400
Long-term Federal Home Loan Bank advances	86,683	90,332
Note payable	2,963	3,321
Subordinated debentures	7,217	7,217
Interest payable	645	838
Other liabilities	5,791	7,583
Total liabilities	946,618	952,864
Stockholders' equity		
Preferred stock, 300,000 shares authorized and unissued	—	—
Common stock, no par value; 10,000,000 shares authorized; 2,978,386 and 2,971,522 shares issued and outstanding at June 30, 2018 and December 31, 2017	21,085	20,931
Retained earnings	84,764	80,395
Accumulated other comprehensive loss	(5,360)	(997)
Total stockholders' equity	100,489	100,329
Total liabilities and stockholders' equity	<u>\$ 1,047,107</u>	<u>\$ 1,053,193</u>

See Accompanying Notes

KENTUCKY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF INCOME (unaudited)
(Dollar amounts in thousands except per share data)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>6/30/2018</u>	<u>6/30/2017</u>	<u>6/30/2018</u>	<u>6/30/2017</u>
INTEREST INCOME:				
Loans, including fees	\$ 8,421	\$ 7,712	\$ 16,433	\$ 15,206
Securities				
Taxable	1,549	1,135	3,051	2,197
Tax exempt	436	568	949	1,176
Trading assets	—	25	—	59
Other	144	144	337	322
Total interest income	<u>10,550</u>	<u>9,584</u>	<u>20,770</u>	<u>18,960</u>
INTEREST EXPENSE:				
Deposits	904	684	1,751	1,329
Repurchase agreements and federal funds purchased	41	25	64	51
Federal Home Loan Bank advances	441	388	876	785
Note payable	26	49	62	99
Subordinated debentures	105	77	190	157
Total interest expense	<u>1,517</u>	<u>1,223</u>	<u>2,943</u>	<u>2,421</u>
Net interest income	9,033	8,361	17,827	16,539
Provision for loan losses	250	200	250	550
Net interest income after provision	<u>8,783</u>	<u>8,161</u>	<u>17,577</u>	<u>15,989</u>
NON-INTEREST INCOME:				
Service charges	1,326	1,302	2,614	2,525
Loan service fee income, net	96	60	148	174
Trust department income	320	287	635	575
Gain (loss) on sale of available for sale securities, net	(30)	43	(74)	43
Gain (loss) on trading assets	—	34	—	51
Gain on sale of loans	445	491	819	1,041
Brokerage income	141	181	350	374
Debit card interchange income	837	780	1,600	1,511
Gain on bank premises	—	6	—	1,200
Other	173	111	267	151
Total other income	<u>3,308</u>	<u>3,295</u>	<u>6,359</u>	<u>7,645</u>
NON-INTEREST EXPENSE:				
Salaries and employee benefits	4,717	4,508	9,210	8,953
Occupancy expenses	1,084	984	2,064	1,949
Repossession expenses, net	42	106	57	185
FDIC Insurance	77	94	156	188
Legal and professional fees	196	194	425	477
Data processing	463	494	932	900
Debit card expenses	432	443	866	818
Amortization expense of intangible assets, excluding mortgage servicing right	35	43	71	86
Advertising and marketing	221	212	440	424
Taxes other than payroll, property and income	313	300	625	600
Telephone	119	137	198	259
Postage	87	85	172	178
Loan fees	17	48	57	111
Other	781	901	1,601	1,607
Total other expenses	<u>8,584</u>	<u>8,549</u>	<u>16,874</u>	<u>16,735</u>
Income before income taxes	3,507	2,907	7,062	6,899
Provision for income taxes	439	497	846	1,352
Net income	<u>\$ 3,068</u>	<u>\$ 2,410</u>	<u>\$ 6,216</u>	<u>\$ 5,547</u>
Earnings per share				
Basic	\$ 1.03	\$ 0.81	\$ 2.09	\$ 1.87
Diluted	1.03	0.81	2.09	1.87
Dividends per share	0.31	0.29	0.62	0.58

See Accompanying Notes

KENTUCKY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (unaudited)
(Dollar amounts in thousands)

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>6/30/2018</u>	<u>6/30/2017</u>	<u>6/30/2018</u>	<u>6/30/2017</u>
Net income	\$ 3,068	\$ 2,410	\$ 6,216	\$ 5,547
Other comprehensive income (loss)				
Unrealized gains (losses) on securities arising during the period	(1,253)	2,214	(5,596)	3,330
Reclassification of realized amount	30	(43)	74	(43)
Net change in unrealized gain (loss) on securities	(1,223)	2,171	(5,522)	3,287
Less: Tax impact	257	(738)	1,159	(1,118)
Other comprehensive income (loss)	(966)	1,433	(4,363)	2,169
Comprehensive income	<u>\$ 2,102</u>	<u>\$ 3,843</u>	<u>\$ 1,853</u>	<u>\$ 7,716</u>

See Accompanying Notes

KENTUCKY BANCSHARES, INC.
 CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY (unaudited)
 (Dollar amounts in thousands except per share data)

	<u>Common Stock</u>		<u>Retained Earnings</u>	<u>Accumulated Other Comprehensive Loss</u>	<u>Total Stockholders' Equity</u>
	<u>Shares</u>	<u>Amount</u>		<u>Loss</u>	
Balances, December 31, 2017	2,971,522	\$20,931	\$ 80,395	\$ (997)	\$ 100,329
Common stock issued (employee stock grants of 5,283 shares, net of 437 shares forfeited, director stock grants of 981 shares and director stock options exercised of 600 shares)	6,864	64	—	—	64
Stock compensation expense	—	90	—	—	90
Other comprehensive loss	—	—	—	(4,363)	(4,363)
Net income	—	—	6,216	—	6,216
Dividends declared - \$0.62 per share	—	—	(1,847)	—	(1,847)
Balances, June 30, 2018	<u>2,978,386</u>	<u>\$21,085</u>	<u>\$ 84,764</u>	<u>\$ (5,360)</u>	<u>\$ 100,489</u>

(1) Common Stock has no par value; amount includes Additional Paid-in Capital

See Accompanying Notes

KENTUCKY BANCSHARES, INC.
CONSOLIDATED STATEMENT OF CASH FLOWS (unaudited)
(Dollar amounts in thousands)

	Six Months Ended	
	6/30/2018	6/30/2017
Cash Flows From Operating Activities		
Net Income	\$ 6,216	\$ 5,547
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	630	586
Amortization (accretion), net	(249)	(263)
Securities amortization (accretion), net	461	500
Stock based compensation expense	90	80
Provision for loan losses	250	550
Securities losses (gains) available for sale gains, net	74	(43)
Net change in trading assets	—	(110)
Net increase in cash surrender value of bank-owned life insurance	(75)	—
Originations of loans held for sale	(29,092)	(32,957)
Proceeds from sale of loans	29,137	32,805
Losses (gains) on sale of bank premises and equipment	—	(1,200)
Losses (gains) on other real estate	(115)	(17)
Gain on sale of loans	(819)	(1,041)
Write-downs of other real estate, net	—	38
Changes in:		
Interest receivable	218	101
Other assets	(248)	(181)
Interest payable	(193)	(30)
Deferred taxes	(25)	260
Other liabilities	(1,792)	(1,374)
Net cash from operating activities	4,468	3,251
Cash Flows From Investing Activities		
Net change in interest bearing time deposits	45	20
Purchases of securities available for sale	(18,631)	(37,702)
Purchase of bank owned life insurance	(10,000)	—
Proceeds from sales of securities available for sale	14,715	4,017
Proceeds from principal payments, maturities and calls securities available for sale	25,553	20,131
Net change in loans	(19,925)	3,533
Purchases of bank premises and equipment	(1,819)	(1,692)
Proceeds from the sale of bank premises and equipment	—	2,174
Capitalized expenditures for other real estate	(74)	—
Proceeds from the sale of other real estate	1,310	918
Net cash used in investing activities	(8,826)	(8,601)
Cash Flows From Financing Activities:		
Net change in deposits	(12,791)	(19,009)
Net change in federal funds purchased	15,717	—
Net change in repurchase agreements	(10,780)	3,077
Net change in short-term Federal Home Loan Bank advances	7,600	5,000
Repayment of long-term Federal Home Loan Bank advances	(3,649)	(8,691)
Repayment of note payable	(358)	(217)
Proceeds from issuance of common stock	64	64
Purchase of common stock	—	(263)
Dividends paid	(1,847)	(1,724)
Net cash (used in) from financing activities	(6,044)	(21,763)
Net change in cash and cash equivalents	(10,402)	(27,113)
Cash and cash equivalents at beginning of period	39,172	43,250
Cash and cash equivalents at end of period	\$ 28,770	\$ 16,137
Supplemental disclosures of cash flow information Cash paid during the year for:		
Interest expense	\$ 3,136	\$ 2,451
Supplemental disclosures of non-cash investing activities		
Securities transactions in process, payable	—	7,642
Real estate acquired through foreclosure	121	1,897

See Accompanying Notes

1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial information presented as of any date other than December 31 has been prepared from the Company's books and records without audit. The accompanying consolidated financial statements have been prepared in accordance with the instructions to Form 10-Q and Rule 10-01 of Regulation S-X. Certain financial information that is normally included in annual financial statements prepared in accordance with accounting principles generally accepted in the United States of America, but is not required for interim reporting purposes, has been condensed or omitted. There have been no significant changes to the Company's accounting and reporting policies as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017. In the opinion of management, all adjustments, consisting of normal recurring adjustments, necessary for a fair presentation of such financial statements, have been included. The results of operations for the interim periods are not necessarily indicative of the results to be expected for the full year. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Basis of Presentation: The consolidated financial statements include the accounts of Kentucky Bancshares, Inc. ("Kentucky Bancshares", the "Company", "we", "our" or "us"), its wholly-owned subsidiaries, Kentucky Bank (the "Bank") and KBI Insurance Company, Inc., and the Bank's wholly-owned subsidiary, KB Special Assets Unit, LLC. Intercompany transactions and balances have been eliminated in consolidation.

Nature of Operations: As a state bank, the Bank is subject to regulation by the Kentucky Department of Financial Institutions and the Federal Deposit Insurance Corporation ("FDIC"). The Company, a bank holding company, is regulated by the Federal Reserve.

KBI Insurance Company, Inc. is a subsidiary of Kentucky Bancshares, Inc. and is located in Las Vegas, Nevada. It is a captive insurance subsidiary which provides various liability and property damage insurance policies for Kentucky Bancshares, Inc. and its related subsidiaries. KBI Insurance Company, Inc. is regulated by the State of Nevada Division of Insurance.

Estimates in the Financial Statements: The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates and such differences could be material to the financial statements.

Bank Owned Life Insurance: The Company has purchased life insurance policies on certain key executives. Bank owned life insurance is recorded at the amount that can be realized under the insurance contract at the balance sheet date, which is the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Loss Contingencies: Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

Reclassifications: Some items in the prior year financial statements were reclassified to conform to the current presentation. Reclassifications had no effect on prior period net income or stockholders' equity.

Adoption of New Accounting Standards

ASU 2016-13, "Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." Issued in June 2016, ASU 2016-13 will add Financial Accounting Standards Board "FASB" ASC Topic 326, "Financial Instruments-Credit Losses" and finalizes amendments to FASB ASC Subtopic 825-15, "Financial Instruments-Credit Losses." The amendments of ASU 2016-13 are intended to provide financial statement users with more decision-useful information related to expected credit losses on financial instruments and other commitments to extend credit by replacing the current incurred loss impairment methodology with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to determine credit loss estimates.

The amendments of ASU 2016-13 eliminate the probable initial recognition threshold and, in turn, reflect an entity's current estimate of all expected credit losses. ASU 2016-13 does not specify the method for measuring expected credit losses, and an entity is allowed to apply methods that reasonably reflect its expectations of the credit loss estimate. Additionally, the amendments of ASU 2016-13 require that credit losses on available for sale debt securities be presented as an allowance rather than as a writedown.

The amendments of ASU 2016-13 are effective for interim and annual periods beginning after December 15, 2019. Earlier application is permitted for interim and annual periods beginning after December 15, 2018. Kentucky Bancshares plans to adopt the amendments of ASU 2016-13 during the first quarter of 2020. Kentucky Bancshares has established a steering committee which includes the appropriate members of management to evaluate the impact this ASU will have on the Company's financial position, results of operations and financial statement disclosures and determine the most appropriate method of implementing the amendments in this ASU as well as any resources needed to implement the amendments.

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 lease liabilities on the balance sheet and by disclosing key information about leasing arrangements. ASU 2016-02 will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis; and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 does not significantly change lease accounting requirements applicable to lessors; however, the ASU contains some targeted improvements that are intended to align, where necessary, lessor accounting with the lessee accounting model and with the updated revenue recognition guidance issued in 2014. The amendments of ASU 2016-02 are effective for interim and annual periods beginning after December 15, 2018. Kentucky Bancshares plans to adopt the amendments of ASU 2016-02 beginning in the first quarter of 2019. At adoption, Kentucky Bancshares will recognize a lease asset and a corresponding lease liability on its consolidated balance sheet for its total lease obligation measured on a discounted basis. As of June 30, 2018, all leases in which Kentucky Bancshares was the lessee were classified as operating leases. The adoption of this standard will not have a material impact on the Company's consolidated statements of income, balance sheet or regulatory capital as the Company has an immaterial amount of leases in which it is the lessee.

