

## 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, 2019

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 every interactive Data File required to be submitted 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 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

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

Securities registered pursuant to Section 12(b) of the Act:

Title of each class  
Common Stock


Trading Symbol(s)  
KTYB

Name of each exchange on which registered  
OTCQX

Number of shares of Common Stock outstanding as of July 31, 2019: 5,981,326.

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KENTUCKY BANCSHARES, INC.

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Item 1 – Financial Statements

KENTUCKY BANCSHARES, INC.  
CONSOLIDATED BALANCE SHEETS (unaudited)  
(Dollar amounts in thousands)

	6/30/2019	12/31/2018
<b>ASSETS</b>		
Cash and due from banks	\$ 27,657	\$ 25,835
Federal funds sold	234	266
Cash and cash equivalents	27,891	26,101
Interest bearing time deposits	1,975	2,175
Securities available for sale	280,593	315,369
Loans held for sale	2,388	1,203
Loans	707,982	686,144
Allowance for loan losses	(8,076)	(8,127)
Net loans	699,906	678,017
Federal Home Loan Bank stock	7,034	7,034
Real estate owned, net	731	830
Bank premises and equipment, net	17,623	17,349
Interest receivable	4,261	4,150
Mortgage servicing rights	1,449	1,536
Goodwill	14,001	14,001
Other intangible assets	181	238
Bank owned life insurance	10,357	10,198
Operating lease right of use asset	8,736	—
Other assets	6,371	7,811
Total assets	<u>\$ 1,083,497</u>	<u>\$ 1,086,012</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Deposits		
Non-interest bearing	\$ 243,845	\$ 231,429
Time deposits, \$250,000 and over	44,602	59,736
Other interest bearing	544,421	559,277
Total deposits	832,868	850,442
Repurchase agreements	4,428	8,077
Short-term Federal Home Loan Bank advances	11,400	11,600
Long-term Federal Home Loan Bank advances	92,468	88,852
Note payable	2,296	2,718
Subordinated debentures	7,217	7,217
Interest payable	878	893
Operating lease liability	8,795	—
Other liabilities	7,000	9,420
Total liabilities	967,350	979,219
Stockholders' equity		
Preferred stock, 300,000 shares authorized and unissued	—	—
Common stock, no par value; 10,000,000 shares authorized; 5,981,326 and 5,955,242 shares issued and outstanding at June 30, 2019 and December 31, 2018	21,579	21,170
Retained earnings	93,115	89,101
Accumulated other comprehensive income (loss)	1,453	(3,478)
Total stockholders' equity	116,147	106,793
Total liabilities and stockholders' equity	<u>\$ 1,083,497</u>	<u>\$ 1,086,012</u>

See Accompanying Notes

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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>6/30/2019</u>	<u>6/30/2018</u>	<u>6/30/2019</u>	<u>6/30/2018</u>
<b>INTEREST INCOME:</b>				
Loans, including fees	\$ 9,115	\$ 8,421	\$ 17,915	\$ 16,433
<b>Securities</b>				
Taxable	1,695	1,549	3,524	3,051
Tax exempt	276	436	609	949
Other	274	144	491	337
Total interest income	<u>11,360</u>	<u>10,550</u>	<u>22,539</u>	<u>20,770</u>
<b>INTEREST EXPENSE:</b>				
Deposits	1,612	904	3,149	1,751
Repurchase agreements and federal funds purchased	13	41	37	64
Federal Home Loan Bank advances	547	441	1,090	876
Note payable	31	43	65	79
Subordinated debentures	98	88	200	173
Total interest expense	<u>2,301</u>	<u>1,517</u>	<u>4,541</u>	<u>2,943</u>
Net interest income	9,059	9,033	17,998	17,827
Provision for loan losses	325	250	450	250
Net interest income after provision	<u>8,734</u>	<u>8,783</u>	<u>17,548</u>	<u>17,577</u>
<b>NON-INTEREST INCOME:</b>				
Service charges	1,397	1,326	2,591	2,614
Loan service fee income, net	31	96	104	148
Trust department income	347	320	675	635
Gain (loss) on sale of available for sale securities, net	20	(30)	114	(74)
Gain on sale of loans	321	445	528	819
Brokerage income	135	141	271	350
Debit card interchange income	903	837	1,693	1,600
Net increase in cash surrender value of bank-owned life insurance	87	—	173	—
Other	94	288	186	382
Total other income	<u>3,335</u>	<u>3,423</u>	<u>6,335</u>	<u>6,474</u>
<b>NON-INTEREST EXPENSE:</b>				
Salaries and employee benefits	4,683	4,717	9,373	9,210
Occupancy expenses	1,057	1,084	2,038	2,064
Repossession expenses, net	29	42	82	57
FDIC Insurance	72	77	149	156
Legal and professional fees	248	196	464	425
Data processing	614	463	1,215	932
Debit card expenses	529	432	1,059	866
Amortization expense of intangible assets, excluding mortgage servicing right	28	35	57	71
Advertising and marketing	212	221	446	440
Taxes other than payroll, property and income	325	313	649	625
Telephone	84	119	211	198
Postage	32	87	63	172
Loan fees	6	17	31	57
Other	859	896	1,706	1,716
Total other expenses	<u>8,778</u>	<u>8,699</u>	<u>17,543</u>	<u>16,989</u>
Income before income taxes	3,291	3,507	6,340	7,062
Provision for income taxes	54	439	292	846
Net income	<u>\$ 3,237</u>	<u>\$ 3,068</u>	<u>\$ 6,048</u>	<u>\$ 6,216</u>
<b>Earnings per share</b>				
Basic	\$ 0.54	\$ 0.52	\$ 1.01	\$ 1.05
Diluted	0.54	0.52	1.01	1.05

See Accompanying Notes

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

	<b>Three Months</b>		<b>Six Months Ended</b>	
	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>	<b>Ended</b>
	<u>6/30/2019</u>	<u>6/30/2018</u>	<u>6/30/2019</u>	<u>6/30/2018</u>
Net income	\$ 3,237	\$ 3,068	\$ 6,048	\$ 6,216
Other comprehensive income (loss)				
Unrealized gains (losses) on securities arising during the period	2,757	(1,253)	6,356	(5,596)
Reclassification of realized amount	(20)	30	(114)	74
Net change in unrealized gain (loss) on securities	2,737	(1,223)	6,242	(5,522)
Less: Tax impact	(575)	257	(1,311)	1,159
Other comprehensive income (loss)	2,162	(966)	4,931	(4,363)
Comprehensive income	<u>\$ 5,399</u>	<u>\$ 2,102</u>	<u>\$ 10,979</u>	<u>\$ 1,853</u>

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

	<u>Common Stock (1)</u>		<u>Retained</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Earnings</u>	<u>Other</u>	<u>Stockholders'</u>
				<u>Comprehensive</u>	<u>Equity</u>
				<u>Loss</u>	
<b>Balances, December 31, 2017</b>	5,943,044	\$20,931	\$ 80,395	\$ (997)	\$ 100,329
Common stock issued (employee stock grants of 5,337 shares, net of 383 shares forfeited, director stock grants of 981 shares and director stock options exercised of 600 shares)	13,836	64	—	—	64
Stock compensation expense	—	45	—	—	45
Common stock purchased and retired	—	—	—	—	—
Other comprehensive loss	—	—	—	(3,397)	(3,397)
Net income	—	—	3,148	—	3,148
Dividends declared - \$0.155 per share	—	—	(923)	—	(923)
<b>Balances, March 31, 2018</b>	<u>5,956,880</u>	<u>\$21,040</u>	<u>\$ 82,620</u>	<u>\$ (4,394)</u>	<u>\$ 99,266</u>
Shares forfeited	(108)	—	—	—	—
Stock compensation expense	—	45	—	—	45
Other comprehensive loss	—	—	—	(966)	(966)
Net income	—	—	3,068	—	3,068
Dividends declared - \$0.155 per share	—	—	(924)	—	(924)
<b>Balances, June 30, 2018</b>	<u>5,956,772</u>	<u>\$21,085</u>	<u>\$ 84,764</u>	<u>\$ (5,360)</u>	<u>\$ 100,489</u>
	<u>Common Stock (1)</u>		<u>Retained</u>	<u>Accumulated</u>	<u>Total</u>
	<u>Shares</u>	<u>Amount</u>	<u>Earnings</u>	<u>Other</u>	<u>Stockholders'</u>
				<u>Income (Loss)</u>	<u>Equity</u>
<b>Balances, December 31, 2018</b>	5,955,242	\$21,170	\$ 89,101	\$ (3,478)	\$ 106,793
Common stock issued (employee stock grants of 23,260 shares, net of 120 shares forfeited, and director stock grants of 2,824 shares)	26,084	295	—	—	295
Stock compensation expense	—	56	—	—	56
Common stock purchased and retired	—	—	—	—	—
Other comprehensive loss	—	—	—	2,769	2,769
Net income	—	—	2,811	—	2,811
Dividends declared - \$0.17 per share	—	—	(1,015)	—	(1,015)
<b>Balances, March 31, 2019</b>	<u>5,981,326</u>	<u>\$21,521</u>	<u>\$ 90,897</u>	<u>\$ (709)</u>	<u>\$ 111,709</u>
Stock compensation expense	—	58	—	—	58
Other comprehensive loss	—	—	—	2,162	2,162
Net income	—	—	3,237	—	3,237
Dividends declared - \$0.17 per share	—	—	(1,019)	—	(1,019)
<b>Balances, June 30, 2019</b>	<u>5,981,326</u>	<u>\$21,579</u>	<u>\$ 93,115</u>	<u>\$ 1,453</u>	<u>\$ 116,147</u>

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

See Accompanying Notes

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

	<b>Six Months Ended</b>	
	<b>6/30/2019</b>	<b>6/30/2018</b>
<b>Cash Flows From Operating Activities</b>		
Net Income	\$ 6,048	\$ 6,216
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	595	630
Amortization (accretion), net	(81)	(249)
Securities amortization (accretion), net	391	461
Stock based compensation expense	114	90
Provision for loan losses	450	250
Securities losses (gains) available for sale gains, net	(114)	74
Net increase in cash surrender value of bank-owned life insurance	(159)	(75)
Originations of loans held for sale	(26,245)	(29,092)
Proceeds from sale of loans	25,588	29,137
Gain on sale of loans	(528)	(819)
Gains on other real estate	(2)	(115)
Write-downs of other real estate, net	38	—
Amortization of operating leases	59	—
Changes in:		
Interest receivable	(111)	218
Other assets	512	(248)
Interest payable	(15)	(193)
Deferred taxes	(383)	(25)
Other liabilities	(2,420)	(1,792)
Net cash from operating activities	<u>3,737</u>	<u>4,468</u>
<b>Cash Flows From Investing Activities</b>		
Net change in interest bearing time deposits	200	45
Purchases of securities available for sale	(14,815)	(18,631)
Purchase of bank owned life insurance	—	(10,000)
Proceeds from sales of securities available for sale	29,734	14,715
Proceeds from principal payments, maturities and calls securities available for sale	25,822	25,553
Net change in loans	(22,186)	(19,925)
Purchases of bank premises and equipment	(869)	(1,819)
Capitalized expenditures for other real estate	—	(74)
Proceeds from the sale of other real estate	135	1,310
Net cash from (used in) investing activities	<u>18,021</u>	<u>(8,826)</u>
<b>Cash Flows From Financing Activities:</b>		
Net change in deposits	(17,574)	(12,791)
Net change in federal funds purchased	—	15,717
Net change in repurchase agreements	(3,649)	(10,780)
Net change in short-term Federal Home Loan Bank advances	(200)	7,600
Proceeds from long-term Federal Home Loan Bank advances	9,000	—
Repayment of long-term Federal Home Loan Bank advances	(5,384)	(3,649)
Repayment of note payable	(422)	(358)
Proceeds from issuance of common stock	295	64
Dividends paid	(2,034)	(1,847)
Net cash used in financing activities	<u>(19,968)</u>	<u>(6,044)</u>
Net change in cash and cash equivalents	1,790	(10,402)
Cash and cash equivalents at beginning of period	26,101	39,172
Cash and cash equivalents at end of period	<u>\$ 27,891</u>	<u>\$ 28,770</u>
<b>Supplemental disclosures of cash flow information Cash paid during the year for:</b>		
Interest expense	\$ 4,556	\$ 3,136
<b>Supplemental disclosures of non-cash investing activities</b>		
Real estate acquired through foreclosure	72	121
In conjunction with the adoption of ASU 2016-02, as detailed in Note 9 of the unaudited consolidated financial statements, a net operating lease asset and a related lease liability was recognized at 1/1/2019	6,373	—
Lease liability arising from obtaining right of use asset	2,669	—

See Accompanying Notes





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### 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, 2018. 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, 2018.

