

Board of Governors of the Federal Reserve System



## Annual Report of Holding Companies—FR Y-6

### Report at the close of business as of the end of fiscal year

This Report is required by law: Section 5(c)(1)(A) of the Bank Holding Company Act (12 U.S.C. § 1844(c)(1)(A)); sections 8(a) and 13(a) of the International Banking Act (12 U.S.C. §§ 3106(a) and 3108(a)); sections 11(a)(1), 25, and 25A of the Federal Reserve Act (12 U.S.C. §§ 248(a)(1), 602, and 611a); and sections 113, 165, 312, 618, and 809 of the Dodd-Frank Act (12 U.S.C. §§ 5361, 5365, 5412, 1850a(c)(1), and 5468(b)(1)). Return to the appropriate Federal Reserve Bank the original and the number of copies specified.

NOTE: The *Annual Report of Holding Companies* must be signed by one director of the top-tier holding company. This individual should also be a senior official of the top-tier holding company. In the event that the top-tier holding company does not have an individual who is a senior official and is also a director, the chairman of the board must sign the report. If the holding company is an ESOP/ESOT formed as a corporation or is an LLC, see the General Instructions for the authorized individual who must sign the report.

I, Timothy K. Schools

Name of the Holding Company Director and Official

President and Chief Executive Officer

Title of the Holding Company Director and Official

attest that the *Annual Report of Holding Companies* (including the supporting attachments) for this report date has been prepared in conformance with the instructions issued by the Federal Reserve System and are true and correct to the best of my knowledge and belief.

With respect to information regarding individuals contained in this report, the Reporter certifies that it has the authority to provide this information to the Federal Reserve. The Reporter also certifies that it has the authority, on behalf of each individual, to consent or object to public release of information regarding that individual. The Federal Reserve may assume, in the absence of a request for confidential treatment submitted in accordance with the Board's "Rules Regarding Availability of Information," 12 C.F.R. Part 261, that the Reporter and individual consent to public release of all details in the report concerning that individual.

*Timothy K. Schools*

Signature of Holding Company Director and Official

03/29/2019

Date of Signature

For holding companies not registered with the SEC—  
Indicate status of Annual Report to Shareholders:

- ☐ is included with the FR Y-6 report  
☐ will be sent under separate cover  
☐ is not prepared

### For Federal Reserve Bank Use Only

RSSD ID \_\_\_\_\_

C.I. \_\_\_\_\_

This report form is to be filed by all top-tier bank holding companies, top-tier savings and loan holding companies, and U.S. intermediate holding companies organized under U.S. law, and by any foreign banking organization that does not meet the requirements of and is not treated as a qualifying foreign banking organization under Section 211.23 of Regulation K (12 C.F.R. § 211.23). (See page one of the general instructions for more detail of who must file.) The Federal Reserve may not conduct or sponsor, and an organization (or a person) is not required to respond to, an information collection unless it displays a currently valid OMB control number.

Date of Report (top-tier holding company's fiscal year-end):

December 31, 2018

Month / Day / Year

549300ZS0XKMQCIH6I27

Reporter's Legal Entity Identifier (LEI) (20-Character LEI Code)

Reporter's Name, Street, and Mailing Address

Highlands Bankshares, Inc.

Legal Title of Holding Company

340 W. Main Street / P.O. Box 1128

(Mailing Address of the Holding Company) Street / P.O. Box

Abingdon

VA

24212-1128

City

State

Zip Code

Physical Location (if different from mailing address)

Person to whom questions about this report should be directed:

Robert M. Little, Jr.

Chief Accounting Officer

Name

Title

276-628-9181 x81515

Area Code / Phone Number / Extension

276-619-2106

Area Code / FAX Number

rlittle@hubank.com

E-mail Address

www.hubank.com

Address (URL) for the Holding Company's web page

Is confidential treatment requested for any portion of this report submission? .....

0=No

1=Yes

0

In accordance with the General Instructions for this report (check only one),

1. a letter justifying this request is being provided along with the report .....

☐

2. a letter justifying this request has been provided separately ...

☐

NOTE: Information for which confidential treatment is being requested must be provided separately and labeled as "confidential."

## For Use By Tiered Holding Companies

*Top-tiered holding companies must list the names, mailing address, and physical locations of each of their subsidiary holding companies below.*

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

Legal Title of Subsidiary Holding Company

(Mailing Address of the Subsidiary Holding Company) Street / P.O. Box

City State Zip Code

Physical Location (if different from mailing address)

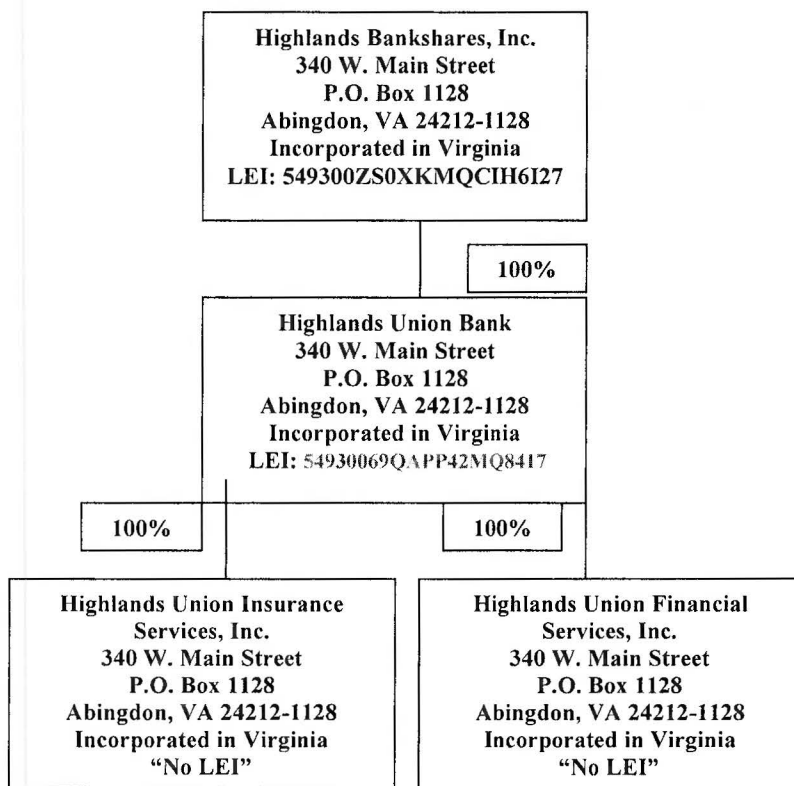


Form FR Y-6

**Highlands Bankshares, Inc.**  
**Abingdon, Virginia**  
**Fiscal Year Ending December 31, 2018**

Report Item

1. Annual Report to Shareholders - Attached.
- 2.a. Organization Chart.



**Form FR Y-6**

**Highlands Bankshares, Inc.  
Abingdon, Virginia  
Fiscal Year Ending December 31, 2018**

2.b. Domestic Branch Listing: **Submitted via email on 03/26/2019. Attached – Page 8.**

**(1) Airport Road Branch - Full Service**

Physical/Mailing Address: 999 Old Airport Road, Bristol, VA 24201

(P) 276.669.9300 (F) 276.466.5968

**(2) Banner Elk Branch - Full Service**

Physical Address: 115 Main Street East, Banner Elk, NC 28604

(P) 828.898.5100 (F) 828.898.5191

**(3) Blountville Branch - Full Service**

Physical Address: 2217 Highway 394, Blountville TN 37617

(P) 423.323.9181 (F) 423.323.9436

**(4) Boone Branch - Full Service**

Physical Address: 1013 NC Hwy 105, Boone, NC 28607

(P) 828.264.7040 (F) 828.263.0535

**(5) Commonwealth Branch - Full Service**

Physical/Mailing Address: 821 Commonwealth Ave., Bristol, VA 24201

(P) 276.645.7110 (F) 276.466.3929

**(6) East Abingdon Branch - Full Service**

Physical Address: 24412 Maringo Road, Abingdon, VA 24211

(P) 276.628.6300 (F) 276.628.8831

**(7) Glade Spring Branch - Full Service**

Physical Address: 506 Maple Street, Glade Spring, VA 24340

(P) 276.429.3000 (F) 276.429.4555

**(9) Main Branch - Full Service**

Physical Address: 340 W Main Street, Abingdon, VA 24210

(P) 276.628.9181 (F) 276.619.2101

**(10) Marion Branch - Full Service**

Physical Address: 1425 N Main Street, Marion, VA 24354

(P) 276.782.9394 (F) 276.783.8369

**(11) Rogersville Branch - Full Service**

Physical Address: 4020 Hwy 66 S, Rogersville, TN 37857

(P) 423.272.1987 (F) 423.272.1897

**(12) Sevierville Branch - Full Service**

Physical/Mailing Address: 113 Hardin Lane, Sevierville, TN 37862

(P) 865.908.0455 (F) 865.908.0456

**(13) South Knoxville Branch - Full Service**

Physical/Mailing Address: 7570 Mountain Grove Dr, Knoxville, TN 37920

(P) 865.573.4471 (F) 865.573.4475

**(14) West Abingdon Branch - Full Service**

Physical/Mailing Address: 164 Old Jonesboro Road, Abingdon, VA 24210

(P) 276.628.3933 (F) 276.676.4431

## Form FR Y-6

**Highlands Bankshares, Inc.**  
**Abingdon, Virginia**  
**Fiscal Year Ending December 31, 2018**

**Report Item 3: Securities Holders**

(1)(a) (1)(c) (2)(a) (2)(b) (2)(c)

Current shareholders with ownership, control or holdings of 5% or more with power to vote as of 12/31/2018			Shareholders not listed in (3)(1)(c) that had ownership, control or holdings of 5% or more with power to vote during the fiscal year ending 12/31/2018		
(1)(a) Name & Address (City, State, Country)	(1)(b) Country of Citizenship or Incorporation	(1)(c) Number and Percentage of Each Class of Voting Securities	(2)(a) Name & Address (City, State, Country)	(2)(b) Country of Citizenship or Incorporation	(2)(c) Number and Percentage of Each Class of Voting Securities
James D. Moore, Jr. Abingdon, Virginia, USA	USA	727,322 – 8.82% Common Stock	N/A	N/A	N/A
TNH Financial Fund, LP 780 Third Avenue 29 <sup>th</sup> Floor New York, NY USA	USA	388,678 – 4.71% Common Stock  2,092,287 – 100% Series A Convertible Perpetual Preferred Stock  Combined (Assuming 100% Conversion) 2,480,965 – 23.99%			
Sienna Capital Partners GP, LLC 100 N. Riverside Plaza, Suite 1630 Chicago, IL 60606 USA	USA	444,164 – 5.38% Common Stock			

Form FR Y-6

Highlands Bankshares, Inc.

**Abingdon, Virginia**  
**Fiscal Year Ending December 31, 2018**

**Report Item 4: Insiders**  
(1) (2) (3)(a)(b)(c) and (4)(a)(b)(c)

(1) Name & Address (City, State, Country)	(2) Principal Occupation if other than with Bank Holding Company	(3)(a) Title and Position with Bank Holding Company	(3)(b) Title and Position with Subsidiaries (Include names of subsidiaries)	(3)(c) Title and Position with Other Businesses (include names of other businesses)	(4)(a) Percentage of Voting Shares in Bank Holding Company	(4)(b) Percentage of Voting Shares in Subsidiaries (Include names of subsidiaries)	(4)(c) List names of other companies (Includes partnerships) if 25% or more of voting securities are held
E. Craig Kendrick Meadowview, Virginia USA	Attorney in private practice	Director	Director, Highlands Union Bank	Attorney in private practice	1.84%	N/A	N/A
Charles P. Olinger Bristol, Tennessee USA	Accountant in private practice	Director	Director, Highlands Union Bank	Certified Public Accountant in private practice	0.42%	N/A	37.5% ownership in Blackley, Olinger CPA's
Timothy K. Schools Greenville, South Carolina USA	N/A	Director, President and Chief Executive Officer	Director, President and Chief Executive Officer Highlands Union Bank	N/A	4.34%	N/A	N/A
Edward M. Rosinus Evanston Illinois USA	Financial services professional	Director	Director, Highlands Union Bank	Vice President at Stephens, Inc.	0.02%	N/A	N/A
Jon C. Lundberg Bristol, Tennessee USA	President, The Corporate Image; Chief Executive Officer of Corporate Marketing; First District state representative for the State of Tennessee	Director	Director, Highlands Union Bank	President, The Corporate Image; Chief Executive Officer of Corporate Marketing; First District state representative for the State of Tennessee	0.14%	N/A	50% ownership in The Corporate Image
Robert W. Moser Greenville, South Carolina USA	Co-founder, President and COO Immedion Data Centers	Director	Director, Highlands Union Bank	Co-founder, President and COO Immedion Data Centers	0.06%	N/A	N/A
E. Sutton Bacon Asheville, North Carolina USA	Chairman of Nantahala Outdoor Center	Director	Director, Highlands Union Bank	Chairman of Nantahala Outdoor Center	0.01%	N/A	Ocoee Retreat Center Inc 100% ORC Properties LLC 100% Sky Zone Asheville LLC 40% Pisgah Hospitality Partners LLC 50% Paddlesports Retailer LLC 50% Panthertown Investment Co. 100

Charles D. Meade Johnson City, Tennessee USA	President, Meade Tractor	Director	Director, Highlands Union Bank	N/A	0.02%	N/A	N/A
TNH Financial Fund, LP 780 Third Avenue 29 <sup>th</sup> Floor New York, NY USA	Financial Fund	Principal Security Holder	N/A	N/A	388,678 – 4.71% Common Stock  2,092,287 – 100% Series A Convertible Perpetual Preferred Stock  Combined (Assuming 100% Conversion) 2,480,965 – 23.99%	N/A	N/A

#### Report Item 4: Directors and Officers

(1) (2) (3)(a)(b)(c) and (4)(a)(b)(c)

(1) Name & Address (City, State, Country)	(2) Principal Occupation if other than with Bank Holding Company	(3)(a) Title and Position with Bank Holding Company	(3)(b) Title and Position with Subsidiaries (Include names of subsidiaries)	(3)(c) Title and Position with Other Businesses (include names of other businesses)	(4)(a) Percentage of Voting Shares in Bank Holding Company	(4)(b) Percentage of Voting Shares in Subsidiaries (Include names of subsidiaries)	(4)(c) List names of other companies (Includes partnerships) if 25% or more of voting securities are held
John H. Gray Raleigh, North Carolina USA	N/A	Chief Financial Officer	Chief Financial Officer	N/A	0.06%	N/A	N/A
Ray Skinner Abingdon, Virginia USA	N/A	Chief Banking Officer	Chief Banking Officer	N/A	0.15%	N/A	N/A
Bryan Booher Blountville, Tennessee USA	N/A	EVP IT / Note Operations	EVP IT / Note Operations	N/A	0.24%	N/A	N/A
Robert M. Little, Jr. Bristol, Virginia USA	N/A	Secretary and Chief Risk Officer	Secretary and Chief Risk Officer	N/A	0.18%	N/A	N/A
Victoria Andrews Abingdon, Virginia USA	N/A	EVP Deposit Operations	EVP Deposit Operations	N/A	0.01%	N/A	N/A



**Results:** A list of branches for your depository institution: HIGHLANDS UNION BANK (ID\_RSSD: 969424).  
This depository institution is held by HIGHLANDS BANKSHARES, INC. (2391270) of ABINGDON, VA.  
The data are as of 12/31/2018. Data reflects information that was received and processed through 01/06/2019.

#### Reconciliation and Verification Steps

1. In the **Data Action** column of each branch row, enter one or more of the actions specified below
2. If required, enter the date in the **Effective Date** column

#### Actions

OK: If the branch information is correct, enter 'OK' in the **Data Action** column.  
Change: If the branch information is incorrect or incomplete, revise the data, enter 'Change' in the **Data Action** column and the date when this information first became valid in the **Effective Date** column.  
Close: If a branch listed was sold or closed, enter 'Close' in the **Data Action** column and the sale or closure date in the **Effective Date** column.  
Delete: If a branch listed was never owned by this depository institution, enter 'Delete' in the **Data Action** column.  
Add: If a reportable branch is missing, insert a row, add the branch data, and enter 'Add' in the **Data Action** column and the opening or acquisition date in the **Effective Date** column.

If printing this list, you may need to adjust your page setup in MS Excel. Try using landscape orientation, page scaling, and/or legal sized paper.

#### Submission Procedure

When you are finished, send a saved copy to your FRB contact. See the detailed instructions on this site for more information.  
If you are e-mailing this to your FRB contact, put your institution name, city and state in the subject line of the e-mail.

Note:  
To satisfy the **FR Y-10 reporting requirements**, you must also submit FR Y-10 Domestic Branch Schedules for each branch with a **Data Action** of Change, Close, Delete, or Add.  
The FR Y-10 report may be submitted in a hardcopy format or via the FR Y-10 Online application - <https://y10online.federalreserve.gov>.

\* FDIC UNINUM, Office Number, and ID\_RSSD columns are for reference only. Verification of these values is not required.

Data Action	Effective Date	Branch Service Type	Branch ID_RSSD*	Popular Name	Street Address	City	State	Zip Code	County	Country	FDIC UNINUM*	Office Number*	Head Office	Head Office ID_RSSD*	Comments
OK		Full Service (Head Office)	969424	HIGHLANDS UNION BANK	340 WEST MAIN STREET	ABINGDON	VA	24210	WASHINGTON	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	3239025	BANNER ELK BRANCH	115 MAIN STREET EAST	BANNER ELK	NC	28604	AVERY	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	2984654	BOONE BRANCH	1013 HWY 105	BOONE	NC	28607	WATAUGA	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	3210819	BLOUNTVILLE BRANCH	2217 HIGHWAY 394	BLOUNTVILLE	TN	37617	SULLIVAN	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	3648841	MOUNTAIN GROVE BRANCH	7570 MOUNTAIN GROVE DRIVE	KNOXVILLE	TN	37920	KNOX	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	940432	ROGERSVILLE BRANCH	4020 HIGHWAY 66 S	ROGERSVILLE	TN	37857	HAWKINS	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	3920921	EAST SEVIERVILLE BRANCH	1824 VETERANS BOULEVARD	SEVIERVILLE	TN	37862	SEVIER	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	3375343	SEVIERVILLE BRANCH	113 HARDIN LANE	SEVIERVILLE	TN	37862	SEVIER	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	2133564	EAST ABINGDON BRANCH	24412 MARINGO ROAD	ABINGDON	VA	24211	WASHINGTON	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	2265362	WEST ABINGDON BRANCH	164 OLD JONESBORO ROAD	ABINGDON	VA	24210	WASHINGTON	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	2380827	BRISTOL OFFICE	821 COMMONWEALTH AVENUE	BRISTOL	VA	24201	BRISTOL CITY	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	1224287	EAST BRISTOL BRANCH	999 OLD AIRPORT ROAD	BRISTOL	VA	24201	BRISTOL CITY	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	2759049	GLADE SPRING BRANCH	506 MAPLE ST	GLADE SPRING	VA	24340	WASHINGTON	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	
OK		Full Service	2639673	MARION BRANCH	1425 NORTH MAIN ST	MARION	VA	24354	SMYTH	UNITED STATES	Not Required	Not Required	HIGHLANDS UNION BANK	969424	

UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10-K

**Annual Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the fiscal year ended December 31, 2018**

☐ 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: 000-27622

**HIGHLANDS BANKSHARES, INC.**  
(Exact name of registrant as specified in its charter)

**Virginia**  
(State or other jurisdiction of  
incorporation or organization)  
  
**P.O. Box 1128**  
**Abingdon, Virginia**  
(Address of principal executive offices)

**54-1796693**  
(I.R.S. Employer  
Identification No.)

**24212-1128**  
(Zip Code)

**276-628-9181**  
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(g) of the Act:  
**Common Stock, \$0.625 par value**  
(Title of class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes No ☒ X

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ☐ No ☒ X

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 ☒ X No ☐

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

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. ☐

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company, or 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 ☒ X Smaller Reporting Company ☒ X 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 Act) Yes ☐ No ☒ X

State the aggregate market value of the voting and non-voting common equity held by non-affiliates computed by reference to the price at which the common equity was last sold, or the average bid and asked price of such common equity, as of the last business day of the registrant's most recently completed second fiscal quarter: \$55,897,874.

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: 8,250,729 shares of common stock, par value \$0.625 per share, outstanding as of March 28, 2019.

DOCUMENTS INCORPORATED BY REFERENCE  
Consolidated Financial Report for year ended **December 31, 2018** – Part II  
Proxy Statement for the 2019 Annual Meeting of Shareholders—Part III

Highlands Bankshares, Inc.  
Form 10-K  
For the Year Ended December 31, 2018

Table of Contents

	<b>Page</b>
<b><u>PART I</u></b>	
Item 1. <u>Business</u>	<u>3</u>
Item 1A. <u>Risk Factors</u>	<u>13</u>
Item 1B. <u>Unresolved Staff Comments</u>	<u>13</u>
Item 2. <u>Properties</u>	<u>13</u>
Item 3. <u>Legal Proceedings</u>	<u>14</u>
Item 4. <u>Mine Safety Disclosures</u>	<u>14</u>
<b><u>PART II</u></b>	
Item 5. <u>Market for the Registrants Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities</u>	<u>15</u>
Item 6. <u>Selected Financial Data</u>	<u>15</u>
Item 7. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>16</u>
Item 7A. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>27</u>
Item 8. <u>Financial Statements and Supplementary Data</u>	<u>27</u>
Item 9. <u>Changes in and Disagreements with Accountants on Accounting and Financial Disclosure</u>	<u>66</u>
Item 9A. <u>Controls and Procedures</u>	<u>66</u>
Item 9B. <u>Other Information</u>	<u>67</u>
<b><u>PART III</u></b>	
Item 10. <u>Directors, Executive Officers and Corporate Governance</u>	<u>67</u>
Item 11. <u>Executive Compensation</u>	<u>67</u>
Item 12. <u>Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters</u>	<u>67</u>
Item 13. <u>Certain Relationships, Related Transactions and Director Independence</u>	<u>67</u>
Item 14. <u>Principal Accounting Fees and Services</u>	<u>67</u>
<b><u>PART IV</u></b>	
Item 15. <u>Exhibits and Financial Statement Schedules</u>	<u>68</u>
<u>Signatures</u>	<u>69</u>

## PART I.

### Item 1. Business

#### History and Business

Highlands Bankshares, Inc. (the "Company") is a one-bank holding company organized under the laws of Virginia in 1995 and registered as a bank holding company under the Bank Holding Company Act of 1956 ("BHCA"). The Company conducts the majority of its business operations through its wholly-owned bank subsidiary, Highlands Union Bank (the "Bank"). The Company's single direct subsidiary as of December 31, 2018 is the Bank, which was formed in 1985.

#### *Highlands Union Bank*

The Bank is a Virginia state chartered bank that was incorporated in 1985. The Bank provides banking, insurance, wealth management, and other financial solutions through 14 banking offices, a loan production office, and 148 full-time equivalent associates located in North Carolina, Tennessee, and Virginia.

The Bank offers retail and commercial banking products and services to individuals, businesses and local government customers. These products and services include traditional deposit and loan options, including checking accounts, money market deposit accounts, interest-bearing demand deposit accounts, savings accounts, time deposits, residential 1-4 family loans, owner occupied and non owner occupied commercial real estate loans, second mortgage loans, home equity lines of credit, consumer, commercial/industrial, credit card and agricultural loans. Other products and services offered include automatic funds transfer, night depository, safe deposit, and other miscellaneous services normally offered by commercial banks.

#### *Highlands Union Insurance Services, Inc.*

Highlands Union Insurance Services, Inc., ("HUIS") a wholly owned subsidiary of the Bank, was formed in 1999. The Bank, through HUIS, joined a consortium of approximately forty-seven other financial institutions to form Bankers' Insurance, LLC. Bankers' Insurance, LLC, as of December 31, 2018, had purchased multiple full service insurance agencies across the state of Virginia. HUIS sells insurance products and services through Bankers' Insurance, LLC.

#### *Highlands Union Financial Services, Inc.*

Highlands Union Financial Services, Inc., ("HUFS") a wholly-owned subsidiary of the Bank, was created to offer third party mutual funds and other financial services to its customers in all market areas served by the Bank. The only activity in Highlands Union Financial Services Inc. now relates to commissions from the sale of life insurance.

#### *Russell Road Properties, LLC*

Russell Road Properties, LLC was created to hold and manage certain properties acquired by the Bank through foreclosure or deed in lieu of foreclosure.

#### Lending Activities

The Bank has written policies and procedures to help manage credit risk. The Bank's policy provides for three levels of lending authority. The first level of authority is granted to individual loan officers who have various levels of approval based upon their position and experience. The second level is the Credit Committee, which is comprised of senior officers of the Bank from all market areas. The Credit Committee considers loans that exceed the individual loan officers' lending authority and reviews loans to be presented to the Board's Risk Committee or the Board of Directors. In addition to approving loans that exceed the Credit Committee's authority, the board's Risk Committee reviews portfolio concentrations and other credit quality metrics. All lending policies are reviewed and approved by the Board of Directors. .