ASU 2016-01, "Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities (An Amendment of the FASB Accounting Standards Codification)." Issued in January 2016, ASU 2016-01 is intended to enhance the reporting model for financial instruments to provide users of financial statements with improved decision-making information. The amendments of ASU 2016-01 include: (i) requiring equity investments, except those accounted for under the equity method of accounting or those that result in the consolidation of an investee, to be measured at fair value with changes in fair value recognized in net income; (ii) requiring a qualitative assessment to identify impairment of equity investments without readily determinable fair values; (iii) eliminating the requirement to disclose the method and significant assumptions used to estimate the fair value for financial instruments measured at amortized cost on the balance sheet; (iv) requiring the use of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (v) requiring an entity that has elected the fair value option to measure the fair value of a liability to present separately in other comprehensive income the portion of the change in the fair value resulting from a change in the instrument-specific credit risk; (vi) requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (vii) clarifying that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available for sale securities in combination with the entity's other deferred tax assets. The amendments of ASU 2016-01 are effective for interim and annual periods beginning after December 15, 2017. Kentucky Bancshares adopted the amendments of ASU 2016-01 during the first quarter of 2018. The adoption of this amendment did not have a material impact on the Company's consolidated financial statements.

ASU 2018-02, "Income Statement-Reporting Comprehensive Income (Topic 220) – Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income." On December 22, 2017, the U.S. federal government enacted a tax bill, H.R.1, An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018 ("Tax Cuts and Jobs Act"). Stakeholders in the banking and insurance industries submitted unsolicited comment letters to the FASB about a narrow-scope financial reporting issue that arose as a consequence of the Tax Cuts and Jobs Act.

Specifically, stakeholders expressed concern about the guidance in current generally accepted accounting principles (GAAP) that requires deferred tax liabilities and assets to be adjusted for the effect of a change in tax laws or rates with the effect included in income from continuing operations in the reporting period that includes the enactment date. That guidance is applicable even in situations in which the related income tax effects of items in accumulated other comprehensive income were originally recognized in other comprehensive income (rather than in income from continuing operations).

Those stakeholders asserted that because the adjustment of deferred taxes due to the reduction of the historical corporate income tax rate to the newly enacted corporate income tax rate is required to be included in income from continuing operations, the tax effects of items within accumulated other comprehensive income (referred to as stranded tax effects for purposes of ASU 2018-02) do not reflect the appropriate tax rate.

The amendments in ASU 2018-02 allowed a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Cuts and Jobs Act. Consequently, the amendments eliminate the stranded tax effects resulting from the Tax Cuts and Jobs Act and will improve the usefulness of information reported to financial statement users. However, because the amendments only relate to the reclassification of the income tax effects of the Tax Cuts and Jobs Act, the underlying guidance that requires that the effect of a change in tax laws or rates be included in income from continuing operations is not affected. The amendments in ASU 2018-02 also require certain disclosures about stranded tax effects.

The amendments in ASU 2018-02 are effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption of the amendments in ASU 2018-02 is permitted, including adoption in any interim period, (1) for public business entities for reporting periods for which financial statements have not yet been issued and (2) for all other entities for reporting periods for which financial statements have not yet been made available for issuance. The Company chose to early adopt the amendments in ASU 2018-02 as of December 31, 2017.

ASU 2014-09, "Revenue from Contracts with Customers (Topic 606)." Issued in May 2014, ASU 2014-09 will add FASB ASC Topic 606, "Revenue from Contracts with Customers," and will supersede revenue recognition requirements in FASB ASC Topic 605, "Revenue Recognition," as well as certain cost guidance in FASB ASC Topic 605-35, "Revenue Recognition – Construction-Type and Production-Type Contracts." ASU 2014-09 provides a framework for revenue recognition that replaces the existing industry and transaction specific requirements under the existing standards. ASU 2014-09 requires an entity to apply a five-step model to determine when to recognize revenue and at what amount. The model specifies that revenue should be recognized when (or as) an entity transfers control of goods or services to a customer at the amount in which the entity expects to be entitled. Depending on whether certain criteria are met, revenue should be recognized either over time, in a manner that depicts the entity's performance, or at a point in time, when control of the goods or services are transferred to the customer. ASU 2014-09 provides that an entity should apply the following steps: (1) identify the contract(s) with a customer; (2) identify the performance obligations in the contract; (3) determine the transaction price; (4) allocate the transaction price to the performance obligations in the contract; and (5) recognize revenue when (or as) the entity satisfies a performance obligation. In addition, the existing requirements for the recognition of a gain or loss on the transfer of non-financial assets that are not in a contract with a customer are amended to be consistent with the guidance on recognition and measurement in ASU 2014-09.

The amendments of ASU 2014-09 may be applied either retrospectively to each prior reporting period presented or retrospectively with the cumulative effect of initially applying ASU 2014-09 recognized at the date of initial application. If the transition method of application is elected, the entity should also provide the additional disclosures in reporting periods that include the date of initial application of (1) the amount by which each financial statement line item is affected in the current reporting period, as compared to the guidance that was in effect before the change, and (2) an explanation of the reasons for significant changes. ASU 2015-14, "Revenue from Contracts with Customers (Topic 606)-Deferral of the Effective Date," issued in August 2015, defers the effective date of ASU 2014-09 by one year. ASU 2015-14 provides that the amendments of ASU 2014-09 become effective for interim and annual periods beginning after December 15, 2017. All subsequently issued ASUs which provide additional guidance and clarifications to various aspects of FASB ASC Topic 606 will become effective when the amendments of ASU 2014-09 become effective. Kentucky Bancshares adopted these amendments during the first quarter of 2018 and there was no material impact to the Company's financial statements.

In March 2016, the FASB issued ASU No. 2016-08, *Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net)*. The amendments relate to when another party, along with the entity, is involved in providing a good or service to a customer. Topic 606 requires an entity to determine whether the nature of its promise is to provide that good or service to the customer (that is, the entity is a principal) or to arrange for the good or service to be provided to the customer by the other party (that is, the entity is an agent). This determination is based upon whether the entity controls the good or the service before it is transferred to the customer. Topic 606 includes indicators to assist in this evaluation. The amendments in this update affect the guidance in ASU No. 2014-09 above. The effective date is the same as the effective date of ASU No. 2014-09.

In April 2016, the FASB issued ASU No. 2016-10, *Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing*. The amendments clarify the following two aspects of Topic 606: identifying performance obligations, and the licensing implementation guidance. Before an entity can identify its performance obligations in a contract with a customer, the entity first identifies the promised goods or services in the contract. The amendments in this update are expected to reduce the cost and complexity of applying the guidance on identifying promised goods or services. To identify performance obligations in a contract, an entity evaluates whether promised goods and services are distinct. Topic 606 includes two criteria for assessing whether promises to transfer goods or services are distinct. One of those criteria is that the promises are separately identifiable. This update will improve the guidance on assessing that criterion. Topic 606 also includes implementation guidance on determining whether an entity's promise to grant a license provides a customer with either a right to use the entity's intellectual property, which is satisfied at a point in time, or a right to access the entity's intellectual property, which is satisfied over time. The amendments in this update are intended to improve the operability and understandability of the licensing implementation guidance. The amendments in this update affect the guidance in ASU No. 2014-09 above. The effective date is the same as the effective date of ASU No. 2014-09.

In May 2016, the FASB issued ASU No. 2016-12, *Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients*. The amendments do not change the core revenue recognition principle in Topic 606. The amendments provide clarifying guidance in certain narrow areas and add some practical expedients.

In December 2016, the FASB issued ASU No. 2016-20, *Revenue from Contracts with Customers (Topic 606): Technical Corrections and Improvements*. The FASB board decided to issue a separate update for technical corrections and improvements to Topic 606 and other Topics amended by ASU No. 2014-09 to increase awareness of the proposals and to expedite improvements to ASU No. 2014-09. The amendment affects narrow aspects of the guidance issued in ASU No. 2014-09.

On January 1, 2018, we adopted ASU 2014-09, *Revenue from Contracts with Customers* and all subsequent amendments to the ASU (collectively, "Topic 606"). We elected to implement using the modified retrospective application, with the cumulative effect recorded as an adjustment to opening retained earnings at January 1, 2018. Due to immateriality, we had no cumulative effect to record. Since interest income on loans and securities are both excluded from this topic, a significant majority of our revenues are not subject to the new guidance. Our services that fall within the scope of Topic 606 are presented within noninterest income and are recognized as revenue as we satisfy our obligation to the customer. Services within the scope of Topic 606 include trust department income, service charges, debit card interchange income, and brokerage income.

Trust department income: We earn wealth management fees based upon asset custody, investment management, trust, and estate services provided to customers. Most of these customers receive monthly billings for services rendered based upon the market value of assets and/or income generated. Fees that are transaction based are recognized at the point in time that the transaction is executed.

Service charges: We earn fees from our deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees and overdraft fees are recognized at a point in time, since the customer generally has a right to cancel the depository arrangement at any time. The arrangement is considered a day-to-day contract with ongoing renewals and optional purchases, so the duration of the contract does not extend beyond the services already performed. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which we satisfy our performance obligation.

Debit card interchange income: As with the transaction-based fees on deposit accounts, debit card interchange income is recognized at the point in time that we fulfill the customer's request. We earn interchange fees from cardholder transactions processed through card association networks. Interchange rates are generally set by the card associations based upon purchase volumes and other factors. Interchange fees represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder.

Brokerage income: Brokerage income fees are the commissions and fees received from a registered broker/dealer and investment adviser that provide those services to our customers. We act as an agent in arranging the relationship between the customer and the third-party service provider. These fees are recognized monthly from the third-party broker based upon services already performed.

ASU 2018-07, Compensation – Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting. Issued in June 2018, the amendments in ASU 2018-07 to Topic 718, Compensation-Stock Compensation, are intended to align the accounting for share-based payment awards issued to employees and nonemployees. Changes to the accounting for nonemployee awards include: 1) equity classified share-based payment awards issued to nonemployees will now be measured on the grant date, instead of the previous requirement to remeasure the awards through the performance completion date; 2) for performance conditions, compensation cost associated with the award will be recognized when achievement of the performance condition is probable, rather than upon achievement of the performance condition; and 3) the current requirement to reassess the classification (equity or liability) for nonemployee awards upon vesting will be eliminated, except for awards in the form of convertible instruments. The new guidance also clarifies that any share-based payment awards issued to customers should be evaluated under ASC 606, Revenue from Contracts with Customers. The amendments in this ASU are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018.

The Company's share-based payment awards to nonemployees consist only of grants made to the Company's Board of Directors as compensation solely related to the individual's role as a Director. As such, in accordance with ASC 718, the Company accounts for these share-based payment awards to its Directors in the same manner as share-based payment awards for its employees. Accordingly, the amendments in this guidance will not have an effect on the accounting for the Company's share-based payment awards to its Directors.

ASU 2018-09, Codification Improvements. Issued in July 2018, the amendments in ASU 2018-09 are intended to clarify or correct unintended guidance in the FASB Codification and affect a wide variety of Topics in the Codification. The topics that are applicable to the Company include: 1) debt modifications and extinguishments and 2) stock compensation. For debt modifications and extinguishments, the amendment clarifies that, in an early extinguishment of debt for which the fair value option has been elected, the net carrying amount of the extinguished debt is equal to its fair value at the reacquisition date, and upon extinguishment, the cumulative amount of the gain or loss on the extinguished debt that resulted from changes in instrument-specific credit risk should be presented in net income. The Company has subordinated debentures. Accordingly, if in the future, the Company chooses to repay this debt prior to its contractual maturity, this amendment would be applicable. For stock compensation, the amendment clarifies that excess tax benefits or tax deficiencies should be recognized in the period in which the amount of the tax deduction is determined, which is typically when an award is exercised (in the case of stock options) or vests (in the case of non-vested stock grants or awards). The Company already records excess tax benefits or tax deficiencies in the periods in which the tax deduction is determined. Therefore, this amendment will not have an effect on the Company's accounting for excess tax benefits or tax deficiencies.

2. SECURITIES

SECURITIES AVAILABLE FOR SALE

Period-end securities are as follows:
(in thousands)

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for Sale				
June 30, 2018				
U.S. treasury notes	\$ 4,039	\$ —	\$ (77)	\$ 3,962
U. S. government agencies	33,948	368	(786)	33,530
States and political subdivisions	74,323	641	(883)	74,081
Mortgage-backed - residential	135,510	20	(4,559)	130,971
Mortgage-backed - commercial	49,199	—	(1,522)	47,677
Equity securities	270	13	—	283
Total	\$ 297,289	\$ 1,042	\$ (7,827)	\$290,504
December 31, 2017				
U.S. treasury notes	\$ 4,046	\$ —	\$ (22)	\$ 4,024
U. S. government agencies	41,658	405	(358)	41,705
States and political subdivisions	88,485	1,783	(133)	90,135
Mortgage-backed - residential	132,664	43	(2,330)	130,377
Mortgage-backed - commercial	52,267	18	(689)	51,596
Equity securities	320	20	—	340
Total	\$ 319,440	\$ 2,269	\$ (3,532)	\$318,177

The amortized cost and fair value of securities as of June 30, 2018 by contractual maturity are shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity are shown separately. Further discussion concerning Fair Value Measurements can be found in Note 9.