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

**Nature of Operations:** The Bank operates under a state bank charter and provides full banking services, including trust services, to customers located in Bourbon, Clark, Elliot, Fayette, Harrison, Jessamine, Madison, Rowan, Scott, Woodford and adjoining counties in Kentucky. 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., a captive insurance subsidiary, is regulated by the State of Nevada Division of Insurance.

**Subsequent Events:** The Company has evaluated subsequent events for recognition and disclosure through August 9, 2019 which is the date the financial statements were available to be issued.

**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.

**Cash Flows:** For purposes of reporting cash flows, cash and cash equivalents include cash on hand, amounts due from banks, federal funds sold, and certain short-term investments with maturities of less than three months. Generally, federal funds are sold for one-day periods. Net cash flows are reported for loan, deposit and short-term borrowing transactions.

**Interest Bearing Time Deposits:** Interest bearing time deposits in other financial institutions have original maturities between one and three years and are carried at cost.

**Securities:** The Company is required to classify its securities portfolio into one of three categories: trading securities, securities available for sale and securities held to maturity. Fair value adjustments are made to the securities based on their classification with the exception of the held to maturity category. The Company has no investments classified as trading securities or held to maturity. Securities available for sale are carried at fair value. Unrealized holding gains and losses for securities which are classified as available for sale are reported in other comprehensive income, net of deferred tax.

Interest income includes amortization of purchase premium or discount. Premiums and discounts on securities are amortized on the level-yield method without anticipating prepayments, except for mortgage backed securities where prepayments are anticipated. Premiums on purchased callable debt securities are amortized to the earliest call date. Gains and losses on sales are recorded on the settlement date and determined using the specific identification method.



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On January 1st, 2018, the Company adopted the new accounting standard for Financial Instruments, which requires equity investments to be measured at fair value with changes in fair value recognized in net income. Equity investments are included in other assets with changes in fair value recorded in other income.

Management evaluates securities for other-than-temporary impairment (“OTTI”) at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings.

For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

Loans Held for Sale: Loans held for sale are carried at the lower of cost or fair value as determined by outstanding commitments from investors or current secondary market prices, calculated on the aggregate loan basis. The Company also provides for any losses on uncovered commitments to lend or sell. The Company sells loans with servicing rights retained and also with servicing rights released.

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity are stated at the amount of unpaid principal, net of deferred loan origination fees and costs and acquired purchase premiums and discounts, reduced by an allowance for loan losses. Interest income on loans is recognized on the accrual basis except for those loans on a nonaccrual status. Interest income on real estate mortgage (1-4 family residential and multi-family residential) and consumer loans is discontinued at the time the loan is 90 days delinquent, and interest income on real estate construction, non-farm and non-residential mortgage, agricultural and commercial loans is discontinued at the time the loan is 120 days delinquent, unless the loan is well-secured and in process of collection. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. 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. Loan origination fees and certain direct origination costs are capitalized and recognized as an adjustment of the yield on the related loan. Recorded investment is the outstanding loan balance, excluding accrued interest receivable.

When interest accrual is discontinued, interest income received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured. Typically, the Company seeks to establish a payment history of at least six consecutive payments made on a timely basis before returning a loan to accrual status. Consumer and credit card loans are typically charged off no later than 120 days past due. Loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

Concentration of Credit Risk: Most of the Company’s business activity is with customers located within Bourbon, Clark, Elliott, Fayette, Harrison, Jessamine, Madison, Rowan, Scott, Woodford and surrounding counties located in Kentucky. Therefore, the Company’s exposure to credit risk is significantly affected by changes in the economy in these counties.

Allowance for Loan Losses: The allowance for loan losses is a valuation allowance for probable incurred credit losses. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance.

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Adjustments are made to the historical loss experience ratios based on the qualitative factors as outlined in the regulatory Interagency Policy Statement on the Allowance for Loan and Lease Losses. These qualitative factors include the nature and volume of portfolio, economic and business conditions, classification, past due and non-accrual trends. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other factors. Allocations of the allowance may be made for specific loans, but the entire allowance is available for any loan that, in management's judgment, should be charged off.

The allowance for loan losses is evaluated at the portfolio segment level using the same methodology for each segment. The recent historical actual net losses is the basis for the general reserve for each segment which is then adjusted for qualitative factors as outlined above (i.e., nature and volume of portfolio, economic and business conditions, classification, past due and non-accrual trends) specifically evaluated at individual segment levels.

The allowance consists of specific and general components. The specific component relates to loans that are individually classified as impaired. The general component covers non-classified loans and is based on historical loss experience adjusted for current factors for non-classified loans and a migration analysis for classified loans.

A loan is impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due according to the contractual terms of the loan agreement. Loans, for which the terms have been modified, and for which the borrower is experiencing financial difficulties and has been granted a concession, are considered troubled debt restructurings and classified as impaired.

Loans are charged off when available information confirms that loans, or portions thereof, are uncollectible. While management considers the number of days a loan is past due in its evaluation process, we also consider a variety of other factors.

Factors considered by management in evaluating the charge-off decision include collateral value, availability of current financial information for both borrower and guarantor, and the probability of collecting contractual principal and interest payments. These considerations may result in loans being charged off before they are 90 days or more past due. This evaluation framework for determining charge-offs is consistently applied to each segment.

From time to time, the Company will charge-off a portion of impaired and non-performing loans. Loans that meet the criteria under ASC 310 are evaluated individually for impairment. Management considers payment status, collateral value, availability of current financial information for the borrower and guarantor, actual and expected cash flows, and probability of collecting amounts due. If a loan's collection status is deemed to be collateral dependent or foreclosure is imminent, the loan is charged down to the fair value of the collateral, less selling costs. In circumstances where the loan is not deemed to be collateral dependent, but we believe, after completing our evaluation process, that probable loss has been incurred, we will provide a specific allocation on that loan.

The impact of recording partial charge-offs is a reduction of gross loans and a reduction of the loan loss reserve. The net loan balance is unchanged in instances where the loan had a specific allocation as a component of the allowance for loan losses. The allowance as a percentage of total loans may be lower as the allowance no longer needs to include a component for the loss, which has now been recorded, and net charge-off amounts are increased as partial charge-offs are recorded.

Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed.

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Commercial and real estate construction and real estate mortgage loans (multi-family residential, and non-farm and non-residential mortgage) over \$200 thousand are individually evaluated for impairment. If a loan is impaired, a portion of the allowance is allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral. Large groups of smaller balance homogeneous loans, such as consumer and 1-4 family residential real estate loans, are collectively evaluated for impairment, and accordingly, they are not separately identified for impairment disclosures. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loan is reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Company determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers non-impaired loans and is based on historical loss experience adjusted for current factors. The historical loss experience is determined by portfolio segment and is based on the actual loss history experienced by the Company over the most recent 5 years. This actual loss experience is supplemented with other economic factors based on the risks present for each portfolio segment. These economic factors include consideration of the following: levels of and trends in delinquencies and impaired loans; levels of and trends in charge-offs and recoveries; trends in volume and terms of loans; effects of any changes in risk selection and underwriting standards; other changes in lending policies, procedures, and practices; experience, ability, and depth of lending management and other relevant staff; national and local economic trends and conditions; industry conditions; and effects of changes in credit concentrations.

A "portfolio segment" is defined as the level at which an entity develops and documents a systematic methodology to determine its allowance for loan losses. The Company has identified the following portfolio segments: commercial, real estate construction, real estate mortgage, agricultural, consumer (credit cards and other consumer) and other (overdrafts).

*Commercial:* These loans to businesses do not have real estate as the underlying collateral. Instead of real estate, collateral could be business assets such as equipment or accounts receivable or the personal guarantee of one or more guarantors. These loans generally present a higher level of risk than loans secured by commercial real estate because in the event of default by the borrower, the business assets must be liquidated and/or guarantors pursued for deficit funds. Business assets are worth more while they are in use to produce income for the business and worth significantly less if the business is no longer in operation. Within the commercial portfolio, risk analysis is performed primarily based on the individual loan type.

*Real estate construction:* Real estate construction consists of loans secured by real estate for additions or alterations to existing structures, as well as constructing new structures. They include fixed and floating rate loans. Real estate construction loans generally present a higher level of risk than loans secured by 1-4 family residential real estate primarily because of the length of the construction period, potential change in prices of construction, the incomplete status of the collateral and economic cycles. Because of these factors, real estate construction loans generally have higher qualitative adjustments.

*Real Estate Mortgage:*

*1-4 family residential:* Loans secured by 1-4 family residential real estate represent the lowest risk of loans for the Company. They include fixed and floating rate loans as well as loans for commercial purposes or consumer purposes. The Company generally does not hold subprime residential mortgages. Borrowers with loans in this category, whether for commercial or consumer purposes, tend to make their payments timely as they do not want to risk foreclosure and loss of property.

*Multifamily residential:* Loans secured by multifamily residential real estate consist primarily of loans secured by apartment buildings and can be either fixed or floating rate loans. Multi-family residential real estate loans generally present a higher level of risk than loans secured by 1-4 family residential real estate because the borrower's repayment ability typically comes from rents from tenants. Local economic and employment fluctuations impact rent rolls and potentially the borrower's repayment ability.

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*Non-farm & non-residential:* Loans secured by non-farm non-residential real estate consist of loans secured by commercial real estate that is not owner occupied. These loans generally consist of loans collateralized by property whereby rents received from commercial tenants of the borrower are the source of repayment. These loans generally present a higher level of risk than loans secured by owner occupied commercial real estate because repayment risk is expanded to be dependent on the success of multiple businesses which are paying rent to the borrower. If multiple businesses fail due to deteriorating economic conditions or poor business management skills, the borrower may not have enough rents to cover their monthly payment. Repayment risk is also increased depending on the level of surplus available commercial lease space in the local market area.

*Agricultural:* These loans to agricultural businesses do not have real estate as the underlying collateral. Instead of real estate, collateral could be assets such as equipment or accounts receivable or the personal guarantee of one or more guarantors. These loans generally present a higher level of risk than loans secured by real estate because in the event of default by the borrower, the assets must be liquidated and/or guarantors pursued for deficit funds. Farm assets are worth more while they are in use to produce income and worth significantly less if the farm is no longer in operation.

*Consumer:* Consumer loans are generally loans to borrowers for non-business purposes. They can be either secured or unsecured. Consumer loans are generally small in the individual amount of principal outstanding and are repaid from the borrower's private funds earned from employment. Consumer lending risk is very susceptible to local economic trends.

If there is a consumer loan default, any collateral that may be repossessed is generally not well maintained and has a diminished value. For this reason, consumer loans tend to have higher overall interest rates to cover the higher cost of repossession and charge-offs. However, due to their smaller average balance per borrower, consumer loans are collectively evaluated for impairment in determining the appropriate allowance for loan losses.

*Other:* All other loan types are aggregated together for credit risk evaluation due to the varying nature but small number of the remaining types of loans in the Company's loan portfolio. Loans in this segment include but are not limited to overdrafts. Due to their smaller balance, other loans are collectively evaluated for impairment in determining the appropriate allowance for loan losses.

Due to the overall high level of real estate mortgage loans within the loan portfolio as a whole, as compared to other portfolio segments, for risk assessment and allowance purposes this segment was segregated into more granular pools by collateral property type.

The non-farm non-residential and the multi-family real estate mortgage loan portfolio segments had the next highest level of qualitative adjustments due to the effects of local markets and economies on the underlying collateral property values, as well as for industry concentrations and risks related to the this type of property.

*Derivatives:* At the inception of a derivative contract, the Company designates the derivative as one of three types based on the Company's intentions and belief as to likely effectiveness as a hedge. These three types are (1) a hedge of the fair value of a recognized asset or liability or of an unrecognized firm commitment ("fair value hedge"), (2) a hedge of a forecasted transaction or the variability of cash flows to be received or paid related to a recognized asset or liability ("cash flow hedge"), or (3) an instrument with no hedging designation ("stand-alone derivative"). For a fair value hedge, the gain or loss on the derivative, as well as the offsetting loss or gain on the hedged item, are recognized in current earnings as fair value changes. Changes in the fair value of derivatives that are not highly effective in hedging are the changes in fair value of the hedged item are recognized immediately in current earnings.

Net cash settlements on derivatives that qualify for hedge accounting are recorded in interest income or interest expense, based on the item being hedged. Net cash settlements on derivatives that do not qualify for hedge accounting are reported in non-interest income.