The Bank has engaged an external third part to perform an independent review of the Bank's loan portfolio to identify loss exposure and to monitor compliance with the Bank's loan policy. The independent credit review seeks to review approximately 50 percent of outstanding loan balances each year.

#### *One-to-Four-Family Residential Real Estate Lending*

Residential loan opportunities may be generated by the Bank's loan officers, referrals by real estate professionals, and by existing or new bank clients. Loan applications are taken by a Bank loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant and originations are underwritten using policy guidelines. Security for the majority of one to four family residential loans is owner occupied single family dwellings. Values of residential real estate collateral are provided by independent appraisers who have been approved by the Bank's Board of Directors.

Second mortgages and Home Equity Lines of Credit are generated, underwritten and secured like single family residential real estate loans discussed above. Second mortgage loans are typically originated at higher interest rates than residential mortgage loans. Home equity lines of credit are typically variable-rate instruments based on a market index, although some have been originated with a promotional interest rate that reverts to standard pricing following a specified period of time. Second mortgages are typically made for no more than fifteen years. Home equity lines of credit mature in ten years.

The Bank also originates adjustable rate products ("ARM") secured by one to four family residential properties with a repricing interval of three and five years. These products provide another outlet instead of secondary market loans and are generated, underwritten and secured the same as single family residential real estate loans discussed above. The Bank retains these loans in its loan portfolio. Senior Management adjusts the ARM rates based on competitive rates within the Bank's market area. The ARM products contain interest rate caps at adjustment periods and rate ceilings based on a cap over and above the original interest rate. Adjustable rate mortgages are underwritten based on payment amounts at the interest rate reaching the lifetime cap.

At December 31, 2018, \$199.4 million, or 44.4 percent, of the Bank's loan portfolio consisted of one-to four-family residential real estate loans, second mortgages, and home equity lines. Fixed rate loans are typically 3, 5, and 7 year balloon loans amortized over a 30 year period. In connection with residential real estate loans, the Bank requires hazard insurance, and if required, flood insurance.

#### *Multifamily Residential Real Estate Lending*

Loan applications for loans to be secured by multi-family residential properties are taken by a loan officer. As part of the application process, information is gathered concerning income, employment and credit history of the applicant, as well as rent rolls, operating costs and occupancy rates of the property to be financed. At December 31, 2018, \$18.4 million, or 4.1 percent, of the Bank's loan portfolio consisted of multi-family residential properties. Loan originations are underwritten using the Bank's underwriting guidelines of a LTV of 80% and a cash flow coverage ratio of 1.25 or better. The valuation of multifamily residential collateral is provided by independent fee appraisers who have been approved by the Bank's Board of Directors.

The Bank originates fixed rate and adjustable rate loans secured by multi-family properties, which are retained in the Bank's portfolio. Adjustable rate mortgages are underwritten based on payment amounts at the interest rate reaching the lifetime cap.

#### *Commercial, Construction, Farmland, Other Land Loans and Land Development Lending*

The Bank makes commercial, construction, farmland and land acquisition and development loans. These loans generally have a higher degree of risk than residential mortgage loans, but also have higher yields. To minimize these risks, the Bank normally obtains appropriate collateral and requires the personal guarantees from the borrower's principal owners and monitors the financial condition of its business borrowers. Commercial business loans typically are made on the basis of the borrower's ability to make repayment from cash flow from its business. As a result, the availability of funds for the repayment of commercial business loans is substantially dependent on the success of the business itself. Furthermore, the collateral for commercial business loans may depreciate over time and generally cannot be appraised with as much precision as historically been the case with residential real estate.

At December 31, 2018, commercial real estate loans aggregated \$136.1 million, or 30.3 percent, of the Bank's total loans. In its underwriting of commercial real estate, the Bank may lend, under its policy, up to 80% of the secured property's appraised value. The Bank's commercial real estate loan underwriting criteria require an examination of debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. The Bank also evaluates the location of the secured property, and as noted above, typically requires personal guarantees or endorsements of the borrowing entity's principal owners.

Construction and Land Development loans, including acquisition and development loans, are primarily those secured by residential houses and commercial structures under construction and the underlying land for which the loan was obtained. Over the past two years the Bank has significantly reduced the number of originations of construction and land development loans in all of its market areas in an effort to reduce portfolio risk.

At December 31, 2018, construction, farmland, and other land loans outstanding were \$33.2 million, or 7.4 percent, of total loans. Construction lending entails significant additional risks and often involves larger loan balances concentrated with single borrowers or groups of related borrowers. Another risk involved in construction lending is attributable to the fact that loan funds are advanced to fund construction, the value of which is estimated prior to the completion of construction on an "as built" basis. Therefore, it is difficult to accurately estimate the total loan funds required to complete the project and the completed loan-to-value ratios. To mitigate the risks associated with construction lending, the Bank generally limits loan amounts to 80% of as built appraised value, in addition to analyzing the creditworthiness of its borrowers. The Bank obtains a first lien on the property as security for construction loans, monitors the construction and advance process and, if a business entity, typically requires personal guarantees from the borrowing entity's principal owners.



### *Commercial and Agricultural Lending-- Non-Real Estate Secured and Unsecured*

The Bank makes local commercial and agricultural unsecured and non-real estate secured loans. These loans generally have a higher degree of risk than other loans. To manage these risks, the Bank generally obtains collateral, such as assignments of inventory or accounts receivable, equipment, and personal guarantees from the borrowing entity's principal owners. In its underwriting of commercial and agricultural non-real estate secured loans, the Bank may lend, under internal policy, up to 80% of the secured collateral appraised value. The Bank's commercial and agricultural non-real estate secured and unsecured underwriting criteria require adequate debt service coverage ratios and the borrower's creditworthiness, prior credit history and reputation. As commercial business and agricultural non-real estate secured loans typically are made on the basis of the borrower's ability to make repayment from cash flow, the availability of funds for the repayment is substantially dependent on the success of the business itself.

At December 31, 2018, commercial and agricultural non-real estate secured loans including unsecured loans aggregated \$49.0 million, or 10.9 percent, of the Bank's total loans.

### *Consumer Lending-Non Real Estate Secured and Unsecured*

The Bank offers various secured and unsecured consumer loans, including unsecured personal loans and lines of credit, automobile loans, deposit account loans made on both an installment and demand basis. At December 31, 2018, the Bank had consumer loans of \$12.8 million or 2.8 percent of gross loans. Such loans are generally made to customers with whom the Bank has a pre-existing relationship, often deposit and residential mortgage relationships. The Bank only originates its consumer loans in its geographic market area. The underwriting standards employed by the Bank for consumer loans include a determination of the applicant's payment history on other debts and an assessment of the ability to meet existing obligations and payments on the proposed loan. The stability of the applicant's monthly income may be determined by the verification of gross monthly income from primary employment and additionally from any verifiable secondary source. The applicant's FICO scores are also analyzed with the credit report analysis. Although creditworthiness of the applicant is of primary consideration, the underwriting process also includes an analysis of the value of the available collateral, if applicable.

Consumer loans may entail significant risk, particularly if unsecured, such as lines of credit, or secured by rapidly depreciable assets such as automobiles. In such cases, any repossessed collateral for a defaulted consumer loan may not provide an adequate source of repayment of the outstanding loan balance. The remaining deficiency often does not warrant further substantial collection efforts against the borrower. In addition, consumer loan collections are dependent on the borrower's continuing financial stability, and thus are more likely to be adversely affected by job loss, divorce, illness or personal bankruptcy. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans. Such loans may also give rise to claims and defenses by a consumer borrower against an assignee of collateral securing the loan such as the Bank and a borrower may raise claims which it has against the seller of the underlying collateral to prevent collection.

### *Participation Loans*

In addition to secondary marketing activities related to 1-4 family residential mortgage loans, the Bank will occasionally buy or sell all or a portion of a loan. The Bank will consider selling a loan or a participation in a loan, if: (i) the full amount of the loan to a single borrower will exceed the Bank's legal lending limit, which is 15 percent of the unimpaired capital and unimpaired surplus of the Bank; (ii) the full amount of the loan, when combined with a borrower's previously outstanding loans, will exceed the Bank's legal lending limit to a single borrower; (iii) the Board of Directors or the Senior Officer Loan Committee believes that a particular borrower has a sufficient level of debt with the Bank; (iv) the borrower requests the sale; (v) the loan to deposit ratio is at or above the optimal level as determined by Bank management; and/or (vi) the loan may create too great a concentration of loans in one particular location, one industry or in one particular type of loan. The Bank will consider purchasing a participation in a loan from another financial institution if the loan meets all applicable credit quality standards; (i) the Bank's loan to deposit ratio is at a level where additional loans would be desirable; and/or (ii) a common customer requests the purchase.

The following table sets forth, for the two fiscal years ended December 31, 2018 and 2017, the percentage of total operating revenue contributed by each class of similar services which contributed 15% or more of total operating revenues of the Company during such periods.

Year Ended	Class of Service	Percentage of Total Revenues
December 31, 2018	Interest and Fees on Loans	88.26%
December 31, 2017	Interest and Fees on Loans	81.83%

## Market Area

The Bank operates five offices in Southwest Virginia, five offices in the Tri-Cities area straddling the Tennessee/Virginia border, three offices in the vicinity of Knoxville, Tennessee, and two offices in the High Country region of Northwestern North Carolina

### *Southwest Virginia Market Area*

Bristol, Virginia is located in far southwestern Virginia and lies directly on the Virginia-Tennessee state line. Washington County surrounds Bristol to the west, north and east. In the Bristol/Washington County community, educational/health care services, manufacturing, and retail trade sectors are the largest industries, in terms of total number of jobs in 2017.

The Bank has a branch office located in Marion which is the county seat of Smyth County, Virginia. Marion is approximately 30 miles northeast of Abingdon, Virginia. In Smyth County, educational/health care services, manufacturing, and retail trade sectors are the largest industries.

### *Tri-Cities Market Area*

Bristol, Tennessee is located in Sullivan County, Tennessee and is Bristol, Virginia's twin city. Bristol, Tennessee's three largest employment sectors are educational/health care services, manufacturing, and retail trade.

Rogersville, Tennessee is located in Hawkins County approximately 45 miles southwest of Bristol, Tennessee. Rogersville is the county seat for Hawkins County. Rogersville's and Hawkins County's largest employment sectors are educational/health care services, manufacturing, and retail trade.

### *Knoxville Market Area*

Sevierville, Tennessee is located in Sevier County, Tennessee. Sevierville, Tennessee is located approximately 20 miles east of Knoxville, Tennessee. Sevierville serves as the county seat and is the largest city located in Sevier County. Major employers for the County include entertainment/recreation, retail trade, and educational/health care services. There is some industrial base that mitigates some of the seasonal employment fluctuation from the tourism and related businesses.

Knoxville, Tennessee is located in Knox County, Tennessee. Knoxville, Tennessee is located approximately 20 miles west of Sevierville, Tennessee. Knoxville serves as the county seat and is the third largest city in the state of Tennessee. Major employers for the County include educational/health care services, retail trade, and professional services. Knoxville's central location to two major interstate highways which link the eastern half of the United States continues to provide many opportunities for economic growth in the future.

### *High Country Market Area*

Banner Elk, North Carolina is located in Avery County in the northwestern mountains of North Carolina. In Banner Elk, educational/health care services, retail trade, tourism and arts/entertainment are the largest industries.

Boone, North Carolina is located in Watauga County in the northwestern mountains of North Carolina. Boone's three largest employment sectors are educational/health care services, entertainment/recreation services, and retail trade.

## Competition

The banking and financial service business in Virginia, North Carolina and Tennessee generally, and in the Bank's market areas specifically, is highly competitive. The increasingly competitive environment is a result of changes in regulation, changes in technology and product delivery systems and new competition from non-traditional financial services. The Bank competes for loans and deposits with other commercial banks, savings and loan associations, securities and brokerage companies, mortgage companies, money market funds, credit unions and other non-bank financial service providers. Many of these competitors are much larger in total assets and capitalization, have greater access to capital markets and offer a broader array of financial services than the Bank.

In order to compete, the Bank relies upon service-based business philosophies, personal relationships with customers, specialized services tailored to meet customers' needs and the convenience of office locations and extended hours of operation. The Bank is generally competitive with other financial institutions in its market areas with respect to interest rates paid on deposit accounts, interest rates charged on loans and other service charges on loans and deposit accounts. Deposit market share for each of the Bank's market areas can be found on the FDIC's website at [www.fdic.gov](http://www.fdic.gov) under the Industry Analysis/Summary of Deposits section.

## Regulatory Considerations

The Company and the Bank are subject to various state and federal banking laws and regulations which impose specific requirements or restrictions on and provide for general regulatory oversight with respect to virtually all aspects of operations. As a result of the substantial regulatory burdens on banking, financial institutions, including the Company and the Bank, are disadvantaged relative to other competitors who are not as highly regulated, and our costs of doing business are much higher.

The following is a summary of the material provisions of certain statutes, rules and regulations which affect the Company and the Bank. This summary is qualified in its entirety by reference to the particular statutory and regulatory provisions referred to below, and is not intended to be an exhaustive description of the statutes or regulations which are applicable to the business of the Company and the Bank. Any change in applicable laws or regulations could have a material adverse effect on the business and prospects of the Company and the Bank.

### *Highlands Bankshares, Inc.*

The Company is a bank holding company within the meaning of the BHCA and a financial institution holding company within the meaning of Chapter 7 of the Virginia Banking Act, as amended (the Virginia Banking Act). The activities of the Company also are governed by the Gramm-Leach-Bliley Act of 1999.

**The Bank Holding Company Act.** The BHCA is administered by the Board of Governors of the Federal Reserve Board, and the Company is required to file with the Federal Reserve an annual report and any additional information the Federal Reserve Board may require under the BHCA. The Federal Reserve Board also is authorized to examine the Company and its subsidiaries. The BHCA requires every bank holding company to obtain the approval of the Federal Reserve Board before (i) it or any of its subsidiaries (other than a bank) acquires substantially all the assets of any bank; (ii) it acquires ownership or control of any voting shares of any bank if after the acquisition it would own or control, directly or indirectly, more than 5% of the voting shares of the bank; or (iii) it merges or consolidates with any other bank holding company.

The BHCA and the Change in Bank Control Act, together with regulations promulgated by the Federal Reserve Board, require that, depending on the particular circumstances, either Federal Reserve Board approval must be obtained or notice must be furnished to the Federal Reserve Board and not disapproved prior to any person or company acquiring "control" of a bank holding company, such as the Company, subject to certain exemptions. Control is conclusively presumed to exist if an individual or company acquires 25% or more of any class of voting securities of the Company. Control is presumed to exist (but rebuttable) if a person acquires 10% or more, but less than 25%, of any class of voting securities of the Company. The regulations provide a procedure for challenging the rebuttable control presumption.

Under the BHCA, a bank holding company is generally prohibited from engaging in, or acquiring direct or indirect control of more than 5% of the voting shares of any company engaged in non-banking activities, unless the Federal Reserve Board, by order or regulation, has found those activities to be so closely related to banking or managing or controlling banks as to be incident to banking. Subject to its capital requirements and certain other restrictions, the Company can borrow money to make a capital contribution to the Bank, and these loans may be repaid from dividends paid from the Bank to the Company (although the ability of the Bank to pay dividends are subject to regulatory restrictions). The Company can raise capital for contribution to the Bank by issuing securities without having to receive regulatory approval, subject to compliance with federal and state securities laws.

**The Gramm-Leach-Bliley Act.** The Gramm-Leach-Bliley Act (the GLBA) permits significant combinations among different sectors of the financial services industry; allows for significant expansion of financial service activities by bank holding companies and provides for a regulatory framework by various governmental authorities responsible for different financial activities; and offers certain financial privacy protections to consumers. The GLBA repealed affiliation and management interlock prohibitions of the Depression-era Glass-Steagall Act and, by amending the Bank Holding Company Act, the GLBA added new substantive provisions to the non-banking activities permitted under the BHCA with the creation of the financial holding company. The GLBA preempts most state laws that prohibit financial holding companies from engaging in insurance activities. The GLBA permits affiliations between banks and securities firms within the same holding company structure, and the GLBA permits financial holding companies to directly engage in a broad range of securities and merchant banking activities. The Company has not elected to become a financial holding company. The GLBA has led to important changes in the manner in which financial services are delivered in the United States. Bank holding companies and their subsidiary banks are able to offer a much broader array of financial services; however, there is greater competition in all sectors of the financial services market.

**The Virginia Banking Act.** All Virginia bank holding companies must register with the Virginia State Corporation Commission (the "Commission") under the Virginia Banking Act. A registered bank holding company must provide the Commission with information with respect to the financial condition, operations, management and inter-company relationships of the holding company and its subsidiaries. The Commission also may require such other information as is necessary to keep informed about

whether the provisions of Virginia law and the regulations and orders issued under Virginia law by the Commission have been complied with, and may make examinations of any bank holding company and its subsidiaries. The Virginia Banking Act allows bank holding companies located in any state to acquire a Virginia bank or bank holding company if the Virginia bank or bank holding company could acquire a bank holding company in their state and the Virginia bank or bank holding company to be acquired has been in existence and continuously operated for more than two years. The Virginia Banking Act permits bank holding companies from throughout the United States to enter the Virginia market, subject to federal and state approval.

Sarbanes-Oxley Act of 2002. The Sarbanes-Oxley Act of 2002 (the "SOX Act") implemented legislative reforms intended to address corporate and accounting fraud. In addition to the establishment of a new accounting oversight board that enforces auditing, quality control and independence standards and is funded by fees from all publicly traded companies, the law restricts provision of both auditing and consulting services by accounting firms. To ensure auditor independence, any non-audit services being provided to an audit client requires pre-approval by the issuer's audit committee members and the SOX Act also restricts certain services that the audit firm may perform. In addition, audit partners must be rotated. The SOX Act requires chief executive officers and chief financial officers, or their equivalent, to certify to the accuracy of periodic reports filed with the SEC, subject to civil and criminal penalties if they knowingly or willfully violate this certification requirement. In addition, under the SOX Act, legal counsel is required to report evidence of a material violation of the securities laws or a breach of fiduciary duty by a company to its chief executive officer or its chief financial officer, and, if such officer does not appropriately respond, to report such evidence to the audit committee or other similar committee of the board of directors or the board itself.

Dodd-Frank Act. The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), made significant changes in the regulation of financial institutions and the financial services industry. The Dodd-Frank Act included several provisions that will affect how community banks, thrifts, and small bank and thrift holding companies will be regulated in the future. Among other things, these provisions abolished the Office of Thrift Supervision and transferred its functions to the other federal banking agencies, relaxed rules regarding interstate branching, allowed financial institutions to pay interest on business checking accounts, changed the scope of federal deposit insurance coverage, and imposed new capital requirements on bank and thrift holding companies. The Dodd-Frank Act also established the Bureau of Consumer Financial Protection, which is given the authority to promulgate consumer protection regulations applicable to all entities offering consumer financial services or products, including banks.

The Dodd-Frank Act also required the Consumer Financial Protection Bureau to issue regulations requiring lenders to make a reasonable good faith determination as to a prospective borrower's ability to repay a residential mortgage loan. The final "Ability to Repay" rules, which were effective January 4, 2013, established a "qualified mortgage" safe harbor for loans whose terms and features are deemed to make the loan less risky. In addition, on October 3, 2015, the new TILA-RESPA Integrated Disclosure (TRID) rules for mortgage closings took effect for new loan applications.

Some provisions of the Dodd-Frank Act involved delayed effective dates and/or require implementing regulations or have not been issued in final form. Their full impact on our operations cannot yet fully be assessed. However, the Dodd-Frank Act has resulted in increased compliance and operating expense for the Company.

#### *Highlands Union Bank*

General. The Bank, as a state chartered member of the Federal Reserve, is subject to regulation and examination by the Virginia State Corporation Commission Bureau of Financial Institutions and the Federal Reserve Bank of Richmond. In addition, the Bank is subject to the rules and regulations of the Federal Deposit Insurance Corporation. Deposits in the Bank are insured by the FDIC up to a maximum amount (generally \$250,000 per depositor, subject to aggregation rules). The Federal Reserve Board and the Bureau of Financial Institutions regulate or monitor all areas of the Bank's operations, including security devices and procedures, adequacy of capitalization and loss reserves, loans, investments, borrowings, deposits, mergers, issuances of securities, payment of dividends, interest rates paid on deposits, interest rates or fees charged on loans, establishment of branches, corporate reorganizations and maintenance of books and records. The Federal Reserve Board requires the Bank to maintain certain capital ratios. The Bank is required by the Federal Reserve Board to prepare quarterly reports on the Bank's financial condition and to conduct an annual audit of its financial affairs in compliance with minimum standards and procedures prescribed by the Federal Reserve Board. The Bank also is required by the Federal Reserve Board to adopt internal control structures and procedures in order to safeguard assets and monitor and reduce risk exposure. While appropriate for safety and soundness of banks, these requirements impact banking overhead costs.

Under the provisions of federal law, federally insured banks are subject, with certain exceptions, to certain restrictions on extensions of credit to their affiliates, on investments in the stock or other securities of affiliates and on the taking of such stock or securities as collateral from any borrower. In addition, these banks are prohibited from engaging in certain tie-in arrangements in connection with any extension of credit or the providing of any property or service. The Virginia State Corporation Commission and the Federal Reserve Board conduct regular examinations of the Bank reviewing the adequacy of



the loan loss reserves, quality of the loans and investments, propriety of management practices, compliance with laws and regulations and other aspects of the bank's operations. In addition to these regular examinations, Virginia chartered banks must furnish to the Federal Reserve Board quarterly reports containing detailed financial statements and schedules.

Community Reinvestment Act. The Bank is subject to the provisions of the Community Reinvestment Act of 1977 (the "CRA"), which requires the appropriate federal bank regulatory agency, in connection with its regular examination of a bank, to assess the bank's record in meeting the credit needs of the community served by the Bank, including low and moderate-income neighborhoods. The focus of the regulations is on the volume and distribution of a bank's loans, with particular emphasis on lending activity in low and moderate-income areas and to low and moderate-income persons. The regulations place substantial importance on a bank's product delivery system, particularly branch locations. The regulations require banks to comply with significant data collection requirements. The regulatory agency's assessment of the bank's record is made available to the public. Further, this assessment is required for any bank which has applied to, among other things, establish a new branch office that will accept deposits, relocate an existing office, or merge, consolidate with or acquire the assets or assume the liabilities of a federally regulated financial institution. Management expects that the Bank's compliance with the CRA, as well as other fair lending laws, will face ongoing government scrutiny and that costs associated with compliance will continue to increase. The Bank received a "Satisfactory" CRA rating in the last examination by bank regulators.

Federal Deposit Insurance Corporation Improvement Act of 1991. The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) requires each federal banking regulatory agency to prescribe, by regulation, standards for all insured depository institutions and depository institution holding companies relating to (i) internal controls, information systems and audit systems; (ii) loan documentation; (iii) credit underwriting; (iv) interest rate exposure; (v) asset growth; (vi) compensation, fees and benefits; and (vii) such other operational and managerial standards as the agency determines to be appropriate. The compensation standards prohibit employment contracts, compensation or benefit arrangements, stock option plans, fee arrangements or other compensatory arrangements that provide excessive compensation, fees or benefits or could lead to material financial loss. In addition, each federal banking regulatory agency must prescribe by regulation standards specifying (i) a maximum ratio of classified assets to capital; (ii) minimum earnings sufficient to absorb losses without impairing capital; (iii) to the extent feasible, a minimum ratio of market value to book value for publicly traded shares of depository institutions and depository institution holding companies; and (iv) such other standards relating to asset quality, earnings and valuation as the agency determines to be appropriate. If an insured institution fails to meet any of the standards promulgated by regulation, then such institution will be required to submit a plan to its federal regulatory agency specifying the steps it will take to correct the deficiency.

Prompt corrective action measures adopted in FDICIA impose significant restrictions and requirements on depository institutions that fail to meet their minimum capital requirements. Under Section 38 of the Federal Deposit Insurance Act (the FDI Act), the federal banking regulatory agencies have developed a classification system pursuant to which all depository institutions are placed into one of five categories based on their capital levels and other supervisory criteria: well capitalized, adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized.

The Bank met the requirements at December 31, 2018 to be classified as "well-capitalized." This classification is determined solely for the purposes of applying the prompt corrective action regulations and may not constitute an accurate representation of the Bank's overall financial condition.

If its principal federal regulator determines that an adequately capitalized institution is in an unsafe or unsound condition or is engaging in an unsafe or unsound practice, it may require the institution to submit a corrective action plan, restrict its asset growth and prohibit branching, new acquisitions and new lines of business. An institution's principal federal regulator may deem it to be engaging in unsafe or unsound practices if it receives a less than satisfactory rating for asset quality, management, earnings or liquidity in its most recent examination.

