



EDGEWATER

BANCORP, INC.

2019

AUDITED FINANCIAL STATEMENT

FOR STOCKHOLDERS

Edgewater Bancorp, Inc.

Independent Auditor's Report
and Consolidated Financial Statements

December 31, 2019 and 2018

Edgewater Bancorp, Inc.

December 31, 2019 and 2018

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Independent Auditor's Report

Stockholders and Board of Directors
Edgewater Bancorp, Inc.
St. Joseph, Michigan

We have audited the accompanying consolidated financial statements of Edgewater Bancorp, Inc. and its subsidiary, which comprise the consolidated balance sheets as of December 31, 2019 and 2018, and the related consolidated statements of income, comprehensive income, stockholders' equity and cash flows for the years then ended, and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

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

Auditor's Responsibility

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

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

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

Opinion

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of Edgewater Bancorp, Inc. and its subsidiary as of December 31, 2019 and 2018, and the results of their operations and their cash flows for the years then ended in accordance with accounting principles generally accepted in the United States of America.

BKD, LLP

Fort Wayne, Indiana
March 24, 2020

Edgewater Bancorp, Inc.
Consolidated Balance Sheets
December 31, 2019 and 2018

| | <u>2019</u> | <u>2018</u> |
|---|----------------------------------|----------------------------------|
| Assets | | |
| Cash and due from banks | \$ 914,818 | \$ 1,037,182 |
| Interest-earning demand accounts | 6,441,172 | 20,254,877 |
| Cash and cash equivalents | <u>7,355,990</u> | <u>21,292,059</u> |
| Interest-bearing time deposits | 4,436,000 | 1,964,000 |
| Available-for-sale securities | 9,052,997 | 13,433,920 |
| Loans held for sale | 50,000 | - |
| Loans receivable, net of allowance for losses of \$1,614,390 and \$1,401,935, respectively | 158,109,103 | 126,941,521 |
| Premises and equipment, net | 3,046,523 | 2,957,803 |
| Federal Home Loan Bank (FHLB) stock | 686,200 | 686,200 |
| Interest receivable | 511,209 | 462,536 |
| Mortgage servicing rights | 351,447 | 365,277 |
| Deferred tax asset | 1,695,219 | 1,393,337 |
| Other assets | <u>643,155</u> | <u>498,638</u> |
| Total assets | <u><u>\$ 185,937,843</u></u> | <u><u>\$ 169,995,291</u></u> |
| Liabilities and Stockholders' Equity | | |
| Liabilities | | |
| Deposits | | |
| Noninterest bearing | \$ 21,195,230 | \$ 22,176,701 |
| Interest-bearing | <u>130,863,522</u> | <u>121,574,192</u> |
| Total deposits | 152,058,752 | 143,750,893 |
| Federal Home Loan Bank advances | 13,000,000 | 7,000,000 |
| Other borrowings | 1,807,908 | 1,967,263 |
| Accrued and other liabilities | <u>2,105,094</u> | <u>1,878,487</u> |
| Total liabilities | <u>168,971,754</u> | <u>154,596,643</u> |
| Temporary Equity | | |
| ESOP shares subject to mandatory redemption | <u>180,006</u> | <u>142,822</u> |
| Stockholders' Equity | | |
| Preferred stock - shares authorized 1,000,000; none issued or outstanding at \$.01 par value | - | - |
| Common stock - shares authorized 4,000,000; shares issued and outstanding 724,999 (2019) and 705,616 (2018) at \$.01 par value | 7,250 | 7,056 |
| Paid-in-capital | 5,074,545 | 4,844,037 |
| Retained earnings | 11,629,325 | 10,531,225 |
| Accumulated other comprehensive income (loss) | 74,963 | (126,492) |
| Total equity | <u>16,786,083</u> | <u>15,255,826</u> |
| Total liabilities and stockholders' equity | <u><u>\$ 185,937,843</u></u> | <u><u>\$ 169,995,291</u></u> |