The Company formally documents the relationship between derivatives and hedged items, as well as the risk-management objective and the strategy for undertaking hedge transactions at the inception of the hedging relationship. This documentation includes linking fair value hedges to specific assets and liabilities on the balance sheet or to specific firm commitments or forecasted transactions.





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The Company also formally assesses, both at the hedge's inception and on an ongoing basis, whether the derivative instruments that are used are highly effective in offsetting changes in fair values or cash flows of the hedged items. The Company discontinues hedge accounting when it determines that the derivative is no longer effective in offsetting changes in the fair value of the hedged item, the derivative is settled or terminates, a hedged forecasted transaction is no longer probable, a hedged firm commitment is no longer firm, or treatment of the derivative as a hedge is no longer appropriate or intended.

When hedge accounting is discontinued, subsequent changes in fair value of the derivative are recorded as non-interest income. When a fair value hedge is discontinued, the hedged asset or liability is no longer adjusted for changes in fair value and the existing basis adjustment is amortized or accreted over the remaining life of the asset or liability.

**Mortgage Banking Derivatives:** Commitments to fund mortgage loans (interest rate locks) to be sold into the secondary market and forward commitments for the future delivery of these mortgage loans are accounted for as free standing derivatives. The fair value of the interest rate lock is recorded at the time the commitment to fund the mortgage loan is executed and is adjusted for the expected exercise of the commitment before the loan is funded. In order to hedge the change in interest rates resulting from its commitments to fund the loans, the Company enters into forward commitments for the future delivery of the mortgage loans when interest rate locks are entered into. Fair values of these mortgage derivatives are estimated based on changes in mortgage interest rates from the date the interest on the loan is locked. Changes in the fair values of these derivatives are included in net gains on the sales of loans.

**Mortgage Servicing Rights:** The Bank has sold certain residential mortgage loans to the Federal Home Loan Mortgage Corporation (FHLMC) while retaining the servicing rights. Servicing rights are recognized separately when they are acquired through sales of loans. When mortgage loans are sold, servicing rights are initially recorded at fair value with the income statement effect recorded in gain on sale of mortgage loans. Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. All classes of servicing assets are subsequently measured using the amortization method which requires servicing rights to be amortized into loan service fee income, net, included in non-interest income in proportion to, and over the period of, the estimated future net servicing income of the underlying loans.

Servicing assets are evaluated for impairment based upon the fair value of the rights as compared to carrying amount. Impairment is determined by stratifying rights into groupings based on predominant risk characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual grouping, to the extent that fair value is less than the carrying amount. If the Company later determines that all or a portion of the impairment no longer exists for a particular grouping, a reduction of the allowance may be recorded as an increase to income. The fair values of servicing rights are subject to significant fluctuations as a result of changes in estimated and actual prepayment speeds and default rates and losses.

Servicing fee income, which is reported on the income statement as loan service income, net, is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights and valuation allowance are netted against loan servicing fee income. Servicing fees totaled \$267 thousand for the six months ended June 30, 2019 compared to \$265 thousand for the first six months ended June 30, 2018. Servicing fees totaled \$134 thousand for the three months ended June 30, 2019 compared to \$140 thousand for the three months ended June 30, 2018. Servicing fees are included in loan service fee income in the income statement. Late fees and ancillary fees related to loan servicing are not material.

**Federal Home Loan Bank (FHLB) Stock:** The Bank is a member of the FHLB system. Members are required to own a certain amount of stock based on the level of borrowings and other factors, and may invest in additional amounts. FHLB stock is carried at cost, classified as a restricted security, and periodically evaluated for impairment based on ultimate recovery of par value. Both cash and stock dividends are reported as income.

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

**Bank Premises and Equipment:** Land is carried at cost. Bank premises and equipment are stated at cost less accumulated depreciation. Buildings and related components are depreciated using the straight-line method with useful lives ranging from 5 to 40 years. Furniture, fixtures and equipment are depreciated using the straight-line (or accelerated) method with useful lives ranging from 3 to 10 years.

**Real Estate Owned:** Real estate acquired through foreclosure is initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at the lower of cost or fair value less estimated costs to sell. The value of the underlying loan is written down to the fair value of the real estate to be acquired by a charge to the allowance for loan losses, if necessary. Any subsequent write-downs are charged to operating expenses. Operating expenses of such properties, net of related income, and gains and losses on their disposition are included in other expenses.

**Investments in Limited Partnerships:** Investments in limited partnerships represent the Company's investments in affordable housing projects for the primary purpose of available tax benefits. The Company is a limited partner in these investments and as such, the Company is not involved in the management or operation of such investments. These investments are amortized over the period that the Company expects to receive the tax benefits. These investments are evaluated for impairment when events indicate the carrying amount may not be recoverable.

The investment recorded at June 30, 2019 was \$3.9 million and \$3.5 million at June 30, 2018, respectively, and is included with other assets in the balance sheet. For the six months ended June 30, 2019 and June 30, 2018, the Company recognized amortization expense of \$318 thousand and \$312 thousand, respectively, which was included within other noninterest expense on the consolidated statements of income. For the three months ended June 30, 2019 and June 30, 2018, the Company recognized amortization expense of \$159 thousand and \$156 thousand, respectively, which was included within other noninterest expense on the consolidated statements of income.

**Leases:** The Company adopted FASB issued ASU No. 2016-02, "Leases (Topic 842)" ("ASU 2016-02"), including the adoption of the practical expedients, on January 1, 2019. Lessees are required to recognize assets and liabilities on the balance sheet for leases with lease terms greater than 12 months. The Company recorded assets and liabilities of \$8.8 million, as of June 30, 2019, as a result of recording operating lease contracts where the Company is lessee. The Company did not restate comparative periods. The operating lease right of use asset and the operating lease liability are included reported on the Company's balance sheet in the accompanying consolidated statements of financial condition.

**Repurchase Agreements:** Substantially all repurchase agreement liabilities represent amounts advanced by various customers. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

**Stock-Based Compensation:** Compensation cost is recognized for stock options and restricted stock awards issued to employees, based on the fair value of these awards at the date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards. Compensation cost is recognized over the required service period, generally defined as the vesting period. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

**Revenue Recognition:** The Company's services that fall within the scope of ASC 606 are presented within Non-Interest Income and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of ASC 606 include trust department income, service charges, debit card interchange income and brokerage income.

**Income Taxes:** Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates. A valuation allowance, if needed, reduces deferred tax assets to the amount expected to be realized.



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

The Company recognizes interest related to income tax matters as interest expense and penalties related to income tax matters as other expense.

**Retirement Plans:** Employee 401(k) and profit sharing plan expense is the amount of matching contributions.

**Goodwill and Intangible Assets:** Goodwill and intangible assets acquired in a purchase business combination and determined to have an indefinite useful life are not amortized, but tested for impairment at least annually. The Company has selected December 31 as the date to perform the annual impairment test. Intangible assets with definite useful lives are amortized over their estimated useful lives to their estimated residual values. Goodwill is the only intangible asset with an indefinite life on our balance sheet.

Intangible assets consist of core deposit intangible assets arising from whole bank and branch acquisitions. They are initially measured at fair value and then are amortized on either an accelerated or straight-line basis, over ten or fifteen years.

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

**Earnings Per Common 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 include the dilutive effect of additional potential common shares issuable under stock options. Earnings and dividends per share have been adjusted in all periods presented to give effect to all stock splits and dividends through the date of issuance of the financial statements.

**Stock Split:** On November 21, 2018, the Company announced that its Board of Directors declared a two-for-one stock split (the “Stock Split”) of the Company’s issued and outstanding common stock (“Common Stock”), no par value per share, pursuant to which one (1) additional share of the Common Stock was issued for each share of Common Stock held by shareholders of record as of the close of business on December 3, 2018. The additional shares were issued on December 10, 2018. Earnings and dividends per share, and the number of shares are restated for the Stock Split through the date of issuance of the financial statements.

**Comprehensive Income (Loss):** Comprehensive income consists of net income and other comprehensive income. Other comprehensive income (loss) includes unrealized gains and losses on securities available for sale, which are also recognized as a separate component of equity.

**Fair Value of Financial Instruments:** Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in a separate note. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates.

**Operating Segments:** While the Company’s chief decision makers monitor the revenue streams of the various Company products and services, operations are managed and financial performance is evaluated on a Company-wide basis. Accordingly, all of the Company’s operations are considered by management to be aggregated into one reportable operating segment: banking.

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

### **Adoption of New Accounting Standards**

We adopted ASU 2016-02, "Leases (Topic 842)," on January 1, 2019, the effective date of the guidance, using the practical expedient transition method whereby we did not revise comparative period information or disclosure. The new standard requires lessees to record assets and liabilities on the balance sheet for all leases with terms longer than 12 months. We elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allows us to carryforward the historical lease classification. We also elected certain optional practical expedients including the hindsight practical expedient under which we considered the actual outcomes of lease renewals and terminations when measuring the lease term at adoption, and we made an accounting policy election to keep leases with an initial term of 12 months or less off of the balance sheet. We recognize these lease payments in the consolidated statements of income on a straight-line basis over the lease term. We have lease agreements with lease and non-lease components, and we have elected the practical expedient to account for these as a single lease component.

We evaluate our contracts at inception to determine if an arrangement is, or contains, a lease. Operating leases are included in operating lease right of use (ROU) assets and operating lease liabilities on our consolidated balance sheet. The Company has no finance leases.

ROU assets represent our right to use an underlying asset for the lease term, and lease liabilities represent our obligation to make lease payments arising from the lease. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. The operating lease ROU asset also includes any initial direct costs and prepaid lease payments made less any lease incentives. Our lease terms may include options to extend or terminate the lease when it is reasonably certain that we will exercise that option.

Our operating leases relate primarily to land and building leases for bank branches and office space. In conjunction with the adoption on January 1, 2019, we recognized operating lease liabilities of \$6.4 million and related lease assets of \$6.4 million on our balance sheet. The adoption of ASU 2016-02 had no material impact on our consolidated income statement or cash flow statement.

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 were adopted on January 1, 2019 and did not have an effect on the accounting for the Company's share-based payment awards to its Directors.

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FASB ASC 815 – In October 2018, the FASB issued ASU No. 2018-16, *Derivatives and Hedging (Topic 815): Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting*. In the United States, eligible benchmark interest rates under Topic 815 are interest rates on direct Treasury obligations of the U.S. government (“UST”), the London Interbank Offered Rate (“LIBOR”) swap rate, and the Overnight Index Swap (“OIS”) Rate based on the Fed Funds Effective Rate. When the FASB issued ASU No. 2017-12, *Derivatives and Hedging (Topic 815): Targeted Improvements to Accounting for Hedging Activities*, in August 2017, it introduced the Securities Industry and Financial Markets Association (“SIFMA”) Municipal Swap Rate as the fourth permissible U.S. benchmark rate.

The new ASU adds the OIS rate based on SOFR as a U.S. benchmark interest rate to facilitate the LIBOR to SOFR transition and provide sufficient lead time for entities to prepare for changes to interest rate risk hedging strategies for both risk management and hedge accounting purposes. The amendments in this update became effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years and the financial statement impact immediately upon adoption was immaterial. The future financial statement impact will depend on any new contracts entered into using new benchmark rates, as well as any existing contracts that get migrated from LIBOR to new benchmark interest rates. The Company has formed a working group who is developing a transition plan for all exposed contracts migrating from LIBOR to SOFR. Additionally, the working group is monitoring industry specific transition guidance around a LIBOR contract’s “fallback” language with the industry goal to minimize or eliminate value transfers resulting from the transition

### **Accounting Standards Issued But Not Yet Adopted**

ASU 2016-13, “Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments.” Issued in June 2016, ASU 2016-13 added Financial Accounting Standards Board “FASB” ASC Topic 326, “Financial Instruments-Credit Losses” and finalized 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 amendment requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts. Financial institutions and other organizations will now use forward-looking information to enhance their credit loss estimates. The amendment requires enhanced disclosures to help investors and other financial statement users better understand significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s portfolio. In addition, the ASU amends the accounting for credit losses on available-for-sale debt securities and purchased financial assets with credit deterioration.

As previously disclosed, the Company formed a steering committee to oversee the adoption of the ASU at the effective date. Appropriate members of Senior Management have developed a plan focused on understanding the ASU, researching issues, identifying data needs for modeling inputs, technology requirements, and modeling considerations. The Company is focused on the completion of its model, refining assumptions, and continued review of the model. Concurrent with this, the Company is also focused on researching and resolving interpretive accounting issues in the ASU, contemplating various related accounting policies, developing processes and related controls, and considering various reporting disclosures.