Section 36 of FDICIA requires insured depository institutions with at least \$500 million but less than \$1 billion in total assets to file annual reports that must include the following:

- Audited comparative annual financial statements
- The independent public accountant's report on the audited financial statements
- A management report that contains a statement of management's responsibilities for preparing the financial statement, establishing and maintaining an adequate internal control structure over financial reporting and complying with the laws and regulations designed by the FDIC and appropriate banking regulators
- An assessment by management of the institution's compliance with the designated laws and regulations during the year.

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 (the Interstate Act) allows bank holding companies to acquire banks in any state, without regard to state law, except that if the state has a minimum requirement for the amount of time a bank must be in existence, that law must be preserved. Under the Virginia Banking Act, a Virginia bank or all of the



subsidiaries of Virginia holding companies sought to be acquired must have been in continuous operation for more than two years before the date of such proposed acquisition. The Interstate Act also permits banks to acquire out-of-state branches through interstate mergers, if the state has not opted out of interstate branching. De novo branching, where an out-of-state bank holding company sets up a new branch in another state, requires a state's specific approval. An acquisition or merger is not permitted under the Interstate Act if the bank, including its insured depository affiliates, will control more than 10% of the total amount of deposits of insured depository institutions in the United States, or will control 30% or more of the total amount of deposits of insured depository institutions in any state.

Virginia has, by statute, elected to opt-in fully to interstate branching under the Interstate Act. Under the Virginia statute, Virginia state banks may, with the approval of the Virginia State Corporation Commission, establish and maintain a de novo branch or acquire one or more branches in a state other than Virginia, either separately or as part of a merger. Procedures also are established to allow out-of-state domiciled banks to establish or acquire branches in Virginia, provided the "home" state of the bank permits Virginia banks to establish or acquire branches within its borders. The activities of these branches are subject to the same laws as Virginia domiciled banks, unless such activities are prohibited by the law of the state where the bank is organized. The Virginia State Corporation Commission has the authority to examine and supervise out-of-state state banks to ensure that the branch is operating in a safe and sound manner and in compliance with the laws of Virginia. The Virginia statute authorizes the Bureau of Financial Institutions to enter into cooperative agreements with other state and federal regulators for the examination and supervision of out-of-state banks with Virginia operations, or Virginia domiciled banks with operations in other states. Likewise, national banks, with the approval of the OCC, may branch into and out of the state of Virginia. Any Virginia branch of an out-of-state state chartered bank is subject to Virginia law (enforced by the Virginia Bureau of Financial Institutions) with respect to intrastate branching, consumer protection, fair lending and community reinvestment as if it were a branch of a Virginia bank, unless preempted by federal law.

**Deposit Insurance.** The Bank's deposits are insured up to applicable limits by the Deposit Insurance Fund (DIF) of the FDIC. Pursuant to the Dodd-Frank Act, FDIC insurance coverage limits on deposits were permanently increased to \$250,000.

The FDIC has adopted a risk-based assessment system to determine assessment rates to be paid by member institutions, such as the Bank. The amount of the assessment is a function of the institution's assessment rate and its assessment base. Under this system, an institution's supervisory ratings, combined with certain other risk measures, including certain financial ratios. In February 2011, the FDIC revised the risk-based assessment system to set new assessment rates that were effective on April 1, 2011. The initial base assessment rates currently range from 3 to 30 basis points, subject to potential adjustments based on the amount of the institution's long-term unsecured debt. After the effect of potential base-rate adjustments, the total base assessment rate can range from 1.5 to 30 basis points. As the DIF reserve ratio grows, the rate schedule will be adjusted downward. Also effective April 1, 2011, the assessment base is an institution's average consolidated total assets less its average tangible equity.

**Gramm-Leach-Bliley Act.** The Gramm-Leach-Bliley Act of 1999 (the GLBA) allows banks, with primary regulator approval, to acquire financial subsidiaries to engage in any activity that is financial in nature or incidental to a financial activity, as defined in the Bank Holding Act, except (i) insurance underwriting, (ii) merchant or insurance portfolio investments, and (iii) real estate development or investment. Well-capitalized banks are also given the authority to engage in municipal bond underwriting.

To establish or acquire a financial subsidiary, a bank must be well-managed, and the consolidated assets of its financial subsidiary must not exceed the lesser of 45% of the consolidated total assets of the bank or \$50 billion. The relationship between a bank and a financial subsidiary are subject to a variety of supervisory enhancements from regulators.

**USA Patriot Act.** The USA Patriot Act facilitates the sharing of information among government entities and financial institutions to combat terrorism and money laundering. The USA Patriot Act creates an obligation on banks to report customer activities that may involve terrorist activities or money laundering.

**Government Policies.** The operations of the Bank are affected not only by general economic conditions, but also by the policies of various regulatory authorities. In particular, the Federal Reserve Board regulates money and credit and interest rates in order to influence general economic conditions. These policies have a significant influence on overall growth and distribution of loans, investments and deposits and affect interest rates charged on loans or paid for time and savings deposits. Federal Reserve Board monetary policies have had a significant effect on the operating results of commercial banks in the past and are expected to continue to do so in the future.

**Limits on Dividends and Other Payments.** The Company is a legal entity separate and distinct from the Bank; virtually all of the Company's cash reserves, and its ability to pay dividends to the Company's shareholders, are dependent on the ability of the Bank to upstream dividends to it. As a state member bank subject to the regulations of the Federal Reserve Board, the Bank must obtain the approval of the Federal Reserve Board for any dividend if the total of all dividends declared in any calendar year would exceed the total of its net profits, as defined by the Federal Reserve Board, for that year, combined with its retained net profits for the preceding two years. In addition, the Federal Reserve Board is authorized to determine, under certain

circumstances relating to the financial condition of a state member bank, that the payment of dividends would be an unsafe or unsound practice and to prohibit payment thereof. The payment of dividends that depletes a bank's capital base could be deemed to constitute such an unsafe or unsound practice.

Virginia law also imposes restrictions on the ability of the Bank to pay dividends. A Virginia state bank is permitted to declare a dividend out of its "net undivided profits", after providing for all expenses, losses, interest and taxes accrued or due by the bank. In addition, a deficit in capital originally paid in must be restored to its initial level, and no dividend can be paid which could impair the Bank's paid in capital. The Bureau of Financial Institutions further has authority to limit the payment of dividends by a Virginia bank if it determines the limitation is in the public interest and is necessary to ensure the bank's financial soundness.

The Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) provides that no insured depository institution may make any capital distribution (which would include a cash dividend) if, after making the distribution, the institution would not satisfy one or more of its minimum capital requirements. The Federal Reserve Board has indicated that banking organizations, including bank holding companies, should generally pay dividends only out of current operating earnings. Federal regulators also have indicated that bank holding companies generally should pay dividends only if the organization's net income available to company shareholders is sufficient to fully fund the dividends as well as maintaining sufficient capital levels.

#### Capital Requirements

The federal banking agencies adopted new regulations that implement the Basel III regulatory capital reforms and changes required by the Dodd-Frank Act.

Effective January 1, 2015, the Bank became subject to new capital requirements adopted by the Federal Reserve (with some changes transitioned into full effectiveness over two to four years). The new requirements created a new required ratio for common equity Tier 1 ("CET1") capital, increased the leverage and Tier 1 capital ratios, changed the risk weight of certain assets for purposes of the risk-based capital ratios, created an additional capital conservation buffer over the required capital ratios and changed what qualifies as capital for purposes of meeting these various capital requirements. CET1 generally consists of common stock and retained earnings, subject to applicable regulatory adjustments and deductions.

Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Bank to pay dividends or pay discretionary bonuses. The Company is exempt from consolidated capital requirements as those requirements do not apply to certain small bank holding companies with assets under \$1 billion.

Under the new capital regulations, the minimum capital ratios are as follows:

- CET1 capital ratio of 4.5% of risk-weighted assets (new);
- Tier 1 capital ratio of 6.0% of risk-weighted assets (increased from 4%);
- Total capital ratio of 8.0% of risk-weighted assets (unchanged); and,
- Leverage ratio of 4.0% (unchanged).

There are a number of changes in what constitutes regulatory capital, some of which are subject to transition periods. These changes include the phasing-out of certain instruments as qualifying capital. The Bank does not use any of these instruments. Under the new requirements for total capital, Tier 2 capital is no longer limited to the amount of Tier 1 capital included in total capital. Mortgage servicing rights, certain deferred tax assets and investments in unconsolidated subsidiaries over designated percentages of CET1 will be deducted from capital. The Bank has elected to permanently opt-out of the inclusion of accumulated other comprehensive income in our capital calculations, as permitted by the regulations. This opt-out will reduce the impact of market volatility on our regulatory capital levels.

The new requirements also include changes in the risk-weights of assets to better reflect credit risk and other risk exposures. These include a 150% risk weight (increased from 100%) for certain high volatility commercial real estate acquisition, development and construction loans and for non-residential mortgage loans that are 90 days past due or otherwise in non-accrual status; a 20% (increased from 0%) credit conversion factor for the unused portion of a commitment with an original maturity of one year or less that is not unconditionally cancellable; a 250% risk weight (increased from 100%) for mortgage servicing and deferred tax assets that are not deducted from capital; and increased risk weights (0% to 600%) for equity exposures.

In addition to the minimum CET1, Tier 1 and total capital ratios, the Bank will have to maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5% of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends or paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. Phase-in of this new capital conservation buffer requirement commenced in January 2016 at 0.625% of risk-weighted assets and will increase each year until fully implemented in January 2019.

Under the new standards, which became effective January 1, 2015, in order to be considered well-capitalized, the Bank must have a CET1 ratio of 6.5% (new), a Tier 1 ratio of 8.0% (increased from 6.0%), a total risk-based capital ratio of 10.0% (unchanged), and a leverage ratio of 5.0% (unchanged).

The risk-based capital standards of the Federal Reserve explicitly identify concentrations of credit risk and the risk arising from non-traditional activities, as well as an institution's ability to manage these risks, as important factors to be taken into account by the agency in assessing an institution's overall capital adequacy. The capital guidelines also provide that an institution's exposure to a decline in the economic value of its capital due to changes in interest rates be considered by the agency as a factor in evaluating a banking organization's capital adequacy.

The FDIC may take various corrective actions against any undercapitalized bank and any bank that fails to submit an acceptable capital restoration plan or fails to implement a plan accepted by the FDIC. These powers include, but are not limited to, requiring the institution to be recapitalized, prohibiting asset growth, restricting interest rates paid, requiring prior approval of capital distributions by any bank holding company that controls the institution, requiring divestiture by the institution of its subsidiaries or by the holding company of the institution itself, requiring new election of directors, and requiring the dismissal of directors and officers. The Company and the Bank presently maintain sufficient capital to remain in compliance with these capital requirements.

#### Other Legislative and Regulatory Concerns

Other legislative and regulatory proposals regarding changes in banking and the regulation of banks, thrifts and other financial institutions are periodically considered by the executive branch of the federal government, Congress and various state governments, including Virginia. New proposals could significantly change the regulation of banks and the financial services industry. It cannot be predicted what might be proposed or adopted or how these proposals would affect the Company.

#### Formal Written Agreement

On October 13, 2010, the Company and Bank entered into a written agreement ("Written Agreement") with the Federal Reserve Bank of Richmond (the "Reserve Bank"). Under the terms of the Written Agreement, the Bank has agreed to develop and submit to the Reserve Bank for approval within the time periods specified therein written plans or programs to:

- strengthen board oversight of the management and operations of the Bank;
- strengthen credit risk management and administration;
- provide for the effective grading of the Bank's loan portfolio;
- summarize the findings of its review of the adequacy of the staffing of its loan review function;
- improve the Bank's position with respect to loans, relationships, or other assets in excess of \$500,000 that currently are or in the future become past due more than 90 days, on the Bank's problem loan list, or adversely classified in any report of examination of the Bank;
- review and revise the Bank's methodology for determining the allowance for loan and lease losses ("ALLL") and maintain an adequate ALLL;
- maintain sufficient capital at the Company and the Bank;
- establish a revised written contingency funding plan;
- establish a revised written strategic and capital plan;
- establish a revised investment policy;
- improve the Bank's earnings and overall condition;
- revise the Bank's information technology program;
- establish a disaster recovery and business continuity program; and,
- establish a committee to monitor compliance with all aspects of the written agreement.

Further, both the Company and the Bank have agreed to refrain from declaring or paying dividends without prior regulatory approval. The Company has agreed that it will not take any other form of payment representing a reduction in Bank's capital or make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities without prior regulatory approval. The Company also has agreed not to incur, increase or guarantee any debt or not to purchase or redeem any shares of its stock without prior regulatory approval.

The following summarizes the Company's progress to comply with the items in the Written Agreement as of December 31, 2018:

- A new board oversight policy has been approved and implemented;
- Revised the Bank's loan grading system and ALLL methodology;
- Improved credit administration policies have been established; the Bank has engaged a third party to provide an independent credit review
- Implemented problem loan action reports and problem asset reports for all assets over \$500,000; these reports are reviewed with the Board and provided to the Federal Reserve Bank on a quarterly basis;

- Revised the written contingency funding plan;
- Implemented stress testing of the loan portfolio;
- Revised the investment policy;
- Completed a multi-year capital plan targeted to improve the Company's and Bank's capital levels;
- Completed a business continuity plan and disaster recovery plan; and,
- Formed a Directors' compliance committee to monitor the progress of each item in the written agreement. The committee meets at least quarterly and files a report with the Federal Reserve Bank.

### Organization and Employment

The Company, the Bank, HUFS, HUIS, and Russell Road, LLC, are organized in a holding company/subsidiary structure. As of December 31, 2018, the Company had no employees, although certain Bank employees are designated as officers of the Company. The Bank pays all employee and officer salaries and director fees. At December 31, 2018, the Bank employed 153 full time equivalent employees at its main office, operations center, support centers and branch offices. The Company's relationship with its employees is considered to be good.

The Company executed an employment agreement with CEO Timothy Schools in December 2015, which was reported on the Company's Form 8-K on December 14, 2015. This is the only employment agreement in effect at December 31, 2018.

### Company Website

The Bank maintains a website at [www.hubank.com](http://www.hubank.com). The Company makes available through the Bank's website its annual report on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, and all amendments to those reports, free of charge, as soon as reasonably practicable after the material is electronically filed with the Securities and Exchange Commission.

### **Item 1A. Risk Factors**

Not applicable

### **Item 1B. Unresolved Staff Comments**

Not applicable

### **Item 2. Properties**

The Company's and the Bank's headquarters are located at 340 W. Main Street, Abingdon, Virginia. In addition to the Bank's Main Office location, the Bank owns thirteen branch offices located in Southwest Virginia, the Tri-Cities area that straddles Virginia and Tennessee, the Knoxville area and the High Country area of Northwestern North Carolina. The Bank owns the land and buildings of all of these branch offices as well as the main office for the Company and Bank. The Bank also owns facilities in Abingdon, Virginia used for its customer call center, computer, loan and deposit operations, and facilities departments.

The Bank currently has three properties held for sale that were previously used for or purchased for banking operations.

All of the existing properties are in good operating condition and are adequate for the Company's present and anticipated future needs.

### **Item 3. Legal Proceedings**

On December 23, 2015, James M. Brock and Jean W. Brock (together, "Brock") filed a complaint in the Circuit Court of Grayson County, Virginia, alleging that the Bank acted negligently when it foreclosed on property adjacent to the Brock's property and allegedly failed to remediate the foreclosed property, allegedly causing damage to Brock's property. Brock seeks damages of \$200,000 plus prejudgment interest, attorneys' fees, and costs. The Bank denies any wrongdoing in this matter and intends to vigorously defend itself. No trial date has yet been set. The Company is unable to estimate the likelihood of an unfavorable outcome or the amount or range of potential loss.

The Company, the Bank and other subsidiaries are occasionally named as defendants in various legal actions arising from our normal business activities in which damages in various amounts are claimed. Although the amount of any ultimate liability with respect to those matters cannot be determined, in the opinion of management, no legal actions currently exist that are expected to have a material effect on the Company's consolidated financial statements.

### **Item 4. Mine Safety Disclosures**

Not Applicable



## PART II. FINANCIAL INFORMATION

### **Item 5. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

#### **Common Stock Information and Dividends**

Transactions in the Company's Common stock are reported on the OTCQX marketplace. The Company's transfer agent is Computershare.

The following table provides market prices for trades in the Company's Common stock for each of the four quarters for 2018 and 2017.

#### Common Stock Performance – 2018

	High	Low	Quarterly Average	Dividends per Share
First Quarter	\$ 8.00	\$ 7.11	\$ 7.64	—
Second Quarter	8.00	7.16	7.48	—
Third Quarter	7.75	7.12	7.34	—
Fourth Quarter	7.26	5.06	6.30	—

#### Common Stock Performance – 2017

	High	Low	Quarterly Average	Dividends per Share
First Quarter	\$ 7.28	\$ 5.95	\$ 6.86	—
Second Quarter	7.50	6.65	7.08	—
Third Quarter	7.25	6.86	7.04	—
Fourth Quarter	7.56	6.92	7.16	—

The Company is currently prohibited from paying dividends without regulatory approval under the terms of the Written Agreement dated October 13, 2010. For additional information regarding regulatory restrictions on the Company's ability to pay dividends, see "Regulatory Considerations - Highlands Union Bank – Limits on Dividends and Other Payments" in Item 1 above.

In connection with its capital raise in 2014, the Company issued shares of Series A Convertible Perpetual Preferred Stock (the "Series A Preferred Stock"). Holders of Series A Preferred Stock are entitled to receive, when and if declared by the Board of Directors or a duly authorized committee of the Board of Directors, out of funds legally available therefore, non-cumulative dividends in the same per share amount as the dividends paid on a share of common stock. The Company will not pay any dividends with respect to its common stock unless an equivalent dividend also is paid to the holders of the Series A Preferred Stock.

As of March 28, 2019, the Company had approximately 1,314 shareholders of record.

#### **Issuer Repurchases of Equity Securities**

The Company had no repurchases of common stock during the twelve months ended December 31, 2018. The Company does not anticipate any repurchases during 2019 as the Company currently is prohibited from repurchasing its common stock without regulatory approval under the terms of the Written Agreement dated October 13, 2010.

The Company currently has 8,250,729 shares of common stock outstanding as of March 28, 2019.

### **Item 6. Selected Financial Data**

Not Applicable

## **Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following discussion and analysis is provided to address information about the Company's financial condition and results of operations that is not otherwise apparent from the Consolidated Financial Statements and the notes thereto or included in this report. Reference should be made to those statements and the notes thereto for an understanding of the following discussion and analysis.

### **Caution About Forward-Looking Statements**

This Annual Report on Form 10-K contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934, including certain plans, expectations, goals and projections, which are inherently subject to numerous assumptions, risks and uncertainties. The Company's actual results could differ materially from those set forth or implied in the forward-looking statements.

Such forward-looking statements involve known and unknown risks including, but not limited to, the following factors:

- adverse economic conditions in the market areas we serve and the impact on credit quality of risks inherent in the loan portfolio, including repayment risk and fluctuations collateral values;
- our ability to manage, dispose of and properly value non-performing assets and other real estate owned;
- further deterioration in housing market and collateral values;
- our ability to assess the creditworthiness of our loan customers and to maintain an adequate allowance for loan losses;
- our ability to maintain adequate sources of funding and liquidity, including customer deposits and access to secondary sources such as Federal Home Loan Bank advances;
- our ability to attract and maintain capital levels adequate to support our asset levels and risk profile;
- our ability to comply with the October 13, 2010 written agreement with the Federal Reserve Bank of Richmond;
- our ability to successfully manage interest rate risk and changes in interest rates and interest rate policies;
- reliance on our management team, including our ability to attract and retain key personnel;
- our ability to successfully manage our strategic plan;
- difficult market conditions in our industry that exist now or may develop in future periods;
- problems with technology utilized by us;
- our ability to successfully manage third-party vendors upon whom we are dependent;
- competition with other banks, non-bank financial institutions, and companies outside of the banking industry, including companies that have substantially greater access to capital and other resources;
- potential impact on us of recently-enacted legislation and future regulations;
- changes in accounting policies or standards;
- demand, development and acceptance of new products and services; and
- changing trends in customer profiles and behavior.

### **Critical Accounting Policies**

The financial condition and results of operations presented in the Consolidated Financial Statements, accompanying Notes to Consolidated Financial Statements and management's discussion and analysis are dependent upon the accounting policies of the Company. The selection and application of these accounting policies involve judgments, estimates, and uncertainties that are subject to change.

Certain accounting policies are deemed to be critical as they are highly subjective, require the broadest judgment by management, and potentially have a material impact on the consolidated financial statements. Different assumptions or actual results could have a material impact on the Company's financial condition or results of operations. The Company has designated its policy for calculating the Allowance for Loan Losses as a critical accounting policy. See Note 1 of the Notes to Consolidated Financial Statements for a more complete discussion of the Company's accounting policies.

The Company monitors credit quality and maintains an allowance for loan losses to absorb the estimate of probable losses inherent in the loan portfolio. The allowance for loan losses is based on management's judgment and analysis of current and historical loss experience, risk characteristics of the loan portfolio, concentrations of credit and asset quality, as well as other internal and external factors, such as general economic conditions. The Company recognizes the inherent imprecision in estimates of losses due to various uncertainties, and variability related to the factors used. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, additional provisions might be required for loan losses would be made, which amount may be material to the Consolidated Financial Statements.

## Performance Summary

The following table provides certain key performance ratios for the years ended December 31, 2018 and December 31, 2017.

	2018	2017
Return on average assets	0.68%	(0.07)%
Return on average equity	7.25%	(0.78)%
Basic earnings (loss) per share	\$ 0.44	\$ (0.05)
Fully diluted earnings (loss) per share	\$ 0.35	\$ (0.05)
Net interest margin	3.90%	3.54 %

## Results of Operations

The Company reported consolidated net income of \$3.6 million for the year ended December 31, 2018, compared to net loss of \$(437,000) for the year ended December 31, 2017. Income before income taxes totaled \$4.5 million for 2018, compared to income before income taxes of \$5.3 million for 2017. The Company recorded income tax expense of \$949 thousand during 2018, compared to tax expense of \$5.7 million during 2017, \$4.0 million of which relates to the revaluation of the Company's net deferred tax asset resulting from enactment of the the Tax Cut and Jobs Act on December 22, 2017.

The following table provides summarized income statements for the years ended December 31, 2018 and December 31, 2017.

	Year ended December 31,	
(thousands)	2018	2017
Net interest income	\$ 20,586	\$ 18,928
Provision for loan losses	738	120
Noninterest income	4,267	6,036
Noninterest expense	19,574	19,587
Income (loss) before income taxes	4,541	5,257
Income tax expense (benefit)	949	5,694
Net income (loss)	\$ 3,592	\$ (437)

### Net interest income

Net interest income for the year ended December 31, 2018 increased \$1.7 million or 8.8 percent compared to the year ended December 31, 2017 primarily due to a \$22.0 million increase in average loans. While average loan balances increased during 2018, average investment securities declined \$18.0 million and average federal funds sold declined \$10.5 million. The reductions in average investment securities and average federal funds sold occurred as existing liquidity was used to fund loan growth and repayment of FHLB advances. Interest income increased \$1.2 million during 2018.

Interest expense declined \$432,000 during 2018. While market conditions resulted in higher rates during 2018, average FHLB advances outstanding declined \$20.4 million and average interest-bearing deposits declined \$5.0 million. The repayment of the FHLB advances contributed to a reduction in the average rate on interest bearing liabilities, which fell from 0.94 percent in 2017 to 0.89 percent in 2018.

As a result of the loan growth and the lower funding cost, the Company's net yield on interest-earning assets increased from 3.54 percent in 2017 to 3.90 percent in 2018.

The following table shows the major categories of interest-earning assets and interest-bearing liabilities, the related interest income or expense, the average yield or rate on the average balance outstanding, net interest income, interest rate spread and net yield on average interest-earning assets for the periods indicated.

	2018			2017			2016		
(\$ thousands)	Average balance	Interest income/expense	Yield/rate	Average balance	Interest income/expense	Yield/rate	Average balance	Interest income/expense	Yield/rate
Loans	\$ 441,979	\$ 21,936	4.96%	\$ 420,024	\$ 20,427	4.86%	\$ 419,670	\$ 21,327	5.08%
Investment securities available for sale	75,457	1,807	2.39%	93,425	2,148	2.30%	98,364	1,968	2.18%
Fed funds sold	10,242	250	2.44%	20,734	192	0.93%	20,589	99	0.48%
Total interest-earning assets	<u>\$ 527,678</u>	<u>23,993</u>	<u>4.55%</u>	<u>\$ 534,183</u>	<u>22,767</u>	<u>4.26%</u>	<u>\$ 538,623</u>	<u>23,394</u>	<u>4.38%</u>
Interest-bearing deposits	\$ 346,788	2,090	0.60%	\$ 351,824	\$ 1,854	0.53%	\$ 359,556	\$ 1,794	0.50%
FHLB advances	34,780	1,317	3.79%	55,164	1,985	3.60%	67,725	2,381	3.52%
Total interest-bearing liabilities	<u>\$ 381,568</u>	<u>3,407</u>	<u>0.89%</u>	<u>\$ 406,988</u>	<u>3,839</u>	<u>0.94%</u>	<u>\$ 427,281</u>	<u>4,175</u>	<u>0.98%</u>
Net interest income		<u>\$ 20,586</u>			<u>\$ 18,928</u>			<u>\$ 19,219</u>	
Interest rate spread			3.66%			3.32%			3.40%
Net yield on interest-earning assets			3.90%			3.54%			3.60%

Loans includes loans held for sale and nonaccrual loans.