	Amortized Cost	Fair Value
Due in one year or less	\$ 84	\$ 84
Due after one year through five years	32,424	32,322
Due after five years through ten years	25,508	25,211
Due after ten years	54,294	53,956
	112,310	111,573
Mortgage-backed - residential	135,510	130,971
Mortgage-backed - commercial	49,199	47,677
Equity	270	283
Total	\$ 297,289	\$290,504

Proceeds from sales of securities during the first six months of 2018 and 2017 were \$14.7 million and \$4.0 million. Gross gains of \$66 thousand and \$43 thousand and gross losses of \$114 thousand and \$0 were realized on those sales, respectively. The tax provision related to these realized net gains or losses was \$(10) thousand and \$15 thousand, respectively.

Proceeds from sales of securities during the three months ended June 30, 2018 and June 30, 2017 were \$10.8 million and \$4.0 million. Gross gains of \$32 thousand and \$43 thousand and gross losses of \$36 thousand and \$0 were realized on those sales, respectively. The tax provision related to these realized net gains or losses was \$(1) thousand and \$15 thousand, respectively.

Securities with unrealized losses at June 30, 2018 and at December 31, 2017 not recognized in income are as follows:

June 30, 2018

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. treasury notes	\$ 3,962	\$ (77)	\$ —	\$ —	\$ 3,962	\$ (77)
U.S. government agencies	23,798	(464)	7,925	(322)	31,723	(786)
States and municipals	38,547	(774)	2,688	(109)	41,235	(883)
Mortgage-backed - residential	70,430	(2,075)	53,567	(2,484)	123,997	(4,559)
Mortgage-backed - commercial	38,069	(1,135)	6,768	(387)	44,837	(1,522)
Total temporarily impaired	<u>\$ 174,807</u>	<u>\$ (4,525)</u>	<u>\$70,948</u>	<u>\$ (3,302)</u>	<u>\$ 245,755</u>	<u>\$ (7,827)</u>

December 31, 2017

Description of Securities	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
U.S. treasury notes	\$ 4,024	\$ (22)	\$ —	\$ —	\$ 4,024	\$ (22)
U.S. government agencies	18,405	(130)	12,692	(228)	31,097	(358)
States and municipals	15,442	(97)	2,769	(36)	18,211	(133)
Mortgage-backed - residential	70,646	(817)	54,760	(1,513)	125,406	(2,330)
Mortgage-backed - commercial	39,394	(409)	7,371	(280)	46,765	(689)
Total temporarily impaired	<u>\$ 147,911</u>	<u>\$ (1,475)</u>	<u>\$ 77,592</u>	<u>\$ (2,057)</u>	<u>\$ 225,503</u>	<u>\$ (3,532)</u>

The Company evaluates securities for other-than-temporary impairment at least on a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. In analyzing an issuer's financial condition, we may consider many factors including, (1) whether the securities are issued by the federal government or its agencies, (2) whether downgrades by bond rating agencies have occurred, (3) the results of reviews of the issuer's financial condition and near-term prospects, (4) the length of time and the extent to which the fair value has been less than cost, and (5) whether we intend to sell the investment security or more likely than not will be required to sell the investment security before its anticipated recovery.

Unrealized losses on securities included in the tables above have not been recognized into income because (1) all rated securities are investment grade and are of high credit quality, (2) management does not intend to sell and it is more likely than not that management would not be required to sell the securities prior to their anticipated recovery, (3) management believes the decline in fair value is largely due to changes in interest rates and (4) management believes the declines in fair value are temporary. The Company believes the fair value will recover as the securities approach maturity.

3. LOANS

Loans at period-end are as follows:
(in thousands)

	<u>6/30/2018</u>	<u>12/31/2017</u>
Commercial	\$ 80,677	\$ 80,070
Real estate construction	22,729	20,816
Real estate mortgage:		
1-4 family residential	245,724	238,121
Multi-family residential	46,015	39,926
Non-farm & non-residential	190,543	192,074
Agricultural	63,711	59,176
Consumer	19,241	18,182
Other	138	170
Total	<u>\$668,778</u>	<u>\$ 648,535</u>

Activity in the allowance for loan losses for the six month and three month periods indicated was as follows:

	Six Months Ended June 30, 2018				
	(in thousands)				
	Beginning				Ending
	Balance	Charge-offs	Recoveries	Provision	Balance
Commercial	\$ 975	\$ —	\$ 6	\$ 202	\$ 1,183
Real estate Construction	462	—	—	(64)	398
Real estate mortgage:					
1-4 family residential	2,316	(63)	262	(62)	2,453
Multi-family residential	640	—	6	91	737
Non-farm & non-residential	1,554	—	—	50	1,604
Agricultural	494	—	146	(165)	475
Consumer	582	(93)	22	71	582
Other	18	(413)	341	103	49
Unallocated	679	—	—	24	703
	<u>\$ 7,720</u>	<u>\$ (569)</u>	<u>\$ 783</u>	<u>\$ 250</u>	<u>\$ 8,184</u>

	Three Months Ended June 30, 2018				
	(in thousands)				
	Beginning				Ending
	Balance	Charge-offs	Recoveries	Provision	Balance
Commercial	\$ 959	\$ —	\$ 6	\$ 218	\$ 1,183
Real estate construction	392	—	—	6	398
Real estate mortgage:					
1-4 family residential	2,499	(1)	5	(50)	2,453
Multi-family residential	776	—	3	(42)	737
Non-farm & non-residential	1,554	—	—	50	1,604
Agricultural	484	—	123	(132)	475
Consumer	561	(65)	6	80	582
Other	24	(199)	151	73	49
Unallocated	656	—	—	47	703
	<u>\$ 7,905</u>	<u>\$ (265)</u>	<u>\$ 294</u>	<u>\$ 250</u>	<u>\$ 8,184</u>

Six Months Ended June 30, 2017
(in thousands)

	Beginning	Charge- offs	Recoveries	Provision	Ending
	Balance				Balance
Commercial	\$ 789	\$ (15)	\$ 15	\$ 217	\$ 1,006
Real estate Construction	564	—	1	19	584
Real estate mortgage:					
1-4 family residential	2,301	(33)	5	302	2,575
Multi-family residential	581	—	7	57	645
Non-farm & non-residential	1,203	—	—	119	1,322
Agricultural	856	—	28	(380)	504
Consumer	547	(102)	28	88	561
Other	60	(468)	401	83	76
Unallocated	640	—	—	45	685
	<u>\$ 7,541</u>	<u>\$ (618)</u>	<u>\$ 485</u>	<u>\$ 550</u>	<u>\$ 7,958</u>

Three Months Ended June 30, 2017
(in thousands)

	Beginning	Charge- offs	Recoveries	Provision	Ending
	Balance				Balance
Commercial	\$ 871	\$ (13)	\$ 7	\$ 141	\$ 1,006
Real estate Construction	545	—	1	38	584
Real estate mortgage:					
1-4 family residential	2,375	(22)	4	218	2,575
Multi-family residential	666	—	4	(25)	645
Non-farm & non-residential	1,311	—	—	11	1,322
Agricultural	862	—	18	(376)	504
Consumer	534	(65)	24	68	561
Other	60	(243)	167	92	76
Unallocated	652	—	—	33	685
	<u>\$ 7,876</u>	<u>\$ (343)</u>	<u>\$ 225</u>	<u>\$ 200</u>	<u>\$ 7,958</u>

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The following tables present the balance in the allowance for loan losses and the recorded investment (excluding accrued interest receivable amounting to \$2.5 million as of June 30, 2018 and \$2.6 million at December 31, 2017) in loans by portfolio segment and based on impairment method as of June 30, 2018 and December 31, 2017:

As of June 30, 2018 (in thousands)	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
Allowance for Loan Losses:			
Commercial	\$ 200	\$ 983	\$ 1,183
Real estate construction	—	398	398
Real estate mortgage:			
1-4 family residential	32	2,421	2,453
Multi-family residential	—	737	737
Non-farm & non-residential	—	1,604	1,604
Agricultural	—	475	475
Consumer	—	582	582
Other	—	49	49
Unallocated	—	703	703
	<u>\$ 232</u>	<u>\$ 7,952</u>	<u>\$ 8,184</u>
Loans:			
Commercial	\$ 323	\$ 80,354	\$ 80,677
Real estate construction	—	22,729	22,729
Real estate mortgage:			
1-4 family residential	420	245,304	245,724
Multi-family residential	697	45,318	46,015
Non-farm & non-residential	1,380	189,163	190,543
Agricultural	279	63,432	63,711
Consumer	—	19,241	19,241
Other	—	138	138
	<u>\$ 3,099</u>	<u>\$ 665,679</u>	<u>\$668,778</u>

As of December 31, 2017 (in thousands)	Individually Evaluated for Impairment	Collectively Evaluated for Impairment	Total
Allowance for Loan Losses:			
Commercial	\$ —	\$ 975	\$ 975
Real estate construction	—	462	462
Real estate mortgage:			
1-4 family residential	23	2,293	2,316
Multi-family residential	—	640	640
Non-farm & non-residential	—	1,554	1,554
Agricultural	—	494	494
Consumer	—	582	582
Other	—	18	18
Unallocated	—	679	679
	<u>\$ 23</u>	<u>\$ 7,697</u>	<u>\$ 7,720</u>
Loans:			
Commercial	\$ —	\$ 80,070	\$ 80,070
Real estate construction	—	20,816	20,816
Real estate mortgage:			
1-4 family residential	206	237,915	238,121
Multi-family residential	—	39,926	39,926
Non-farm & non-residential	1,130	190,944	192,074
Agricultural	284	58,892	59,176
Consumer	—	18,182	18,182
Other	—	170	170
Total	<u>\$ 1,620</u>	<u>\$ 646,915</u>	<u>\$ 648,535</u>

The following table presents loans individually evaluated for impairment by class of loans as of and for the six months ended June 30, 2018 (in thousands):

	Unpaid Principal Balance	Recorded Investment	Allowance for Loan Losses Allocated	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
With no related allowance recorded:						
Real estate mortgage:						
Multi-family residential	\$ 697	\$ 697	\$ -	\$ 709	\$ 24	\$ 24
Non-farm & non-residential	1,380	1,380	-	1,397	35	35
Agricultural	279	279	-	282	8	8
With an allowance recorded:						
Commercial	323	323	200	350	18	18
Real estate mortgage:						
1-4 family residential	420	420	32	420	10	10
Total	<u>\$ 3,099</u>	<u>\$ 3,099</u>	<u>\$ 232</u>	<u>\$ 3,158</u>	<u>\$ 95</u>	<u>\$ 95</u>

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality.

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The following table presents loans individually evaluated for impairment by class of loans for the six months ended June 30, 2017:

<u>(in thousands):</u>	<u>Average Recorded Investment</u>	<u>Year to Date Interest Income Recognized</u>	<u>Year to Date Cash Basis Interest Recognized</u>
With no related allowance recorded:			
Real estate mortgage:			
1-4 family residential	\$ 311	\$ —	\$ —
Non-farm and non-residential	2,595	53	53
Agricultural	472	7	7
With an allowance recorded:			
Real estate mortgage:			
1-4 family residential	1,358	—	—
Total	<u>\$ 4,736</u>	<u>\$ 60</u>	<u>\$ 60</u>

The recorded investment in loans excludes accrued interest receivable and loan origination fees, net due to immateriality.