As of the beginning of the first reporting period in which the new standard is effective, the Company expects to recognize a one-time cumulative effect adjustment increasing the allowance for loan losses, if any, since the ASU covers credit losses over the expected life of a loan as well as considering future changes in macroeconomic conditions. The magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements cannot yet be reasonably estimated, however, we expect to run multiple parallel models before finalizing the adjustment amount by December 31, 2022.

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In December 2018, the OCC, the Board of Governors of the Federal Reserve System, and the FDIC approved a final rule to address changes to credit loss accounting under GAAP, including banking organizations' implementation of CECL. The final rule provides banking organizations the option to phase in over a three-year period the day-one adverse effects on regulatory capital that may result from the adoption of the new accounting standard. In June 2019, the Financial Accounting Standards Board proposed a delay for the implementation of the current expected credit loss standard until January 2023 for certain companies. The delay would apply to smaller reporting companies (as defined by the SEC), non-SEC public companies and private companies. The proposed delayed implementation date of January 2023 would apply to Kentucky Bancshares and the Company does not intend to early adopt. The proposal is currently in a comment period.

2. SECURITIES

SECURITIES AVAILABLE FOR SALE

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

	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
<b>Available for Sale</b>				
<b>June 30, 2019</b>				
U.S. treasury notes	\$ 4,025	\$ 6	\$ —	\$ 4,031
U.S. government agencies	32,230	344	(59)	32,515
States and political subdivisions	46,126	886	(69)	46,943
Mortgage-backed - residential	103,732	482	(330)	103,884
Mortgage-backed - commercial	76,809	787	(199)	77,397
Asset-backed	15,831	58	(66)	15,823
<b>Total</b>	<u>\$ 278,753</u>	<u>\$ 2,563</u>	<u>\$ (723)</u>	<u>\$ 280,593</u>
<b>December 31, 2018</b>				
U.S. treasury notes	\$ 4,032	\$ —	\$ (57)	\$ 3,975
U.S. government agencies	41,122	515	(459)	41,178
States and political subdivisions	64,196	503	(495)	64,204
Mortgage-backed - residential	150,704	159	(3,614)	147,249
Mortgage-backed - commercial	49,484	—	(921)	48,563
Asset-backed	10,234	56	(90)	10,200
<b>Total</b>	<u>\$ 319,772</u>	<u>\$ 1,233</u>	<u>\$ (5,636)</u>	<u>\$ 315,369</u>

The amortized cost and fair value of securities as of June 30, 2019 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.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due in one year or less	\$ 3,223	\$ 3,208
Due after one year through five years	35,456	35,790
Due after five years through ten years	18,215	18,449
Due after ten years	25,487	26,042
	<u>82,381</u>	<u>83,489</u>
Mortgage-backed - residential	103,732	103,884
Mortgage-backed - commercial	76,809	77,397
Asset-backed	15,831	15,823
<b>Total</b>	<u>\$ 278,753</u>	<u>\$ 280,593</u>





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Proceeds from the sale of available for sale securities for the six months ended June 30, 2019 and June 30, 2018 were \$29.7 million and \$14.7 million. Gross gains of \$154 thousand and \$92 thousand and gross losses of \$40 thousand and \$0 were realized on those sales, respectively. The tax provision related to these realized net gains or losses was \$24 thousand and \$(16) thousand, respectively.

Proceeds from the sale of available for sale securities for the three months ended June 30, 2019 and June 30, 2018 were \$13.4 million and \$10.8 million. Gross gains of \$45 thousand and \$6 thousand and gross losses of \$25 thousand and \$36 thousand were realized on those sales, respectively. The tax provision related to these realized net gains or losses was \$4 thousand and \$(6) thousand, respectively.

Securities with unrealized losses at June 30, 2019 and at December 31, 2018 not recognized in income are as follows:

June 30, 2019

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	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
U.S. government agencies	—	—	8,675	(59)	8,675	(59)
States and political subdivisions	3,761	(13)	3,522	(56)	7,283	(69)
Mortgage-backed - residential	2,400	(24)	37,752	(306)	40,152	(330)
Mortgage-backed - commercial	3,992	(24)	15,567	(175)	19,559	(199)
Asset-backed	9,337	(66)	—	—	9,337	(66)
Total temporarily impaired	\$ 19,490	\$ (127)	\$ 65,516	\$ (596)	\$ 85,006	\$ (723)

December 31, 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	\$ —	\$ —	\$ 3,975	\$ (57)	\$ 3,975	\$ (57)
U.S. government agencies	—	—	21,102	(459)	21,102	(459)
States and political subdivisions	8,007	(125)	25,540	(370)	33,547	(495)
Mortgage-backed - residential	19,250	(144)	112,369	(3,470)	131,619	(3,614)
Mortgage-backed - commercial	—	—	45,949	(921)	45,949	(921)
Asset-backed	1,920	(90)	—	—	1,920	(90)
Total temporarily impaired	\$29,177	\$ (359)	\$ 208,935	\$ (5,277)	\$ 238,112	\$ (5,636)

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.

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3. LOANS

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

	<u>6/30/2019</u>	<u>12/31/2018</u>
Commercial	\$ 89,739	\$ 86,149
Real estate construction	24,220	24,254
Real estate mortgage:		
1-4 family residential	266,694	252,318
Multi-family residential	47,704	46,403
Non-farm & non-residential	198,378	196,674
Agricultural	59,807	60,049
Consumer	21,277	20,089
Other	163	208
Total	<u>\$ 707,982</u>	<u>\$ 686,144</u>

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

	<b>Six Months Ended June 30, 2019</b>				
	<b>(in thousands)</b>				
	<b>Beginning</b>				<b>Ending</b>
	<b>Balance</b>	<b>Charge-</b>	<b>Recoveries</b>	<b>Provision</b>	<b>Balance</b>
Commercial	\$ 1,159	\$ (191)	\$ 10	\$ (16)	\$ 962
Real estate Construction	414	—	—	(1)	413
Real estate mortgage:					
1-4 family residential	2,605	(104)	12	253	2,766
Multi-family residential	733	—	—	10	743
Non-farm & non-residential	1,649	(17)	—	(33)	1,599
Agricultural	420	—	4	(7)	417
Consumer	410	(140)	17	105	392
Other	58	(440)	348	138	104
Unallocated	679	—	—	1	680
	<u>\$ 8,127</u>	<u>\$ (892)</u>	<u>\$ 391</u>	<u>\$ 450</u>	<u>\$ 8,076</u>

	<b>Three Months Ended June 30, 2019</b>				
	<b>(in thousands)</b>				
	<b>Beginning</b>				<b>Ending</b>
	<b>Balance</b>	<b>Charge-</b>	<b>Recoveries</b>	<b>Provision</b>	<b>Balance</b>
Commercial	\$ 943	\$ —	\$ 3	\$ 16	\$ 962
Real estate construction	351	—	—	62	413
Real estate mortgage:					
1-4 family residential	2,660	(5)	4	107	2,766
Multi-family residential	723	—	—	20	743
Non-farm & non-residential	1,609	—	—	(10)	1,599
Agricultural	406	—	3	8	417
Consumer	389	(79)	3	79	392
Other	70	(199)	139	94	104
Unallocated	731	—	—	(51)	680
	<u>\$ 7,882</u>	<u>\$ (283)</u>	<u>\$ 152</u>	<u>\$ 325</u>	<u>\$ 8,076</u>

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**Six Months Ended June 30, 2018**  
(in thousands)

	<b>Beginning</b>				<b>Ending</b>
	<b>Balance</b>	<b>Charge-offs</b>	<b>Recoveries</b>	<b>Provision</b>	<b>Balance</b>
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)

	<b>Beginning</b>				<b>Ending</b>
	<b>Balance</b>	<b>Charge-offs</b>	<b>Recoveries</b>	<b>Provision</b>	<b>Balance</b>
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>

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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 \$3.1 million as of June 30, 2019 and \$2.8 million at December 31, 2018) in loans by portfolio segment and based on impairment method as June 30, 2019 and December 31, 2018:

<b>As of June 30, 2019</b> <b>(in thousands)</b>	<b>Individually</b> <b>Evaluated for</b>	<b>Collectively</b> <b>Evaluated for</b>	<b>Total</b>
	<b>Impairment</b>	<b>Impairment</b>	
<b>Allowance for Loan Losses:</b>			
Commercial	\$ —	\$ 962	\$ 962
Real estate construction	—	413	413
Real estate mortgage:			
1-4 family residential	8	2,758	2,766
Multi-family residential	—	743	743
Non-farm & non-residential	—	1,599	1,599
Agricultural	—	417	417
Consumer	—	392	392
Other	—	104	104
Unallocated	—	680	680
	<u>\$ 8</u>	<u>\$ 8,068</u>	<u>\$ 8,076</u>
<b>Loans:</b>			
Commercial	\$ —	\$ 89,739	\$ 89,739
Real estate construction	374	23,846	24,220
Real estate mortgage:			
1-4 family residential	1,241	265,453	266,694
Multi-family residential	1,292	46,412	47,704
Non-farm & non-residential	—	198,378	198,378
Agricultural	526	59,281	59,807
Consumer	—	21,277	21,277
Other	—	163	163
Total	<u>\$ 3,433</u>	<u>\$ 704,549</u>	<u>\$707,982</u>

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<b>As of December 31, 2018 (in thousands)</b>	<b>Individually Evaluated for Impairment</b>	<b>Collectively Evaluated for Impairment</b>	<b>Total</b>
<b>Allowance for Loan Losses:</b>			
Commercial	\$ 191	\$ 968	\$ 1,159
Real estate construction	—	414	414
<b>Real estate mortgage:</b>			
1-4 family residential	10	2,595	2,605
Multi-family residential	—	733	733
Non-farm & non-residential	—	1,649	1,649
Agricultural	—	420	420
Consumer	—	410	410
Other	—	58	58
Unallocated	—	679	679
	<u>\$ 201</u>	<u>\$ 7,926</u>	<u>\$ 8,127</u>
<b>Loans:</b>			
Commercial	\$ 191	\$ 85,958	\$ 86,149
Real estate construction	374	23,880	24,254
<b>Real estate mortgage:</b>			
1-4 family residential	1,003	251,315	252,318
Multi-family residential	1,973	44,430	46,403
Non-farm & non-residential	227	196,447	196,674
Agricultural	1,164	58,885	60,049
Consumer	—	20,089	20,089
Other	—	208	208
Total	<u>\$ 4,932</u>	<u>\$ 681,212</u>	<u>\$686,144</u>

The following table presents loans individually evaluated for impairment by class of loans as of and for the six months ended June 30, 2019 (in thousands):

	<b>Unpaid Principal Balance</b>	<b>Recorded Investment</b>	<b>Allowance for Loan Losses Allocated</b>	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>	<b>Cash Basis Interest Recognized</b>
<b>With no related allowance recorded:</b>						
Real estate construction	\$ 374	\$ 374	\$ -	\$ 374	\$ -	\$ -
<b>Real estate mortgage:</b>						
1-4 family residential	243	243	-	122	7	7
Multi-family residential	1,292	1,292	-	1,633	54	54
Non-farm and non-residential	-	-	-	114	5	5
Agricultural	526	526	-	845	10	10
<b>With an allowance recorded:</b>						
<b>Real estate mortgage:</b>						
1-4 family residential	998	998	8	1,001	10	10
Total	<u>\$ 3,433</u>	<u>\$ 3,433</u>	<u>\$ 8</u>	<u>\$ 4,087</u>	<u>\$ 86</u>	<u>\$ 86</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, 2018:

<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>
<b>With no related allowance recorded:</b>			
Real estate mortgage:			
Multi-family residential	\$ 709	\$ 24	\$ 24
Non-farm and non-residential	1,397	35	35
Agricultural	282	8	8
<b>With an allowance recorded:</b>			
Commercial	350	18	18
Real estate mortgage:			
1-4 family residential	420	10	10
<b>Total</b>	<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.