The Company's primary source of revenue is net interest income, which is the difference between the interest and fees earned on loans and investments and the interest paid on deposits, FHLB borrowings and other interest-bearing liabilities. The Company's net interest income is affected by changes in the amount and mix of interest-earning assets and interest-bearing liabilities and by changes in yields earned on interest-earning assets and rates paid on interest-bearing liabilities. The following table sets forth, for the years indicated, a summary of the changes in interest income and interest expense resulting from changes in average asset and liability balances (volume) and changes in average interest rates (rate). The increase (decrease) due to change in volume is computed using the change in the average balances between the current and prior period, multiplied by the corresponding current year average yield/rate. The remaining increase or decrease in net interest income is allocated between yield and rate.

	2018			2017		
(thousands)	Increase (decrease) due to change in			Increase (decrease) due to change in		
	Volume	Rate	Total	Volume	Rate	Total
Loans	\$ 1,067	\$ 442	\$ 1,509	\$ 18	\$ (918)	\$ (900)
Investment securities available for sale	(413)	72	(341)	(108)	288	180
Fed funds sold	(98)	156	58	1	92	93
Total interest income	556	670	1,226	(89)	(538)	(627)
Interest-bearing deposits	(27)	263	236	(39)	99	60
FHLB advances	(734)	66	(668)	(442)	46	(396)
Total interest expense	(761)	329	(432)	(481)	145	(336)
Increase (decrease) in net interest income	<u>\$ 1,317</u>	<u>\$ 341</u>	<u>\$ 1,658</u>	<u>\$ 392</u>	<u>\$ (683)</u>	<u>\$ (291)</u>

#### Provision for loan losses

The provision for loan losses for the year ended December 31, 2018 totaled \$738,000, compared to \$120,000 during 2017, primarily due to loan growth during 2018 and higher levels of nonperforming loans. Average loans increased \$22.0 million during 2018, while nonperforming loans increased \$3.9 million from December 31, 2017 to December 31, 2018.

The Company continually monitors the loan portfolio for signs of credit weaknesses or developing collection problems. Loan loss provisions for each period are determined after evaluating the loan portfolio and determining the level necessary to absorb current charge-offs and maintain the reserve at adequate levels. The allowance for loan losses increased to 0.98 percent of total loans at December 31, 2018, compared to 0.92 percent at December 31, 2017. Net charge offs during 2018 totaled \$319,000 or 0.07 percent of average loans, compared to \$898,000 of net charge-offs during 2017, representing 0.21 percent of average loans.

#### Noninterest income

Noninterest income for 2018 totaled \$4.3 million, compared to \$6.0 million during 2017. The \$1.8 million reduction in noninterest income during 2018 primarily resulted from lower mortgage banking income. Income from the gain on sale of loans totaled \$315,000 during 2018 compared to \$1.9 million during 2017. During early 2018, in an effort to reduce the costs associated with the mortgage division, the Company initiated a plan to outsource the underwriting and other operational areas to a third party. Previously, underwriting and other operational responsibilities related to originating and marketing these mortgage loans were performed by bank personnel.

Other service charges, commissions and fees decreased \$254,000 compared to 2017, primarily due to lower financial services income. Service charge income decreased \$97,000 during 2018, compared to 2017, primarily due to lower NSF income, while other noninterest income increased \$228,000 during 2018 due to increased earnings from equity method investments.

#### Noninterest expense

Total noninterest expense for 2018 decreased \$13,000 from 2017, the net result of lower salaries and employee benefits expense, offset by higher other noninterest expense. Salaries and employee benefits decreased \$1.2 million for 2018, compared to the prior year, resulting from the impact of earlier workforce reductions, net of higher employee health benefit costs during 2018. Other noninterest expense increased \$1.0 million, the combined result of a \$353,000 increase in legal expense, primarily related to regulatory compliance services, a \$235,000 increase in writedowns of real estate held for sale, a \$167,000 increase in software-related expense, and a \$146,000 increase in non-credit losses, primarily related to customer fraud. OREO-related expenses increased \$119,000 over 2017, resulting from higher OREO losses and writedowns during 2018.

#### Income tax expense

Income tax expense for 2018 totaled \$949,000, compared to \$5.7 million recorded during 2017. Income tax expense for 2017 included \$4.0 million of income tax expense resulting from revaluation of the Company's net deferred tax asset resulting from enactment of the Tax Cut and Jobs Act on December 22, 2017. The Tax Cut and Jobs Act reduced the Company's federal income tax rate for 2018 and future periods to 21.0 percent. Tax expense for 2017 was calculated at a rate of 34.0 percent.

## Financial Position

### Loans

Total loans, net of deferred fees, totaled \$448.1 million at December 31, 2018, compared to \$431.6 million at December 31, 2017. The loan to deposit ratio was 89.1 percent at December 31, 2018 compared to 86.5 percent at December 31, 2017. During 2018, the Company experienced significant growth among commercial real estate, both owner-occupied and non-owner-occupied, commercial loans and construction and land loans. Residential 1-4 family and outstanding equity lines of credit all declined during 2018.

The following table provides balance by loan class as of December 31 for past five years.

(\$ thousands)	December 31, 2018		December 31, 2017		December 31, 2016		December 31, 2015		December 31, 2014	
	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent	Amount	Percent
Real estate secured:										
Residential 1-4 family	\$ 165,109	36.8%	\$ 174,889	40.5%	\$ 186,695	45.5%	\$ 194,287	44.9%	\$ 186,829	45.8%
Multifamily	18,378	4.1%	19,469	4.5%	22,630	5.5%	23,895	5.5%	21,131	5.2%
Construction and land loans	21,029	4.7%	15,907	3.7%	15,978	3.9%	19,163	4.4%	18,518	4.5%
Commercial, owner occupied	96,224	21.5%	82,121	19.0%	72,383	17.6%	73,031	16.9%	70,748	17.4%
Commercial, non-owner occupied	39,869	8.9%	33,748	7.8%	28,818	7.0%	38,025	8.8%	32,173	7.9%
Second mortgages	4,054	0.9%	4,684	1.1%	6,934	1.7%	8,169	1.9%	8,075	2.0%
Equity lines of credit	30,221	6.7%	34,378	8.0%	13,395	3.3%	6,000	1.4%	6,499	1.6%
Farmland	12,149	2.7%	13,188	3.1%	12,194	3.0%	11,283	2.6%	8,246	2.0%
Total real estate secured	387,033	86.3%	378,384	87.5%	359,027	87.5%	373,853	86.4%	352,219	86.4%
Non-real estate secured:										
Personal	12,754	2.8%	14,192	3.3%	17,887	4.4%	20,914	4.8%	21,186	5.2%
Commercial	46,202	10.3%	36,785	8.5%	29,977	7.3%	35,144	8.1%	31,586	7.7%
Agricultural	2,830	0.6%	2,950	0.7%	3,490	0.9%	2,959	0.7%	2,683	0.7%
Total non-real estate secured	61,786	13.8%	53,927	12.5%	51,354	12.5%	59,017	13.6%	55,455	13.6%
Total	\$ 448,819	100.0%	\$ 432,311	100.0%	\$ 410,381	100.0%	\$ 432,870	100.0%	\$ 407,674	100.0%



The following table provides loan maturity information as of December 31, 2018.

(thousands)	Within 1 year		1-5 years		After 5 years		Total
	Fixed	Variable	Fixed	Variable	Fixed	Variable	
Real estate secured:							
Residential 1-4 family	\$ 21,036	\$ 13,151	\$ 52,978	\$ 39,012	\$ 22,491	\$ 16,441	\$ 165,109
Multifamily	1,371	2,106	6,238	6,127	—	2,536	18,378
Construction and land loans	1,490	811	14,141	—	3,400	1,187	21,029
Commercial, owner occupied	15,306	2,357	42,314	7,926	12,418	15,903	96,224
Commercial, non-owner occupied	5,769	888	19,548	2,988	4,681	5,995	39,869
Second mortgages	907	342	1,651	989	101	64	4,054
Equity lines of credit	—	6,955	—	16,758	—	6,508	30,221
Farmland	2,835	889	4,520	1,538	—	2,367	12,149
Non-real estate secured:							
Personal	3,746	2,469	4,949	896	—	694	12,754
Commercial and agricultural	15,237	6,455	25,159	1,680	—	501	49,032
Total	<u>\$ 67,697</u>	<u>\$ 36,423</u>	<u>\$ 171,498</u>	<u>\$ 77,914</u>	<u>\$ 43,091</u>	<u>\$ 52,196</u>	<u>\$ 448,819</u>

Investment securities available for sale

Investment securities available for sale totaled \$68.6 million at December 31, 2018, compared to \$78.5 million at December 31, 2017. The \$9.9 million reduction occurred as proceeds from maturing securities were used to fund loan demand and to fund the repayment of FHLB advances during 2018.

Investment securities available for sale at December 31, 2018 included mortgage backed securities/CMOs (73.7 percent of the total securities portfolio), municipal issues (18.7 percent), and SBAs bonds (7.6 percent). There were no investment securities held to maturity at December 31, 2018 or December 31, 2017.

The following table presents the maturity distribution, fair value, and taxable-equivalent yield of the investment portfolio at December 31, 2018 and December 31, 2017.

	Fair value maturing:						
(\$ thousands)	Within 1 year	1-5 years	5-10 years	Beyond 10 years	Total	Yield	
<b>December 31, 2018</b>							
Mortgage-backed securities:							
Fixed rate	\$ —	\$ —	\$ 14,128	\$ 34,421	\$ 48,549	2.13%	
Variable rate	—	—	234	1,771	2,005	3.34%	
State and municipal securities:							
Tax-exempt	77	150	598	6,873	7,698	3.09%	
Taxable	—	—	1,569	3,569	5,138	2.96%	
SBA bonds:							
Fixed rate	23	216	471	4,531	5,241	2.46%	
Total	<u>\$ 100</u>	<u>\$ 366</u>	<u>\$ 17,000</u>	<u>\$ 51,165</u>	<u>\$ 68,631</u>	2.36%	
Fixed rate	\$ 100	\$ 366	\$ 16,766	\$ 49,394	\$ 66,626		
Variable rate	—	—	234	1,771	2,005		
Total	<u>\$ 100</u>	<u>\$ 366</u>	<u>\$ 17,000</u>	<u>\$ 51,165</u>	<u>\$ 68,631</u>		
<b>December 31, 2017</b>							
Mortgage-backed securities:							
Fixed rate	\$ —	\$ —	\$ 11,423	\$ 45,416	\$ 56,839	2.10%	
Variable rate	—	—	1	2,467	2,468	2.26%	
State and municipal securities:							
Tax-exempt	125	230	—	6,602	6,957	3.58%	
Taxable	—	301	197	5,056	5,554	2.92%	
SBA bonds:							
Fixed rate	—	502	644	5,563	6,709	2.29%	
Variable rate	—	—	—	—	—	—%	
Total	<u>\$ 125</u>	<u>\$ 1,033</u>	<u>\$ 12,265</u>	<u>\$ 65,104</u>	<u>\$ 78,527</u>	2.31%	
Fixed rate	\$ 125	\$ 1,033	\$ 12,264	\$ 62,637	\$ 76,059		
Variable rate	—	—	1	2,467	2,468		
Total	<u>\$ 125</u>	<u>\$ 1,033</u>	<u>\$ 12,265</u>	<u>\$ 65,104</u>	<u>\$ 78,527</u>		

All of the mortgage-backed securities included above are agency-issued by FHLMC, FNMA or GNMA. The Company does not hold any non-agency mortgage-backed securities. All SBA bonds owned by the Company have the full faith and credit of the U.S. Government and carry a zero risk weighting.

The following table provides credit ratings for the Company's municipal securities assigned by Moody's and/or Standard & Poors as of December 31, 2018:

Moody's	Standard & Poor's	Fair value (thousands)
Aaa	AAA	\$ 1,147
Aa	AA	11,219
A	A	470
		<u>\$ 12,836</u>

### Other investments

Other investments include capital stock investments in the Federal Reserve, the Federal Home Loan Bank of Atlanta, Community Bankers Bank, and Pacific Coast Bankers Bank. These investments had a carrying value of \$2.8 million at December 31, 2018, and are considered to be non-marketable as the Company is required to hold these investments and the only market for these investments is the issuing agency.

### Deposits

The following table provides a breakdown of deposits at December 31, 2018 and December 31, 2017, showing the amount and percent increase or decrease by deposit type.

(thousands)	December 31, 2018	December 31, 2017	Increase (decrease)	% increase (decrease)
Non-interest bearing demand	\$ 156,408	\$ 148,633	\$ 7,775	5.2 %
Interest bearing demand	105,941	119,197	(13,256)	(11.1)%
Savings deposits	105,110	104,390	720	0.7 %
Time deposits greater than \$100,000	52,774	36,794	15,980	43.4 %
Other time deposits	82,583	89,769	(7,186)	(8.0)%
Total deposits	<u>\$ 502,816</u>	<u>\$ 498,783</u>	<u>\$ 4,033</u>	0.8 %

Deposits at December 31, 2018 increased \$4.0 million since December 31, 2017. There were significant changes in deposit mix during 2018. Deposit growth during 2018 includes time deposits greater than \$100,000, which increased \$16.0 million, and non-interest bearing deposits, which increased \$7.8 million since December 31, 2017. Interest-bearing demand deposits decreased \$13.3 million during 2018, and other time deposits decreased \$7.2 million.

The following table provides the scheduled maturities of time deposits greater than or equal to \$100,000 at December 31, 2018.

(thousands)	
< 3 months	\$ 4,379
3-6 months	4,732
6-12 months	9,864
> 12 months	33,799
Total time deposits greater than \$100,000	<u>\$ 52,774</u>

### Short-term borrowings and long-term debt

As of December 31, 2018, the Company had \$30.1 million in FHLB advances. Although the Company utilized FHLB advances for short-term liquidity needs during the year, no advances were originated in 2018 that remained outstanding as of December 31, 2018. The Company currently secures all FHLB advances with 1-4 family residential mortgage, commercial real estate and multifamily loans. As of December 31, 2018, short-term borrowings included \$30.0 million of the outstanding FHLB advances, scheduled to mature within one year. The remaining \$93,000 is included in long-term debt.

### Nonperforming assets

Nonperforming assets include nonaccrual loans, loans contractually past due 90 days or more and still accruing interest and other real estate owned. Nonperforming assets were \$8.2 million or 1.83 percent of loans held for investment and OREO at December 31, 2018, compared to \$4.4 million or 1.02 percent of loans held for investment and OREO at December 31, 2017. The increase in nonperforming assets during 2018 primarily resulted from two specific relationships, and management does not believe the increase is reflective of a broader decline in asset quality. The Company continues its efforts to reduce non-performing assets, primarily by reducing nonaccrual loans and selling OREO. However, in certain of the Company's markets, the ability to sell OREO continues to be negatively affected by limited demand.

(thousands)	December 31, 2018	December 31, 2017	December 31, 2016	December 31, 2015	December 31, 2014
Nonaccrual loans	\$ 5,920	\$ 2,065	\$ 3,999	\$ 9,456	\$ 11,666
Loans 90+ days past due and still accruing	107	26	2,210	—	22
Total nonperforming loans	6,027	2,091	6,209	9,456	11,688
Other real estate owned	2,212	2,350	2,768	5,694	6,685
Total nonperforming assets	\$ 8,239	\$ 4,441	\$ 8,977	\$ 15,150	\$ 18,373

At December 31, 2018, other real estate owned totaled \$2.2 million and consisted of 20 relationships. At December 31, 2017 OREO balances were \$2.4 million and consisted of 15 relationships. The following chart details each category type, number of relationships, and balance.

(\$ thousands)	December 31, 2018		December 31, 2017	
	Number	Balance	Number	Balance
Construction and land loans	8	\$ 308	10	\$ 663
Residential 1-4 family	9	785	2	142
Commercial real estate	3	1,119	3	1,545
Total	20	\$ 2,212	15	\$ 2,350

The Company's major markets include: Southwestern Virginia, the Tri-City region of Eastern Tennessee, the Sevierville/ Knoxville, Tennessee area, and Boone/Banner Elk, North Carolina. The following table provides information about properties owned in each geographic area, the number of individual properties and balance.

(\$ thousands)	December 31, 2018		December 31, 2017	
	Number	Balance	Number	Balance
Sevierville and Knoxville TN Area	1	\$ 71	1	\$ 71
Southwest VA and Tri-City TN Area	17	2,089	12	2,209
Boone and Banner Elk NC Area	2	52	2	70
Total	20	\$ 2,212	15	\$ 2,350

As of December 31, 2018, the Company had loans with a total balance of \$1.3 million that were in process of foreclosure. The Company expects the balance of other real estate owned will increase during 2019 as these foreclosures occur. The Company believes the loans are generally well-secured, and any anticipated deficiencies in collateral values are offset by specific loan allowances that have been previously established.

As of December 31, 2018 and December 31, 2017, loan balances totaling \$11.5 million and \$8.0 million, respectively, were classified as troubled debt restructurings. Nonperforming TDRs totaled \$2.6 million and \$881,000, respectively, as of December 31, 2018 and December 31, 2017.

### Allowance for Loan Losses

The allowance for loan losses is calculated based on management's judgment and analysis of current and historical loss experience, risk characteristics of the loan portfolio, concentrations of credit and asset quality, as well as other internal and external factors, including general economic conditions. The internal credit review function includes pre-approval analyses of large credits and credit review activities that provide early warnings of loan deterioration. The senior risk officer prepares quarterly analyses of the

adequacy of the allowance for loan losses. These analyses include individual loans considered impaired for direct exposure. In addition, potential losses on loan pools and pool allocations are estimated based upon historical losses and other factors, as adjusted, for various loan types. The calculation of the allowance for loan losses is reviewed by the chief risk officer, senior financial officers and the board of directors.

At December 31, 2018 and December 31, 2017, management determined that the Company's allowance for loan losses is adequate based on accounting principles generally accepted in the United States of America.

The following table provides an allocation of the allowance for loan losses as of the dates indicated.

(\$ thousands)	December 31, 2018		December 31, 2017		December 31, 2016		December 31, 2015		December 31, 2014	
	Allowance for loan losses	Percent of total loans	Allowance for loan losses	Percent of total loans	Allowance for loan losses	Percent of total loans	Allowance for loan losses	Percent of total loans	Allowance for loan losses	Percent of total loans
Residential 1-4 family	\$ 492	36.8%	\$ 133	40.3%	\$ 371	45.4%	\$ 654	44.9%	\$ 995	45.8%
Multifamily	25	4.1%	—	4.5%	—	5.5%	—	5.5%	20	5.2%
Construction and land loans	27	4.7%	1	3.7%	21	3.9%	37	4.4%	87	4.5%
Commercial - owner-occupied	1,022	21.5%	1,636	19.0%	1,339	17.6%	1,012	16.9%	409	17.4%
Commercial - non-owner-occupied	895	8.9%	955	7.8%	445	7.0%	748	8.8%	1,063	7.9%
Second mortgages	13	0.9%	12	1.1%	15	1.7%	43	1.9%	67	2.0%
Equity lines of credit	127	6.7%	—	8.0%	27	3.3%	20	1.4%	74	1.6%
Farmland	11	2.7%	54	3.1%	16	3.0%	7	2.6%	12	2.0%
Personal	114	2.8%	265	3.3%	802	4.4%	704	4.8%	665	5.2%
Commercial/Agricultural	957	10.9%	383	9.2%	535	8.2%	886	8.8%	982	8.4%
Unallocated	690	—%	515	—%	1,258	—%	1,543	—%	1,103	—%
Total	<u>\$ 4,373</u>	100.0%	<u>\$ 3,954</u>	100.0%	<u>\$ 4,829</u>	100.0%	<u>\$ 5,654</u>	100.0%	<u>\$ 5,477</u>	100.0%



The following table presents the Company's loan loss experience for the past five years.

(thousands)	2018	2017	2016	2015	2014
Allowance for loan losses at January 1	\$ 3,954	\$ 4,829	\$ 5,654	\$ 5,477	\$ 6,825
Provision for loan losses	738	120	1,526	1,469	1,324
Loans charged off:					
Residential 1-4 family	117	57	249	360	258
Multifamily	—	—	—	—	—
Construction and land loans	—	—	28	12	18
Commercial - owner-occupied	123	755	1,245	407	345
Commercial - non-owner-occupied	—	—	—	12	1,239
Second mortgages	5	—	4	3	25
Equity lines of credit	—	—	8	—	116
Farmland	1	—	2	—	—
Personal	197	321	1,046	796	544
Commercial/agricultural	347	470	164	257	407
Total charge-offs	790	1,603	2,746	1,847	2,952
Recoveries of loans previously charged off:					
Residential 1-4 family	42	39	32	3	1
Multifamily	—	—	—	—	—
Construction and land loans	8	4	14	41	17
Commercial - owner-occupied	19	27	7	376	132
Commercial - non-owner-occupied	—	1	8	6	1
Second mortgages	32	1	—	—	—
Equity lines of credit	—	1	2	41	—
Farmland	2	2	—	3	—
Personal	161	182	195	76	90
Commercial/agricultural	207	448	137	9	39
Total recoveries	471	705	395	555	280
Net loan charge-offs	319	898	2,351	1,292	2,672
Establish reserve for unfunded commitments	—	97	—	—	—
Allowance for loan losses at December 31	\$ 4,373	\$ 3,954	\$ 4,829	\$ 5,654	\$ 5,477

## Liquidity and Capital Resources

Total stockholders' equity of the Company was \$56.6 million at December 31, 2018. Total stockholders' equity at December 31, 2017 was \$53.8 million, reflecting increases in retained earnings, net of higher accumulated other comprehensive loss.

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of tier 1 common equity, total risk-based capital and tier 1 capital to risk-weighted assets, and tier 1 capital to adjusted total assets. As of December 31, 2018, the Bank exceeded all minimum capital requirements. See Note 18 for a more detailed discussion of the Bank's regulatory capital ratios.

Liquidity is the ability to provide sufficient cash levels to meet financial commitments and to fund loan demand and deposit withdrawals. The Company and subsidiary Bank maintain a significant level of liquidity in the form of cash and cash equivalents (\$30.1 million as of December 31, 2018) and unpledged investment securities available for sale (\$31.2 million as of December 31, 2018). Cash and cash equivalents are immediately available for satisfaction of deposit withdrawals, customer credit needs, and operations of the Bank. The Bank also maintains a significant amount of available credit with both the Federal Home Loan Bank and correspondent financial institutions. Unencumbered investment securities available for sale represent a secondary level of liquidity available for conversion to liquid funds in the event of extraordinary needs. The Company believes that it maintains sufficient liquidity to meet its current and projected requirements and needs.

## **Risk Management**

The Company is exposed to various risks resulting from its normal operations, including, but not limited to, credit risk, liquidity risk, interest rate risk, compliance risk and other operational risks. Through its reliance on technology, the Company has risks related to the performance of its technology and information security risks related to customer information and other data. Through its reliance on third parties, the Company also has vendor risk, and, by extension, exposure to the technology and information security risks of its vendors. Collectively, all of these risks contribute to the Company's reputational risk. The Company seeks to manage and mitigate each of these risks and other risks through various risk management techniques including effective policies and procedures, internal and external monitoring, and risk transfer.

Despite these efforts, the volume of business conducted through electronic devices, our internet presence, and reliance on external vendors expose the Company to various attacks, including cybersecurity attacks from both domestic and international sources that seek to obtain customer information for fraudulent purposes or to disrupt business activities. During the second quarter of 2018, the Company identified an incident that was limited to a portion of the Company's email system. The incident did not result in a direct financial loss, although the Company elected to engage professional advisors to investigate and remediate the incident. The Company has taken steps to prevent a similar situation from occurring in the future and continues to dedicate significant attention to risk management.

### **Item 7A. Quantitative and Qualitative Disclosures About Market Risk**

Not Applicable

### **Item 8. Financial Statements**



## REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Stockholders  
Highlands Bankshares, Inc. and Subsidiary  
Abingdon, Virginia

### Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of Highlands Bankshares, Inc. and Subsidiary (the "Company") as of December 31, 2018 and 2017, and the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the years in the three-year period ended December 31, 2018, and the related notes (collectively referred to as the "consolidated financial statements"). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018 and 2017, and the results of its operations and its cash flows for each of the years in the three-year period ended December 31, 2018, in conformity with accounting principles generally accepted in the United States of America.

### Basis for Opinion

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

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

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

*Brown, Edwards & Company, L.L.P.*

CERTIFIED PUBLIC ACCOUNTANTS

We have been the Company's auditor since 1995.