The following table presents loans individually evaluated for impairment by class of loans as of and for the year ended December 31, 2017 (in thousands):

	<u>Unpaid Principal Balance</u>	<u>Recorded Investment</u>	<u>Allowance for Loan Losses Allocated</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Interest Recognized</u>
With no related allowance recorded:						
Real-estate mortgage:						
Non-farm & non-residential	\$ 1,130	\$ 1,130	\$ —	\$ 1,140	\$ 68	\$ 68
Agricultural	284	284	—	289	11	11
With an allowance recorded:						
Real estate mortgage:						
1-4 family residential	206	206	23	208	8	8
Total	<u>\$ 1,620</u>	<u>\$ 1,620</u>	<u>\$ 23</u>	<u>\$ 1,637</u>	<u>\$ 87</u>	<u>\$ 87</u>

The following tables present loans individually evaluated for impairment by class of loans for the three months ended June 30, 2018 and June 30, 2017:

<u>(in thousands):</u>	<u>Three Months Ending June 30, 2018</u>		
	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Interest Recognized</u>
With no related allowance recorded:			
Real estate mortgage:			
Multi-family residential	\$ 703	\$ 12	\$ 12
Non-farm & non-residential	1,385	16	16
Agricultural	280	2	2
With an allowance recorded:			
Commercial			
	342	—	—
Real estate mortgage:			
1-4 family residential	422	5	5
Total	<u>\$ 3,132</u>	<u>\$ 35</u>	<u>\$ 35</u>

	Three Months Ending June 30, 2017		
	Average Recorded Investment	Interest Income Recognized	Cash Basis Interest Recognized
With no related allowance recorded:			
Real estate mortgage:			
1-4 family residential	\$ 947	\$ 40	\$ 40
Non-farm and non-residential	292	47	47
Agricultural			
With an allowance recorded:			
Real estate mortgage:			
Construction	2,394	—	—
1-4 family residential	720	1	1
Non-farm and non-residential	2,070	23	23
Agricultural	3,957	—	—
Total	<u>\$ 10,380</u>	<u>\$ 111</u>	<u>\$ 111</u>

The following tables present the recorded investment in nonaccrual, loans past due over 90 days still on accrual and accruing troubled debt restructurings by class of loans as of June 30, 2018 and December 31, 2017:

As of June 30, 2018 (in thousands)	Loans Past Due Over 90 Days		
Nonaccrual	Still Accruing	Troubled Debt Restructurings	
Commercial	\$ 322	\$ 324	\$ —
Real estate construction	—	374	
Real estate mortgage:			
1-4 family residential	568	8	—
Non-farm & non-residential	226	—	—
Agricultural	92	—	—
Consumer	42	11	—
Total	<u>\$ 1,250</u>	<u>\$ 717</u>	<u>\$ —</u>

As of December 31, 2017 (in thousands)	Loans Past Due Over 90 Days		
Nonaccrual	Still Accruing	Troubled Debt Restructurings	
Commercial	\$ —	\$ 32	\$ —
Real estate mortgage:			
1-4 family residential	1,086	184	—
Agricultural	96	—	—
Consumer	11	15	—
Total	<u>\$ 1,193</u>	<u>\$ 231</u>	<u>\$ —</u>

Nonaccrual loans secured by real estate make up 70.8% of the total nonaccrual loan balances at June 30, 2018.

Nonaccrual loans and loans past due 90 days still on accrual include both smaller balance homogeneous loans that are collectively evaluated for impairment and individually classified impaired loans.

A loan is considered impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. All amounts due according to the contractual terms means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.

Nonaccrual loans are loans for which payments in full of principal or interest is not expected or which principal or interest has been in default for a period of 90 days or more unless the asset is both well secured and in the process of collection. Other impaired loans may be loans showing signs of weakness or interruptions in cash flow, but ultimately are current or less than 90 days past due with respect to principal and interest and for which we anticipate full payment of principal and interest but not in accordance with contractual terms.

Additional factors considered by management in determining impairment and non-accrual status include payment status, collateral value, availability of current financial information, and the probability of collecting all contractual principal and interest payments.

The following tables present the aging of the recorded investment in past due and non-accrual loans as of June 30, 2018 and December 31, 2017 by class of loans:

As of June 30, 2018	30-59 Days	60-89 Days	Greater than 90 Days	Non- accrual	Total Past Due & Non-accrual	Loans Not Past Due
(in thousands)	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due
Commercial	\$ 21	\$ 55	\$ 324	\$ 322	\$ 722	\$ 79,955
Real estate construction	—	—	374	—	374	22,355
Real estate mortgage:						
1-4 family residential	1,154	347	8	568	2,077	243,647
Multi-family residential	—	—	—	—	—	46,015
Non-farm & non-residential	325	184	—	226	735	189,808
Agricultural	96	—	—	92	188	63,523
Consumer	147	16	11	42	216	19,025
Other	—	—	—	—	—	138
Total	<u>\$ 1,743</u>	<u>\$ 602</u>	<u>\$ 717</u>	<u>\$ 1,250</u>	<u>\$ 4,312</u>	<u>\$ 664,466</u>

As of December 31, 2017	30-59 Days	60-89 Days	Greater than 90 Days	Non- accrual	Total Past Due & Non-accrual	Loans Not Past Due
(in thousands)	Past Due	Past Due	Past Due	Past Due	Past Due	Past Due
Commercial	\$ 678	\$ 44	\$ 32	\$ —	\$ 754	\$ 79,316
Real estate construction	—	—	—	—	—	20,816
Real estate mortgage:						
1-4 family residential	2,222	321	184	1,086	3,813	234,308
Multi-family residential	—	—	—	—	—	39,926
Non-farm & non-residential	162	—	—	—	162	191,912
Agricultural	249	—	—	96	345	58,831
Consumer	132	14	15	11	172	18,010
Other	—	—	—	—	—	170
Total	<u>\$ 3,443</u>	<u>\$ 379</u>	<u>\$ 231</u>	<u>\$ 1,193</u>	<u>\$ 5,246</u>	<u>\$ 643,289</u>

Troubled Debt Restructurings:

Management periodically reviews renewals and modifications of previously identified troubled debt restructurings (TDR), for which there was no principal forgiveness, to consider if it is appropriate to remove the TDR classification. If the borrower is no longer experiencing financial difficulty and the renewal/modification did not contain a concessionary interest rate or other concessionary terms, management considers the potential removal of the TDR classification. If deemed appropriate based upon current underwriting, the TDR classification is removed as the borrower has complied with the terms of the loan at the date of renewal/modification and there was a reasonable expectation that the borrower will continue to comply with the terms of the loan after the date of the renewal/modification. Additionally, TDR classification can be removed in circumstances in which the Company performs a non-concessionary re-modification of the loan at terms considered to be at market for loans with comparable risk and management expects the borrower will continue to perform under the re-modified terms based on the borrower's past history of performance.

The Company had no loans classified as troubled debt restructurings as of June 30, 2018 or December 31, 2017.

Credit Quality Indicators:

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. This analysis is performed on a quarterly basis. The Company uses the following definitions for risk ratings:

Special Mention. Loans classified as special mention have one or more potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard. Loans classified as substandard are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified have a well-defined and documented weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful. Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with 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.

Loans not meeting the criteria above that are analyzed individually as part of the above described process are considered to be pass rated loans.

As of June 30, 2018 and December 31, 2017, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

As of June 30, 2018 (in thousands)	Pass	Special Mention	Substandard	Doubtful
Commercial	\$ 79,433	\$ 887	\$ 357	\$ —
Real estate construction	22,729	—	—	—
Real estate mortgage:				
1-4 family residential	238,377	2,877	4,470	—
Multi-family residential	42,801	2,517	697	—
Non-farm & non-residential	180,534	8,233	1,776	—
Agricultural	56,612	6,385	714	—
Total	<u>\$ 620,486</u>	<u>\$ 20,899</u>	<u>\$ 8,014</u>	<u>\$ —</u>

As of December 31, 2017 (in thousands)	Pass	Special Mention	Substandard	Doubtful
Commercial	\$ 78,326	\$ 1,703	\$ 41	\$ —
Real estate construction	20,816	—	—	—
Real estate mortgage:				
1-4 family residential	230,103	3,522	4,496	—
Multi-family residential	36,654	2,551	721	—
Non-farm & non-residential	183,230	7,240	1,604	—
Agricultural	54,765	3,682	729	—
Total	<u>\$ 603,894</u>	<u>\$ 18,698</u>	<u>\$ 7,591</u>	<u>\$ —</u>

For consumer loans, the Company evaluates the credit quality based on the aging of the recorded investment in loans, which was previously presented. Non-performing consumer loans are loans which are greater than 90 days past due or on non-accrual status, and total \$53 thousand at June 30, 2018 and \$26 thousand at December 31, 2017.

4. REAL ESTATE OWNED

Activity in real estate owned, net was as follows (in thousands):

	Six Months Ended	
	June 30,	
	2018	2017
Beginning of year	\$ 2,404	\$ 1,824
Additions	121	1,897
Capitalized Expenditures	74	—
Sales	(1,195)	(901)
Fair value adjustments	—	(38)
End of period	<u>\$ 1,404</u>	<u>\$ 2,782</u>

Activity in the valuation allowance was as follows (in thousands):

	Six Months Ended	
	June 30,	
	2018	2017
Beginning of year	\$ 777	\$ 803
Fair value adjustments	—	38
Reductions from sale	(364)	(46)
End of Period	<u>\$ 413</u>	<u>\$ 795</u>

Expenses related to foreclosed assets include (in thousands):

	Six Months Ended	
	June 30,	
	2018	2017
Net gains on sales, included in other income on income statement	\$ (115)	\$ (17)
Fair value adjustments	—	38
Operating expenses, net of rental income	57	147
Repossession expense, net	57	185
Net expense, net of gain or loss on sales, for the period	<u>\$ (58)</u>	<u>\$ 168</u>

	Three Months	
	Ended	
	June 30,	
	2018	2017
Net gains on sales, included in other income on income statement	\$ (117)	\$ 28
Fair value adjustments	—	38
Operating expenses, net of rental income	42	68
Repossession expense, net	42	106
Net expense, net of gain or loss on sales, for the period	<u>\$ (75)</u>	<u>\$ 134</u>

5. EARNINGS PER SHARE

Basic earnings per common share is net income divided by the weighted average number of common shares outstanding during the period. Diluted earnings per common share includes the dilutive effect of additional potential common shares issuable under stock based compensation agreements.

The factors used in the earnings per share computation follow:

	Six Months Ended	
	June 30,	
	2018	2017
	(in thousands)	
Basic and Diluted Earnings Per Share		
Net Income	\$ 6,216	\$ 5,547
Weighted average common shares outstanding	2,962	2,954
Basic and diluted earnings per share	\$ 2.09	\$ 1.87

	Three Months Ended	
	June 30,	
	2018	2017
	(in thousands)	
Basic and Diluted Earnings Per Share		
Net Income	\$ 3,068	\$ 2,410
Weighted average common shares outstanding	2,962	2,954
Basic and diluted earnings per share	\$ 1.03	\$ 0.81

Stock options for 0 shares of common stock for the six months and three months ended June 30, 2018 and 0 shares of common stock for the six months and three months ended June 30, 2017 were excluded from diluted earnings per share because their impact was antidilutive.

6. STOCK COMPENSATION

We have three stock based compensation plans as described below.

Stock Option Plan

Under the expired 1993 Non-Employee Directors Stock Ownership Incentive Plan, the Company granted certain directors stock option awards which vested and became fully exercisable immediately and provided for issuance of up to 20,000 options. The exercise price of each option which has a ten year life, was equal to the market price of the Company's stock on the date of grant.

Summary of activity in the stock option plan for the first six months of 2018 follows:

	Shares	Weighted Average Exercise Price	Weighted Average Remaining Contractual Term	Aggregate Intrinsic Value (in thousands)
Outstanding, beginning of year	600	\$ 31.00		
Granted	—	—		—
Forfeited or expired	—	—		—
Exercised	(600)	31.00		
Outstanding, end of period	—	\$ —	0 months	\$ —
Vested and expected to vest	—	\$ —	0 months	\$ —
Exercisable, end of period	—	\$ —	0 months	\$ —

As of June 30, 2018, there was \$0 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. Since the stock option plan has expired, no additional options will be issued.

2005 Restricted Stock Grant Plan

On May 10, 2005, the Company's stockholders approved a restricted stock grant plan. Total shares issuable under the plan were 50,000. There were no shares issued during the first six months of 2018 or 2017. The plan is now expired and no additional shares will be issued from the 2005 plan. There were 71 shares forfeited during the six months and three months ending June 30, 2018 and no shares were forfeited during the first six months and three months ending June 30, 2017.

A summary of changes in the Company's nonvested shares for the year follows:

Nonvested Shares	Shares	Weighted- Average Grant-Date Fair Value	Fair Value Per Share
Nonvested at January 1, 2018	6,141	\$ 151,984	\$ 24.75
Vested	(3,090)	(72,224)	23.37
Forfeited	(71)	(1,883)	26.52
Nonvested at June 30, 2018	<u>2,980</u>	<u>\$ 77,877</u>	<u>\$ 26.13</u>

(1) Grant date fair value in thousands

As of June 30, 2018, there was \$51 thousand of total unrecognized compensation cost related to nonvested shares granted under the 2005 restricted stock grant plan. The cost is expected to be recognized over a weighted-average period of 1.2 years. As of June 30, 2018, no additional shares are available for issuance under the restricted stock grant plan.

2009 Stock Award Plan

On May 13, 2009, the Company's stockholders approved a stock award plan that provides for the granting of both incentive and nonqualified stock options and other share based awards. Total shares issuable under the plan are 150,000. There were 5,720 shares issued during the six months ended June 30, 2018 and 6,575 shares were issued during the first six months of 2017. There were 366 shares forfeited during the six months ended June 30, 2018 and 600 shares were forfeited during the six months ended June 30, 2017.