The following table presents loans individually evaluated for impairment by class of loans as of and for the year ended December 31, 2018 (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>
<b>With no related allowance recorded:</b>						
Real-estate construction	\$ 374	\$ 374	\$ —	\$ 187	\$ 3	\$ 3
Real-estate mortgage:						
Multi-family	1,973	1,973	—	1,991	101	101
Non-farm & non-residential	227	227	—	679	12	12
Agricultural	1,164	1,164	—	724	54	54
<b>With an allowance recorded:</b>						
Commercial	\$ 191	\$ 191	\$ 191	\$ 96	\$ 18	\$ 18
Real estate mortgage:						
1-4 family residential	1,003	1,003	10	605	13	13
<b>Total</b>	<u>\$ 4,932</u>	<u>\$ 4,932</u>	<u>\$ 201</u>	<u>\$ 4,282</u>	<u>\$ 201</u>	<u>\$ 201</u>

The following tables present loans individually evaluated for impairment by class of loans for the three months ended June 30, 2019 and June 30, 2018:

<u>(in thousands):</u>	<u>Three Months Ending June 30, 2019</u>		
	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>	<u>Cash Basis Interest Recognized</u>
<b>With no related allowance recorded:</b>			
Real estate construction	\$ 374	\$ —	\$ —
Real estate mortgage:			
1-4 family residential	222	3	3
Multi-family residential	1,622	10	10
Non-farm and non-residential	138	—	0
Agricultural	527	6	6
<b>With an allowance recorded:</b>			
Real estate mortgage:			
1-4 family residential	1,127	3	3
<b>Total</b>	<u>\$ 4,010</u>	<u>\$ 22</u>	<u>\$ 22</u>



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	<b>Three Months Ending June 30, 2018</b>		
	<b>Average Recorded Investment</b>	<b>Interest Income Recognized</b>	<b>Cash Basis Interest Recognized</b>
With no related allowance recorded:			
Real estate mortgage:			
Multi-family	\$ 703	\$ 12	\$ 12
Non-farm and 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>

The following tables present the recorded investment in nonaccrual, loans past due over 89 days still on accrual and accruing troubled debt restructurings by class of loans as of June 30, 2019 and December 31, 2018:

<b>As of June 30, 2019 (in thousands)</b>	<b>Loans Past Due Over 89 Days</b>		
	<b>Nonaccrual</b>	<b>Still Accruing</b>	<b>Troubled Debt Restructurings</b>
Commercial	\$ 59	\$ —	\$ —
Real estate construction	374	—	—
Real estate mortgage:			
1-4 family residential	535	970	—
Non-farm & non-residential	143	—	—
Agricultural	200	—	—
Consumer	19	30	—
Total	<u>\$ 1,330</u>	<u>\$ 1,000</u>	<u>\$ —</u>

<b>As of December 31, 2018 (in thousands)</b>	<b>Loans Past Due Over 89 Days</b>		
	<b>Nonaccrual</b>	<b>Still Accruing</b>	<b>Troubled Debt Restructurings</b>
Commercial	\$ 191	\$ —	\$ —
Real estate construction	—	374	—
Real estate mortgage:			
1-4 family residential	525	784	—
Non-farm & non-residential	156	14	—
Agricultural	252	—	—
Consumer	17	10	—
Total	<u>\$ 1,141</u>	<u>\$ 1,182</u>	<u>\$ —</u>

Nonaccrual loans secured by real estate make up 94.1% of the total nonaccrual loan balances at June 30, 2019.

Nonaccrual loans and loans past due over 89 days and still accruing 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.



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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 June 30, 2019 and December 31, 2018 by class of loans:

As of June 30, 2019	30-59 Days	60-89 Days	Greater than 89 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	\$ 278	\$ 148	\$ —	\$ 59	\$ 485	\$ 89,254
Real estate construction	445	—	—	374	819	23,401
Real estate mortgage:						
1-4 family residential	1,803	618	970	535	3,926	262,768
Multi-family residential	348	945	—	—	1,293	46,411
Non-farm & non-residential	—	—	—	143	143	198,235
Agricultural	532	—	—	200	732	59,075
Consumer	116	101	30	19	266	21,011
Other	—	—	—	—	—	163
<b>Total</b>	<b>\$ 3,522</b>	<b>\$ 1,812</b>	<b>\$ 1,000</b>	<b>\$ 1,330</b>	<b>\$ 7,664</b>	<b>\$ 700,318</b>

As of December 31, 2018	30-59 Days	60-89 Days	Greater than 89 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	\$ 10	\$ 24	\$ —	\$ 191	\$ 225	\$ 85,924
Real estate construction	309	—	374	—	683	23,571
Real estate mortgage:						
1-4 family residential	2,158	563	784	525	4,030	248,288
Multi-family residential	951	—	—	—	951	45,452
Non-farm & non-residential	68	84	14	156	322	196,352
Agricultural	502	15	—	252	769	59,280
Consumer	119	15	10	17	161	19,928
Other	—	—	—	—	—	208
<b>Total</b>	<b>\$ 4,117</b>	<b>\$ 701</b>	<b>\$ 1,182</b>	<b>\$ 1,141</b>	<b>\$ 7,141</b>	<b>\$ 679,003</b>

**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, 2019 or December 31, 2018.



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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, 2019 and December 31, 2018, and based on the most recent analysis performed, the risk category of loans by class of loans is as follows:

<b>As of June 30, 2019</b> <b>(in thousands)</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>Doubtful</b>
Commercial	\$ 89,255	\$ 405	\$ 79	\$ —
Real estate construction	22,944	880	396	—
Real estate mortgage:				
1-4 family residential	257,229	3,512	5,953	—
Multi-family residential	43,315	3,097	1,292	—
Non-farm & non-residential	193,217	4,876	285	—
Agricultural	56,021	2,856	930	—
Total	<u>\$661,981</u>	<u>\$15,626</u>	<u>\$ 8,935</u>	<u>\$ —</u>

<b>As of December 31, 2018</b> <b>(in thousands)</b>	<b>Pass</b>	<b>Special Mention</b>	<b>Substandard</b>	<b>Doubtful</b>
Commercial	\$ 84,911	\$ 994	\$ 53	\$ 191
Real estate construction	23,857	—	397	—
Real estate mortgage:				
1-4 family residential	244,382	2,685	5,201	50
Multi-family residential	43,248	1,182	1,973	—
Non-farm & non-residential	188,186	7,967	503	18
Agricultural	54,654	3,715	1,680	—
Total	<u>\$639,238</u>	<u>\$16,543</u>	<u>\$ 9,807</u>	<u>\$ 259</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 89 days past due or on non-accrual status, and total \$49 thousand at June 30, 2019 and \$27 thousand at December 31, 2018.

Non-consumer loans with an outstanding balance less than \$200 thousand are evaluated similarly to consumer loans. Loan performance is evaluated based on delinquency status. Both are reviewed at least quarterly and credit quality grades are updated as needed



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4. 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:

	<b>Six Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>
(in thousands)		
<b>Basic and Diluted Earnings Per Share</b>		
Net Income	\$ 6,048	\$ 6,216
Weighted average common shares outstanding	5,937	5,924
Basic and diluted earnings per share	\$ 1.01	\$ 1.05
	<b>Three Months Ended June 30,</b>	
	<b>2019</b>	<b>2018</b>
(in thousands)		
<b>Basic and Diluted Earnings Per Share</b>		
Net Income	\$ 3,237	\$ 3,068
Weighted average common shares outstanding	5,937	5,924
Basic and diluted earnings per share	\$ 0.55	\$ 0.52

Restricted stock grants were excluded in shares outstanding for purposes of computing basic and diluted earnings per share for the both the six months ended June 30, 2019 and June 30, 2018.

5. STOCK COMPENSATION

We have two stock based compensation plans as described below.

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 100,000. There were no shares issued during the first three months of 2019 or 2018. The plan is now expired and no additional shares will be issued from the 2005 plan. There were 12 shares forfeited during the six months ended June 30, 2019 and 142 shares were forfeited during the six months ended June 30, 2018.

A summary of changes in the Company's nonvested shares for the year follows (in thousands, except per share data):

<u>Nonvested Shares</u>	<u>Shares</u>	<u>Weighted- Average Grant-Date Fair Value</u>	<u>Fair Value Per Share</u>
Nonvested at January 1, 2019	5,924	\$ 77,404	\$ 13.07
Vested	(4,254)	(54,566)	12.83
Forfeited	(12)	(164)	13.68
Nonvested at June 30, 2019	<u>1,658</u>	<u>\$ 22,674</u>	<u>\$ 13.68</u>

As of June 30, 2019, unrecognized compensation cost related to nonvested shares granted under the 2005 Restricted Stock Grant Plan will be recognized over a weighted-average period of 0.5 years. Further, as of June 30, 2019, no additional shares are available for issuance under the 2005 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 300,000.



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There were 23,380 shares issued during the six months ended June 30, 2019 and 11,440 shares were issued during the six months ended June 30, 2018. There were 108 shares forfeited during the six months ended June 30, 2019 and 732 shares were forfeited during the six months ended June 30, 2018.

A summary of changes in the Company's nonvested shares for the year follows (in thousands, except per share data):

<u>Nonvested Shares</u>	<u>Shares</u>	<u>Weighted-Average Grant-Date Fair Value</u>	<u>Fair Value Per Share</u>
Nonvested at January 1, 2019	25,778	\$ 482,213	\$ 18.71
Granted	23,380	549,430	23.50
Vested	(9,242)	(175,749)	19.02
Forfeited	(108)	(2,046)	18.94
Nonvested at June 30, 2019	<u>39,808</u>	<u>\$ 853,848</u>	<u>\$ 21.45</u>

As of June 30, 2019, unrecognized compensation cost related to nonvested shares granted under the 2009 Restricted Stock Grant Plan will be recognized over a weighted-average period of 3.8 years. As of June 30, 2019, 229,750 shares are still available for issuance.

## 6. REPURCHASE AGREEMENTS

Repurchase agreements totaled \$4.4 million at June 30, 2019. Of this, \$2.4 million in balances were overnight obligations and \$2.0 million in balances had terms extending through May 2021 with a weighted remaining average life of 1.4 years. The Company pledged U.S. government agency securities with a total carrying amount of \$12.2 million to secure repurchase agreements as of June 30, 2019.

## 7. OTHER BORROWINGS

On July 20, 2015, the Company borrowed \$5.0 million which had an outstanding balance of \$2.3 million as of June 30, 2019. 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, 2019 is as follows (in thousands):

2019	\$ 259
2020	539
2021	567
2022	596
Thereafter	335
	<u>\$ 2,296</u>

## 8. 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.

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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 \$(193) thousand the first six months of 2019 and \$209 for the first six months of 2018 and resulted in a Level 3 classification of the inputs for determining fair value. Net adjustments totaled \$(11) thousand for the three months ended June 30, 2019 and \$167 for the three months ended June 30, 2018 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.

**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.

**Derivatives and Financial Instruments:** The fair values of derivative financial instruments are based on derivative valuation models using market data inputs as of the valuation date (Level 2).



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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, 2019 (in thousands):

<u>Description</u>	<u>Carrying Value</u>	<u>Quoted Prices In Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
<b>Financial Assets</b>				
U.S. treasury notes	\$ 4,031	\$ —	\$ 4,031	\$ —
U. S. government agencies	32,515	—	32,515	—
States and political subdivisions	46,943	—	46,943	—
Mortgage-backed - residential	103,884	—	103,884	—
Mortgage-backed-commercial	77,397	—	77,397	—
Asset-backed	15,823	—	15,823	—
Derivatives and financial instrument assets	146	—	146	—
Other Assets	291	291	—	—
Total	<u>\$281,030</u>	<u>\$ 291</u>	<u>\$ 280,739</u>	<u>\$ —</u>
<b>Financial Liabilities</b>				
Derivatives and financial instrument liabilities	\$ 143	\$ —	\$ 143	\$ —

Fair Value Measurements at December 31, 2018 (in thousands):

<u>Description</u>	<u>Carrying Value</u>	<u>Quoted Prices In Active Markets for Identical Assets (Level 1)</u>	<u>Significant Other Observable Inputs (Level 2)</u>	<u>Significant Unobservable Inputs (Level 3)</u>
U.S. treasury notes	\$ 3,975	\$ —	\$ 3,975	\$ —
U. S. government agencies	41,178	—	41,178	—
States and political subdivisions	64,204	—	64,204	—
Mortgage-backed - residential	147,249	—	147,249	—
Mortgage-backed - commercial	48,563	—	48,563	—
Asset-backed	10,200	—	10,200	—
Other Assets	284	284	—	—
Total	<u>\$315,653</u>	<u>\$ 284</u>	<u>\$ 315,369</u>	<u>\$ —</u>

There were no transfers between level 1 and level 2 during 2019 or 2018.

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

(In thousands)	Fair Value Measurements at June 30, 2019 Using :			
	Carrying Value	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<b>Description</b>				
Impaired loans:				
1-4 family residential	\$ 990	\$ —	\$ —	\$ 990
Other real estate owned, net:				
Commercial	246	—	—	246
Agricultural	233	—	—	233
Mortgage servicing rights	986	—	—	986

(In thousands)	Fair Value Measurements at December 31, 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)
<b>Description</b>				
Impaired loans:				
Real Estate Mortgage:				
1-4 family residential	\$ 993	\$ —	\$ —	\$ 993
Other real estate owned, net:				
Commercial	246	—	—	246
Mortgage servicing rights	430	—	—	430

Impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans had a net carrying amount of \$990 thousand, which includes a valuation allowance of \$8 thousand as of June 30, 2019.