Blacksburg, Virginia  
March 28, 2019

**Highlands Bankshares, Inc. and Subsidiary**  
**Consolidated Balance Sheets**  
(Amounts in thousands)

	December 31, 2018	December 31, 2017
<b>ASSETS</b>		
Cash and due from banks	\$ 19,965	\$ 15,179
Federal funds sold	10,101	15,618
Total cash and cash equivalents	30,066	30,797
Investment securities available for sale (amortized cost \$71,260 at December 31, 2018 and \$79,990 at December 31, 2017)	68,631	78,527
Other investments, at cost	2,774	3,116
Loans held for sale	265	4,808
Loans	448,121	431,574
Allowance for loan losses	(4,373)	(3,954)
Net loans	443,748	427,620
Premises and equipment, net	17,447	18,332
Real estate held for sale	817	1,430
Deferred tax assets	6,526	7,161
Interest receivable	1,617	1,987
Bank-owned life insurance	15,022	14,679
Other real estate owned	2,212	2,350
Other assets	2,816	3,290
Total assets	\$ 591,941	\$ 594,097
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
<b>LIABILITIES</b>		
Deposits:		
Non-interest bearing	\$ 156,408	\$ 148,633
Interest bearing	346,408	350,150
Total deposits	502,816	498,783
Short-term borrowings	30,000	10,000
Long-term debt	93	30,146
Interest, taxes and other liabilities	2,391	1,364
Total liabilities	535,300	540,293
<b>STOCKHOLDERS' EQUITY</b>		
Common stock (8,251 shares issued and outstanding at December 31, 2018 and 8,199 at December 31, 2017)	5,156	5,124
Preferred stock (2,092 shares issued and outstanding for each period presented)	4,184	4,184
Additional paid-in capital	19,277	19,113
Retained earnings	30,131	26,539
Accumulated other comprehensive loss	(2,107)	(1,156)
Total stockholders' equity	56,641	53,804
Total liabilities and stockholders' equity	\$ 591,941	\$ 594,097

See accompanying Notes to Consolidated Financial Statements

**Highlands Bankshares, Inc. and Subsidiary**  
**Consolidated Statements of Income**  
(Amounts in thousands, except per share data)

	Year ended December 31,		
	2018	2017	2016
<b>INTEREST INCOME</b>			
Loans receivable and fees on loans	\$ 21,936	\$ 20,427	\$ 21,327
Investment securities	1,807	2,148	1,968
Federal funds sold	250	192	99
Total interest income	23,993	22,767	23,394
<b>INTEREST EXPENSE</b>			
Deposits	2,090	1,854	1,794
Other borrowed funds	1,317	1,985	2,381
Total interest expense	3,407	3,839	4,175
Net interest income	20,586	18,928	19,219
Provision for loan losses	738	120	1,526
Net interest income after provision for loan losses	19,848	18,808	17,693
<b>NONINTEREST INCOME</b>			
Mortgage banking income	315	1,942	525
Securities gains, net	—	19	47
Service charges on deposit accounts	1,471	1,568	1,786
Other service charges, commissions and fees	1,627	1,881	1,748
Other operating income	854	626	762
Total noninterest income	4,267	6,036	4,868
<b>NONINTEREST EXPENSE</b>			
Salaries and employee benefits	9,648	10,858	12,005
Occupancy and equipment expense	2,658	2,614	2,848
Foreclosed assets – write-down and operating expenses	420	301	1,883
Other operating expense	6,848	5,814	6,173
Total noninterest expense	19,574	19,587	22,909
Income (loss) before income taxes	4,541	5,257	(348)
Income tax expense (benefit) (Note 8)	949	5,694	(360)
Net income (loss)	\$ 3,592	\$ (437)	\$ 12
Net income (loss) per common share (Note 13)			
Basic	\$ 0.44	\$ (0.05)	\$ —
Fully diluted	0.35	(0.05)	—

See accompanying Notes to Consolidated Financial Statements



**Highlands Bankshares, Inc. and Subsidiary**  
**Consolidated Statements of Comprehensive Income**  
(Amounts in thousands)

	Year ended December 31,		
	2018	2017	2016
Net income (loss)	\$ 3,592	\$ (437)	\$ 12
Other comprehensive income:			
Unrealized (losses) gains on securities during the period	(1,165)	413	(1,434)
Less: reclassification adjustment for gains included in net income	—	(19)	(47)
Other comprehensive (loss) income before tax	(1,165)	394	(1,481)
Income tax (benefit) expense related to other comprehensive income	(214)	133	(503)
Other comprehensive (loss) income	(951)	261	(978)
Comprehensive income (loss)	\$ 2,641	\$ (176)	\$ (966)

See accompanying Notes to Consolidated Financial Statements

**Highlands Bankshares, Inc. and Subsidiary**  
**Consolidated Statements of Cash Flows**  
(Amounts in thousands)

	Year ended December 31,		
	2018	2017	2016
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>			
Net income (loss)	\$ 3,592	\$ (437)	\$ 12
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	738	120	1,526
Depreciation and amortization	1,551	1,710	1,870
Provision for deferred tax assets	880	5,694	297
Net realized gains on available for sale securities	—	(19)	(47)
Restricted stock expense	164	222	54
Loss on sale of premises and equipment	—	34	—
Originations of loans held for sale	(17,377)	(19,050)	(16,969)
Proceeds from loans held for sale	21,920	15,497	15,714
(Increase) decrease in interest receivable	370	60	(286)
Valuation adjustment of other real estate owned	215	187	890
Valuation allowance of real estate held for sale	250	—	315
Increase (decrease) in other assets	131	(840)	(5)
Increase in interest, taxes and other liabilities	1,027	11	592
Net cash provided by operating activities	13,461	3,189	3,963
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>			
Securities available for sale:			
Proceeds from sale of securities	—	7,624	21,164
Proceeds from maturities of securities	10,955	15,599	19,035
Purchase of debt and equity securities	(2,706)	(6,938)	(57,759)
Redemptions (purchases) of other investments, net	342	3,521	(45)
Net (increase) decrease in loans	(17,756)	(23,286)	18,433
Proceeds from sales of other real estate owned	813	712	3,060
Proceeds from sale of real estate held for sale	378	216	—
Premises and equipment expenditures	(198)	(1,832)	(372)
Disposition of premises and equipment	—	245	—
Net cash (used in) provided by investing activities	(8,172)	(4,139)	3,516
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>			
Net decrease in time deposits	(4,687)	(13,922)	(15,163)
Net increase in demand, savings and other deposits	8,720	22,836	10,120
Change in short-term borrowings	(10,000)	(17,552)	7,500
Decrease in long-term debt	(53)	(10,000)	(7,552)
Issuance of common stock	—	—	1,110
Net cash used in financing activities	(6,020)	(18,638)	(3,985)
Net change in cash and cash equivalents	(731)	(19,588)	3,494
Cash and cash equivalents at beginning of period	30,797	50,385	46,891
Cash and cash equivalents at end of period	\$ 30,066	\$ 30,797	\$ 50,385
<b>SUPPLEMENTAL DISCLOSURES</b>			
Cash payments for interest	\$ 3,240	\$ 3,888	\$ 4,186
Cash payments for income taxes	68	—	—
<b>SUPPLEMENTAL DISCLOSURE OF NONCASH TRANSACTIONS</b>			
Non-cash transfers of loans to other real estate owned	890	481	1,632
Non-cash loans resulting from sales of other real estate owned	—	—	105

See accompanying Notes to Consolidated Financial Statements

**Highlands Bankshares, Inc. and Subsidiary**  
**Consolidated Statements of Changes in Stockholders' Equity**  
(Amounts in thousands)

	Common stock shares	Common stock par value	Preferred stock shares	Preferred stock par value	Additional paid-in-capital	Retained earnings	Accumulated other comprehensive income (loss)	Stockholders' equity
Balance December 31, 2016	8,199	\$ 5,124	2,092	\$ 4,184	\$ 18,891	\$ 26,785	\$ (1,226)	\$ 53,758
Net loss	—	—	—	—	—	(437)	—	(437)
Other comprehensive income	—	—	—	—	—	—	261	261
ASU 2018-02 Topic 220 reclassification adjustment	—	—	—	—	—	191	(191)	—
Stock-based compensation	—	—	—	—	222	—	—	222
Balance December 31, 2017	8,199	5,124	2,092	4,184	19,113	26,539	(1,156)	53,804
Net income	—	—	—	—	—	3,592	—	3,592
Other comprehensive loss	—	—	—	—	—	—	(951)	(951)
Grant of restricted stock	52	32	—	—	(32)	—	—	—
Stock-based compensation	—	—	—	—	196	—	—	196
Balance December 31, 2018	8,251	\$ 5,156	2,092	\$ 4,184	\$ 19,277	\$ 30,131	\$ (2,107)	\$ 56,641

See accompanying Notes to Consolidated Financial Statements

**Highlands Bankshares, Inc. and Subsidiary**  
**Notes to Consolidated Financial Statements**  
**(in thousands, except share, per share and percentage data)**

**Note 1 - Basis of Presentation and Accounting Policies**

Basis of Presentation and Consolidation

The accompanying consolidated financial statements include the accounts of Highlands Bankshares, Inc., (the "Parent Company") and its wholly-owned subsidiary, Highlands Union Bank (the "Bank"). The statements also include Highlands Union Insurance Services, Inc., Highlands Union Financial Services, Inc., which are wholly owned subsidiaries of the Bank. The Bank owns a portion of Russell Road Properties, LLC, was formed in March of 2015 to hold and manage certain properties acquired by the Bank through foreclosure of properties that previously secured a participation loan.

All significant intercompany balances and transactions have been eliminated in consolidation. The accounting and reporting policies of Highlands Bankshares, Inc. and its subsidiaries, (collectively the "Company") conform to U.S. generally accepted accounting principles and to standard practices within the banking industry.

Nature of Operations

The Company operates in Abingdon, Virginia, and surrounding southwest Virginia, eastern Tennessee, and western North Carolina under the laws of the Commonwealth of Virginia. The Parent Company was organized on December 29, 1995. The Parent Company is supervised by the Federal Reserve Bank under the Bank Holding Company Act of 1956, as amended. The Bank began banking operations on April 27, 1985 under a state bank charter and provides a wide range of financial services to individuals and businesses. The Bank provides mortgage, consumer and commercial loans, and various deposit products including checking, savings, and certificates of deposit. As a state bank and a member of the Federal Reserve Bank of Richmond, the Bank is subject to regulation by the Virginia State Bureau of Financial Institutions, the Federal Deposit Insurance Corporation, and the Federal Reserve Bank. Highlands Union Insurance Services, Inc. commenced operations on October 8, 1999 for the purpose of selling insurance through Bankers Insurance LLC. Highlands Union Financial Services is inactive.

Cash and Cash Equivalents

For purposes of the consolidated statements of cash flows, cash and cash equivalents include cash and due from banks and federal funds sold, all of which mature within ninety days. The Company maintains its cash in bank deposit accounts which, at times, may exceed federally insured limits.

Investment Securities Available-for-Sale

Investment securities classified as available-for-sale are those debt and equity securities that the Company intends to hold for an indefinite period of time, but not necessarily to maturity. Any decision to sell a security classified as available-for-sale would be based on various factors, including significant movements in interest rates, changes in the maturity mix of the Company's assets and liabilities, liquidity needs, regulatory capital considerations, and other factors. Investment securities available-for-sale are carried at fair value. Unrealized gains or losses are reported as increases or decreases in other comprehensive income, net of the related deferred income tax effect. Realized gains or losses are included in earnings on the trade date and are determined on the basis of the amortized cost of specific securities sold. Premiums and discounts are recognized in interest income using the interest method over the period to maturity. On a quarterly basis the Company reviews any securities that are considered to be impaired to determine if the impairment is other than temporary. If the impairment is other than temporary, the investment is written down by a charge to securities losses in the statement of income.

Loans

The Company's lending operation includes both real estate-secured and non-real estate-secured loans. Real estate secured loans include 1-4 family residential mortgage loans, loans secured by multifamily properties, construction and land loans, commercial real estate, both owner-occupied and non-owner-occupied, second mortgage loans, home equity lines of credit, and loans secured by farmland. Non-real estate-secured loans include personal loans to consumers, commercial loans, and agricultural loans.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances. Interest income is accrued on the unpaid balance. Loan origination fees, net of certain direct origination costs, are deferred and amortized to income over the estimated lives of the loans using the straight-line method which is not materially different from the interest method.

The accrual of interest on a loan is discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Credit card loans and other personal loans are typically charged off no later than 180 days past due. In

all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful. Payments on non-accrual loans are applied to principal or applied on a cash basis. When a loan is placed on non-accrual status, all accrued interest receivable is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

#### Loans Held for Sale

The Company's mortgage division originates certain single family, residential mortgage loans for sale. The loans are sold to various investors on a servicing released basis using a best efforts approach. The Company does not consider either the rate lock commitment or the purchased commitment a derivative contract. Loans held for sale are recorded at the lower of cost or fair value, based on prices available as of the measurement date.

#### Allowance for Loan Losses and Reserve for Unfunded Commitments

The Company maintains an allowance for loan losses, representing an estimate of probable losses inherent in the loan portfolio existing as of the measurement date.

The Company's Credit Department evaluates various loans individually for impairment as required by Financial Accounting Standards Board ASC 310, *Receivables – Subsequent Measurement*. Loans evaluated individually for impairment include adversely classified loans, non-performing loans, non-accrual loans, loans past due by 90 days or more, restructured loans and other loans selected by management. The evaluations are based upon discounted expected cash flows or collateral valuations. If the evaluation concludes that a loan is impaired, then a specific reserve is established for the amount of impairment. For loans that are not individually evaluated, the Company makes estimates of losses for groups of loans as required by ASC 450-20, *Accounting for Contingencies*. Loans are grouped by similar characteristics, including the type of loan, the assigned loan grade and the general collateral type. Assigned loan grades include Quality, Satisfactory, Acceptable, Special Mention, Substandard and Doubtful. A loss rate reflecting the expected loss inherent in a group of loans is derived based upon estimates of default rates for a given loan grade, the predominant collateral type for the group and the terms of the loan. The resulting estimate of losses for groups of loans are adjusted for relevant environmental factors and other conditions of the portfolio of loans, including: borrower and industry concentrations; levels and trends in delinquencies, charge-offs and recoveries; changes in underwriting standards and risk selection; and, national and local economic conditions.

The amounts of estimated impairment for individually evaluated loans and groups of loans are added together for a total estimate of loan losses. This estimate of losses is compared to the allowance for loan losses of the Company as of the measurement date and, if the estimate of losses is greater than the allowance, an additional provision to the allowance is made. If the estimate of losses is less than the allowance, the degree to which the allowance exceeds the estimate is evaluated to determine whether the allowance falls outside a range of estimates. If the estimate of losses is below the range of reasonable estimates, the allowance is reduced by adjusting the provision for loan losses. The Company recognizes the inherent imprecision in estimates of losses due to various uncertainties and variability related to the factors used, and therefore a reasonable range around the estimate of losses is derived and used to ascertain whether the allowance is too high or too low. If different assumptions or conditions were to prevail and it is determined that the allowance is not adequate to absorb the new estimate of probable losses, an additional provision for loan losses would be made, which amount may be material to the consolidated financial statements.

During 2017, the Company established a reserve for unfunded commitments, which represents an estimate of the potential losses related to commitment amounts that, as of the measurement date, have not yet been funded. The initial reserve for unfunded commitments was created by a reclassification from the allowance for loan losses to the reserve for unfunded commitments. Adjustments to the reserve for unfunded commitments, whether increases due to higher loss estimates, or reductions resulting from lower loss estimates, are recorded with an offset to noninterest expense.

#### Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed on a straight-line method over each asset's estimated useful life. Maintenance and repairs are charged to current operations while improvements are capitalized. Disposition gains and losses are reflected in current operations. Purchased software is included in other assets and expensed over the estimated useful life.

#### Real Estate Held for Sale

Real estate held for sale is measured at the lower of the carrying amount or fair value less costs to sell. A loss is recognized for any adjustment of the of the asset's carrying amount to its fair value less cost to sell in the period the held for sale criteria are met. Subsequent changes in the asset's fair value less cost to sell would be reported as an adjustment to its carrying amount, except that the adjusted carrying amount will not exceed the carrying amount of the asset at the time it was initially classified as held for sale.



### Other Real Estate Owned

Assets acquired through or in lieu of loan foreclosure are initially recorded at fair value at the date of foreclosure. Subsequent to foreclosure, valuations are periodically performed by management using updated appraisals and other information, and the assets are carried at the lower of carrying amount or fair value less cost to sell. Generally, appraisals are updated every 24 months for all individually significant properties or when current events indicate that a property may have incurred a material decrease in value. Revenue and expenses from operations and gains and losses on disposals are reported as foreclosed assets-write-down and operating expenses within noninterest expense.

### Income Taxes

Under the asset and liability method, deferred income taxes are recognized for the tax consequences of temporary differences by applying enacted statutory tax rates to the differences between the financial statement carrying amounts and the tax bases of existing assets and liabilities. Under ASC 740, the effect on deferred taxes of a change in tax rates is recognized in income in the period that includes the enactment date. The December 22, 2017 enactment of the Tax Cuts and Jobs Act resulted in a reduction in the Company's federal income tax rate, which resulted in a revaluation of the net deferred tax asset, the impact of which was reflected in the 2017 consolidated financial statements.

Management evaluates the Company's tax circumstances and filings under the most current and relevant accounting rules and believes the Company has incurred no liability for uncertain tax positions (or any related penalties and interest) for the periods open to normal jurisdictional examinations (2015 through 2017).

### Net Income (Loss) Per Common Share

Net income (loss) per common share is calculated based on the weighted average outstanding shares during the year. Net income per common share assumes dilution is calculated based on the weighted average outstanding shares during the year plus common stock equivalents at year end. Net loss per common share excludes the impact of common stock equivalents at year end due to the antidilutive nature of those securities.

### Stock Compensation Plans

The Company accounts for stock compensation plans under the guidance of ASC 718 which requires all share-based payments to employees, including grants of employee stock options, to be recognized in the income statement based on their grant-date fair values. No stock options were granted during 2018 or 2017. See Note 12 for information regarding restricted stock awarded during 2018. No restricted stock was awarded during 2017.

### Use of Estimates

In preparing consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and reported amounts of revenue and expense during the reporting period. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of other real estate, calculation of deferred tax assets and investment securities.

### Business Segments

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

### Recent Accounting Pronouncements

In February 2018, ASU No. 2018-02, *Income Statement—Reporting Comprehensive Income* (ASU 2018-02) was issued by the FASB. ASU 2018-02 permits a reclassification from accumulated other comprehensive income (AOCI) to retained earnings for stranded tax effects resulting from the newly enacted federal corporate income tax rate in the Tax Cuts and Jobs Act, which was enacted on December 22, 2017. The Tax Cuts and Jobs Act included a reduction to the corporate income tax rate from 35 percent to 21 percent effective January 1, 2018. The amendments in this ASU are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption was permitted, and the Company adopted the guidance during the fourth quarter of 2017.

In June 2016, ASU No. 2016-13, *Measurement of Credit Losses on Financial Instruments* (ASU 2016-13) was issued by the FASB. ASU 2016-13 significantly changes how entities will measure credit losses for most financial assets and certain other instruments that aren't measured at fair value through net income. ASU 2016-13 is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments. ASU 2016-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted for interim and annual reporting periods beginning after December 15, 2018. Entities will apply the standard's provisions as a cumulative-effect adjustment to

retained earnings as of the beginning of the first reporting period in which the guidance is effective (i.e., modified retrospective approach). The Company continues to evaluate the impact ASU 2016-13 will have on its consolidated financial statements, but the magnitude of this impact has not been determined. The ultimate financial impact will depend on multiple items including, among other items, loan portfolio composition, credit quality at the adoption date, economic conditions, financial models used and forecasts. Working with an external advisor, the Company's implementation team continues critical activities such as building models, reviewing data quality, and development of accounting policies and disclosures.

In January 2016, ASU No. 2016-01 *Financial Instruments--Overall* (ASU 2016-01) was issued by the FASB. ASU 2016-01 addresses certain aspects of recognition, measurement, presentation, and disclosure of financial instruments. ASU 2016-01 was effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company adopted the provisions of ASU 2016-01 on January 1, 2018, with no material impact on the consolidated financial statements.

In May 2014, the FASB issued ASU No. 2014-09, *Revenue from Contracts with Customers*. ASU 2014-09 is a comprehensive revenue recognition model that requires a company to recognize revenue to depict the transfer of goods or services to a customer at an amount that reflects the consideration it expects to receive in exchange for those goods or services. ASU 2014-09 also requires additional disclosure about the nature, amount, timing and uncertainty of revenue and cash flows arising from customer contracts, including significant judgments and changes in judgments and assets recognized from costs incurred to obtain or fulfill a contract. ASU 2014-09 was effective for annual reporting periods, and interim periods within that period, beginning after December 15, 2016. ASU No. 2015-14 issued in August 2015 deferred the effective date of ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. The Company adopted ASU 2014-09 effective January 1, 2018. Adoption of ASU 2014-09 did not have a material effect on the Company's current financial position or results of operations; however, certain income statement items were reclassified, with no impact on net income.

#### Revenue Recognition

ASU 2014-09 requires disclosure of qualitative and quantitative information surrounding the amount, nature, timing and uncertainty of revenues and cash flows arising from contracts with customers. Descriptions of significant noninterest revenue-generating activities that are within the scope of ASU 2014-09 include the following:

**Service charges on deposit accounts** - These deposit account-related fees represent monthly account maintenance and transaction-based service fees such as overdraft fees, stop payment fees and charges for issuing cashier's checks and money orders. For account maintenance services, revenue is recognized at the end of the statement period when the Company's performance obligation has been satisfied. All other revenues from transaction-based services are recognized at a point in time when the performance obligation has been completed.

**Other service charges, commissions and fees** - These include interchange fees from customer debit and credit card transactions that are earned at the time a cardholder engages in a transaction with a merchant as well as fees charged to merchants for the ability to accept and process the debit and credit card transaction. Revenue is recognized when the performance obligation has been satisfied, which is upon completion of the card transaction. Additionally, these include, but are not limited to, check cashing fees, wire transfer fees and safe deposit fees. The performance obligation is fulfilled, and revenue is recognized, at the point in time the requested service is provided to the customer.

**Other operating income** - includes various forms of revenue including changes in the cash surrender value of bank-owned life insurance, none of which are within the scope of ASU 2014-09. The remaining miscellaneous income is the result of immaterial transactions where revenue is recognized when, or as, the performance obligation is satisfied.

The following table identifies components of noninterest income accounted for pursuant to ASU 2014-09.

	Year Ended December 31,		
	2018	2017	2016
Service charges on deposit accounts <sup>1</sup>	\$ 1,471	\$ 1,568	\$ 1,786
Other service charges, commissions and fees <sup>1</sup>	1,627	1,881	1,748
Mortgage banking income <sup>2</sup>	315	1,942	525
Securities gains, net <sup>2</sup>	—	19	47
Other operating income <sup>2</sup>	854	626	762
Total non-interest income	\$ 4,267	\$ 6,036	\$ 4,868

<sup>1</sup> Income recognized pursuant to ASC 2014-09

<sup>2</sup> Income recognized pursuant to accounting standards other than ASC 2014-09

In February 2016, the FASB issued ASU 2016-02 Leases (Topic 842) (ASU 2016-02), which increases transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU 2016-02 generally requires lessees to recognize all lease contracts on their balance sheet. This ASU requires lessees to classify leases as either operating or finance leases, which are substantially similar to the current operating and capital leases classifications. The distinction between these two classifications under the new standard does not relate to balance sheet treatment, but relates to treatment in the statements of income and cash flows. ASU 2016-02 is effective for public business entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. The Company adopted ASU 2016-02 during the first quarter of 2019, recording an increase to the consolidated balance sheets for right-of-use assets and associated lease liabilities, as well as resulting depreciation expense of the right-of-use assets and interest expense of the lease liabilities in the consolidated statements of income, for arrangements previously accounted for as operating leases. Adding these assets to the Company's consolidated balance sheet will increase total risk-weighted assets used to determine HUB's risk-based regulatory capital levels.

In August 2018, the FASB issued ASU 2018-13 Fair Value Measurement (Topic 820): Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement (ASU 2018-13). ASU 2018-13 modifies the disclosure requirements on fair value measurements by eliminating the requirements to disclose (i) the amount of and reasons for transfers between level 1 and level 2 of the fair value hierarchy; (ii) the policy for timing of transfers between levels; and (iii) the valuation processes for level 3 fair value measurements. ASU 2018-13 also added specific disclosure requirements for fair value measurements for public entities including the requirement to disclose the changes in unrealized gains and losses for the period included in other comprehensive income for recurring level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop level 3 fair value measurements. ASU 2018-13 is effective for fiscal years beginning after December 15, 2019, and all interim periods within those fiscal years. Early adoption is permitted, and issuers may early adopt amendments that remove or modify disclosures and delay the adoption of the additional disclosures until their effective date. The Company plans to adopt all applicable amendments and update the disclosures as appropriate during the first quarter of 2020.