Edgewater Bancorp, Inc.
Consolidated Statements of Income
Years Ended December 31, 2019 and 2018

| | <u>2019</u> | <u>2018</u> |
|---|---------------------|---------------------|
| Interest Income | | |
| Loans, including fees | \$ 6,911,375 | \$ 5,805,923 |
| Debt securities | | |
| Taxable | 348,312 | 293,178 |
| Tax-exempt | 31,340 | 28,426 |
| Federal Home Loan Bank stock | 37,044 | 34,348 |
| Other | 333,337 | 283,612 |
| Total interest income | <u>7,661,408</u> | <u>6,445,487</u> |
| Interest Expense | | |
| Deposits | 1,245,197 | 805,067 |
| Federal Home Loan Bank advances | 171,386 | 110,844 |
| Other borrowing | 97,059 | 57,655 |
| Total interest expense | <u>1,513,642</u> | <u>973,566</u> |
| Net Interest Income | 6,147,766 | 5,471,921 |
| Provision for loan losses | <u>262,500</u> | <u>150,000</u> |
| Net Interest Income After Provision for Loan Losses | <u>5,885,266</u> | <u>5,321,921</u> |
| Noninterest Income | | |
| Service charges, deposits | 356,678 | 335,090 |
| Mortgage banking activities | 336,487 | 342,601 |
| Net losses on available-for-sale securities | - | (509) |
| Other | 162,848 | 170,737 |
| Total noninterest income | <u>856,013</u> | <u>847,919</u> |
| Noninterest Expense | | |
| Salaries and employee benefits | 3,537,445 | 2,968,352 |
| Multiple employer defined benefit pension termination expense | 150,068 | 1,231,000 |
| Occupancy and equipment | 637,528 | 630,757 |
| Data processing | 696,241 | 596,246 |
| Gain on sale of other real estate, net | (32,200) | (4,015) |
| Interchange | 3,933 | 35,349 |
| Advertising | 148,707 | 119,823 |
| FDIC insurance premiums | 49,217 | 62,184 |
| Other real estate | 12,273 | 28,416 |
| Professional fees | 287,317 | 270,326 |
| Insurance | 36,938 | 46,673 |
| Other | 418,192 | 351,585 |
| Total noninterest expense | <u>5,945,659</u> | <u>6,336,696</u> |
| Income (Loss) Before Income Taxes | 795,620 | (166,856) |
| Income Tax Benefit | <u>(302,480)</u> | <u>(1,412,667)</u> |
| Net Income | <u>\$ 1,098,100</u> | <u>\$ 1,245,811</u> |
| Basic and Diluted Income Per Share | <u>\$ 1.50</u> | <u>\$ 1.89</u> |

Edgewater Bancorp, Inc.
Consolidated Statements of Comprehensive Income
Years Ended December 31, 2019 and 2018

| | <u>2019</u> | <u>2018</u> |
|--|---------------------|---------------------|
| Net Income | <u>\$ 1,098,100</u> | <u>\$ 1,245,811</u> |
| Other Comprehensive Income (Loss) | | |
| Unrealized appreciation (depreciation) on available-for-sale debt securities | 255,006 | (84,721) |
| Less: reclassification adjustment for realized losses included in net income | <u>-</u> | <u>(509)</u> |
| Other comprehensive income (loss) before income tax benefit | 255,006 | (84,212) |
| Tax benefit (expense) | <u>(53,551)</u> | <u>17,684</u> |
| | <u>201,455</u> | <u>(66,528)</u> |
| Comprehensive Income | <u>\$ 1,299,555</u> | <u>\$ 1,179,283</u> |

Edgewater Bancorp, Inc.
Consolidated Statements of Stockholders' Equity
Years Ended December 31, 2019 and 2018

| | Shares | Common Stock | Paid-in Capital | Retained Earnings | Accumulated Other Comprehensive Income (Loss) | Total |
|---|----------------|-----------------|---------------------|----------------------|--|----------------------|
| Balance at January 1, 2018 | 683,198 | \$ 6,832 | \$ 4,734,077 | \$ 9,285,414 | \$ (59,964) | \$ 13,966,359 |
| Issuance of common stock (restricted) net of forfeitures of 2,430 shares | 22,970 | 230 | (230) | - | - | - |
| Net income | - | - | - | 1,245,811 | - | 1,245,811 |
| Stock-based compensation expense | - | - | 120,210 | - | - | 120,210 |
| Shares repurchased for employee tax costs upon vesting of restricted stock | (552) | (6) | (10,020) | - | - | (10,026) |
| Other comprehensive loss | - | - | - | - | (66,528) | (66,528) |
| Balance at December 31, 2018 | 705,616 | 7,056 | 4,844,037 | 10,531,225 | (126,492) | 15,255,826 |
| Issuance of common stock (restricted) net of forfeitures of 3,060 shares | 19,940 | 200 | (200) | - | - | - |
| Net income | - | - | - | 1,098,100 | - | 1,098,100 |
| Stock-based compensation expense | - | - | 243,019 | - | - | 243,019 |
| Shares repurchased for employee tax costs upon vesting of restricted stock | (557) | (6) | (12,311) | - | - | (12,317) |
| Other comprehensive income | - | - | - | - | 201,455 | 201,455 |
| Balance at December 31, 2019 | 724,999 | \$ 7,250 | \$ 5,074,545 | \$ 11,629,325 | \$ 74,963 | \$ 16,786,083 |