A summary of changes in the Company’s nonvested shares for the year follows:

Nonvested Shares	Shares	Weighted-Average Grant-Date Fair Value	Fair Value Per Share
Nonvested at January 1, 2018	10,930	\$ 338,545	\$ 30.97
Granted	5,720	263,406	46.05
Vested	(2,448)	(74,504)	30.43
Forfeited	(366)	(13,841)	37.82
Nonvested at June 30, 2018	13,836	\$ 513,606	\$ 37.12

(1) Grant date fair value in thousands

As of June 30, 2018, there was \$449 thousand of total unrecognized compensation cost related to nonvested shares granted under the restricted stock grant plan. The cost is expected to be recognized over a weighted-average period of 3.8 years. As of June 30, 2018, 127,166, shares are still available for issuance.

7. REPURCHASE AGREEMENTS

Repurchase agreements totaled \$9.1 million at June 30, 2018. Of this, \$6.1 million were overnight obligations and \$3.0 million had terms extending through May 2021 and a weighted remaining average life of 1.9 years. The Company pledged agency and mortgage-backed securities with a carrying amount of \$15.2 million to secure repurchase agreements as of June 30, 2018.

8. OTHER BORROWINGS

On July 20, 2015, the Company borrowed \$5.0 million which had an outstanding balance of \$3.0 million at June 30, 2018. The term loan has a fixed interest rate of 5.02%, requires quarterly principal and interest payments, matures July 20, 2025 and is collateralized by Kentucky Bank stock. The maturity schedule for the term loan as of June 30, 2018 is as follows (in thousands):

2018	\$ 246
2019	511
2020	537
2021	564
2022	593
Thereafter	512
	<u>\$ 2,963</u>

9. FAIR VALUE MEASUREMENTS

ASC Topic 820, “Fair Value Measurements and Disclosures”, defines fair value, establishes a framework for measuring fair value, and sets forth disclosures about fair value measurements. ASC Topic 825, “Financial Instruments”, allows entities to choose to measure certain financial assets and liabilities at fair value. The Company has not elected the fair value option for any financial assets or liabilities.

ASC Topic 820 defines fair value as 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. It also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. This Topic describes three levels of inputs that may be used to measure fair value:

Level 1 – Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 – Significant other observable inputs other than Level 1 prices such as 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.

Level 3 – Significant unobservable inputs that reflect a company’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate the fair value:

Investment Securities: The fair values for available for sale investment securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on recent third party real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the appraisers to adjust for differences between the comparable sales and income data available for similar loans and collateral underlying such loans.

Net adjustments totaled \$209 thousand the first six months of 2018 and \$0 for the first six months of 2017 and resulted in a Level 3 classification of the inputs for determining fair value. Net adjustments totaled \$167 thousand the three months June 30, 2018 and \$0 for the three months ending June 30, 2017 and resulted in a Level 3 classification of the inputs for determining fair value

Non-real estate collateral may be valued using an appraisal, net book value per the borrower’s financial statements, or aging reports, adjusted or discounted based on management’s historical knowledge, changes in market conditions from the time of the valuation, and management’s expertise and knowledge of the client and client’s business, resulting in a Level 3 fair value classification. Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted in accordance with the allowance policy.

Other Real Estate Owned: Assets acquired through or instead of loan foreclosure and classified as other real estate owned “OREO” are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach with data from comparable properties. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments were \$0 for both the six months and three months ended June 30, 2018 and \$38 thousand for the six months and three months ended June 30, 2017, and resulted in a Level 3 classification of the inputs for determining fair value. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Mortgage Servicing Rights: Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively based on a valuation model that calculates the present value of estimated future net servicing income, resulting in a Level 3 classification.

Assets and Liabilities Measured on a Recurring Basis:

Available for sale investment securities and trading assets are the Company's only balance sheet items that meet the disclosure requirements for instruments measured at fair value on a recurring basis. Disclosures are as follows in the tables below.

Fair Value Measurements at June 30, 2018 (in thousands):

Description	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. treasury notes	\$ 3,962	\$ —	\$ 3,962	\$ —
U. S. government agencies	33,530	—	33,530	—
States and municipals	74,081	—	74,081	—
Mortgage-backed - residential	130,971	—	130,971	—
Mortgage-backed-commercial	47,677	—	47,677	—
Equity securities	283	283	—	—
Total	\$ 290,504	\$ 283	\$ 290,221	\$ —

Fair Value Measurements at December 31, 2017 (in thousands):

Description	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
U.S. treasury notes	\$ 4,024	\$ —	\$ 4,024	\$ —
U. S. government agencies	41,705	—	41,705	—
States and municipals	90,135	—	90,135	—
Mortgage-backed - residential	130,377	—	130,377	—
Mortgage-backed - commercial	51,596	—	51,596	—
Equity securities	340	340	—	—
Total	\$ 318,177	\$ 340	\$ 317,837	\$ —

There were no transfers between level 1 and level 2 during 2018 or 2017.

Assets measured at fair value on a non-recurring basis are summarized below (in thousands):

(In thousands)	Fair Value Measurements at June 30, 2018 Using :			
	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Impaired loans:				
Commercial	\$ 123	\$ —	\$ 123	\$ —
Real Estate Mortgage:				
1-4 family Residential	310	—	—	310
Other real estate owned, net:				
Residential	93	—	—	93
Commercial	246	—	—	246

(In thousands)	Fair Value Measurements at December 31, 2017 Using :			
	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Description				
Impaired loans:				
Real Estate Mortgage:				
1-4 family residential	\$ 183	\$ —	\$ —	\$ 183
Other real estate owned, net:				
Residential	910	—	—	910
Commercial	200	—	—	200
Mortgage servicing rights	1,323	—	—	1,323

Impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans had a net carrying amount of \$433 thousand, which includes a valuation allowance of \$232 thousand at June 30, 2018. Impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans had a net carrying amount of \$183 thousand, with a valuation allowance of \$23 thousand at December 31, 2017. Four additional loans were impaired at June 30, 2018 when compared to December 31, 2017 and resulted in additional provision for loan loss expense of \$211 thousand for the six months ended June 30, 2018 and \$167 thousand for the three months ended June 30, 2018. For the six months and three months ended June 30, 2017, no loans became impaired.

Other real estate owned measured at fair value less costs to sell had a net carrying amount of \$339 thousand, which is made up of the outstanding balance of \$752 thousand, net of a valuation allowance of \$413 thousand at June 30, 2018. Other real estate owned which was measured at fair value less costs to sell, had a net carrying amount of \$1.1 million, which was made up of the outstanding balance of \$1.9 million, net of a valuation allowance of \$777 thousand at December 31, 2017. The Company recorded \$0 in write-downs of other real estate owned properties for the six months and three months ended June 30, 2018 and \$38 thousand for the six months and three months ended June 30, 2017.

At December 31, 2017, impaired mortgage servicing rights, which are carried at the lower of cost or fair value, were carried at their fair value of \$1.3 million, which was made up of the outstanding balance of \$1.4 million, net of a valuation allowance of \$56 thousand. There were no impaired mortgage servicing rights as of June 30, 2018. For the first six months of 2018, the Company recorded a net recovery of prior write-downs of \$56 thousand and \$0 for the three months ended June 30, 2018. For the six months ended June 30, 2017, the Company recorded a net recovery of prior write-downs of \$34 thousand and net write-downs of \$5 thousand for the three months ended June 30, 2017.

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The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis at June 30, 2018 and December 31, 2017:

June 30, 2018 (In thousands)	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans				
Real estate mortgage:				
1-4 family residential	\$ 310	sales comparison	adjustment for differences between the comparable sales	0%-27% (2)%
Other real estate owned:				
Residential	93	sales comparison	adjustment for differences between the comparable sales	0%-16% (6)%
Commercial	246	income approach	capitalization rate	10%-10% (10)%
December 31, 2017 (In thousands)	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
Impaired loans				
Real estate mortgage:				
1-4 family residential	183	sales comparison	adjustment for differences between the comparable sales	3%-27% (15)%
Other real estate owned:				
Residential	910	sales comparison	adjustment for differences between the comparable sales	0%-16% (6)%
Commercial	200	income approach	capitalization rate	10%-10% (10)%
Mortgage Servicing Rights	1,323	discounted cash flow	constant prepayment rates	7%-25% (10)%

Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, at June 30, 2018 and December 31, 2017 are as follows:

June 30, 2018:

(in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	\$ 28,770	\$ 28,770	\$ —	\$ —	\$ 28,770
Interest bearing time deposits	1,785	1,785	—	—	1,785
Securities available for sale	290,504	283	290,221	—	290,504
Loans held for sale	2,005	—	2,037	—	2,037
Net Loans	660,594	—	123	656,405	656,528
Federal Home Loan Bank stock	7,034	—	—	—	N/A
Interest receivable	3,733	—	1,244	2,489	3,733
Financial liabilities					
Total deposits	\$ 802,482	\$ 643,404	\$ 159,975	\$ —	\$ 803,379
Federal Funds Purchased	15,717	15,717	—	—	15,717
Repurchase agreements	9,120	—	9,152	—	9,152
Short-term Federal Home Loan Bank advances	16,000	—	16,002	—	16,002
Long-term Federal Home Loan Bank advances	86,683	—	82,158	—	82,158
Note payable	2,963	—	3,180	—	3,180
Subordinated debentures	7,217	—	—	7,210	7,210
Interest payable	645	—	632	13	645

December 31, 2017:

(in thousands)	Carrying Value	Level 1	Level 2	Level 3	Total
Financial assets					
Cash and cash equivalents	\$ 39,172	\$ 39,172	\$ —	\$ —	\$ 39,172
Interest bearing time deposits	1,830	1,830	—	—	1,830
Securities available for sale	318,177	340	317,837	—	318,177
Loans held for sale	1,231	—	1,269	—	1,269
Net Loans	640,815	—	—	639,421	639,421
Federal Home Loan Bank stock	7,034	—	—	—	—
Interest receivable	3,951	—	1,378	2,573	3,951
Financial liabilities					
Total deposits	\$ 815,273	\$ 621,139	\$ 195,143	\$ —	\$ 816,282
Repurchase agreements	19,900	—	19,968	—	19,968
Short-term Federal Home Loan Bank advances	8,400	—	8,393	—	8,393
Long-term Federal Home Loan Bank advances	90,332	—	86,899	—	86,899
Note payable	3,321	—	3,560	—	3,560
Subordinated debentures	7,217	—	—	7,212	7,212
Interest payable	838	—	825	13	838

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and Cash Equivalents - The carrying amounts of cash and cash equivalents approximate fair values and are classified as Level 1.

Interest Bearing Deposits - The carrying amounts of interest bearing deposits approximate fair values and are classified as Level 1.

FHLB Stock - It is not practical to determine the fair value of FHLB stock due to restrictions placed on its transferability.

Loans - Fair values of loans are estimated based on discounted cash flows of portfolios of loans with similar credit quality and financial characteristics including the type of loan, interest terms and repayment history. The Company calculates a fair value by using a net present value of scheduled cash flows methodology incorporating estimated maturities using estimated market discount rates. Estimated market discount rates are reflective of market rates for similarly offered products, market interest rate projections, credit spreads and prepayment assumptions. In accordance with ASU 2016-01, the fair value of loans as of June 30, 2018 are based on the notion of exit price.

The methods utilized to estimate the fair value of loans as of December 31, 2017 was measured using an entry price notion.

The fair value of mortgage loans held for sale is estimated based upon binding contracts and quotes from third party investors resulting in a Level 2 classification.

Deposits - The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) resulting in a Level 1 classification. The carrying amounts of variable rate, fixed-term money market accounts and certificates of deposit approximate their fair values at the reporting date resulting in a Level 1 classification. Fair values for fixed rate certificates of deposit are estimated using a discounted cash flows calculation that applies interest rates currently being offered on certificates to a schedule of aggregated expected monthly maturities on time deposits resulting in a Level 2 classification.

Securities Sold Under Agreements to Repurchase and Other Borrowings - The carrying amounts of borrowings under repurchase agreements approximate their fair values resulting in a Level 2 classification.

The carrying amount of the Company's variable rate borrowings approximate their fair values resulting in a Level 2 classification.

Federal Funds Purchased - The carrying amounts of federal funds purchased approximate fair values and are classified as Level 1.

FHLB Advances, Borrowings and Subordinated Debentures - The fair values of the Company's FHLB advances and other borrowings are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 2 classification.

The fair values of the Company's Subordinated Debentures are estimated using discounted cash flow analyses based on the current borrowing rates for similar types of borrowing arrangements resulting in a Level 3 classification.

Accrued Interest Receivable/Payable - The carrying amounts of accrued interest approximate fair value resulting in a Level 2 or Level 3 classification based on the level of the related asset/liability.

Off-balance Sheet 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. The fair value of off-balance sheet instruments is not material.

Item 2 - MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements

The following discussion provides information about the financial condition and results of operations of the Company and its subsidiaries as of the dates and periods indicated. This discussion and analysis should be read in conjunction with the unaudited consolidated financial statements and Notes thereto appearing elsewhere in this report and the Management's Discussion and Analysis in the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

This discussion contains forward-looking statements under the Private Securities Litigation Reform Act of 1995 that involve risks and uncertainties. We intend such forward-looking statements to be covered by the safe harbor provisions for forward-looking statements contained in the federal securities laws. These statements are not historical facts, but rather statements based on our current expectations regarding our business strategies and their intended results and our future performance. Forward-looking statements are preceded by terms such as "expects," "believes," "anticipates," "intends," "estimates," "potential," "may," and similar expressions.