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

## **Note 2 – Formal Written Agreement**

On October 13, 2010, the Company and Bank entered into a written agreement ("Written Agreement") with the Federal Reserve Bank of Richmond (the "Reserve Bank"). Under the terms of the Written Agreement, the Bank has agreed to develop and submit to the Reserve Bank for approval within the time periods specified therein written plans or programs to:

- strengthen board oversight of the management and operations of the Bank;
- strengthen credit risk management and administration;
- provide for the effective grading of the Bank's loan portfolio;
- summarize the findings of its review of the adequacy of the staffing of its loan review function;
- improve the Bank's position with respect to loans, relationships, or other assets in excess of \$500 that currently are, or in the future become past due more than 90 days, on the Bank's problem loan list, or adversely classified in any report of examination of the Bank;
- review and revise the Bank's methodology for determining the allowance for loan and lease losses ("ALLL") and maintain an adequate ALLL;
- maintain sufficient capital at the Company and the Bank;
- establish a revised written contingency funding plan;
- establish a revised written strategic and capital plan;
- establish a revised investment policy;
- improve the Bank's earnings and overall condition;
- revise the Bank's information technology program;
- establish a disaster recovery and business continuity program; and,
- establish a committee to monitor compliance with all aspects of the written agreement.

Further, both the Company and the Bank have agreed to refrain from declaring or paying dividends without prior regulatory approval. The Company has agreed that it will not take any other form of payment representing a reduction in Bank's capital or make any distributions of interest, principal or other sums on subordinated debentures or trust preferred securities without prior regulatory approval. The Company also has agreed not to incur, increase or guarantee any debt or not to purchase or redeem any shares of its stock without prior regulatory approval.

### Note 3 - Investment Securities Available For Sale

The amortized cost and fair value of investment securities available for sale are as follows:

December 31, 2018				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
State and political subdivisions	\$ 13,590	\$ 9	\$ 763	\$ 12,836
Mortgage backed securities	52,344	8	1,798	50,554
SBA pools	5,326	—	85	5,241
Investment securities available for sale	<u>\$ 71,260</u>	<u>\$ 17</u>	<u>\$ 2,646</u>	<u>\$ 68,631</u>

December 31, 2017				
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
State and political subdivisions	\$ 12,766	\$ 44	\$ 299	\$ 12,511
Mortgage backed securities	60,383	12	1,088	59,307
SBA pools	6,841	1	133	6,709
Investment securities available for sale	<u>\$ 79,990</u>	<u>\$ 57</u>	<u>\$ 1,520</u>	<u>\$ 78,527</u>

Investment securities available for sale with a fair value of \$37,448 and \$26,856 at December 31, 2018 and December 31, 2017, respectively, were pledged as collateral on public deposits, FHLB advances and for other purposes as required or permitted by law.

The following table presents the age of gross unrealized losses and fair value by investment category:

December 31, 2018						
	Less Than 12 months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
State and political subdivisions	\$ 3,608	\$ 73	\$ 7,791	\$ 690	\$ 11,399	\$ 763
Mortgage-backed securities	2,319	8	46,661	1,790	48,980	1,798
SBA pools	—	—	5,218	85	5,218	85
Total	<u>\$ 5,927</u>	<u>\$ 81</u>	<u>\$ 59,670</u>	<u>\$ 2,565</u>	<u>\$ 65,597</u>	<u>\$ 2,646</u>

December 31, 2017						
	Less Than 12 months		12 Months or More		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
State and political subdivisions	\$ 1,744	\$ 18	\$ 7,158	\$ 281	\$ 8,902	\$ 299
Mortgage-backed securities	14,540	177	42,415	911	56,955	1,088
SBA pools	176	1	6,206	132	6,382	133
Total	<u>\$ 16,460</u>	<u>\$ 196</u>	<u>\$ 55,779</u>	<u>\$ 1,324</u>	<u>\$ 72,239</u>	<u>\$ 1,520</u>

The Company assesses its securities for other than temporary impairment quarterly by reviewing credit ratings, financial and regulatory reports as well as other pertinent published financial data. As of December 31, 2018 and December 31, 2017, the Company's assessment revealed no other than temporary impairment.

The amortized cost and estimated fair value of securities available for sale at December 31, 2018 and December 31, 2017, by contractual maturity are shown below. Expected maturities may differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

	December 31, 2018		December 31, 2017	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Investment securities with scheduled maturities:				
Due in one year or less	\$ 98	\$ 100	\$ 125	\$ 125
Due after one year through five years	367	366	1,028	1,033
Due after five years through ten years	2,782	2,638	869	841
Due after ten years	15,669	14,973	17,585	17,221
Total investment securities with scheduled maturities	18,916	18,077	19,607	19,220
Mortgage-backed securities	52,344	50,554	60,383	59,307
Total investment securities available for sale	<u>\$ 71,260</u>	<u>\$ 68,631</u>	<u>\$ 79,990</u>	<u>\$ 78,527</u>

The following table summarizes the securities gains (losses) recognized for the periods presented:

	Year Ended December 31,		
	2018	2017	2016
Gross gains	\$ —	\$ 32	\$ 65
Gross losses	—	(13)	(18)
Securities gains, net	<u>\$ —</u>	<u>\$ 19</u>	<u>\$ 47</u>

#### Note 4 - Other Investments

Federal Home Loan Bank of Atlanta stock, Federal Reserve Bank stock, Community Bankers' Bank stock and Pacific Coast Banker's Bank stock with a carrying value of \$2,774 and \$3,116 at December 31, 2018 and 2017, respectively, are stated at cost and included as other investments on the Company's consolidated balance sheets. These investments are considered to be restricted as the Company is required by these entities to hold these investments, and the only market for these investments is stock is the issuer.



## Note 5 - Loans and Allowance for Loan Losses

The composition of net loans is as follows:

	December 31, 2018	December 31, 2017
<b>Real estate secured:</b>		
Residential 1-4 family	\$ 165,109	\$ 174,889
Multifamily	18,378	19,469
Construction and land loans	21,029	15,907
Commercial, owner occupied	96,224	82,121
Commercial, non-owner occupied	39,869	33,748
Second mortgages	4,054	4,684
Equity lines of credit	30,221	34,378
Farmland	12,149	13,188
Total real estate secured	387,033	378,384
<b>Non-real estate secured:</b>		
Personal	12,754	14,192
Commercial	46,202	36,785
Agricultural	2,830	2,950
Total non-real estate secured	61,786	53,927
Gross loans	448,819	432,311
Less:		
Allowance for loan losses	4,373	3,954
Net deferred fees	698	737
Loans, net	\$ 443,748	\$ 427,620

As of December 31, 2018, loans totaling \$144,525 were pledged to the Federal Home Loan Bank of Atlanta to secure existing debt obligations and to provide additional borrowing capacity, compared to \$130,773 at December 31, 2017.

The following table is an analysis of past due loans as of December 31, 2018:

	Past Due			Current	Total	> 90 Days and Accruing
	30-89 days	90 days and over	Total			
<b>Real estate secured</b>						
Residential 1-4 family	\$ 1,481	\$ 819	\$ 2,300	\$ 162,809	\$ 165,109	\$ 105
Equity lines of credit	218	75	293	29,928	30,221	—
Multifamily	402	—	402	17,976	18,378	—
Farmland	754	—	754	11,395	12,149	—
Construction, land development, other land loans	16	—	16	21,013	21,029	—
Commercial real estate:						
Owner-occupied	9	756	765	95,459	96,224	—
Non-owner-occupied	—	1,859	1,859	38,010	39,869	—
Second mortgages	—	—	—	4,054	4,054	—
<b>Non-real estate secured</b>						
Personal	186	4	190	12,564	12,754	—
Commercial	82	114	196	46,006	46,202	2
Agricultural	—	—	—	2,830	2,830	—
Total	\$ 3,148	\$ 3,627	\$ 6,775	\$ 442,044	\$ 448,819	\$ 107



The following table is an analysis of past due loans as of December 31, 2017:

	Past Due			Current	Total	> 90 Days and Accruing
	30-89 days	90 days and over	Total			
Real estate secured						
Residential 1-4 family	\$ 1,092	\$ 566	\$ 1,658	\$ 173,231	\$ 174,889	\$ —
Equity lines of credit	—	—	—	34,378	34,378	—
Multifamily	—	—	—	19,469	19,469	—
Farmland	234	50	284	12,904	13,188	—
Construction, land development, other land loans	—	—	—	15,907	15,907	—
Commercial real estate:						
Owner-occupied	11	708	719	81,402	82,121	—
Non-owner-occupied	—	—	—	33,748	33,748	—
Second mortgages	—	—	—	4,684	4,684	—
Non-real estate secured						
Personal	211	23	234	13,958	14,192	—
Commercial	502	279	781	36,004	36,785	26
Agricultural	49	—	49	2,901	2,950	—
Total	\$ 2,099	\$ 1,626	\$ 3,725	\$ 428,586	\$ 432,311	\$ 26

Loans are considered delinquent when payments have not been made according to the terms of the contract. The accrual of interest on loans is generally discontinued at the time the loan is 90 days delinquent unless the credit is well-secured and in process of collection. Additionally, in certain instances, loans that have been restructured or modified may also be classified as non-accrual per regulatory guidance until a satisfactory payment history has been established. Credit card loans and other personal loans are typically charged off no later than 180 days past due. In all cases, loans are placed on non-accrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

The following is a summary of non-accrual loans at December 31, 2018 and December 31, 2017:

	December 31, 2018	December 31, 2017
<b>Real estate secured</b>		
Residential 1-4 family	\$ 1,196	\$ 887
Construction and land loans	8	—
Commercial real estate:		
Owner-occupied	2,038	708
Non-owner-occupied	2,004	—
Equity lines of credit	75	—
Farmland	142	193
<b>Non-real estate secured</b>		
Personal	26	23
Commercial	431	254
Total	<u>\$ 5,920</u>	<u>\$ 2,065</u>

The following is a summary of residential real estate currently in the process of foreclosure as well as foreclosed residential real estate as of December 31, 2018.

	Number	Balance
Residential real estate in the process of foreclosure	7	\$ 1,304
Foreclosed residential real estate	9	785

The following tables represent a summary of credit quality indicators of the Company's loan portfolio at December 31, 2018 and December 31, 2017. The grades are assigned and/or modified by the Company's credit review and credit analysis departments based on the creditworthiness of the borrower and the overall strength of the loan.

The following tables provide the credit risk profile by internally assigned grade as of December 31, 2018 and December 31, 2017:

December 31, 2018	Residential 1-4 Family	Multifamily	Farmland	Construction, Land Loans	Commercial Real Estate- Owner Occupied	Commercial Real Estate Non-Owner Occupied
Quality	\$ 12,991	\$ —	\$ —	\$ 724	\$ 1,632	\$ 131
Satisfactory	107,925	4,276	2,736	5,314	39,679	13,046
Acceptable	37,036	13,700	3,617	13,349	47,963	21,073
Special Mention	1,696	402	—	1,565	2,720	3,615
Substandard	5,461	—	5,796	77	4,230	2,004
Doubtful	—	—	—	—	—	—
Total	<u>\$ 165,109</u>	<u>\$ 18,378</u>	<u>\$ 12,149</u>	<u>\$ 21,029</u>	<u>\$ 96,224</u>	<u>\$ 39,869</u>

December 31, 2017	Residential 1-4 Family	Multifamily	Farmland	Construction, Land Loans	Commercial Real Estate- Owner Occupied	Commercial Real Estate Non-Owner Occupied
Quality	\$ 33,107	\$ —	\$ 13	\$ 2,870	\$ 3,535	\$ 295
Satisfactory	95,659	10,653	4,419	5,445	45,906	13,602
Acceptable	40,487	8,816	3,333	5,906	28,344	15,609
Special Mention	388	—	3,206	1,565	2,542	2,226
Substandard	5,248	—	2,217	121	1,661	2,016
Doubtful	—	—	—	—	133	—
Total	<u>\$ 174,889</u>	<u>\$ 19,469</u>	<u>\$ 13,188</u>	<u>\$ 15,907</u>	<u>\$ 82,121</u>	<u>\$ 33,748</u>

#### Explanation of credit grades:

**Quality** - This grade is reserved for the Bank's top quality loans. These loans have excellent sources of repayment, with no significant identifiable risk of collection. Generally, loans assigned this rating will demonstrate the following characteristics:

- Conformity in all respects with Bank policy, guidelines, underwriting standards, and Federal and State regulations (no exceptions of any kind).
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

For existing loans, all of the requirements above apply plus all payments have been made as agreed, current financial information on all borrowers and guarantors has been obtained and analyzed, and overall business operating trends are either stable or improving.

Satisfactory - This grade is given to performing loans. These loans have adequate sources of repayment, with little identifiable risk of collection. Loans assigned this rating will demonstrate the following characteristics:

- General conformity to the Bank's policy requirements, product guidelines and underwriting standards. Any exceptions that are identified during the underwriting and approval process have been adequately mitigated by other factors.
- Documented historical cash flow that meets or exceeds required minimum Bank guidelines, or that can be supplemented with verifiable cash flow from other sources.
- Adequate secondary sources to liquidate the debt, including combinations of liquidity, liquidation of collateral, or liquidation value to the net worth of the borrower or guarantor.

For existing loans, all of the requirements outlined above will apply, plus all payments have been made as agreed, current financial information on all borrowers and guarantors has been obtained and analyzed, and overall business operating trends are stable with any declines considered minor and temporary.

Acceptable - This grade is given to loans that show signs of weakness in either adequate sources of repayment or collateral, but have demonstrated mitigating factors that minimize the risk of delinquency or loss. Loans assigned this rating may demonstrate some or all of the following characteristics:

- Additional exceptions to the Bank's policy requirements, product guidelines or underwriting standards that present a higher degree of risk to the Bank. Although the combination and/or severity of identified exceptions is greater, all exceptions have been properly mitigated by other factors.
- Unproved, insufficient or marginal primary sources of repayment that appear sufficient to service the debt at this time. Repayment weaknesses may be due to minor operational issues, financial trends, or reliance on projected (not historic) performance.
- Marginal or unproven secondary sources to liquidate the debt, including combinations of liquidation of collateral and liquidation value to the net worth of the borrower or guarantor.

For existing loans, payments have generally been made as agreed with only minor and isolated delinquencies.

Special Mention - This grade is given to Watch List loans that include the following characteristics:

- Loans with underwriting guideline tolerances and/or exceptions with no identifiable mitigating factors.
- Extending loans that are currently performing satisfactorily but with potential weaknesses that may, if not corrected, weaken the asset or inadequately protect the Bank's position at some future date. Potential weaknesses are the result of deviations from prudent lending practices.
- Loans where adverse economic conditions that develop subsequent to the loan origination do not jeopardize liquidation of the debt, but do substantially increase the level of risk may also warrant this rating.

Substandard - Loans in this category are characterized by deterioration in quality exhibited by any number of well-defined weaknesses requiring corrective action. A substandard loan is inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified as substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt; they are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

The weaknesses may include, but are not limited to:

- High debt to worth ratios and or declining or negative earnings trends
- Declining or inadequate liquidity
- Improper loan structure or questionable repayment sources
- Lack of well-defined secondary repayment source, and
- Unfavorable competitive comparisons.

Such loans are no longer considered to be adequately protected due to the borrower's declining net worth, lack of earnings capacity, declining collateral margins and/or unperfected collateral positions. A possibility of loss of a portion of the loan balance cannot be ruled out. The repayment ability of the borrower is marginal or weak and the loan may have exhibited excessive overdue status or extensions and/or renewals.

Doubtful - Loans classified Doubtful have all the weaknesses inherent in loans classified Substandard, plus the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values highly questionable and improbable. The ability of the borrower to service the debt is extremely weak, overdue status is constant, the debt has been placed on non-accrual status, and no definite repayment schedule exists.

However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Among these events are:

- Injection of capital
- Alternative financing
- Liquidation of assets or the pledging of additional collateral.

The credit risk profile based on payment activity as of December 31, 2018:

	Consumer - Non Real Estate	Equity Line of Credit /Second Mortgages	Commercial - Non Real Estate	Agricultural - Non Real Estate
Performing	\$ 12,750	\$ 34,200	\$ 46,088	\$ 2,830
Nonperforming (>90 days past due)	4	75	114	—
Total	<u>\$ 12,754</u>	<u>\$ 34,275</u>	<u>\$ 46,202</u>	<u>\$ 2,830</u>

The credit risk profile based on payment activity as of December 31, 2017:

	Consumer - Non Real Estate	Equity Line of Credit /Second Mortgages	Commercial - Non Real Estate	Agricultural - Non Real Estate
Performing	\$ 14,169	\$ 39,062	\$ 36,506	\$ 2,950
Nonperforming (>90 days past due)	23	—	279	—
Total	<u>\$ 14,192</u>	<u>\$ 39,062</u>	<u>\$ 36,785</u>	<u>\$ 2,950</u>

The following tables reflect the Bank's impaired loans at December 31, 2018:

December 31, 2018	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance					
Real estate secured					
Residential 1-4 family	\$ 4,325	\$ 4,325	\$ —	\$ 5,862	\$ 134
Equity lines of credit	7	7	—	28	—
Multifamily	402	402	—	201	—
Farmland	5,681	5,681	—	3,084	10
Construction, land development, other land loans	1,635	1,635	—	1,700	2
Commercial real estate-owner occupied	5,332	5,332	—	3,442	9
Commercial real estate-non owner occupied	—	—	—	32	—
Second mortgages	100	100	—	155	—
Non-real estate secured					
Personal	—	—	—	48	9
Commercial	317	317	—	411	20
Agricultural	—	—	—	—	—
Total	<u>\$ 17,799</u>	<u>\$ 17,799</u>	<u>\$ —</u>	<u>\$ 14,963</u>	<u>\$ 184</u>

December 31, 2018	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With an allowance recorded					
Real estate secured					
Residential 1-4 family	\$ 631	\$ 631	\$ 191	\$ 353	\$ 307
Equity lines of credit	105	105	80	53	6
Multifamily	—	—	—	—	—
Farmland	122	122	2	927	—
Construction, land development, other land loans	—	—	—	—	—
Commercial real estate-owner occupied	1,704	1,704	351	1,789	—
Commercial real estate-non owner occupied	3,686	3,686	844	3,789	45
Second mortgages	35	35	7	18	—
Non-real estate secured					
Personal	18	18	7	10	—
Commercial	1,161	1,161	880	832	—
Agricultural	—	—	—	—	—
Total	<u>\$ 7,462</u>	<u>\$ 7,462</u>	<u>\$ 2,362</u>	<u>\$ 7,771</u>	<u>\$ 358</u>

The following tables reflect the Bank's impaired loans at December 31, 2017:

December 31, 2017	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance					
Real estate secured					
Residential 1-4 family	\$ 7,398	\$ 7,398	\$ —	\$ 6,123	\$ 279
Equity lines of credit	49	49	—	37	—
Multifamily	—	—	—	495	56
Farmland	486	486	—	586	42
Construction, land development, other land loans	1,765	1,765	—	1,753	67
Commercial real estate- owner occupied	1,552	1,552	—	3,677	22
Commercial real estate- non owner occupied	63	63	—	973	19
Second mortgages	209	209	—	198	3
Non real estate secured					
Personal	95	95	—	55	—
Commercial and agricultural	504	504	—	274	—
Total	<u>\$ 12,121</u>	<u>\$ 12,121</u>	<u>\$ —</u>	<u>\$ 14,171</u>	<u>\$ 488</u>

December 31, 2017	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With an allowance recorded					
Real estate secured					
Residential 1-4 family	\$ 74	\$ 74	\$ 11	\$ 267	\$ 24
Equity lines of credit	—	—	—	—	—
Multifamily	—	—	—	—	—
Farmland	1,731	1,731	257	962	13
Construction, land development, other land loans	—	—	—	183	24
Commercial real estate- owner occupied	1,873	1,873	465	1,506	—
Commercial real estate- non owner occupied	3,892	3,892	955	2,951	141
Second mortgages	—	—	—	9	—
Non real estate secured					
Personal	2	2	2	27	—
Commercial and agricultural	502	502	418	568	4
Total	<u>\$ 8,074</u>	<u>\$ 8,074</u>	<u>\$ 2,108</u>	<u>\$ 6,473</u>	<u>\$ 402</u>



The following tables present the balance in the allowance for loan losses and the recorded investment in loans by loan category and is segregated by impairment evaluation method as of and for the years ended December 31, 2018 and December 31, 2017.

Year ended December 31, 2018	Residential 1-4 Family	Multifamily	Construction and Land Loans	Commercial Owner Occupied	Commercial Non-Owner Occupied	Second Mortgages	Equity Line of Credit	Farmland	Personal and Overdrafts	Commercial and Agricultural	Unallocated	Total
Allowance for Loan Losses:												
Balance at December 31, 2017	\$ 133	—	\$ 1	\$ 1,636	\$ 955	\$ 12	\$ —	\$ 54	\$ 265	\$ 383	\$ 515	\$ 3,954
Provision for credit losses	434	25	18	(510)	(60)	(26)	127	(44)	(115)	714	175	738
Charge-offs	117	—	—	123	—	5	—	1	197	347	—	790
Recoveries	(42)	—	(8)	(19)	—	(32)	—	(2)	(161)	(207)	—	(471)
Net charge-offs	75	—	(8)	104	—	(27)	—	(1)	36	140	—	319
Balance at December 31, 2018	<u>\$ 492</u>	<u>\$ 25</u>	<u>\$ 27</u>	<u>\$ 1,022</u>	<u>\$ 895</u>	<u>\$ 13</u>	<u>\$ 127</u>	<u>\$ 11</u>	<u>\$ 114</u>	<u>\$ 957</u>	<u>\$ 690</u>	<u>\$ 4,373</u>
Allowance allocated by impairment method:												
Individually evaluated	\$ 191	—	—	\$ 351	\$ 844	\$ 7	\$ 80	\$ 2	\$ 7	\$ 880	—	\$ 2,362
Collectively evaluated	301	25	27	671	51	6	47	9	107	77	690	2,011
Loan balances by impairment method used:												
Individually evaluated	\$ 5,026	\$ 412	\$ 1,676	\$ 7,066	\$ 3,466	\$ 135	\$ 108	\$ 5,938	\$ 17	\$ 1,417	—	\$ 25,261
Collectively evaluated	160,083	17,966	19,353	89,158	36,403	3,919	30,113	6,211	12,737	47,615	—	423,558
Balance at December 31, 2018	<u>\$ 165,109</u>	<u>\$ 18,378</u>	<u>\$ 21,029</u>	<u>\$ 96,224</u>	<u>\$ 39,869</u>	<u>\$ 4,054</u>	<u>\$ 30,221</u>	<u>\$ 12,149</u>	<u>\$ 12,754</u>	<u>\$ 49,032</u>	<u>—</u>	<u>\$ 448,819</u>

Year ended December 31, 2017	Residential 1-4 Family	Multifamily	Construction and Land Loans	Commercial Owner Occupied	Commercial Non-Owner Occupied	Second Mortgages	Equity Line of Credit	Farmland	Personal and Overdrafts	Commercial and Agricultural	Unallocated	Total
Allowance for Loan Losses:												
Balance at December 31, 2016	\$ 371	—	\$ 21	\$ 1,339	\$ 445	\$ 15	\$ 27	\$ 16	\$ 802	\$ 535	\$ 1,258	\$ 4,829
Provision for credit losses	(220)	—	(24)	1,025	509	(4)	(28)	36	(398)	(130)	(646)	120
Charge-offs	57	—	—	755	—	—	—	—	321	470	—	1,603
Recoveries	(39)	—	(4)	(27)	(1)	(1)	(1)	(2)	(182)	(448)	—	(705)
Net charge-offs	18	—	(4)	728	(1)	(1)	(1)	(2)	139	22	—	898
Reclassification of reserve for unfunded commitments	—	—	—	—	—	—	—	—	—	—	(97)	(97)
Balance at December 31, 2017	<u>\$ 133</u>	<u>\$ —</u>	<u>\$ 1</u>	<u>\$ 1,636</u>	<u>\$ 955</u>	<u>\$ 12</u>	<u>\$ —</u>	<u>\$ 54</u>	<u>\$ 265</u>	<u>\$ 383</u>	<u>\$ 515</u>	<u>\$ 3,954</u>
Allowance allocated by impairment method:												
Individually evaluated	\$ 11	\$ —	\$ —	\$ 772	\$ 955	\$ —	\$ —	\$ —	\$ 2	\$ 368	\$ —	\$ 2,108
Collectively evaluated	122	—	1	864	—	12	—	54	263	15	515	1,846
Loan balances by impairment method used:												
Individually evaluated	\$ 7,472	\$ —	\$ 1,766	\$ 3,425	\$ 3,954	\$ 209	\$ 49	\$ 2,217	\$ 97	\$ 1,006	\$ —	\$ 20,195
Collectively evaluated	167,417	19,469	14,141	78,696	29,794	4,475	34,329	10,971	14,095	38,729	—	412,116
Balance at December 31, 2017	<u>\$ 174,889</u>	<u>\$ 19,469</u>	<u>\$ 15,907</u>	<u>\$ 82,121</u>	<u>\$ 33,748</u>	<u>\$ 4,684</u>	<u>\$ 34,378</u>	<u>\$ 13,188</u>	<u>\$ 14,192</u>	<u>\$ 39,735</u>	<u>\$ —</u>	<u>\$ 432,311</u>

The Company's credit administration personnel and senior financial officers are responsible for tracking, coding, and monitoring troubled debt restructurings ("TDRs"). Concessions are made to existing borrowers in the form of modified interest rates and / or payment terms. The loans are segregated for regulatory and external reporting. Each specific TDR is reviewed to determine if the accrual of interest should be discontinued and also reviewed for impairment. The Company's senior credit officer performs this analysis on a quarterly basis in addition to determining any other loans that are impaired within the loan portfolio. The Company had a total of \$11,546 and \$8,005 of loans categorized as TDRs as of December 31, 2018 and December 31, 2017, respectively. Interest is accrued on TDRs if the loan is not otherwise impaired and the full collection of principal and interest under the modified terms is deemed probable.