Edgewater Bancorp, Inc.
Consolidated Statements of Cash Flows
Years Ended December 31, 2019 and 2018

| | <u>2019</u> | <u>2018</u> |
|---|---------------------|----------------------|
| Operating Activities | | |
| Net income | \$ 1,098,100 | \$ 1,245,811 |
| Items not requiring (providing) cash | | |
| Depreciation and amortization | 289,199 | 268,366 |
| Provision for loan losses | 262,500 | 150,000 |
| Net (accretion) amortization of available-for-sale securities | (5,560) | 14,087 |
| ESOP shares earned | 37,184 | 35,329 |
| Stock-based compensation expense | 243,019 | 120,210 |
| Change in fair value of mortgage servicing rights | 18,374 | (2,748) |
| Gain on sale of other real estate | (32,200) | (4,015) |
| Amortization of mortgage servicing rights | 93,764 | 90,360 |
| Deferred income taxes | (321,810) | (1,393,336) |
| Loans originated for sale | (10,397,725) | (8,970,440) |
| Proceeds from loans sold | 10,405,617 | 9,037,941 |
| Gain on sale of loans | (156,200) | (148,315) |
| Loss on sale of available-for-sale securities | - | 509 |
| Change in | | |
| Interest receivable and other assets | (226,815) | (166,834) |
| Interest payable and other liabilities | 226,607 | 1,198,270 |
| Net cash provided by operating activities | <u>1,534,054</u> | <u>1,475,195</u> |
| Investing Activities | | |
| Purchases of available-for-sale securities | - | (6,957,477) |
| Proceeds from calls, maturities and paydowns of available-for-sale securities | 4,641,491 | 4,388,716 |
| Proceeds from sale of available-for-sale securities | - | 240,591 |
| Net change in interest-bearing time deposits | (2,472,000) | (1,964,000) |
| Net change in loans | (31,494,299) | (8,180,935) |
| Proceeds from sale of other real estate | 96,417 | 537,263 |
| Purchases of premises and equipment | (377,919) | (200,061) |
| Net cash used in investing activities | <u>(29,606,310)</u> | <u>(12,135,903)</u> |
| Financing Activities | | |
| Net change in deposits | 8,307,859 | 6,120,621 |
| Proceeds from short-term Federal Home Loan Bank advances | 6,000,000 | - |
| Proceeds from long-term Federal Home Loan Bank advances | 5,000,000 | 5,000,000 |
| Repayment of short-term Federal Home Loan Bank advances | (3,000,000) | - |
| Repayment of long-term Federal Home Loan Bank advances | (2,000,000) | (2,000,000) |
| Repurchase of common stock | (12,317) | (10,026) |
| Proceeds from other borrowings | - | 2,000,000 |
| Repayment of other borrowings | (159,355) | (32,737) |
| Net cash provided by financing activities | <u>14,136,187</u> | <u>11,077,858</u> |
| Net Change in Cash and Cash Equivalents | (13,936,069) | 417,150 |
| Cash and Cash Equivalents, Beginning of Period | <u>21,292,059</u> | <u>20,874,909</u> |
| Cash and Cash Equivalents, End of Period | <u>\$ 7,355,990</u> | <u>\$ 21,292,059</u> |
| Additional Cash Flows Information | | |
| Interest paid | \$ 1,510,376 | \$ 972,131 |
| Loans transferred to other real estate | 64,217 | 37,800 |
| Capitalization of mortgage servicing rights | 98,308 | 80,814 |

Edgewater Bancorp, Inc.
Notes to Consolidated Financial Statements
December 31, 2019 and 2018

Note 1: Nature of Operations and Summary of Significant Accounting Policies

Nature of Operations and Conversion

Edgewater Bancorp Inc. is a bank holding company that owns Edgewater Bank. Edgewater Bank, a state chartered commercial bank (Bank) is primarily engaged in providing a full range of banking and financial services to individual and corporate customers in the Berrien, Van Buren and to a lesser extent Cass Counties, Michigan. The Bank is subject to competition from other financial institutions. The Bank is subject to the regulation of the certain federal and state agencies and undergoes periodic examinations by those regulatory authorities.