Although we believe that the assumptions underlying the forward-looking statements contained herein are reasonable, any of the assumptions could be inaccurate, and therefore, there can be no assurance that the forward-looking statements included herein will prove to be accurate. Factors that could cause actual results to differ from the results discussed in the forward-looking statements include, but are not limited to: economic conditions (both generally and more specifically in the markets, including the tobacco market and the thoroughbred horse industry, in which we and our Bank operate); competition for our subsidiary's customers from other providers of financial and mortgage services; government legislation, regulation and monetary policy (which changes from time to time and over which we have no control); changes in interest rates (both generally and more specifically mortgage interest rates); ability to successfully gain regulatory approval when required; material unforeseen changes in the liquidity, results of operations, or financial condition of our subsidiary's customers; adequacy of the allowance for losses on loans and the level of future provisions for losses on loans; future acquisitions, changes in technology, information security breaches or cyber security attacks involving the Company, its subsidiaries, or third-party service providers; and other risks detailed in our filings with the Securities and Exchange Commission, all of which are difficult to predict and many of which are beyond our control.

As a result of the uncertainties and the assumptions on which this discussion and the forward-looking statements are based, actual future operations and results in the future may differ materially from those indicated herein. You should not place undue reliance on any forward-looking statements made by us or on our behalf. Our forward-looking statements are made as of the date of the report, and we undertake no obligation to republish revised forward-looking statements to reflect events or circumstances after the date hereof or to reflect the occurrence of unanticipated events.

Summary

The Company recorded net income of \$6.2 million, or \$2.09 basic earnings and diluted earnings per share for the first six months ended June 30, 2018 compared to \$5.5 million or \$1.87 basic earnings and diluted earnings per share for the six month period ended June 30, 2017. The first six months net earnings reflect an increase of \$669 thousand, or 12.1%, compared to the same time period in 2017. The increase in net earnings is mostly attributed to an increase of \$1.3 million, or 7.8%, in net interest income, a decrease of \$1.3 million, or 16.8%, in non-interest income, an increase of \$139 thousand, or 0.8%, in non-interest expense, and a decrease of \$300 thousand, or 54.6%, for the provision for loan losses. The decrease in non-interest income is mostly attributed to the sale of a branch building located in Winchester, Kentucky, to a non-banking real estate investor that was recorded in 2017. The sale was solely for the building and not for the loans or deposits associated with the branch. The sale of the building resulted in a pre-tax gain of approximately \$1.2 million. Absent the sale of the building, non-interest income would have decreased \$86 thousand from the same period one year ago.

The earnings for the three months ended June 30, 2018 were \$3.1 million or \$1.03 basic and diluted earnings per share compared to \$2.4 million or \$0.81 basic and diluted earnings per share for the three month period ended June 30, 2017. The earnings for the three month period in 2018 reflect an increase of 27.3% compared to the same time period in 2017.

For the six months ended June 30, 2018 and compared to the six months ended June 30, 2017, service charges increased \$89 thousand, gain on the sale of loans decreased \$222 thousand, and debit card interchange income increased \$89 thousand. Salaries and benefits expense increased \$257 thousand, legal and professional fees decreased \$52 thousand, debit card expenses increased \$48 thousand and repossession expenses decreased \$128 thousand. For the three months ended June 30, 2018 and compared to the three months ended June 30, 2017, service charges increased \$24 thousand, debit card interchange income increased \$57 thousand, and gains on the sale of loans decreased \$46 thousand. For the three months ended June 30, 2018 and compared to the three months ended June 30, 2017, salaries and benefits expense increased \$209 thousand, data processing expense decreased \$31 thousand, debit card expense decreased \$11 thousand and other expenses decreased \$120 thousand. For the same three month comparison, repossession expense decreased \$64 thousand and occupancy expense increased \$100 thousand.

Return on average assets was 1.19% for the six months ended June 30, 2018 and 1.06% for the six months ended June 30, 2017. Return on average assets was 1.17% for the three months ended June 30, 2018 and 0.93% for the three months ended June 30, 2017. Return on average equity was 12.53% for the six month period ended June 30, 2018 and 11.57% for the six month period ended June 30, 2017. Return on average equity was 12.34% for the three month period ended June 30, 2018 and 9.81% for the three month period ended June 30, 2017.

Securities available for sale decreased \$27.7 million from \$318.2 million at December 31, 2017 to \$290.5 million at June 30, 2018.

Gross Loans increased \$20.3 million from \$648.5 million on December 31, 2017 to \$668.8 million at June 30, 2018.

The overall increase in loan balances from December 31, 2017 to June 30, 2018 is comprised of the following: an increase of \$7.6 million in 1-4 family residential loans, an increase of \$607 thousand in commercial loans, an increase of \$6.1 million in multi-family residential loans, an increase of \$4.5 million in agricultural loans, a decrease of \$1.5 million in non-farm and non-residential loans, an increase of \$1.1 million in consumer loans and an increase of \$1.9 million in real-estate construction loans. Other loan balances decreased \$32 thousand from December 31, 2017 to June 30, 2018.

Total deposits decreased from \$815.3 million on December 31, 2017 to \$802.5 million on June 30, 2018, a decrease of \$12.8 million. Non-interest bearing demand deposit accounts increased \$7.8 million from December 31, 2017 to June 30, 2018 while time deposits \$250 thousand and over decreased \$30.3 million and other interest bearing deposit accounts increased \$9.8 million from December 31, 2017 to June 30, 2018.

Public fund account balances decreased \$12.1 million from December 31, 2017 to June 30, 2018. Public fund accounts typically decrease during the first three quarters of the year and increase during the last quarter of the year due to tax payments collected during the fourth quarter and then withdrawn from the Bank during the following months.

Borrowings from the Federal Home Loan Bank increased \$4.0 million from December 31, 2017 to June 30, 2018. Long-term borrowings decreased \$3.6 million while short-term borrowings increased \$7.6 million during the six month period. Repurchase agreements decreased \$10.8 million and the note payable decreased \$358 thousand.

Net Interest Income

Net interest income is the difference between interest income earned on interest-earning assets and the interest expense paid on interest-bearing liabilities.

Net interest income was \$17.8 million for the six months ended June 30, 2018 compared to \$16.5 million for the six months ended June 30, 2017, an increase of 7.8%. Net interest income was \$9.0 million for the three months ended June 30, 2018 compared to \$8.4 million for the three months ended June 30, 2017, an increase of 8.0%.

The interest spread, excluding tax equivalent adjustments, was 3.59% for the first six months of 2018 compared to 3.30% for the first six months of 2017. For the first six months in 2018, the yield on assets increased from 3.82% in 2017 to 4.18% in 2018, excluding tax equivalent adjustments. The yield on loans increased 35 basis points compared to the six months ended June 30, 2017 from 4.67% to 5.02% for the six months ended June 30, 2018. The yield on securities, excluding tax equivalent adjustments, increased from 2.33% at June 30, 2017 to 2.55% at June 30, 2018. The cost of liabilities was 0.83% for the first six months in 2018 compared to 0.52% in 2017.

Year to date average loans, excluding overdrafts, increased \$3.1 million, or 0.47% for the six months ended June 30, 2018 compared to the six months ended June 30, 2017. Loan interest income increased \$1.2 million during the first six months of 2018 compared to the first six months of 2017. Year to date total average interest bearing liabilities decreased from June 30, 2017 to June 30, 2018 by \$21.7 million or 3.0%. Year to date average interest bearing deposits decreased \$20.0 million, or 3.3%, from June 30, 2017 to June 30, 2018. Deposit interest expense increased \$422 thousand for the first six months of 2018 compared to the same period in 2017. Year to date average borrowings, including repurchase agreements, decreased \$1.7 million, or 1.4%, from June 30, 2017 to June 30, 2018. Interest expense on borrowed funds, including repurchase agreements, increased \$99 thousand for the first six months of 2018 compared to the same period in 2017.

The volume rate analysis for the six months ended June 30, 2018 indicates that \$72 thousand of the increase in loan interest income is attributable to an increase in loan volume and \$198 thousand of the increase in securities interest income is attributable to an increase in the volume of our security portfolio. Further, an increase in loan rates caused an increase of \$1.2 million in interest income and an increase in rates in our security portfolio contributed to an increase of \$370 thousand in securities interest income. The net effect to interest income was an increase of \$1.8 million for the first six months of 2018 compared to the same time period in 2017.

Also based on the following volume rate analysis for the six months ended June 30, 2018, an increase in demand deposit interest rates resulted in \$388 thousand additional interest expense, an increase in interest rates paid for savings deposits resulted in an additional \$6 thousand in interest expense, and increases in interest rates paid for time deposits resulted in an addition of \$252 thousand in interest expense.

The change in volume in deposits and borrowings was responsible for a \$356 thousand decrease in interest expense, of which a decrease in demand deposits resulted in a decrease of \$24 thousand in interest expense, a decrease in time deposits resulted in a decrease of \$200 thousand in interest expense, a decrease in repurchase agreements resulted in a decrease of \$195 thousand in interest expense, and an increase in other borrowings resulted in an increase of \$63 thousand in interest expense. The net effect to interest expense was an increase of \$522 thousand.

As a result, the increase in net interest income for the first six months in 2018 is mostly attributed to increasing rates in the loan portfolio.

The volume rate analysis for the three months ended June 30, 2018 indicates that the \$672 thousand increase in net interest income is attributable to an increase of \$268 thousand due to change in growth in the Company's balance sheet and an increase of \$404 thousand is a result of changes in rates.

Changes in Interest Income and Expense

(in thousands)	Six Months Ended 2018 vs. 2017		
	Volume	Rate	Net Change
INTEREST INCOME			
Loans	\$ 72	\$ 1,155	\$ 1,227
Investment Securities	198	370	568
Other	(157)	172	15
Total Interest Income	113	1,697	1,810
INTEREST EXPENSE			
Deposits			
Demand	(24)	388	364
Savings	—	6	6
Negotiable Certificates of Deposit and Other Time Deposits	(200)	252	52
Securities sold under agreements to repurchase and other borrowings	(195)	204	9
Federal Home Loan			
Bank advances	63	28	91
Total Interest Expense	(356)	878	522
Net Interest Income	\$ 469	\$ 819	\$ 1,288

	Three Months Ended 2018 vs. 2017		
	Volume	Rate	Net Change
INTEREST INCOME			
Loans	\$ 191	\$ 518	\$ 709
Investment Securities	63	193	256
Other	23	(22)	1
Total Interest Income	277	689	966
INTEREST EXPENSE			
Deposits			
Demand	36	160	196
Savings	—	3	3
Negotiable Certificates of Deposit and Other Time Deposits	(65)	86	21
Securities sold under agreements to repurchase and other borrowings	(23)	44	21
Federal Home Loan			
Bank advances	61	(8)	53
Total Interest Expense	9	285	294
Net Interest Income	\$ 268	\$ 404	\$ 672

Non-Interest Income

Non-interest income decreased \$1.3 million for the six months ended June 30, 2018, compared to the same period in 2017, to \$6.4 million. Non-interest income increased \$13 thousand for the three months ended June 30, 2018, compared to the three months ended June 30 2017, to remain at \$3.3 million.

Decreases to non-interest income for the six months ended June 30, 2018 compared to the six months ended June 30, 2017 include a decrease of \$117 thousand in gains on the sale of securities, a decrease of \$26 thousand in loan servicing fees, a decrease of \$51 thousand in trading securities, a decrease of \$24 thousand in brokerage income, and a decrease of \$1.2 million in gain on bank premises which relates to the 2017 sale of a branch building.

The gain on the sale of loans decreased from \$1.0 million during the first six months of 2017 to \$819 thousand during the first six months of 2018, a decrease of \$222 thousand. For the three months ended June 30, the gain on the sale of loans decreased from \$491 thousand in 2017 to \$445 thousand in 2018.

The volume of loans originated to sell during the first six months of 2018 decreased \$3.9 million compared to the same time period in 2017. The volume of mortgage loan originations and sales is generally inverse to rate changes. A change in the mortgage loan rate environment can have a significant impact on the related gain on sale of mortgage loans. Loan service fee income, net of amortization and impairment expense, was \$148 thousand for the six months ended June 30, 2018 compared to \$174 thousand for the six months ended June 30, 2017, a decrease of \$26 thousand. During the first six months of 2018, the market value adjustment to the carrying value of the mortgage servicing right was a net recovery of prior-writedowns of \$56 thousand for the six months ended June 30, 2018, as the fair value of this asset increased, and no adjustments were made during the three months ended June 30, 2018. During the six months ended June 30 2017, the market value adjustment to the carrying value of the mortgage servicing right asset was a net recovery of \$34 thousand as the fair value of the mortgage servicing asset increased, and a net write-down of \$5 thousand for the three months ended June 30, 2017.