Impaired loans measured for impairment using the fair value of the collateral for collateral dependent loans had a net carrying amount of \$993 thousand, with a valuation allowance of \$201 thousand at December 31, 2018.

No additional loans were impaired at June 30, 2019 when compared to December 31, 2018 and resulted in no additional provision for loan loss expense for the six months and three months ended June 30, 2019. 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.

Other real estate owned measured at fair value less costs to sell had a net carrying amount of \$479 thousand, which is made up of the outstanding balance of \$924 thousand, net of a valuation allowance of \$445 thousand as of June 30, 2019. Other real estate owned which was measured at fair value less costs to sell, had a net carrying amount of \$246 thousand, which was made up of the outstanding balance of \$653 thousand, net of a valuation allowance of \$407 thousand at December 31, 2018. The Company recorded \$38 thousand in write-downs of other real estate owned properties for the six months ended June 30, 2019 and \$0 for the six months ended June 30, 2018. The Company recorded no write-downs of other real estate owned properties for the three months ended June 30, 2019 and June 30, 2018.

Impaired mortgage servicing rights are carried at the lower of cost or fair value. At June 30, 2019, impaired mortgage servicing rights totaled \$1.1 million, less a valuation allowance of \$79 thousand, resulting in a carrying value of \$986 thousand. At December 31, 2018, impaired mortgage servicing rights totaled \$469 thousand, less a valuation allowance of \$39 thousand, resulting in a carrying value of \$430 thousand..



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For the six months ended June 30, 2019, the Company recorded net writedowns of \$41 thousand. For the six months ended June 30, 2018, the Company recorded net recoveries of prior write-downs of \$56 thousand. For the three months ended June 30, 2019, the Company recorded net write-downs of \$35 thousand compared to net write-downs of \$0 for the three months ended June 30, 2018.

The following table presents quantitative information about level 3 fair value measurements for financial instruments measured at fair value on a non-recurring basis as of June 30, 2019 and December 31, 2018:

<b>June 30, 2019 (In thousands)</b>	<b>Fair Value</b>	<b>Valuation Technique(s)</b>	<b>Unobservable Input(s)</b>	<b>Range (Weighted Average)</b>
<b>Impaired loans</b>				
Real estate mortgage:				
1-4 family residential	\$ 990	sales comparison	adjustment for differences between the comparable sales	(30)% - 10% (21)%
Other real estate owned:				
Commercial	246	income approach	capitalization rate	10% - 10% (10)%
Agricultural	233	sales comparison	adjustment for differences between the comparable sales	(29)% - 41% (13)%
Mortgage servicing rights	986	discounted cash flow	constant prepayment rates	(7)% - (11)% (19)%
<b>December 31, 2018 (In thousands)</b>	<b>Fair Value</b>	<b>Valuation Technique(s)</b>	<b>Unobservable Input(s)</b>	<b>Range (Weighted Average)</b>
<b>Impaired loans</b>				
Real estate mortgage:				
1-4 family residential	\$ 993	sales comparison	adjustment for differences between the comparable sales	(21)% - 7% (7)%
Other real estate owned:				
Commercial	246	income approach	capitalization rate	10% - 10% (10)%
Mortgage servicing rights	430	discounted cash flow	constant prepayment rates	7% - 25% (9)%

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Fair Value of Financial Instruments

The carrying amounts and estimated fair values of financial instruments, as of June 30, 2019 and December 31, 2018 are as follows:

June 30, 2019

<b>(in thousands)</b>	<b>Carrying Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Financial assets</b>					
Cash and cash equivalents	\$ 27,891	\$ 27,891	\$ —	\$ —	\$ 27,891
Interest bearing time deposits	1,975	1,975	—	—	1,975
Securities available for sale	280,593	—	280,593	—	280,593
Loans held for sale	2,388	—	2,417	—	2,417
Net Loans	699,906	—	—	692,366	692,366
Federal Home Loan Bank stock	7,034	—	—	—	N/A
Interest receivable	4,261	—	1,167	3,094	4,261
Derivative and financial instruments	146	—	146	—	146
<b>Financial liabilities</b>					
Total deposits	\$832,868	\$617,685	\$214,251	\$ —	\$831,936
Repurchase agreements	4,428	—	4,428	—	4,428
Short-term Federal Home Loan Bank advances	11,400	—	11,400	—	11,400
Long-term Federal Home Loan Bank advances	92,468	—	92,346	—	92,346
Note payable	2,296	—	2,435	—	2,435
Subordinated debentures	7,217	—	—	7,217	7,217
Interest payable	878	—	864	14	878
Derivative and financial instruments	143	—	143	—	143

December 31, 2018

<b>(in thousands)</b>	<b>Carrying Value</b>	<b>Level 1</b>	<b>Level 2</b>	<b>Level 3</b>	<b>Total</b>
<b>Financial assets</b>					
Cash and cash equivalents	\$ 26,101	\$ 26,101	\$ —	\$ —	\$ 26,101
Interest bearing time deposits	2,175	2,175	—	—	2,175
Securities available for sale	315,369	—	315,369	—	315,369
Loans held for sale	1,203	—	1,224	—	1,224
Net Loans	678,017	—	—	666,942	666,942
Federal Home Loan Bank stock	7,034	—	—	—	N/A
Interest receivable	4,150	—	1,346	2,804	4,150
<b>Financial liabilities</b>					
Total deposits	\$850,442	\$620,885	\$226,734	\$ —	\$847,619
Repurchase agreements	8,077	—	8,009	—	8,009
Short-term Federal Home Loan Bank advances	11,600	—	11,592	—	11,592
Long-term Federal Home Loan Bank advances	88,852	—	84,983	—	84,983
Note payable	2,718	—	2,841	—	2,841
Subordinated debentures	7,217	—	—	7,213	7,213
Interest payable	893	—	877	16	893

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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, 2019 and December 31, 2018 are based on the notion of exit price.

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.

**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.

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9. LEASES

On January 1, 2019, the Company adopted FASB issued ASU No. 2016-02, "Leases (Topic 842)." Leases (Topic 842) establishes a right of use model that requires a lessee to record a right of use ("ROU") asset and a lease liability for all leases with terms longer 12 months. As of the adoption date, the Company was obligated under six operating leases. In the second quarter of 2019, the Company entered into one new operating lease for land in Lexington, KY which will be used to construct a new branch building on. As of June 30, 2019, the Company is obligated under seven operating leases, three of which are for building leases and four of which are for land leases, with terms extending through 2078. The Company's lease agreements include options to renew at the Company's discretion. The extensions are reasonably certain to be exercised, therefore they were considered in the calculation of the ROU asset and lease liability.

	<b>Statement of Financial Condition Location</b>	<b>June 30, 2019</b>
		(in thousands)
<b>Operating Lease Right of Use Asset:</b>		
Gross Carrying Amount		\$ 8,983
Accumulated Amortization		(247)
Net Book Value	Operating lease right of use asset	<u>\$ 8,736</u>
<b>Operating Lease Liabilities</b>		
Right of use lease obligations	Operating lease liability	<u>\$ 8,795</u>

As of June 30, 2019, the weighted-average remaining lease term for operating leases was 35.5 years and the weighted- average discount rate used in the measurement of operating lease liabilities was 4.11%. The Company utilized the FHLB fixed rate advance rate as of December 31, 2018 for the term most closely aligning with the remaining lease term for lease obligations in existence as of December 31, 2018. The Company utilized the FHLB fixed rate advance rate as of April 30, 2019 as a basis for determining the discount rate for one contract which was entered into during April 2019.

	<b>Six Months Ended June 30, 2019</b>
	(in thousands)
Lease Cost:	
Operating lease cost	\$ 247
Total lease cost	<u>\$ 247</u>
Other information	
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash flows from operating leases	<u>\$ 182</u>

	<b>Three Months Ended June 30, 2019</b>
	(in thousands)
Lease Cost:	
Operating lease cost	\$ 136
Total lease cost	<u>\$ 136</u>
Other information	
Cash paid for amounts included in the measurement of lease liabilities:	
Operating cash flows from operating leases	<u>\$ 93</u>





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Maturity analysis of liabilities under operating leases with terms longer than 12 months, are as follows at June 30, 2019:

	<b>As of June 30, 2019</b>	
	(in thousands)	
Twelve months ended March 31,		
2020	\$	556
2021		573
2022		574
2023		583
2024		524
Thereafter		19,143
Total undiscounted lease payments	\$	21,953
Amounts representing interest		(13,158)
Lease liability	\$	8,795

10. REVENUE FROM CONTRACTS WITH CUSTOMERS

The Company's revenue from contracts with customers in the scope of Topic 606 is recognized within noninterest income. The consolidated statements of income include all categories of noninterest income. The following table reflects only the categories of noninterest income that are within the scope of Topic 606:

	<u>Three Months Ended</u>		<u>Six Months Ended</u>	
	<u>6/30/2019</u>	<u>6/30/2018</u>	<u>6/30/2019</u>	<u>6/30/2018</u>
Service charges	1,397	1,326	2,591	2,614
Trust department income	347	320	675	635
Brokerage income	135	141	271	350
Debit card interchange income	903	837	1,693	1,600
Total	2,782	2,624	5,230	5,199

*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.



## 11. DERIVATIVES AND FINANCIAL INSTRUMENTS

As part of our overall interest rate risk management, the Company uses derivative instruments, including interest rate swaps. The notional amount does not represent amounts exchanged by the parties. The amount exchanged is determined by reference to the notional amount and the other terms of the individual agreements. The notional amount of these derivative instruments was \$7.0 million at June 30, 2019 and \$0 at December 31, 2018. These derivative financial instruments at June 30, 2019 consisted of \$7.0 million notional amount of receive-variable, pay-fixed interest rate swaps on certain mortgage loans. These hedges were entered into to manage interest rate risk. Derivative instruments are recognized in other assets and other liabilities on the balance sheet at their fair value and are not reported on a net basis. Changes to the fair value are recognized in loan interest income on the statement of income.

In accordance with ASC 815-20-35-1, subsequent changes in fair value for a hedging instrument that has been designated and qualifies as part of a hedging relationship should be accounted for in the following manner:

*Fair value hedges:* changes in fair value will be recognized concurrently in earnings.

Consistent with this guidance, as long as a hedging instrument is designated and the results of the effectiveness testing support that the instrument qualifies for hedge accounting treatment, 100% of the periodic changes in fair value of the hedging instrument will be accounted for as outlined above. This is the case whether or not economic mismatches exist in the hedging relationship. As a result, there will be no periodic measurement or recognition of ineffectiveness. Rather, the full impact of hedge gains and losses will be recognized in the period in which the hedged transactions impact earnings.

While separate measurement and presentation of ineffectiveness is being eliminated, paragraph 815-20-45-1A requires the change in fair value of the hedging instrument that is included in the assessment of hedge effectiveness be presented in the same income statement line item that is used to present the earnings effect of the hedged item.

Commitments to fund certain mortgage loans (interest rate lock commitments) and forward commitments for the future delivery of mortgage loans to third party investors are considered derivatives. These derivative contracts do not qualify for hedge accounting. At June 30, 2019, the notional amount of the interest rate lock commitments was \$9.4 million and at December 31, 2018, the notional amount of the interest rate lock commitments was \$4.6 million. It is our practice to enter into forward commitments for the future delivery of residential mortgage loans to third party investors when interest rate lock commitments are entered into in order to economically hedge the effect of changes in interest rates resulting from our commitment to fund the loans.

Credit risk arises from the possible inability of counterparties to meet the terms of their contracts. Kentucky Bancshare's exposure is limited to the replacement value of the contracts rather than the notional, principal, or contract amounts. There are provisions in our agreements with the counterparties that allow for certain unsecured credit exposure up to an agreed threshold. Exposures in excess of the agreed thresholds are collateralized. In addition, we minimize credit risk through credit approvals, limits, and monitoring procedures.

The direct impact to earnings for the six months and three months ended June 30, 2019 was immaterial.

## **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, 2018.

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 \$6.0 million, or \$1.01 basic earnings and diluted earnings per share for the first six months ended June 30, 2019 compared to \$6.2 million or \$1.05 basic earnings and diluted earnings per share for the six month period ended June 30, 2018. The first six months net earnings reflect a decrease of \$168 thousand, or 2.7%, compared to the same time period in 2018. The decrease in net earnings is mostly attributed to an increase of \$171 thousand, or 1.0%, in net interest income, a decrease of \$139 thousand, or 2.2%, in non-interest income, an increase of \$554 thousand, or 3.3%, in non-interest expense, and an increase of \$200 thousand, or 80%, for the provision for loan losses. The decrease in non-interest income is mostly attributed to a decrease in gain on sale of loans.