In the determination of the allowance for loan losses, management considers subsequent TDR defaults by adjusting the TDR loan risk grades. Defaults resulting in charge-offs affect the historical loss experience ratios which are a component of the allowance calculation. Additionally, specific reserves may be established on restructured loans evaluated individually.

The following table summarizes new TDRs during December 31, 2018. There were no new TDRs in the year ended December 31, 2017.

December 31, 2018	Number	Pre-Modification Recorded Investment	Post-Modification Recorded Investment
<i>Below Market Rate</i>			
Residential 1-4 family	4	\$ 639	\$ 639
Farmland	4	768	768
Commercial real estate-owner occupied	3	1,107	1,107
Commercial real estate-non owner occupied	1	1,462	1,462
Commercial	1	120	120
Total below market rate	13	4,096	4,096
Total restructurings	13	\$ 4,096	\$ 4,096

There were no defaults of loans restructured in the previous 12 months in the years ended December 31, 2018 or December 31, 2017.

The Bank has engaged an external third party to perform its loan review function in order to identify weaknesses within the loan portfolio. The review, which seeks to cover 40 percent of loan balances each year, considers collateral, repayment history, guarantor strength, debt service coverage, and other relevant information on an individual and global level. These reviews consider borrower cash flow capacity, using financial statements, income tax returns and internally prepared interim statements for borrowers and guarantors. Debt service coverage (DSC) is calculated on each individual customer, or guarantor, as well as the aggregate or global DSC. Collateral evaluation includes an inspection of the collateral file to determine if the Bank is properly secured. Collateral is discounted, when appropriate, to determine a stressed loan to value (LTV) ratio.

The Company also seeks to identify potential problem relationships through watch list reviews, which include reviews of past due data and other information that might be helpful in evaluating a particular loan relationship that is exhibiting stress. Watch list relationships display distinct characteristics including, but not limited to, late payments greater than 60 days, a low DSC calculation, bankruptcy filings, casualty losses, or other issues that would cause a perceived increase in the risk of loss to the Bank.

The segments of the Company's loan portfolio are disaggregated to a level that allows management to monitor risk and performance. In reviewing risk, management has determined there to be several different risk categories within the loan portfolio. The allowance for loan losses consists of amounts applicable to: (i) the commercial loan portfolio; (ii) the commercial real estate loan portfolio; (iii) the construction loan portfolio; (iv) the consumer loan portfolio; and, (v) the residential loan portfolio. The commercial real estate ("CRE") loan segment is further disaggregated into two classes. Non-owner occupied CRE loans, which include loans secured by non-owner occupied nonfarm nonresidential properties, generally have a greater risk profile than all other CRE loans, which include multifamily structures and owner-occupied commercial structures. The construction loan segment is further disaggregated into two classes. One-to-four family residential construction loans are generally made to individuals for the acquisition of and/or construction on a lot or lots on which a residential dwelling is to be built. Commercial construction loans are generally made to developers or investors for the purpose of acquiring, developing and constructing residential or commercial structures. Construction lending is generally considered to involve a higher degree of credit risk than long-term permanent financing.

The following describes the Company's basic methodology for computing its ALLL.

On a quarterly basis, the ALLL methodology begins with the identification of loans subject to ASC 310. All loans that are rated "7" (Doubtful) are assessed as impaired based on the expectation that the full collection of principal and interest is in doubt. All loans that are rated "6" (Substandard) or are expected to be downgraded to "6", require additional analysis to determine whether they may be impaired under ASC 310. All loans that are rated "5" (Special Mention) are presumed not to be impaired. However, "5" rated loans, together with any Troubled Debt Restructured (TDR) loan, may warrant further analysis before completing an assessment of impairment.

A loan is considered impaired and an allowance for loan losses is established on loans for which it is probable that the full collection of principal and interest is in doubt. Once a loan is identified as individually impaired, management measures impairment using one of several methods, including collateral value based on a recent appraisal, liquidation value and/or discounted cash flows. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. At December 31, 2018 and December 31, 2017, all of the total impaired loans were evaluated based on either the fair value of the collateral or the discounted cash flows.

For ASC 310 loans that are individually evaluated and found to be impaired (primarily those designated as Substandard and Doubtful), the associated ALLL will be based upon one of the three impairment measurement methods specified within ASC 310:

- (1) Present value of expected future cash flows discounted at the loan's effective interest rate;
- (2) Loan's observable market price; or
- (3) Fair value of the collateral.

To determine the amount of loan loss exposure for the impaired ASC 310 loans, the value of collateral for secured loans is evaluated to determine the current value and potential exposure. The collateral value is adjusted for its age and condition, and, for real estate, adjusted for condition, location, and age of the most current appraisal. If the adjusted value of the collateral is less than the current principal balance, the difference is designated as direct exposure for loan loss calculations. The total balance of unsecured loans is considered as direct exposure.

For all other loans, including individual loans determined not to be impaired under ASC 310, the associated ALLL is calculated in accordance with ASC 450 that provides for estimated credit losses likely to be realized on groups of loans with similar risk characteristics. The Company uses standard call report categories to segregate loans into groups with similar risk characteristics. Estimated credit losses reflect significant factors that affect the collectability of the portfolio as of the evaluation date. Key factors that influence risk within the Company's loan portfolio are divided into three major categories:

(1) Historical Loss Factor: To calculate the anticipated loan loss in each call report category for ASC 450 loans, the Company begins with the net loss in each category for each of the last twelve quarters. The Company uses a rolling twelve quarter weighted historical loss average where the most recent quarters are weighted heavier than the earlier quarters so that the calculation reflects current risk trends within the portfolio. The weighting used by the Company is similar to the Rule of 78's with the net losses of the most recent quarter weighted at 12/78ths and those in the first quarter in the twelve quarter period weighted at 1/78th. Therefore, the net losses of the most recent year represent approximately 54% of the calculation compared with 33% if a simple average of losses over the three-year period was used. The total of weighted factors for each call report category is applied to the current outstanding loan balance in each category to calculate expected loss based on historical data for a group of loans with similar risk characteristics. The same weighting is applied to all loan types.

(2) External economic factors: Economic conditions have a significant impact on Company's loan portfolio because deteriorating conditions can adversely impact both collateral values and the customer's ability to service debt. Management has selected the following external factors as indicators of economic conditions:

- a. National GDP growth rate
- b. Local unemployment rates
- c. Prime interest rate

The values for external factors are updated on a quarterly basis based on current data.

(3) Internal process factors: Internal factors that influence loss rates as a result of risk management and control practices include the following:

- d. Past-due loans
- e. Non-accrual loans
- f. Commercial real estate concentrations
- f. Loan volume
- g. Level and trend of classified loans

The values for internal factors are updated on a quarterly basis based on current portfolio metrics.

Once the quarterly ALLL is computed, the calculations are reviewed by the Company's management. The ALLL is then reviewed and approved by the Board of Directors.

#### Loans Held for Sale

The Company's mortgage division, Highlands Home Mortgage, originates certain single family, residential first mortgage loans for sale on a presold basis. Loan sale activity is summarized below. This division began operations in the second quarter of 2016. Loans are typically sold to one of the various investors within 20 days of closing. Management believes that, for each period presented, the carrying amount approximates the fair value of loans held for sale.

	Year ended December 31,	
	2018	2017
Loans held for sale at end of period	\$ 265	\$ 4,808
Proceeds from sales of mortgage loans originated for sale	21,920	15,497
Gain on sales of mortgage loans originated for sale	315	1,942

#### Note 6 - Premises and Equipment / Real Estate Held for Sale

Premises and equipment include the following as of December 31, 2018 and December 31, 2017:

	2018	2017
Land	\$ 7,238	\$ 7,238
Buildings	14,976	14,520
Equipment	16,058	16,182
Gross investment in premises and equipment	38,272	37,940
Less: accumulated depreciation	20,825	19,608
Premises and equipment, net	\$ 17,447	\$ 18,332

Depreciation expense was \$1,068 and \$1,042 for 2018 and 2017, respectively.

Total rent expense for all operating leases amounted to \$195 in 2018, compared to \$212 in 2017.

Future minimum rental commitments for noncancellable operating leases with initial or remaining terms of one or more years consisted of the following as of December 31, 2018:

	Year ended December 31
2019	\$ 49
2020	37
2021	37
2022	15
Total	\$ 138

The Company also reports real estate held for sale totaling \$817 and \$1,430 as of December 31, 2018 and December 31, 2017, respectively. Real estate held for sale includes vacant lots that were originally purchased for future branch expansion or bank operations.

#### Note 7 - Bank Owned Life Insurance

The Company maintains insurance on the lives of certain current and former directors and officers. As beneficiary, the Company receives the cash surrender value if the policy is terminated, and upon death of the insured, receives all benefits payable. The current value of the policies at December 31, 2018 and 2017 was \$15,022 and \$14,679, respectively.

#### Note 8 - Income Taxes

The components of income tax expense (benefit) related to continuing operations are as follows:

	2018	2017
Federal:		
Current	\$ —	\$ —
Deferred	949	5,694
Total	<u>\$ 949</u>	<u>\$ 5,694</u>

The Company's income tax expense differs from tax expense calculated at a statutory federal rate of 21 percent for 2018 and 34 percent for 2017 as follows:

	2018	2017
Statutory rate applied to income before income taxes	\$ 954	\$ 1,787
Tax exempt interest	(44)	(108)
Revaluation of deferred tax asset due to change in enacted federal income tax rate	—	3,960
Other, net	39	55
Income tax expense	<u>\$ 949</u>	<u>\$ 5,694</u>

The components of the net deferred tax asset (DTA) are as follows:

	2018	2017
Deferred tax asset:		
Allowance for loan loss	\$ 918	\$ 830
Previous years AMT	742	742
Loss on other equity investments	—	—
Net operating loss carry-forwards (20 year carry-forward period) and other	4,565	5,571
Net unrealized loss on investment securities available-for-sale	552	423
Deferred tax asset	<u>6,777</u>	<u>7,566</u>
Deferred tax liability:		
Depreciation	(251)	(405)
Net deferred tax asset	<u>\$ 6,526</u>	<u>\$ 7,161</u>



The DTA related to the Company's net operating losses represent future benefits that will expire in periods ranging from 2030 to 2036.

The Company evaluates the carrying amount of its DTA in accordance with the guidance provided in FASB ASC Topic 740 (ASC 740), in particular, applying the criteria set forth therein to determine whether it is more likely than not (i.e., a likelihood of more than 50 percent) that some portion, or all, of the DTA will not be realized within its life cycle, based on the weight of available evidence. In most cases, the realization of the DTA is dependent upon the Company generating a sufficient level of taxable income in future periods, which can be difficult to predict. If the Company's forecast of taxable income within the carry forward periods available under applicable law is not sufficient, the DTA could be impaired. Management considers the reversal of deferred tax liabilities (including the impact of available carry-back and carry-forward periods), projected future taxable income and tax-planning strategies in making this assessment.

Management periodically evaluates the carrying value of the Company's DTA in accordance with ASC 740, to determine whether a valuation allowance is required based upon circumstances and expectations then in existence. No valuation allowance was recorded as of December 31, 2018 or December 31, 2017.

#### Note 9 - Deposits

The composition of deposits is as follows:

	December 31, 2018	December 31, 2017
Non-interest bearing demand	\$ 156,408	\$ 148,633
Interest bearing demand	105,941	119,197
Savings deposits	105,110	104,390
Time deposits, in amounts of \$100,000 or more	52,774	36,794
Other time deposits	82,583	89,769
Total deposits	<u>\$ 502,816</u>	<u>\$ 498,783</u>

The scheduled maturities of time deposits at December 31, 2018 are as follows:

Year	Amount
2019	\$ 75,037
2020	22,236
2021	9,594
2022	10,769
2023	8,909
Thereafter	8,812
	<u>\$ 135,357</u>

Time deposits greater than \$250 totaled \$13,899 and \$6,019 at December 31, 2018 and December 31, 2017, respectively.

## Note 10 - Short-Term Borrowings and Long-Term Debt

Short-term borrowings at December 31, 2018 and December 31, 2017 include Federal Home Loan Bank advances that are secured by blanket liens on the Bank's 1-4 family residential mortgage loans, commercial mortgage loans and multifamily loans.

	Interest rate	December 31, 2018	December 31, 2017
FHLB advances maturing:			
August 29, 2018	2.855%	\$ —	\$ 5,000
August 29, 2018	2.733%	—	5,000
August 29, 2019	3.530%	12,500	—
August 29, 2019	3.700%	12,500	—
August 29, 2019	3.740%	5,000	—
Total		<u>\$ 30,000</u>	<u>\$ 10,000</u>

Long-term debt includes the following obligations as of December 31, 2018 and December 31, 2017:

	Interest rate	December 31, 2018	December 31, 2017
FHLB advances maturing:			
August 29, 2019	3.53%	\$ —	\$ 12,500
August 29, 2019	3.70%	—	12,500
August 29, 2019	3.74%	—	5,000
FHLB Affordable Housing Program payable	—%	93	146
Total		<u>\$ 93</u>	<u>\$ 30,146</u>

FHLB advances require quarterly interest payments.

Certain commercial real estate, multi-family, and residential mortgage loans, with a balance of \$144,525 and \$130,773 at December 31, 2018 and December 31, 2017, respectively, were pledged to the FHLB as collateral for short-term borrowings, long-term debt, and to secure additional available lines of credit.

Contractual principal maturities of long-term debt at December 31, 2018 are as follows:

2019	\$ 53
2020	40
Total	<u>\$ 93</u>

## Note 11 - Off-Balance Sheet Activities

The Bank is party to various financial instruments with off-balance sheet risk arising in the normal course of business to meet customers' financing needs. Those financial instruments include unfunded commitments under lines of credit, commitments to extend credit, and commercial standby letters of credit.

Unfunded commitments under lines of credit, revolving credit lines and overdraft protection agreements are commitments for possible future extensions of credit to existing customers. These lines of credit may or may not contain a specified maturity date and may or may not be drawn upon to the total extent to which the Company is committed.

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. The total commitment amount does not necessarily represent future cash requirements since commitments could expire with ever being accessed. The amount of collateral obtained, if deemed necessary by the Company, is based on management's credit evaluation of the customer.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Standby letters of credit are primarily issued to support public and private borrowing arrangements. Essentially all letters of credit issued have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Company holds collateral supporting those commitments if deemed necessary.

	December 31, 2018	December 31, 2017
Unfunded commitments	\$ 49,588	\$ 46,119
Commitments to extend credit	7,138	8,919
Standby letters of credit	3,477	991

These instruments contain credit risk for potential non-performance by the borrower following assumed funding of the commitment. The Bank uses the same credit policies in making commitments and conditional obligations that is used for instruments recorded on the consolidated balance sheet.

As of December 31, 2018, other liabilities included a \$85 reserve for unfunded commitments, representing management's estimate of potential losses, compared to \$97 as of December 31, 2017. These commitments also present interest rate risk.

## Note 12 - Stock Issuances / Equity Compensation Plan

On April 16, 2014, management and board of directors of Highlands Bankshares, Inc. announced the completion of a \$16,525 private placement capital raise. Purchasers in the private placement included outside investors, as well as certain directors and executive officers of the Company. The Company sold 2,673,249 newly issued shares of the Company's common stock at \$3.50 per share, and 2,048,179 shares of Series-A convertible perpetual preferred stock at \$3.50 per share. The private placement was disclosed on Form 8-K on April 16, 2014. The Company immediately repaid a \$3,440 holding company loan on April 16, 2014. The Company also repaid \$3,150 of trust preferred securities and related accrued interest. The payoff totaling \$4,802 was completed on July 15, 2014. The Company down-streamed \$7,500 to the subsidiary Bank in June 2014.

During the third quarter of 2014, the Company conducted a rights offering to its existing shareholders other than directors and executive officers. The Company raised a total of \$556 as a result of the offering. The Company down-streamed \$400 of the \$556 to the Bank in September of 2014. In October 2014, one of the private placement purchasers, TNH Financial Fund, LP, purchased another \$183 of common and preferred stock which allowed them to maintain the same ownership percentage that was held immediately prior to the rights offering. Net proceeds received from the private placement issues and rights offering totaled \$16,123.

In January 2016, the Company's CEO purchased 235,294 shares of the Company's common stock at a price of \$4.25 per share in a private placement. In February 2016, two of the private placement purchasers participating in the capital raise in 2014, MFP Partners LP and Deerhill Pond Investment Partners, LP, each purchased another 12,744 shares of common stock at \$4.25

per share which allowed them to maintain the same ownership percentage that was held immediately prior to the CEO's purchase. The Company down-streamed \$1,150 to the Bank.

During 2006, the Company's board of directors approved an equity compensation plan (the "2006 Plan"), which authorized up to 200,000 shares of common stock to be used for nonqualified stock options, stock appreciation rights, stock awards and stock units to directors, officers and employees. During September 2016, the Company granted 86,667 restricted shares of the Company's common stock pursuant to the 2006 Plan. The restricted shares were fully vested on the second anniversary of the award date and were expensed over the 2 year vesting period based on the grant date fair value of the shares. The 2006 Plan expired during 2016.

The Company did not grant any equity compensation in 2017.

On May 15, 2018, the shareholders of the Company approved the 2018 Restricted Stock Plan (the "2018 Plan"), which authorized the board's compensation committee (the "Compensation Committee") to issue up to 250,000 shares of Company common stock in grants of restricted stock and restricted stock unit awards to eligible employees.

Effective July 27, 2018, the Compensation Committee approved a form of Restricted Stock Award Agreement ("Restricted Stock Award Agreement"). The Restricted Stock Award Agreement provides eligible Company employees the right to receive Company common stock ("Restricted Stock") according to a time-based vesting schedule. The Restricted Stock is subject to various restrictions on transfer and risks of forfeiture that lapse upon vesting. The Restricted Stock Award Agreement provides for forfeiture of the award in certain cases of termination. Additionally, other events may accelerate the vesting of the restricted stock, such as the death or disability of the grantee or upon a change of control. During 2018, the Compensation Committee awarded 51,500 shares of the Company's common stock to be issued under the 2018 Plan (the "2018 Restricted Stock Awards"). The value of the 2018 Restricted Stock Awards is being recognized over the 5-year vesting period. During 2018, the Company recognized \$56 of restricted stock expense resulting from the 2018 Restricted Stock Awards.

Effective July 27, 2018, the Compensation Committee approved the form of Performance Based Restricted Stock Award Agreement (the "Performance Based Restricted Stock Agreement"), pursuant to which each recipient will receive a specified target number of shares of restricted stock, each of which will represent the right to receive one share of the Company's common stock, subject to the terms of the Performance Based Restricted Stock Agreement. Under the terms of the Performance Based Restricted Stock Agreement, the restricted shares will vest only if the Company meets certain specified targets: return of average equity, return on average assets, and earnings per share, in each case for the Performance Period. The Performance Based Restricted Stock Agreement provides for forfeiture of the Performance Based Restricted Stock in certain cases of termination. Additionally, other events may accelerate the vesting of the Performance Based Restricted Stock, such as the death or disability of the grantee or upon a change of control.

#### **Note 13 - Stock and Net Income Per Share**

Net income (loss) per common share is computed using the weighted average outstanding shares for the years ended December 31. The impact of restricted stock on net income per share is determined using the treasury stock method.

During 2014, the Company issued a total of 2,092,287 shares of Series A preferred stock. These preferred shares are non-voting mandatorily convertible non-cumulative preferred shares which are entitled to receive dividends equal to dividends paid on the Company's common shares. The Series A preferred shares will rank *pari passu* with the common stock with respect to all terms (other than voting), including, the payment of dividends or distributions, and payments and rights upon liquidation and dissolution. Diluted shares also include restricted stock awards made by the Company discussed in Note 12.

The following is a calculation of the basic and diluted net (loss) income per common share for 2018 and 2017:

	2018	2017
Net income (loss) available to common stockholders	\$ 3,592	\$ (437)
Weighted average shares outstanding	8,199,000	8,199,000
Weighted average shares outstanding including assumed conversion of preferred stock and other potential stock	10,313,458	8,199,000
Basic net income (loss) per common share	\$ 0.44	\$ (0.05)
Fully diluted net income (loss) per share (including convertible preferred shares outstanding)	\$ 0.35	\$ (0.05)

At December 31, 2017, 2,092,287 shares of convertible preferred stock were not included in the diluted calculation as their effect would have been anti-dilutive.

#### Note 14 - Profit Sharing and Retirement Savings Plan

The Bank has a 401(k) savings plan available to substantially all employees meeting minimum eligibility requirements. Employees may elect to make voluntary contributions to the plan up to the maximum allowed by law. The Bank also matches 100 percent of the employee's initial 1 percent contribution and 50 percent of the next 5 percent. The cost of Bank contributions under the savings plan was \$156 and \$190 in 2018 and 2017, respectively.

#### Note 15 - Restrictions on Cash

The Federal Reserve Bank requires the Bank to maintain reserve balances. The total of those reserve balances including available vault cash at December 31, 2018 and 2017 was \$5,996 and \$6,046 respectively.

#### Note 16 – Fair Value

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

##### Fair Value Hierarchy

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

- Level 1 Valuation is based upon quoted prices for identical instruments traded in active markets.
- Level 2 Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market.
- Level 3 Valuation is generated from model-based techniques that use at least one significant assumption not observable in the market. These unobservable assumptions reflect estimates of assumptions that market participants would use in pricing the asset or liability. Valuation techniques include use of option pricing models, discounted cash flow models and similar techniques.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon third party models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to determine fair value. These adjustments may include amounts to reflect counterparty credit quality, the borrower's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. The Company's valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and

consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date.

#### Recurring - Investment Securities Available for Sale

Securities classified as available for sale are reported at fair value utilizing level 2. For level 2 securities, the Company obtains fair value measurements from multiple independent third party sources. The fair value measurements consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information, and the bond's terms and conditions, among other things.

The following tables summarize the Company's available for sale securities portfolio measured at fair value on a recurring basis as of December 31, 2018 and December 31, 2017, segregated by the level of the valuation inputs within the fair value hierarchy.

	December 31, 2018			
	Level 1	Level 2	Level 3	Total Fair Value
State and political subdivisions	\$ —	\$ 12,836	\$ —	\$ 12,836
Mortgage backed securities	—	50,554	—	50,554
SBA pools	—	5,241	—	5,241
Total available for sale securities	<u>\$ —</u>	<u>\$ 68,631</u>	<u>\$ —</u>	<u>\$ 68,631</u>

	December 31, 2017			
	Level 1	Level 2	Level 3	Total Fair Value
State and political subdivisions	\$ —	\$ 12,511	\$ —	\$ 12,511
Mortgage backed securities	—	59,307	—	59,307
SBA pools	—	6,709	—	6,709
Total available for sale securities	<u>—</u>	<u>\$ 78,527</u>	<u>—</u>	<u>\$ 78,527</u>

#### Recurring - Derivatives

Beginning in 2017, the Company entered into interest rate swaps related to customer loan transactions to manage its interest rate risk. These interest rate swaps, which had a notional value of \$12,890 as of December 31, 2018 and \$7,902 at December 31, 2017, are considered to be derivative financial instruments and are recorded at fair value, based on third party pricing models that are sensitive to market observable data and are therefore classified as level 2 values. The fair value of derivative financial instruments totaled \$38 as of December 31, 2018, compared to \$45 at December 31, 2017.

#### Non Recurring - Loans

The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired and an allowance for loan loss is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. Once a loan is identified as individually impaired, management measures impairment using one of several methods, including appraised collateral value and / or tax assessed value, liquidation value and discounted expected cash flow. Those impaired loans not requiring an allowance represent loans for which the fair value of the expected repayments or collateral exceed the recorded investments in such loans. The Company frequently obtains appraisals prepared by external professional appraisers and applies discounts ranging from 8% to 40% depending on type of property, condition, location, etc. The Company also, in certain instances, prepares internally generated valuations from on-site inspections, third-party valuation models or other information.

#### Non Recurring - Loans Held for Sale

Loans held for sale are carried at the lower of cost or fair value. The fair value of loans held for sale is based on inputs derived from secondary markets for loans with similar characteristics. The Company considers loans held for sale as non-recurring level 2.