Non-Interest Expense

Total non-interest expense increased \$139 thousand for the six month period ended June 30, 2018 compared to the same period in 2017. Total non-interest expense increased \$35 thousand for the three month period ended June 30, 2018 compared to the three months ended June 30, 2017. Management continues to consider opportunities for branch expansion, and will also consider acquisition opportunities that help advance its strategic objectives, which would result in additional future non-interest expense.

For the comparable six month periods, salaries and employees benefits expense increased \$257 thousand, an increase of 2.9%. The number of full-time employee equivalent employees decreased from 243 at June 30, 2017 to 234 at June 30, 2018, a decrease of nine full-time employee equivalent employees. For the three months ended June 30, 2018 compared to the three months ended June 30, 2017, salaries and employee benefits expense increased \$209 thousand, or 4.6%.

Occupancy expense increased \$115 thousand to \$2.1 million for the first six months of 2018 compared to the same time period in 2017. Occupancy expense was \$1.1 million for the three months ended June 30, 2018 compared to \$984 thousand for the three months ended June 30, 2017, an increase of 10.2%.

Legal and professional fees decreased \$52 thousand for the six months ended June 30, 2018 compared to the first six months in 2017. The reduction in legal and professional fees is attributed to expenses being higher for the six months ended June 30, 2017 due to the Company incurring additional expense related to acquiring the services of an outside firm to help the Company identify ways to become more efficient and profitable.

Debit card expenses increased \$48 thousand for the six months ended June 30, 2018 compared to the first six months of 2017 and decreased \$11 thousand for the three months ended June 30, 2018 compared to the three months ended June 30, 2017. The year to date increase in debit card expense is attributed to an increase in debit card interchange activity which also resulted in increases in debit card interchange income as shown on the income statement.

Repossession expense decreased \$128 thousand for the first six months ended June 30, 2018 compared to the same time period in 2017 and decreased \$64 thousand for the three month period ended June 30, 2018 compared to the three months ended June 30, 2017. Repossession expenses are reported net of rental income earned on repossessed properties.

Income Taxes

The effective tax rate for the six months ended June 30, 2018 was 12.0% compared to 19.6% in 2017. The effective tax rate for the three months ended June 30, 2018 was 12.5% compared to 17.1% in 2017. The effective tax rate was higher in 2017 due to lower tax rates in 2018. On December 22, 2017, the “Tax Cuts and Jobs Act” was enacted into legislation. As a result, the 2018 statutory tax rate for the Company is 21% compared to 34% in recent prior years.

These effective tax rates are less than the statutory rate as a result of the Company investing in tax-free securities, loans and other investments which generate tax credits for the Company.

The Company also has a captive insurance subsidiary which contributes to reducing taxable income. Income tax expense decreased \$506 thousand for the six months ended June 30, 2018 compared to the first six months in 2017. Tax-exempt interest income decreased \$241 thousand for the first six months of 2018 compared to the first six months of 2017. Further, for the first six months of 2018, the Company had tax credits totaling \$277 thousand for investments made in low income housing projects compared to similar tax credits of \$277 for the first six months of 2017.

As part of normal business, the Bank typically makes tax free loans to select municipalities in our market and invests in selected tax free securities, primarily in the Commonwealth of Kentucky. In making these investments, the Company considers the overall impact to managing our net interest margin, credit worthiness of the underlying issuer and the favorable impact on our tax position.

For the six months ended June 30, 2018, the Company averaged \$64.2 million in tax free securities and \$38.5 million in tax free loans. As of June 30, 2018, the weighted average remaining maturity for the tax free securities is 82 months, while the weighted average remaining maturity for the tax free loans is 136 months.

Liquidity and Funding

Liquidity is the ability to meet current and future financial obligations. The Company’s primary sources of funds consist of deposit inflows, loan repayments, maturities and sales of investment securities and Federal Home Loan Bank borrowings.

Liquidity risk is the possibility that we may not be able to meet our cash requirements in an orderly manner. Management of liquidity risk includes maintenance of adequate cash and sources of cash to fund operations and to meet the needs of borrowers, depositors and creditors. Excess liquidity has a negative impact on earnings as a result of the lower yields on short-term assets.

Cash and cash equivalents were \$28.8 million as of June 30, 2018 compared to \$39.2 million at December 31, 2017. The decrease in cash and cash equivalents is attributed to a decrease of \$10.1 million in cash and due from banks and a decrease of \$316 thousand in federal funds sold. The decrease in cash and cash equivalents is mostly attributed to deposits balances being greater at December 31 for our public entity depositors due to the recent collection of tax revenues. As the tax dollars are dispersed throughout the year, the balances for these depositors will decrease resulting in a decrease in the Company’s cash and cash equivalents.

In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Securities available for sale totaled \$290.5 million at June 30, 2018 compared to \$318.2 million at December 31, 2017. The securities available for sale are available to meet liquidity needs on a continuing basis. However, we expect our customers’ deposits to be adequate to meet our funding demands.

Generally, we rely upon net cash inflows from financing activities, supplemented by net cash inflows from operating activities, to provide cash used in our investing activities. As is typical of many financial institutions, significant financing activities include deposit gathering and the use of short-term borrowings, such as federal funds purchased and securities sold under repurchase agreements along with long-term debt. Our primary investing activities include purchasing investment securities and loan originations.

For the first six months of 2018, deposits decreased \$12.8 million compared to December 31, 2017. The Company's borrowed funds from the Federal Home Loan Bank increased \$4.0 million from December 31, 2017 to June 30, 2018, federal funds purchased increased \$15.7 million, and total repurchase agreements decreased \$10.8 million from December 31, 2017 to June 30, 2018.

Management is aware of the challenge of funding sustained loan growth. Therefore, in addition to deposits, other sources of funds, such as Federal Home Loan Bank advances, may be used. We rely on Federal Home Loan Bank advances for both liquidity and asset/liability management purposes. These advances are used primarily to fund long-term fixed rate residential mortgage loans. As of June 30, 2018, we have sufficient collateral to borrow an additional \$67 million from the Federal Home Loan Bank.

In addition, as of June 30, 2018, \$38 million is available in overnight borrowing through various correspondent banks and the Company has access to an additional \$202 million in brokered deposits. In light of this, management believes there is sufficient liquidity to meet all reasonable borrower, depositor and creditor needs in the present economic environment.

Capital Requirements

The Company and the Bank are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Company's financial statements.

Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific capital guidelines that involve quantitative measures of the Company's and the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Company and Bank capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier I capital, including Common Equity Tier 1 Capital, (as defined in the applicable banking regulations) to risk-weighted assets (as defined), and of Tier I capital to average assets (as defined). Management believes, as of June 30, 2018 and December 31, 2017, that the Company and the Bank meet all capital adequacy requirements to which they are subject.

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

In July 2013, the FDIC and the other federal bank regulatory agencies issued a final rule that revised their leverage and risk-based capital requirements and the method of calculating risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act.

Among other things, the rule establishes a new common equity Tier 1 minimum capital requirement (4.5% of risk-weighted assets), increases the minimum Tier 1 capital to risk-based assets requirement (from 4% to 6% of risk-weighted assets) and assigns a higher risk weight (150%) to exposures that are more than 90 days past due or are on nonaccrual status and to certain commercial real estate facilities that finance the acquisition, development or construction of real property. The final rule also requires unrealized gains and losses on certain "available-for-sale" securities holdings to be included for purposes of calculating regulatory capital requirement unless a one-time opt-in or opt-out is exercised, which the Company did opt-out of.

The rule limits a banking organization’s capital distributions and certain discretionary bonus payments if the banking organization does not hold a “capital conservation buffer” consisting of 2.5% of common equity Tier 1 capital to risk-weighted assets in addition to the amount necessary to meet its minimum risk-based capital requirements.

The capital conservation buffer was 1.875% at June 30, 2018 and the Company is in compliance with the capital conservation buffer. The final rule became effective for the Bank on January 1, 2016. In accordance with the final rule, the capital conservation buffer requirement began being phased in beginning January 1, 2016 and will continue through January 1, 2019, when the full capital conservation buffer requirement will be effective. The Company’s and the Bank’s actual amounts and ratios, exclusive of the capital conservation buffer, are presented in the table below:

	<u>Actual</u>		<u>For Capital Adequacy Purposes</u>		<u>To Be Well Capitalized Under Prompt Corrective Action Provisions</u>	
	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>	<u>Amount</u>	<u>Ratio</u>
June 30, 2018						
Consolidated						
Total Capital (to Risk-Weighted Assets)	\$106,877	15.4 %	\$ 55,355	8.0 %	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)	98,613	14.3	41,516	6.0	N/A	N/A
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	91,613	13.2	31,137	4.5	N/A	N/A
Tier I Capital (to Average Assets)	98,613	9.5	41,543	4.0	N/A	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	\$102,923	14.8 %	\$ 55,794	8.0 %	\$ 69,742	10.0 %
Tier I Capital (to Risk-Weighted Assets)	94,658	13.6	41,845	6.0	55,794	8.0
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	94,658	13.6	31,384	4.5	45,332	6.5
Tier I Capital (to Average Assets)	94,658	9.1	41,453	4.0	51,817	5.0
December 31, 2017						
Consolidated						
Total Capital (to Risk-Weighted Assets)	\$101,896	14.9 %	\$ 54,599	8.0 %	N/A	N/A
Tier I Capital (to Risk-Weighted Assets)	94,092	13.8	40,949	6.0	N/A	N/A
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	87,092	12.8	30,712	4.5	N/A	N/A
Tier I Capital (to Average Assets)	94,092	9.2	40,754	4.0	N/A	N/A
Bank Only						
Total Capital (to Risk-Weighted Assets)	\$ 99,688	14.6 %	\$ 54,581	8.0 %	\$ 68,226	10.0 %
Tier I Capital (to Risk-Weighted Assets)	91,884	13.5	40,936	6.0	54,581	8.0
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	91,884	13.5	30,702	4.5	44,347	6.5
Tier I Capital (to Average Assets)	91,884	9.0	40,669	4.0	50,836	5.0

Non-Performing Assets

As of June 30, 2018, our non-performing assets totaled \$3.4 million or 0.32% of assets compared to \$3.8 million or 0.36% of assets at December 31, 2017 (See table below.) The Company experienced an increase of \$57 thousand in nonaccrual loans from December 31, 2017 to June 30, 2018. As of June 30, 2018, non-accrual loans include \$322 thousand in loans secured by commercial properties, \$92 thousand in loans secured by farmland, \$568 thousand in loans secured by 1-4 family properties, \$226 thousand in loans secured by non-farm and non-residential properties and \$42 thousand in consumer loans.

Loans secured by real estate composed 70.9% of the non-performing, nonaccrual loans as of June 30, 2018 and 99.1% as of December 31, 2017. Forgone interest income on non-accrual loans totaled \$55 thousand for the first six months of 2018 compared to forgone interest of \$102 thousand for the same time period in 2017. Accruing loans that are contractually 90 days or more past due as of June 30, 2018 totaled \$717 thousand compared to \$231 thousand at December 31, 2017, an increase of \$486 thousand.

Total nonperforming and restructured loans increased \$543 thousand from December 31, 2017 to June 30, 2018. The increase in non-performing loan balances contributed to the increase in the ratio of nonperforming and restructured loans of seven basis points to 0.29% from December 31, 2017 to June 30, 2018.

In addition, the amount the Company has recorded as other real estate owned decreased \$1.0 million from December 31, 2017 to June 30, 2018. As of June 30, 2018, the amount recorded as other real estate owned totaled \$1.4 million compared to \$2.4 million at December 31, 2017. During the first six months of 2018, \$121 thousand in loan balances were foreclosed upon and added to other real estate properties while \$1.2 million in other real estate properties were sold. The allowance as a percentage of non-performing and restructured loans and other real estate owned increased from 202% at December 31, 2017 to 329% at June 30, 2018.

Nonperforming and Restructured Assets

	<u>6/30/2018</u>	<u>12/31/2017</u>
	(in thousands)	
Non-accrual Loans	\$ 1,250	\$ 1,193
Accruing Loans which are Contractually past due 90 days or more	717	231
Accruing Troubled Debt Restructurings	—	—
Total Nonperforming and Restructured Loans	1,967	1,424
Other Real Estate	1,404	2,404
Total Nonperforming and Restructured Loans and Other Real Estate	<u>\$ 3,371</u>	<u>\$ 3,828</u>
Nonperforming and Restructured Loans as a Percentage of Loans	0.29 %	0.22 %
Nonperforming and Restructured Loans and Other Real Estate as a Percentage of Total Assets	0.32 %	0.36 %
Allowance as a Percentage of Period-end Loans	1.22 %	1.19 %
Allowance as a Percentage of Non-performing and Restructured Loans and Other Real Estate	243 %	202 %

We maintain a “watch list” of agricultural, commercial, real estate mortgage, and real estate construction loans and review those loans at least quarterly but more often if needed. Generally, assets are designated as “watch list” loans to ensure more frequent monitoring. If we determine that there is serious doubt as to performance in accordance with original terms of the contract, then the loan is generally downgraded and often placed on non-accrual status.