The earnings for the three months ended June 30, 2019 were \$3.2 million or \$0.54 basic and diluted earnings per share compared to \$3.1 million or \$0.52 basic and diluted earnings per share for the three month period ended June 30, 2018. The earnings for the three month period in 2019 reflect an increase of 5.5% compared to the same time period in 2018.

For the six months ended June 30, 2019 and compared to the six months ended June 30, 2018, service charges decreased \$23 thousand, gain on the sale of loans decreased \$291 thousand, and debit card interchange income increased \$93 thousand. Salaries and benefits expense increased \$163 thousand, legal and professional fees increased \$39 thousand, debit card expenses increased \$193 thousand and repossession expenses increased \$25 thousand.



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For the three months ended June 30, 2019 and compared to the three months ended June 30, 2018, service charges increased \$71 thousand, debit card interchange income increased \$66 thousand, and gains on the sale of loans decreased \$124 thousand. For the three months ended June 30, 2019 and compared to the three months ended June 30, 2018, salaries and benefits expense decreased \$34 thousand, data processing expense increased \$151 thousand, debit card expense increased \$97 thousand and other expenses increased \$78 thousand. For the same three month comparison, repossession expense decreased \$13 thousand and occupancy expense decreased \$27 thousand.

Return on average assets was 1.11% for the six months ended June 30, 2019 and 1.19% for the six months ended June 30, 2018. Return on average assets was 1.19% for the three months ended June 30, 2019 and 1.17% for the three months ended June 30, 2018. Return on average equity was 10.92% for the six month period ended June 30, 2019 and 12.53% for the six month period ended June 30, 2018. Return on average equity was 11.44% for the three month period ended June 30, 2019 and 12.34% for the three month period ended June 30, 2018.

Securities available for sale decreased \$34.8 million from \$315.4 million at December 31, 2018 to \$280.6 million at June 30, 2019.

Gross Loans increased \$21.8 million from \$686.1 million on December 31, 2018 to \$708.0 million at June 30, 2019.

The overall increase in loan balances from December 31, 2018 to June 30, 2019 is comprised of the following: an increase of \$14.4 million in 1-4 family residential loans, an increase of \$3.6 million in commercial loans, an increase of \$1.3 million in multi-family residential loans, a decrease of \$242 thousand in agricultural loans, an increase of \$1.7 million in non-farm and non-residential loans, an increase of \$1.2 million in consumer loans and a decrease of \$34 thousand in real-estate construction loans. Other loan balances decreased \$45 thousand from December 31, 2018 to June 30, 2019.

Total deposits decreased from \$850.4 million on December 31, 2018 to \$832.9 million on June 30, 2019, a decrease of \$17.6 million. Non-interest bearing demand deposit accounts increased \$12.4 million from December 31, 2018 to June 30, 2019 while time deposits \$250 thousand and over decreased \$15.1 million and other interest bearing deposit accounts decreased \$14.9 million from December 31, 2018 to June 30, 2019.

Public fund account balances decreased \$54.2 million from December 31, 2018 to June 30, 2019. 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 \$3.4 million from December 31, 2018 to June 30, 2019. Long-term borrowings increased \$3.6 million while short-term borrowings decreased \$200 thousand during the six month period. Repurchase agreements decreased \$3.6 million and the note payable decreased \$422 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 \$18.0 million for the six months ended June 30, 2019 compared to \$17.8 million for the six months ended June 30, 2018, an increase of 1.0%. Net interest income was \$9.1 million for the three months ended June 30, 2019 compared to \$9.0 million for the three months ended June 30, 2018, an increase of 0.3%.

The tax equivalent net interest margin was 3.58% for the first six months of 2019 compared to 3.66% for the first six months of 2018. For the first six months in 2019, the tax equivalent yield on interest earning assets increased from 4.25% in 2018 to 4.47% in 2019.

The yield on loans, excluding tax equivalent adjustments, increased eighteen basis points for the six months ended June 30, 2019 compared to the six months ended June 30, 2018 from 5.02% to 5.20%. The yield on securities, excluding tax equivalent adjustments, increased seventeen basis points during the first six months of 2019 compared to 2018 from 2.55% in 2018 to 2.73% in 2019. The cost of interest bearing liabilities was 1.24% for the first six months in 2019 compared to 0.83% in 2018.

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Year to date average loans, excluding overdrafts, increased \$34.9 million, or 5.31% for the six months ended June 30, 2019 compared to the six months ended June 30, 2018. Loan interest income increased \$1.5 million during the first six months of 2019 compared to the first six months of 2018. Year to date average total deposits increased from June 30, 2018 to June 30, 2019 by \$28.9 million or 3.5%. Year to date average interest bearing deposits increased \$19.4 million, or 3.3%, from June 30, 2018 to June 30, 2019. Deposit interest expense increased \$1.4 million for the first six months of 2019 compared to the same period in 2018. Year to date average borrowings, including repurchase agreements, decreased \$1.2 million, or 1.0%, from June 30, 2018 to June 30, 2019. Interest expense on borrowed funds, including repurchase agreements, increased \$200 thousand for the first six months of 2019 compared to the same period in 2018.

The volume rate analysis for the six months ended June 30, 2019 indicates that \$881 thousand of the increase in loan interest income is attributable to an increase in loan volume and \$300 thousand of the decrease in securities interest income is attributable to a decrease in the volume of our security portfolio. Much of the increase in loan income is attributed to variable rate loans repricing at higher rates. The increase in loan rates caused an increase of \$601 thousand in interest income and an increase in rates in our security portfolio contributed to an increase of \$436 thousand in securities interest income. The net effect to interest income was an increase of \$1.8 million for the first six months of 2019 compared to the same time period in 2018.

Also based on the following volume rate analysis for the six months ended June 30, 2019, an increase in demand deposit interest rates resulted in \$733 thousand additional interest expense, interest rates paid for savings deposits remained flat, and increases in interest rates paid for time deposits resulted in an addition of \$591 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 \$41 thousand in interest expense, of which an increase in time deposits resulted in an increase of \$60 thousand in interest expense, a decrease in repurchase agreements resulted in a decrease of \$154 thousand in interest expense, and an increase in other borrowings resulted in an increase of \$39 thousand in interest expense. The net effect to interest expense was an increase of \$171 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 and securities portfolios along with loan growth.

The volume rate analysis for the three months ended June 30, 2019 indicates that the \$26 thousand increase in net interest income is attributable to an increase of \$970 thousand due to change in growth in the Company's balance sheet and a decrease of \$944 thousand is a result of changes in rates.

**Changes in Interest Income and Expense**

(in thousands)	Six Months Ended 2019 vs. 2018		
	Volume	Rate	Net Change
<b>INTEREST INCOME</b>			
Loans	\$ 881	\$ 601	\$ 1,482
Investment Securities	(300)	436	136
Other	(87)	238	151
Total Interest Income	494	1,275	1,769
<b>INTEREST EXPENSE</b>			
<b>Deposits</b>			
Demand	14	733	747
Savings	—	—	—
Negotiable Certificates of Deposit and Other Time Deposits	60	591	651
Securities sold under agreements to repurchase and other borrowings	(154)	140	(14)
<b>Federal Home Loan</b>			
Bank advances	39	175	214
Total Interest Expense	(41)	1,639	1,598
Net Interest Income	\$ 535	\$ (364)	\$ 171

	Three Months Ended 2019 vs. 2018		
	Volume	Rate	Net Change
<b>INTEREST INCOME</b>			
Loans	\$ 451	\$ 243	\$ 694
Investment Securities	315	(328)	(13)
Other	186	(57)	129
Total Interest Income	952	(142)	810
<b>INTEREST EXPENSE</b>			
<b>Deposits</b>			
Demand	10	348	358
Savings	—	—	—
Negotiable Certificates of Deposit and Other Time Deposits	35	315	350
Securities sold under agreements to repurchase and other borrowings	(81)	51	(30)
<b>Federal Home Loan</b>			
Bank advances	18	88	106
Total Interest Expense	(18)	802	784
Net Interest Income	\$ 970	\$ (944)	\$ 26

**Non-Interest Income**

Non-interest income decreased \$139 thousand for the six months ended June 30, 2019, compared to the same period in 2018, to \$6.3 million. Non-interest income decreased \$88 thousand for the three months ended June 30, 2019, compared to the three months ended June 30 2018, to remain at \$3.3 million.

Favorable variances to non-interest income for the six months ended June 30, 2019 compared to the six months ended June 30, 2018 include an increase of \$40 thousand in trust department income, an increase of \$188 thousand in gains on the sale of securities, an increase of \$93 thousand in debit card interchange income, and an increase of \$173 thousand in the cash surrender value of bank-owned life insurance.



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Decreases to non-interest income for the six months ended June 30, 2019 compared to the six months ended June 30, 2018 include a decrease of \$23 thousand in service charge income, a \$44 thousand decrease in loan servicing fees, a decrease of \$291 thousand in gain on sale of loans, a decrease of \$79 thousand in brokerage income, and a decrease of \$196 thousand in other income mostly due to a decrease of \$113 thousand in gains on the sale of other real estate.

The gain on the sale of loans decreased from \$819 thousand during the first six months of 2018 to \$528 thousand during the first six months of 2019, a decrease of \$291 thousand. For the three months ended June 30, the gain on the sale of loans decreased from \$445 thousand in 2018 to \$321 thousand in 2019.

The volume of loans originated to sell during the first six months of 2019 decreased \$2.8 million compared to the same time period in 2018. 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 \$104 thousand for the six months ended June 30, 2019 compared to \$148 thousand for the six months ended June 30, 2018, a decrease of \$44 thousand. During the first six months of 2019, the market value adjustment to the carrying value of the mortgage servicing right was a net write-down of \$41 thousand, as the fair value of this asset decreased. During the six months ended June 30 2018, the market value adjustment to the carrying value of the mortgage servicing right asset was a net recovery of \$56 thousand as the fair value of the mortgage servicing asset increased.

### **Non-Interest Expense**

Total non-interest expense increased \$554 thousand, or 3.26%, for the six month period ended June 30, 2019 compared to the same period in 2018. Total non-interest expense increased \$79 thousand for the three month period ended June 30, 2019 compared to the three months ended June 30, 2018. 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. Our most recent expansion involves constructing two new branch locations in Lexington, KY. Both locations are expected to open in 2020.

For the comparable six month periods, salaries and employees benefits expense increased \$163 thousand, an increase of 1.8%. The number of full-time employee equivalent employees decreased from 234 at June 30, 2018 to 232 at June 30, 2019, a decrease of two full-time employee equivalent employees. For the three months ended June 30, 2019 compared to the three months ended June 30, 2018, salaries and employee benefits expense decreased \$34 thousand, or 0.7%.

Occupancy expense decreased \$26 thousand to \$2.0 million for the first six months of 2019 compared to the same time period in 2018. Occupancy expense was \$1.1 million for the three months ended June 30, 2019 compared to \$1.1 million for the three months ended June 30, 2018.

Debit card expenses increased \$193 thousand for the six months ended June 30, 2019 compared to the first six months of 2018 and increased \$97 thousand for the three months ended June 30, 2019 compared to the three months ended June 30, 2018. 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.

Data processing expenses increased \$283 thousand for the six months ended June 30, 2019 compared to the first six months of 2018 and decreased \$151 thousand for the three months ended June 30, 2019 compared to the three months ended June 30, 2018. The increase in data processing expense is due to additional services obtained from vendors.

Repossession expense increased \$25 thousand for the first six months ended June 30, 2019 compared to the same time period in 2018 and decreased \$13 thousand for the three month period ended June 30, 2019 compared to the three months ended June 30, 2018. 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, 2019 was 4.6% compared to 12.0% in 2018. The effective tax rate for the three months ended June 30, 2019 was 1.6% compared to 12.5% in 2018. The effective tax rate is lower in 2019 in comparison to 2018 mostly due to the Company recording a deferred tax asset of \$380 thousand and a decrease in taxable income. 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. On December 22, 2017, the 'Tax Cuts and Jobs Act' was enacted into legislation. As a result, the 2019 statutory tax rate for the company is 21% compared to 34% in years prior to 2018.

Income tax expense decreased \$554 thousand for the six months ended June 30, 2019 compared to the first six months in 2018. Tax-exempt interest income decreased \$402 thousand for the first six months of 2019 compared to the first six months of 2018. Further, for the first six months of 2019, the Company had tax credits totaling \$276 thousand for investments made in low income housing projects compared to similar tax credits of \$277 for the first six months of 2018.