Non Recurring—Other Real Estate Owned / Repossessions / Real Estate Held for Sale

Other real estate owned and repossessions are adjusted to fair value upon transfer of the loans to other real estate owned and repossessions. Subsequently, foreclosed assets and repossessions are carried at the lower of carrying value or fair value. Fair value is based upon independent market prices or recent appraised values of the collateral which the Company considers as nonrecurring level 2. When the current appraised value is not available or is further discounted below the most recent appraised value less selling costs due to absorption rates and market conditions, the Company records the foreclosed assets within level 3 of the fair value hierarchy.

Real estate held for sale is adjusted to fair value upon transfer from fixed assets or when no longer being used for banking purposes.

The following table summarizes the Company's assets recorded at fair value on a non-recurring basis as of December 31, 2018 and December 31, 2017, segregated by the level of the valuation inputs within the fair value hierarchy. The tables disclose the recorded investment in impaired loans requiring a specific allowance.

	Level 1	Level 2	Level 3	Total Fair Value
December 31, 2018				
Impaired loans	\$ —	\$ —	\$ 5,100	\$ 5,100
OREO	—	—	2,212	2,212
Real estate held for sale	—	—	817	817
December 31, 2017				
Impaired loans	\$ —	\$ —	\$ 5,967	\$ 5,967
OREO	—	—	2,350	2,350
Real estate held for sale	—	—	1,430	1,430

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis for which the Company uses level 3 inputs to determine fair value:

Quantitative Information about Level 3 Fair Value Measurements						
	December 31,		Valuation Techniques	Unobservable Input (2)	Range	
	2018	2017				
Other real estate owned	\$ 2,212	\$ 2,350	Appraisals (1)	Appraisal adjustments	0% to 20%	
				Liquidation expenses	0% to 10%	
Real estate held for sale	\$ 817	\$ 1,430	Appraisals (1)	Appraisal adjustments	0% to 20%	
				Liquidation expenses	0% to 10%	
Impaired loans	\$ 5,100	\$ 5,967	Fair value of collateral—real estate (1), (3)	Appraisal adjustments	0% to 100%	
			Fair value of collateral—equipment, inventory, other (1), (3)	Appraisal adjustments	25% to 80%	
				Liquidation expenses	0% to 12%	

Valuation adjustments and liquidation cost adjustments represent unobservable inputs for OREO and impaired loans. The ranges of discounts applied are based on age of independent appraisals, type and condition of collateral, current market conditions, and experience with the local market.

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

#### Fair Value of Financial Instruments

Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Fair value is best determined based upon quoted market prices. However, in many instances, there are no quoted market prices for the Company's various financial instruments. In cases where quoted market prices are not available, fair values are based on estimates using present value or other valuation techniques. Those techniques are significantly affected by the assumptions used, including the discount rate and estimates of future cash flows. Fair value estimates may not be realized in an immediate settlement, and the aggregate fair value amounts presented may not necessarily represent the underlying fair value of the Company.

#### Cash and Cash Equivalents

The carrying amount reported in the balance sheets for cash, short-term investments and federal funds sold approximates fair value. The fair value of cash and cash equivalents is measured using level 1 inputs.

#### Investment Securities Available for Sale

Fair values are determined in the manner described above. The fair value of investment securities available for sale is measured using level 2 inputs.

#### Other Investments

Other investments include Federal Home Loan Bank stock, Federal Reserve Bank stock, and investments in correspondent bank stock. The carrying value of those securities approximates fair value based on the redemption provisions of those Banks. The fair value of other investments is measured using level 2 inputs.

#### Loans

The fair value of loans represent the amount at which the loans of the Bank could be exchanged on the open market, based upon the current lending rate for similar types of lending arrangements discounted over the remaining life of the loans. For fixed rate loans and for variable rate loans with infrequent re-pricing or re-pricing limits, fair value is based on discounted cash flows using current market rates applied to the cash flow analysis. The fair value of loans is measured using level 3 inputs.

#### Deposits

The fair value of time deposits is based on discounted cash flows using current market rates applied to the cash flow analysis for each time deposit. Other non-maturity deposits are reported at their carrying values. The fair value of deposits is measured using level 2 inputs.

#### Short-Term Borrowings

Fair values of short-term borrowings are estimated using discounted cash flow analyses based on the Company's current incremental borrowing rates for similar types of borrowing arrangements. Estimated maturity dates are also included in the calculation of fair value for these borrowings. The fair value of short-term borrowings is measured using level 2 inputs.

#### Long-term Debt

Rates currently available to the Company for debt with similar terms and remaining maturities or established call prices are used to estimate fair value of existing debt. The fair value of long-term debt borrowings is measured using level 2 inputs.

#### Off-Balance Sheet Instruments

Off-balance sheet instruments include commitments to extend credit, standby letters of credit, and financial guarantees. Because of the uncertainty involved in attempting to assess the likelihood and timing of commitments being drawn upon, coupled with the lack of an established market and the wide diversity of fee structures, the Company does not believe it is meaningful to provide an estimate of fair value for these instruments.

The carrying amounts and fair values of the Company's financial instruments at December 31, 2018 and December 31, 2017 were as follows:

	December 31, 2018		December 31, 2017	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Cash and cash equivalents	\$ 27,016	\$ 27,016	\$ 27,016	\$ 27,016
Securities available for sale	68,631	68,631	78,527	78,527
Other investments	2,774	2,774	3,116	3,116
Loans held for sale	697	697	4,808	4,808
Loans, net	443,748	429,289	427,620	429,467
Interest rate swaps	38	38	45	45
Deposits	502,816	422,570	498,783	424,664
Short-term borrowings	30,000	30,142	10,000	10,000
Long-term debt	93	89	30,243	30,780

#### Note 17 - Related Party Transactions

In the normal course of business, the Bank has made loans to its directors, officers and their affiliates. All loans and commitments made to such officers and directors and to companies in which they are officers or have significant ownership interest have been made on substantially the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated persons, and did not, in the opinion of management, involve more than normal credit risk or present other unfavorable features.

The following table summarizes loans to related parties during the years ended December 31, 2018 and 2017:

	2018	2017
Balance, beginning of period	\$ 1,885	\$ 4,703
Additions	—	211
Reductions	(1,132)	(3,029)
Balance, end of period	\$ 753	\$ 1,885

Deposits from related parties held by the Bank at December 31, 2018 and 2017 were \$349 and \$1,156 respectively.

#### Note 18 - Minimum Regulatory Capital Requirements

Regulators of the Company's subsidiary, Highlands Union Bank (the "Bank"), have implemented risk-based capital guidelines that require compliance with certain minimum capital ratios as a percent of assets and other certain off-balance sheet items, which are adjusted for predefined credit risk factors.

Under rules previously enacted under BASEL III, the Bank was required to maintain a minimum common equity tier 1 ("CET1") ratio, increase the tier 1 risk-based ratio, change the risk weighting of certain assets for risk-based capital ratios, create an additional capital conservation buffer over the required capital ratios and change what qualifies as capital for purposes of meeting these various capital requirements. Beginning in 2016, failure to maintain the required capital conservation buffer will limit the ability of the Bank to pay dividends, repurchase shares or pay discretionary bonuses.

Under current regulations applicable to the Bank, the minimum capital ratios are: (1) CET1 capital ratio of 4.5 percent of risk-weighted assets (new); (2) tier 1 capital ratio of 6.0 percent of risk-weighted assets (increased from 4.0 percent); (3) total capital ratio of 8.0 percent of risk-weighted assets (unchanged); and (4) leverage ratio of 4.0 percent (unchanged). CET1 generally consists of common stock and retained earnings, subject to applicable regulatory adjustments and deductions.

As permitted under the final guidelines, the Bank has irrevocably elected to exclude accumulated other comprehensive income in our capital calculations. This election reduces the impact of market volatility on our regulatory capital.

In addition to the minimum CET1, tier 1 and total capital ratios, the Bank is required to maintain a capital conservation buffer consisting of additional CET1 capital greater than 2.5 percent of risk-weighted assets above the required minimum levels in order to avoid limitations on paying dividends, engaging in share repurchases, and paying discretionary bonuses based on percentages of eligible retained income that could be utilized for such actions. The implementation of the new capital conservation buffer requirement began in January 2016 at 0.625 percent of risk-weighted assets and has increased each subsequent year. The fully-implemented capital conservation buffer became effective for the Bank in January 2019.

As of December 31, 2018, the Bank meets all capital ratio requirements, including the fully-implemented capital conservation buffer. The following table provides the Bank's actual and required capital amounts and ratios as of December 31, 2018 and December 31, 2017:

	Actual		To Be Well Capitalized under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio
As of December 31, 2018:				
Tier 1 leverage capital to total adjusted assets	\$ 54,292	9.14%	\$ 29,713	=> 5%
Common equity tier 1 capital to risk-weighted assets	54,292	12.31%	28,670	=> 6.5%
Tier 1 capital to risk-weighted assets	54,292	12.31%	35,286	=> 8%
Total capital to risk-weighted assets	58,665	13.30%	44,108	=> 10%
As of December 31, 2017:				
Tier 1 leverage capital to total adjusted assets	49,547	8.36%	29,631	=> 5%
Common equity tier 1 capital to risk-weighted assets	49,547	12.15%	26,516	=> 6.5%
Tier 1 capital to risk-weighted assets	49,547	12.15%	32,635	=> 8%
Total capital to risk-weighted assets	53,501	13.11%	40,794	=> 10%

The Company is exempt from consolidated capital requirements as those requirements do not apply to certain small bank holding companies with assets under \$1 billion.

#### Note 19 - Restrictions on Dividends

The Parent Company's principal asset is its investment in the Bank, its wholly-owned consolidated subsidiary. The primary source of income for the Parent Company historically has been dividends from the Bank. Regulatory agencies limit the amount of funds that may be transferred from the Bank to the Parent Company in the form of dividends, loans or advances.

Under applicable laws and without prior regulatory approval, the total dividend payments of the Bank in any calendar year are restricted to the net profits of that year, as defined, combined with the retained net profits for the two preceding years.

Currently, the Company and Bank are prohibited from paying dividends unless regulatory approval is obtained (See Note 2 Formal Written Agreement).

**Note 20 - Other Operating Income and Other Operating Expense**

Other operating income and other operating expense that exceed 1 percent of the total of interest income and noninterest income include the following:

	2018	2017
Other noninterest income includes:		
BOLI income	\$ 342	\$ 365
Other noninterest expense includes:		
Software licensing/maintenance	\$ 1,467	\$ 1,300
FDIC insurance	425	488
Other insurance	435	390
Other contracted services	561	466
Bank franchise taxes	480	474
Write-down of real estate held for sale	235	—
Audit	457	332
Printing and postage	379	385
Legal	466	113
All other items	1,943	1,866
Other noninterest expense	<u>\$ 6,848</u>	<u>\$ 5,814</u>

**Note 21 - Condensed Parent Company Financial Statements**

The condensed financial statements below relate to Highlands Bankshares, Inc., as of December 31, 2018 and 2017, and for the years then ended. Equity in undistributed earnings of subsidiary includes the change in unrealized gains or losses on securities, net of tax.

**CONDENSED BALANCE SHEETS**

	December 31, 2018	December 31, 2017
<b>ASSETS</b>		
Cash	\$ 215	\$ 215
Other investments	102	102
Equity in subsidiary	56,324	53,487
Total assets	<u>\$ 56,641</u>	<u>\$ 53,804</u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>		
Stockholders' equity	\$ 56,641	\$ 53,804
Total liabilities and stockholders' equity	<u>\$ 56,641</u>	<u>\$ 53,804</u>

# CONDENSED STATEMENTS OF INCOME

	Year ended December 31,	
	2018	2017
Interest and dividend income	\$ 5	\$ 5
Operating expense	(196)	(255)
Loss before income tax benefit	(191)	(250)
Income tax benefit	40	85
Equity in undistributed (loss) earnings of subsidiary	3,743	(272)
Net (loss) income	<u>\$ 3,592</u>	<u>\$ (437)</u>

# CONDENSED STATEMENTS OF CASH FLOWS

	Year ended December 31,	
	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$ 3,592	\$ (437)
Adjustments to reconcile net income to net cash Used in operating activities:		
Restricted stock expense	197	221
Equity in undistributed loss (earnings) of subsidiary	(3,743)	272
Decrease (increase) in other assets	(46)	(65)
Net cash provided (used) in operating activities	<u>—</u>	<u>(9)</u>
Net increase in cash and cash equivalents	<u>—</u>	<u>(9)</u>
Cash and cash equivalents at beginning of year	215	224
Cash and cash equivalents at end of year	<u>\$ 215</u>	<u>\$ 215</u>



## **Item 9. Changes in and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

### **Item 9A. Controls and Procedures**

We have carried out an evaluation, under the supervision and the participation of our management, including our Chief Executive Officer and Chief Financial Officer, of the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Exchange Act) as of the end of the period covered by this report. Based upon that evaluation, our Chief Executive Officer and Chief Financial Officer concluded that our disclosure controls and procedures are effective in providing reasonable assurance that (a) the information required to be disclosed by us in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (b) such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

There have not been any changes in the Company's internal controls over financial reporting during the fourth quarter of 2018 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

### **Management's Annual Report on Internal Control Over Financial Reporting**

Management is responsible for establishing and maintaining adequate internal control over financial reporting (as such term is defined in Rule 13a-15(f) under the Exchange Act). Our internal control over financial reporting includes those policies and procedures that (i) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of our assets; (ii) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with U.S. generally accepted accounting principles, and that our receipts and expenditures are being made only in accordance with authorizations of our management and directors; and (iii) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of our assets that could have a material effect on the financial statements.

Because of the inherent limitations in any internal control, no matter how well designed, misstatements may occur and not be prevented or detected. Accordingly, even effective internal control over financial reporting can provide only reasonable assurance with respect to financial statement preparation. Further, the evaluation of the effectiveness of internal control over financial reporting was made as of a specific date, and continued effectiveness in future periods is subject to the risks that controls may become inadequate because of changes in conditions or that the degree of compliance with the policies and procedures may decline.

Management conducted an evaluation of the effectiveness of our system of internal control over financial reporting as of December 31, 2018 based on the framework set forth in the Committee of Sponsoring Organizations of the Treadway Commission's 2013 Internal Control - Integrated Framework. Based on its evaluation, management concluded that, as of December 31, 2018, Highlands Bankshares Inc.'s internal control over financial reporting was effective.

## **Item 9B. Other Information**

None

## **PART III.**

### **Item 10. Directors, Executive Officers and Corporate Governance**

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings "The Nominees," "Executive Officers Who Are Not Directors," "Section 16(a) Beneficial Ownership Reporting Compliance," "The Board of Directors and its Committees" and "Code of Ethics" in the Company's Proxy Statement for the 2019 Annual Meeting of Shareholders is incorporated herein by reference.

### **Item 11. Executive Compensation**

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings "Executive Compensation" in the Company's Proxy Statement for the 2019 Annual Meeting of Shareholders is incorporated herein by reference.

### **Item 12. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings "Security Ownership of Certain Beneficial Owners" and "Security Ownership of Management" in the Company's Proxy Statement for the 2019 Annual Meeting of Shareholders is incorporated herein by reference.

### **Item 13. Certain Relationships and Related Transactions, and Director Independence**

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the heading "Transactions with Related Parties" and "The Board of Directors and its Committees" in the Company's Proxy Statement for the 2019 Annual Meeting of Shareholders is incorporated herein by reference.

### **Item 14. Principal Accounting Fees and Services**

Pursuant to General Instruction G(3) of Form 10-K, the information contained under the headings "Services and Fees" and "Pre-Approved Policies and Procedures" in the Company's Proxy Statement for the 2019 Annual Meeting of Shareholders is incorporated herein by reference.

## PART IV.

### Item 15. Exhibits

Exhibit Number	Description
3.1	<u>Amended and Restated Articles of Incorporation of Highlands Bankshares, Inc., filed as Exhibit 3.1 to the Quarterly Report on Form 10-Q for the period ended March 31, 2009</u>
3.2	<u>Articles of Amendment to the Articles of Incorporation of Highlands Bankshares, Inc. (attached as Exhibit 3.1 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)</u>
3.3	<u>Bylaws of the Company, as amended and restated March 23, 2018 (attached as Exhibit 3.1 to the Current Report on Form 8-K filed March 28, 2018 and incorporated by reference herein)</u>
10.1	<u>Securities Purchase Agreement, dated April 14, 2014, by and between Highlands Bankshares, Inc. and TNH Financials Fund, L.P. (attached as Exhibit 10.1 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)</u>
10.2	<u>Form of Securities Purchase Agreement, dated April 14, 2014, by and among Highlands Bankshares, Inc. and certain institutional investors (attached as Exhibit 10.2 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)</u>
10.3	<u>Form of Securities Purchase Agreement, dated April 14, 2014, by and among Highlands Bankshares, Inc. and certain institutional investors (attached as Exhibit 10.3 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)</u>
10.4	<u>Form of Securities Purchase Agreement, dated April 14, 2014, by and among Highlands Bankshares, Inc. and certain directors and executive officers (attached as Exhibit 10.4 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)</u>
10.5	<u>Form of Director Indemnification Agreement (attached as Exhibit 10.5 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)</u>
10.6	<u>Highlands Union Bank 1995 Stock Option Plan, attached as Exhibit 10.1 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2002, File No. 000-27622, incorporated herein by reference</u>
10.7	<u>Highlands Bankshares, Inc. 2006 Equity Compensation Plan, filed as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 20, 2006, incorporated herein by reference</u>
10.8	<u>Written Agreement, dated October 13, 2010, between Highlands Bankshares, Inc., Highlands Union Bank and the Federal Reserve Bank of Richmond, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on October 19, 2010, incorporated herein by reference</u>
10.9	<u>Employment Agreement, dated December 9, 2015, between Highlands Bankshares, Inc., and Timothy K. Schools, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on December 14, 2015, incorporated herein by reference</u>
10.10	<u>First Amendment to Employment Agreement between Highlands Bankshares, Inc. and Timothy K. Schools, dated September 6, 2016, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 22, 2016, incorporated herein by reference</u>
10.11	<u>Restricted Stock Award Agreement between Highlands Bankshares, Inc. and Timothy K. Schools, dated September 6, 2016, attached as Exhibit 10.2 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 22, 2016, incorporated herein by reference</u>
10.12	<u>Consulting Agreement, dated February 15, 2016, between Highlands Bankshares, Inc., and Samuel L. Neese, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on February 19, 2016, incorporated herein by reference</u>
21	<u>Subsidiaries of the Corporation (filed herewith)</u>
23	<u>Consent of Brown, Edwards &amp; Company, L.L.P. (filed herewith)</u>
24	<u>Power of Attorney (filed herewith)</u>
31.1	<u>Section 302 Certification of Chief Executive Officer (filed herewith)</u>
31.2	<u>Section 302 Certification of Chief Financial Officer of the Corporation (filed herewith)</u>
32.1	<u>Statement of Chief Executive Officer Pursuant to 18 U.S.C. § 1350 (filed herewith)</u>
32.2	<u>Statement of Chief Financial Officer of the Corporation Pursuant to 18 U.S.C. § 1350 (filed herewith)</u>
101	<u>The following materials from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2018, formatted in Extensible Business Reporting Language (XBRL), include: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Cash Flows; (v) Consolidated Statements of Changes in Stockholders' Equity and (vi) related notes (furnished herewith).</u>

## SIGNATURES

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

### HIGHLANDS BANKSHARES, INC (Registrant)

Date: March 28, 2019

By: /s/ Timothy K. Schools  
Timothy K. Schools, President and Chief Executive Officer

Date: March 28, 2019

/s/ John H. Gray  
John H. Gray, Chief Financial Officer

Pursuant to the requirements of the Securities Exchange Act of 1934, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated:

<u>Signature</u>	<u>Title</u>	<u>Date</u>
<u>/s/ Robert W. Moser, Jr. *</u> Robert W. Moser, Jr.	Chairman of the Board of Directors	March 28, 2019
<u>/s/ Timothy K. Schools</u> Timothy K. Schools	Chief Executive Officer (principal executive officer) and Director	March 28, 2019
<u>/s/ John H. Gray</u> John H. Gray	Chief Financial Officer (principal accounting officer)	March 28, 2019
<u>/s/ E. Sutton Bacon, Jr. *</u> E. Sutton Bacon, Jr.	Director	March 28, 2019
<u>/s/ E. Craig Kendrick *</u> E. Craig Kendrick	Director	March 28, 2019
<u>/s/ Jon C. Lundberg *</u> Jon C. Lundberg	Director	March 28, 2019
<u>/s/ Charles D. Meade, III *</u> Charles D. Meade, III	Director	March 28, 2019
<u>/s/ Charles P. Olinger *</u> Charles P. Olinger	Director	March 28, 2019
<u>/s/ Edward M. Rosinus *</u> Edward M. Rosinus	Director	March 28, 2019

\* Robert M. Little, Jr. hereby signs this Annual Report on Form 10-K on March 28, 2019 on behalf of the indicated persons for whom he is attorney-in-fact pursuant to a Power of Attorney filed herewith.

By: /s/ Robert M. Little, Jr.  
Robert M. Little, Jr. as Attorney-in-Fact

## Exhibit Index

- 3.1 Amended and Restated Articles of Incorporation of Highlands Bankshares, Inc., filed as Exhibit 3.1 to the Quarterly Report on Form 10-Q for the period ended March 31, 2009
- 3.2 Articles of Amendment to the Articles of Incorporation of Highlands Bankshares, Inc. (attached as Exhibit 3.1 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)
- 3.3 Bylaws of the Company, as amended and restated March 23, 2018 (attached as Exhibit 3.1 to the Current Report on Form 8-K filed March 28, 2018 and incorporated by reference herein)
- 10.1 Securities Purchase Agreement, dated April 14, 2014, by and between Highlands Bankshares, Inc. and TNH Financials Fund, L.P. (attached as Exhibit 10.1 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)
- 10.2 Form of Securities Purchase Agreement, dated April 14, 2014, by and among Highlands Bankshares, Inc. and certain institutional investors (attached as Exhibit 10.2 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)
- 10.3 Form of Securities Purchase Agreement, dated April 14, 2014, by and among Highlands Bankshares, Inc. and certain institutional investors (attached as Exhibit 10.3 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)
- 10.4 Form of Securities Purchase Agreement, dated April 14, 2014, by and among Highlands Bankshares, Inc. and certain directors and executive officers (attached as Exhibit 10.4 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)
- 10.5 Form of Director Indemnification Agreement (attached as Exhibit 10.5 to the Current Report on Form 8-K filed April 16, 2014 and incorporated by reference herein)
- 10.6 Highlands Union Bank 1995 Stock Option Plan, attached as Exhibit 10.1 to the Annual Report on Form 10-K for the fiscal year ended December 31, 2002, File No. 000-27622, incorporated herein by reference
- 10.7 Highlands Bankshares, Inc. 2006 Equity Compensation Plan, filed as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 20, 2006, incorporated herein by reference
- 10.8 Written Agreement, dated October 13, 2010, between Highlands Bankshares, Inc., Highlands Union Bank and the Federal Reserve Bank of Richmond, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on October 19, 2010, incorporated herein by reference
- 10.9 Employment Agreement, dated December 9, 2015, between Highlands Bankshares, Inc., and Timothy K. Schools, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on December 14, 2015, incorporated herein by reference
- 10.1 First Amendment to Employment Agreement between Highlands Bankshares, Inc. and Timothy K. Schools, dated September 6, 2016, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 22, 2016, incorporated herein by reference
- 10.1 Restricted Stock Award Agreement between Highlands Bankshares, Inc. and Timothy K. Schools, dated September 6, 2016, attached as Exhibit 10.2 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on September 22, 2016, incorporated herein by reference
- 10.1 Consulting Agreement, dated February 15, 2016, between Highlands Bankshares, Inc., and Samuel L. Neese, attached as Exhibit 10.1 to the Current Report on Form 8-K, File No. 000-27622, filed with the Commission on February 19, 2016, incorporated herein by reference
- 21 Subsidiaries of the Corporation (filed herewith)
- 23 Consent of Brown, Edwards & Company, L.L.P. (filed herewith)
- 24 Power of Attorney (filed herewith)
- 31.1 Section 302 Certification of Chief Executive Officer (filed herewith)
- 31.2 Section 302 Certification of Chief Financial Officer of the Corporation (filed herewith)
- 32.1 Statement of Chief Executive Officer Pursuant to 18 U.S.C. § 1350 (filed herewith)
- 32.2 Statement of Chief Financial Officer of the Corporation Pursuant to 18 U.S.C. § 1350 (filed herewith)
- 101 The following materials from the Registrant's Annual Report on Form 10-K for the year ended December 31, 2018, formatted in Extensible Business Reporting Language (XBRL), include: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income, (iii) the Consolidated Statements of Comprehensive Income, (iv) Consolidated Statements of Cash Flows; (v) Consolidated Statements of Changes in Stockholders' Equity and (vi) related notes (furnished herewith).