We review and evaluate nonaccrual loans, past due loans, and loans graded substandard or worse on a regular basis to determine if the loan should be evaluated for impairment and whether specific allocations are needed.

Provision for Loan Losses

The loan loss provision for the first six months of 2018 was \$250 thousand compared to \$550 thousand for the first six months of 2017. The loan loss provision for the three months ended June 30, 2018 was \$250 thousand compared to \$200 thousand for the three months ended June 30, 2017. The decrease in the total loan loss provision during the first six months of 2018 compared to the same time period in 2017 is largely attributed to recording net recoveries of prior charge-offs of \$214 thousand during the six months ended June 30, 2018. The allowance for loan losses as a percentage of loans was 1.22% at June 30, 2018 compared to 1.22% at June 30, 2017.

Management evaluates the loan portfolio by reviewing the historical loss rate for each respective loan type and assigns risk multiples to certain categories to account for qualitative factors including current economic conditions. The average loss rates are reviewed for trends in the analysis, as well as comparisons to peer group loss rates.

Management makes allocations within the allowance for loan losses for specifically classified loans regardless of loan amount, collateral or loan type. Loan categories are evaluated utilizing subjective factors in addition to the historical loss calculations to determine a loss allocation for each of those types.

As this analysis, or any similar analysis, is an imprecise measure of loss, the allowance is subject to ongoing adjustments. Therefore, management will often take into account other significant factors that may be necessary or prudent in order to reflect probable incurred losses in the total loan portfolio.

Nonperforming loans and restructured loans decreased \$337 thousand from December 31, 2017 to \$1.1 million at June 30, 2018. The Company recorded net recoveries of \$214 thousand for the six months ended June 30, 2018 compared to net charge-offs of \$133 thousand for the six months ended June 30, 2017. During the first six months of 2018, the Company recorded recoveries of \$368 for two loans which were charged-off in a prior year. Future levels of charge-offs will be determined by the particular facts and circumstances surrounding individual loans.

Based on the above information, management believes the current loan loss allowance is sufficient to meet probable incurred loan losses.

Loan Losses

	Six Months Ended June 30,	
	(in thousands)	
	2018	2017
Balance at Beginning of Period	\$ 7,720	\$ 7,541
Amounts Charged-Off:		
Commercial	—	15
1-4 family residential	63	33
Consumer and other	506	570
Total Charged-off Loans	569	618
Recoveries on Amounts Previously Charged-off:		
Commercial	6	15
Real Estate Construction	—	1
1-4 family residential	262	5
Multi-family residential	6	7
Agricultural	146	28
Consumer and other	363	429
Total Recoveries	783	485
Net Charge-offs (Recoveries)	(214)	133
Provision for Loan Losses	250	550
Balance at End of Period	8,184	7,958
Loans		
Average	656,515	655,491
At June 30,	668,778	650,657
As a Percentage of Average Loans:		
Net Charge-offs for the period	(0.03)%	0.02 %
Provision for Loan Losses for the period	0.04 %	0.08 %
Allowance as a Multiple of Net Charge-offs annualized	(19.1)	29.9

	Three Months Ended	
	June 30,	
	(in thousands)	
	2018	2017
Balance at Beginning of Period:	\$ 7,905	\$ 7,876
Amounts Charged-Off:		
Commercial	—	13
1-4 family residential	1	22
Consumer and other	264	308
Total Charged-off Loans	265	343
Recoveries on Amounts Previously Charged-off:		
Commercial	6	7
Real Estate Construction	—	1
1-4 family residential	5	4
Multi-family residential	3	4
Agricultural	123	18
Consumer and other	157	191
Total Recoveries	294	225
Net Charge-offs	(29)	118
Provision for Loan Losses	250	200
Balance at End of Period	8,184	7,958
Loans		
Average	661,220	655,665
At June 30,	668,778	650,657
As a Percentage of Average Loans:		
Net Charge-offs (Recoveries) for the period	(0.00)%	0.02 %
Provision for Loan Losses for the period	0.04 %	0.03 %
Allowance as a Multiple of Net Charge-offs annualized	(70.6)	16.9

Item 3 - QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISK

Asset/Liability management control is designed to ensure safety and soundness, maintain liquidity and regulatory capital standards, and achieve acceptable net interest income. Management considers interest rate risk to be the most significant market risk since a bank's net income is largely dependent on net interest income. Our exposure to market risk is reviewed on a regular basis by the Asset/Liability Committee. Interest rate risk is the potential of economic losses due to future interest rate changes.

These economic losses can be reflected as a loss of future net interest income and/or a loss of current fair market values. The objective is to measure the effect on net interest income and to adjust the balance sheet to minimize the inherent risk, while at the same time, maximize income.

Management realizes certain risks are inherent and that the goal is to identify and minimize the risks. The primary tools used by management are interest rate shock and economic value of equity (EVE) simulations.

Using interest rate shock simulations, the following table depicts the change in net interest income resulting from 100 and 300 basis point changes in rates on the Company's interest earning assets and interest bearing liabilities.

The projections are based on balance sheet growth assumptions and repricing opportunities for new, maturing and adjustable rate amounts. As of June 30, 2018, the projected percentage changes are within limits approved by our Board of Directors ("Board").

Although management does analyze and monitor the projected percentage change in a declining interest rate environment, due to the current rate environment many of the current deposit rates cannot decline an additional 100 basis points. Therefore, management places more emphasis in the rising rate environment scenarios. Similar to prior periods, this period's volatility is comparable in each rate shock simulation when compared to the same period a year ago.

The projected net interest income report summarizing our interest rate sensitivity as of June 30, 2018 is as follows:

PROJECTED NET INTEREST INCOME
(dollars in thousands)

Change in basis points:	- 100	Level Rates	+ 100	+ 300
Year One (7/18-6/19)				
Net interest income percentage change	(2.1)%	N/A	0.5 %	0.6 %
	>		>	>
Board approved limit	(4.0) %	N/A	(4.0) %	(10.0) %

The projected net interest income report summarizing the Company's interest rate sensitivity as of June 30, 2017 is as follows:

PROJECTED NET INTEREST INCOME
(dollars in thousands)

Change in basis points:	- 100	Level Rates	+ 100	+ 300
Year One (7/17-6/18)				
Net interest income percentage change	(2.7)%	N/A	0.4 %	0.1 %
	>		>	>
Board approved limit	(4.0) %	N/A	(4.0) %	(10.0) %

Projections from June 30, 2018 and June 30, 2017, year one reflected declines of 2.1% and 2.7% in net interest income assuming rates were to decline 100 basis points. Assuming an increase in rates of 100 basis points, projections reflected a 0.5% increase in net interest income as of June 30, 2018 and a 0.4% increase as of June 30, 2017.

EVE applies discounting techniques to future cash flows to determine the present value of assets, liabilities, and therefore equity. Based upon applying these techniques to the June 30, 2018, balance sheet, a 100 basis point decrease in rates results in a 5.6% decrease in EVE. A 100 basis point increase in rates results in a 0.1% increase in EVE. These are within the Board approved limits.

Item 4 - CONTROLS AND PROCEDURES

As of the end of the period covered by this report, and pursuant to Rule 13a-15(b) of the Securities Exchange Act of 1934 ("Exchange Act"), our management, including the Chief Executive Officer and the Chief Financial Officer, carried out an evaluation of the effectiveness of the design and operation of our disclosure controls and procedures (as that term is defined in Rule 13a-15(e) of the Exchange Act). Based on the foregoing, our Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective, in all material respects, to ensure that information required to be disclosed in the reports the Company files and submits under the Exchange Act is recorded, processed, summarized and reported as and when required.

We also conducted an evaluation of internal control over financial reporting to determine whether any changes occurred during the quarter covered by this report that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting. Based on this evaluation, there has been no such change during the quarter covered by this report.

Our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives.

Part II - Other Information

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

ISSUER PURCHASES OF EQUITY SECURITIES

Period	(a) Total Number of Shares (or Units) Purchased	(b) Average Price Paid Per Share (or Unit)	(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans Or Programs	(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
4/1/18-4/30/18	—	\$ —	—	100,912 shares
5/1/18-5/31-18	—	—	—	100,912 shares
6/1/18-6/30/18	—	—	—	100,912 shares
Total	—	\$ —	—	100,912 shares

On October 25, 2000, we announced that our Board approved a stock repurchase program and authorized the Company to purchase up to 100,000 shares of its outstanding common stock. On November 11, 2002, the Board approved and authorized the Company's repurchase of an additional 100,000 shares. On May 20, 2008, the Board of Directors approved and authorized the Company to purchase an additional 100,000 shares. On May 17, 2011, the Board approved and authorized the Company's repurchase of an additional 100,000 shares. On November 18, 2016, the Board of Directors approved and authorized the Company's repurchase of an additional 50,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through June 30, 2018, 349,088 shares have been purchased.

Item 6. Exhibits

- 2.1 [Agreement and Plan of Merger with Peoples Bancorp of Sandy Hook is incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K dated and filed February 24, 2006.](#)
- 2.2 [Agreement and Plan of Share Exchange with Madison Financial Corporation is incorporated by reference to Exhibit 2.1 of the Registrant's Current Report on Form 8-K dated and filed January 21, 2015.](#)
- 3.1 [Amended and Restated Articles of Incorporation of the Registrant are incorporated by reference to Exhibit 3.1 of the Registrant's Quarterly Report on Form 10-Q for the quarterly period ended March 31, 2000 and filed May 15, 2000.](#)
- 3.2 [Bylaws of the Registrant are incorporated by reference to Exhibit 3.1 of the Registrant's Current Report on Form 8-K dated and filed November 21, 2007.](#)
- 3.3 [Articles of Amendment to Amended and Restated Articles of Incorporation of the Registrant are incorporated by reference to Exhibit 3.3 of the Registrant's Annual Report of Form 10-K for the period ended December 31, 2005 and filed March 29, 2006.](#)
- 31.1 [Certifications of Chief Executive Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](#)
- 31.2 [Certifications of Chief Financial Officer pursuant to Section 302 of the Sarbanes-Oxley Act of 2002.](#)
- 32 [Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.](#)
- 101 INS XBRL Instance Document
- 101 SCH XBRL Taxonomy Extension Scheme Document
- 101 CAL XBRL Taxonomy Extension Calculation Linkbase Document
- 101 DEF XBRL Taxonomy Extension Definition Linkbase Document
- 101 LAB XBRL Taxonomy Extension Label Linkbase Document
- 101 PRE XBRL Taxonomy Extension Presentation Linkbase Document

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

KENTUCKY BANCSHARES, INC.

Date 8/8/18 /s/Louis Prichard
Louis Prichard, President and C.E.O.

Date 8/8/18 /s/Gregory J. Dawson
Gregory J. Dawson, Chief Financial Officer

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Section 2: EX-31.1 (EX-31.1)

Exhibit 31.1

CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER PURSUANT TO SECTION 302 OF SARBANES-OXLEY ACT

I, Louis Prichard, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Kentucky Bancshares, Inc.;
2. Based on my knowledge, this report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this report;
3. Based on my knowledge, the financial statements, and other financial information included in this report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this report;
4. The registrant's other certifying officer and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-15(e) and 15d-15(e)) and internal control over financial reporting (as defined in Exchange Act Rules 13a-15(f) and 15d-15(f)) for the registrant and have:
 - a) Designed such disclosure controls and procedures, or caused such disclosure controls and procedures to be designed under our supervision, to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this report is being prepared;
 - b) Designed such internal control over financial reporting, or caused such internal control over financial reporting to be designed under our supervision, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles;
 - c) Evaluated the effectiveness of the registrant's disclosure controls and procedures and presented in this report our conclusions about the effectiveness of the disclosure controls and procedures, as of the end of the period covered by this report based on such evaluation; and
 - d) Disclosed in this report any change in the registrant's internal control over financial reporting that occurred during the registrant's most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, the registrant's internal control over financial reporting; and
5. The registrant's other certifying officer and I have disclosed, based on our most recent evaluation of internal control over financial reporting, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent functions):

Date: August 8, 2018

BY /s/ Gregory J. Dawson _____

Gregory J. Dawson
Chief Financial Officer

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Section 4: EX-32 (EX-32)

Exhibit 32

CERTIFICATIONS OF CHIEF EXECUTIVE OFFICER AND CHIEF FINANCIAL OFFICER
PURSUANT TO 18 U.S.C. SECTION 1350
(AS ADOPTED PURSUANT TO SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002)

In connection with the Quarterly Report of Kentucky Bancshares, Inc. (the "Company") on Form 10-Q for the period ended June 30, 2018, as filed with the Securities and Exchange Commission on the date hereof (the "Report"), the undersigned, the Chief Executive Officer and Chief Financial Officer of the Company, certify, pursuant to 18 U.S.C. Section 1350, that:

(1) The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and

(2) The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: August 8, 2018 _____

By /s/ Louis Prichard _____

Louis Prichard
President & Chief Executive Officer

Date: August 8, 2018 _____

By /s/ Gregory J. Dawson _____

Gregory J. Dawson
Chief Financial Officer

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