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, 2019, the Company averaged \$43.3 million in tax free securities and \$41.2 million in tax free loans. As of June 30, 2019, the weighted average remaining maturity for the tax free securities is 49 months, while the weighted average remaining maturity for the tax free loans is 141 months. For the year ended December 31, 2018, the Company averaged \$60.1 million in tax free securities, and \$38.2 million in tax free loans. As of December 31, 2018, the weighted average remaining maturity for the tax free securities was 115 months, while the weighted average remaining maturity for the tax free loans was 149 months.

On March 26, 2019, Governor Bevin signed House Bill 354 into law which, among other things, repealed the bank franchise tax structure in Kentucky. The capital based franchise tax structure will be replaced with the state-wide corporate income tax structure starting in 2021. Kentucky Bancshares, Inc. has historically filed a separate return in Kentucky, and has generated a Kentucky net operating loss ("NOL") carryforward, given the nature of its operations. Given House Bill 354, Kentucky Bancshares, Inc. will file a combined return in 2021, unless the Company decides to timely elect to file on a consolidated basis.

On April 9, 2019, Governor Bevin signed House Bill 458 into law which, among other things, allows a taxpayer to utilize certain net operating loss ("NOL") carryforwards to offset other members in the combined filing group starting in 2021. As a result of this tax law change, we recorded a deferred tax asset of \$380 thousand in the second quarter of 2019 for these NOL's.

## **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 may have a negative impact on earnings as a result of the lower yields on short-term assets.

Cash and cash equivalents were \$27.9 million as of June 30, 2019 compared to \$26.1 million at December 31, 2018. The increase in cash and cash equivalents is attributed to an increase of \$1.8 million in cash and due from banks.

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In addition to cash and cash equivalents, the securities portfolio provides an important source of liquidity. Securities available for sale totaled \$280.6 million at June 30, 2019 compared to \$315.4 million at December 31, 2018. The decrease of \$34.8 million, from December 31, 2018 to June 30, 2019 in our available for sale security portfolio had minimal impact on available liquidity. 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 2019, deposits decreased \$17.6 million compared to December 31, 2018. The Company's borrowed funds from the Federal Home Loan Bank increased \$3.4 million from December 31, 2018 to June 30, 2019, federal funds purchased remained at zero, and total repurchase agreements decreased \$3.6 million from December 31, 2018 to June 30, 2019.

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, 2019, we have sufficient collateral to borrow an additional \$73 million from the Federal Home Loan Bank.

In addition, as of June 30, 2019, \$48 million is available in overnight borrowing through various correspondent banks and the Company has access to an additional \$256 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**

In August 2018, the Federal Reserve Board issued an interim final ruling that holding companies with assets less than \$3 billion are not subject to minimum capital requirements. As a result, only Bank capital data and capital ratios are presented as of June 30, 2019 and December 31, 2018.

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and 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 Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank capital amounts and classifications are also subject to qualitative judgments by regulators about components, risk weightings, and other factors.

The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for US banks (Basel III rules) became effective for the Company on January 1, 2015 with full compliance with all of the requirements being phased in over a multi-year schedule, and was fully phased in on January 1, 2019. Under the Basel III rules, the Bank must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer was phased in from 0.0% for 2015 to 2.50% for 2019. The capital conservation buffer for 2019 is 2.50% and was 1.875% for 2018. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital.

Management believes as of June 30, 2019, the Bank meets all capital adequacy requirements to which it is subject. Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the following table) of Total and Tier I capital (as defined in the regulations) to riskweighted assets (as defined), and of Tier I capital to average assets (as defined).

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Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required.

At June 30, 2019 and at December 31, 2018, the most recent regulatory notifications 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 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.

The Bank's actual amounts and ratios, exclusive of the capital conservation buffer, are presented in the following table:

	<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>
(Dollars in Thousands)						
<b>June 30, 2019</b>						
Bank Only						
Total Capital (to Risk-Weighted Assets)	\$107,772	14.8 %	\$ 58,430	8.0 %	\$73,037	10.0 %
Tier I Capital (to Risk-Weighted Assets)	99,621	13.6	43,822	6.0	58,430	8.0
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	99,621	13.6	32,867	4.5	47,474	6.5
Tier I Capital (to Average Assets)	99,621	9.2	43,086	4.0	53,857	5.0
<b>December 31, 2018</b>						
Bank Only						
Total Capital (to Risk-Weighted Assets)	\$105,345	14.7 %	\$ 57,496	8.0 %	\$71,870	10.0 %
Tier I Capital (to Risk-Weighted Assets)	97,143	13.5	43,122	6.0	57,496	8.0
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	97,143	13.5	32,341	4.5	46,715	6.5
Tier I Capital (to Average Assets)	97,143	9.2	42,348	4.0	53,047	5.0

**Non-Performing Assets**

As of June 30, 2019, our non-performing assets totaled \$3.1 million or 0.28% of assets compared to \$3.2 million or 0.29% of assets at December 31, 2018. The Company experienced an increase of \$189 thousand in non-accrual loans from December 31, 2018 to June 30, 2019. As of June 30, 2019, non-accrual loans include \$59 thousand in loans secured by commercial properties, \$200 thousand in loans secured by farmland, \$535 thousand in loans secured by 1-4 family properties, \$374 thousand in loans secured by real estate construction, \$143 thousand in loans secured by non-farm and non-residential properties and \$19 thousand in consumer loans.

Loans secured by real estate composed 94.1% of the non-performing, non-accrual loans as of June 30, 2019 and 90.6% as of December 31, 2018. Forgone interest income on non-accrual loans totaled \$41 thousand for the first six months of 2019 compared to forgone interest of \$55 thousand for the same time period in 2018. Accruing loans that are contractually 90 days or more past due as of June 30, 2019 totaled \$1 million compared to \$1.2 million at December 31, 2018, a decrease of \$182 thousand.

Total nonperforming and restructured loans remained flat, increasing just \$7 thousand from December 31, 2018 to June 30, 2019. The ratio of nonperforming and restructured loans as a percentage of loans decreased one basis point to 0.33% from December 31, 2018 to June 30, 2019.



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In addition, the amount the Company has recorded as other real estate owned decreased \$99 thousand from December 31, 2018 to June 30, 2019. As of June 30, 2019, the amount recorded as other real estate owned totaled \$731 thousand compared to \$830 thousand at December 31, 2018. During the first six months of 2019, \$72 thousand in loan balances were foreclosed upon and added to other real estate properties while \$133 thousand in other real estate properties were sold. A write-down of \$38 thousand was also recorded during the first quarter of 2019. The allowance as a percentage of non-performing and restructured loans and other real estate owned increased from 258% at December 31, 2018 to 264% at June 30, 2019.

### Nonperforming and Restructured Assets

	<u>6/30/2019</u>	<u>12/31/2018</u>
	(in thousands)	
Non-accrual Loans	\$ 1,330	\$ 1,141
Accruing Loans which are Contractually past due over 89 days	1,000	1,182
Accruing Troubled Debt Restructurings	—	—
Total Nonperforming and Restructured Loans	2,330	2,323
Other Real Estate	731	830
Total Nonperforming and Restructured Loans and Other Real Estate	\$ 3,061	\$ 3,153
Nonperforming and Restructured Loans as a Percentage of Loans	0.33 %	0.34 %
Nonperforming and Restructured Loans and Other Real Estate as a Percentage of Total Assets	0.28 %	0.29 %
Allowance as a Percentage of Period-end Loans	1.14 %	1.18 %
Allowance as a Percentage of Non-performing and Restructured Loans and Other Real Estate	264 %	258 %

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 2019 was \$450 thousand compared to \$250 thousand for the first six months of 2018. The loan loss provision for the three months ended June 30, 2019 was \$325 thousand compared to \$250 thousand for the three months ended June 30, 2018. The increase in the total loan loss provision during the first six months of 2019 compared to the same time period in 2018 is attributed to growth in the Company’s loan portfolio, along with the Company 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 1.14% at June 30, 2019 compared to 1.22% at June 30, 2018.

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.

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Nonperforming loans and restructured loans increased \$7 thousand from December 31, 2018 to \$2.3 million at June 30, 2019. The Company recorded net charge-offs of \$501 thousand for the six months ended June 30, 2019 compared to net recoveries of \$214 thousand for the six months ended June 30, 2018. During the first quarter of 2019, a single note balance of \$191 thousand was charged-off. The note had a specific reserve of \$191 thousand at December 31, 2018; thus, this charged-off balance did not result in additional loan loss provision expense. 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.

	<b>Six Months Ended June</b>	
	<b>30,</b>	
	<b>(in thousands)</b>	
	<b>2019</b>	<b>2018</b>
Balance at Beginning of Period	\$ 8,127	\$ 7,720
Amounts Charged-Off:		
Commercial	191	—
1-4 family residential	104	63
Non-farm & non-residential	17	—
Consumer and other	580	506
<b>Total Charged-off Loans</b>	<b>892</b>	<b>569</b>
Recoveries on Amounts Previously Charged-off:		
Commercial	10	6
1-4 family residential	12	262
Multi-family residential	—	6
Agricultural	4	146
Consumer and other	365	363
<b>Total Recoveries</b>	<b>391</b>	<b>783</b>
<b>Net Charge-offs (Recoveries)</b>	<b>501</b>	<b>(214)</b>
<b>Provision for Loan Losses</b>	<b>450</b>	<b>250</b>
<b>Balance at End of Period</b>	<b>8,076</b>	<b>8,184</b>
Loans		
Average	691,399	656,515
At June 30,	707,982	668,778
As a Percentage of Average Loans:		
Net Charge-offs for the period	0.07 %	(0.03)%
Provision for Loan Losses for the period	0.07 %	0.04 %
Allowance as a Multiple of Net Charge-offs annualized	8.1	(19.1)



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	<b>Three Months Ended June 30, (in thousands)</b>	
	<b>2019</b>	<b>2018</b>
Balance at Beginning of Period:	\$ 7,882	\$ 7,905
Amounts Charged-Off:		
1-4 family residential	5	1
Consumer and other	278	264
Total Charged-off Loans	283	265
Recoveries on Amounts Previously Charged-off:		
Commercial	3	6
1-4 family residential	4	5
Multi-family residential	—	3
Agricultural	3	123
Consumer and other	142	157
Total Recoveries	152	294
Net Charge-offs	131	(29)
Provision for Loan Losses	325	250
Balance at End of Period	8,076	8,184
Loans		
Average	697,381	661,220
At June 30,	707,982	668,778
As a Percentage of Average Loans:		
Net Charge-offs (Recoveries) for the period	0.02 %	(0.00)%
Provision for Loan Losses for the period	0.05 %	0.04 %
Allowance as a Multiple of Net Charge-offs annualized	15.4	(70.6)

**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

<b>Period</b>	<b>(a) Total Number of Shares (or Units) Purchased</b>	<b>(b) Average Price Paid Per Share (or Unit)</b>	<b>(c) Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans Or Programs</b>	<b>(d) Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs</b>	
4/1/19-4/30/19	—	\$ —	—	201,824	shares
5/1/19-5/31/19	—	—	—	201,824	shares
6/1/19-6/30/19	—	—	—	201,824	shares
<b>Total</b>	—	\$ —	—	201,824	shares

On October 25, 2000, we announced that our Board approved a stock repurchase program and authorized the Company to purchase up to 200,000 shares of its outstanding common stock. On November 11, 2002, the Board approved and authorized the Company's repurchase of an additional 200,000 shares. On May 20, 2008, the Board of Directors approved and authorized the Company to purchase an additional 200,000 shares. On May 17, 2011, the Board approved and authorized the Company's repurchase of an additional 200,000 shares. On November 18, 2016, the Board of Directors approved and authorized the Company's repurchase of an additional 100,000 shares. Shares will be purchased from time to time in the open market depending on market prices and other considerations. Through June 30, 2019, 698,176 shares have been purchased.

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**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 8/9/19 /s/Louis Prichard  
Louis Prichard, President and C.E.O.

Date 8/9/19 /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):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: August 9, 2019

BY /s/ Louis Prichard  
Louis Prichard  
President & Chief Executive Officer

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## Section 3: EX-31.2 (EX-31.2)

Exhibit 31.2

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

I, Gregory J. Dawson, 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):
  - a) All significant deficiencies and material weaknesses in the design or operation of internal control over financial reporting which are reasonably likely to adversely affect the registrant's ability to record, process, summarize and report financial information; and
  - b) Any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls over financial reporting.

Date: August 9, 2019

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, 2019, 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 9, 2019

By /s/ Louis Prichard

Louis Prichard  
President & Chief Executive Officer

Date: August 9, 2019

By /s/ Gregory J. Dawson

Gregory J. Dawson  
Chief Financial Officer



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