The Bank's wholly-owned subsidiary, Edgewater Insurance Agency, Inc. (EIA) is included in the consolidated financial statements. EIA is used to collect premiums and receive commissions for insurance related benefits the Bank offers its employees.

On January 16, 2014, the Bank completed a mutual-to-stock conversion pursuant to which the Bank became the wholly-owned subsidiary of Edgewater Bancorp, Inc. (Company), a Maryland stock holding corporation. In connection with the conversion, the Company sold 667,898 shares of common stock, at an offering price of \$10 per share.

The net proceeds from the stock offering, net of offering costs of approximately \$1,455,000, amounted to approximately \$4,690,000. Also, in connection with the conversion, the Bank established an employee stock ownership plan (ESOP), which purchased 53,431 shares of the Company's common stock at a price of \$10 per share.

On January 27, 2017, a Form 15 was filed giving notice of termination of registration under Section 12(g) of the Securities Exchange Act of 1934 or suspension of duty to file reports under sections 13 and 15(d) of the *Securities and Exchange Act of 1934*. Edgewater Bancorp, Inc. is no longer an SEC registrant. The Company's stock is currently quoted on the OTC Pink operated by OTC Markets Group, Inc. under the symbol "EGDW."

In accordance with the regulations, at the time of the conversion of the mutual bank to a stock holding company, the Company was required to substantially restrict retained earnings by establishing a liquidation account and the Bank established a parallel liquidation account. The liquidations account will be maintained for the benefit of eligible holders who continue to maintain their accounts at the Bank after conversion. The liquidation account will be reduced annually to the extent that eligible account holders have reduced their qualifying deposits. Subsequent increases will not restore an eligible account holders' interest in the liquidation account. In the event of a complete liquidation of the Bank, and only in such event, each account holder will be entitled to receive a distribution from the liquidation account in an amount proportionate to the adjusted qualifying account balances then held. The Bank may not pay dividends if those dividends would reduce equity capital below the required liquidation account amount.

Edgewater Bancorp, Inc.
Notes to Consolidated Financial Statements
December 31, 2019 and 2018

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and its subsidiary. All significant intercompany accounts and transactions have been eliminated in consolidation.

Use of Estimates

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

Material estimates that are particularly susceptible to significant change relate to the determination of the allowance for loan losses, accrual for termination of multiple employer defined benefit plan and fair values of financial instruments.

Cash and Cash Equivalents

The Company considers all liquid investments with original maturities of three months or less to be cash equivalents. At December 31, 2019 and 2018, the Company had no cash equivalents.

At December 31, 2019, none of the Company's cash accounts at nonfederal government or governmental related entities exceeded federally insured limits, which is \$250,000 per covered institution.

Interest-bearing Deposits in Banks

Interest-bearing deposits in banks mature within one year and are carried at cost.

Edgewater Bancorp, Inc.
Notes to Consolidated Financial Statements
December 31, 2019 and 2018

Debt Investments

Debt securities held by the Company generally are classified and recorded in the consolidated financial statements as follows:

| Classified as | Description | Recorded at |
|--------------------------|--|--|
| Held to maturity (HTM) | Certain debt securities that management has the positive intent and ability to hold to maturity | Amortized cost |
| Trading | Securities that are bought and held principally for the purpose of selling in the near term and, therefore, held for only a short period of time | Fair value, with changes in fair value included in earnings |
| Available for sale (AFS) | Securities not classified as HTM or trading | Fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income |

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

When the fair value of securities is below the amortized cost, the Company's accounting treatment for an other-than-temporary impairment (OTTI) is as follows:

| Circumstances of Impairment Considerations | Accounting Treatment for OTTI Components | |
|---|---|--|
| | Credit Component | Remaining Portion |
| Not intended for sale and more likely than not that the Company will not have to sell before recovery of cost basis | Recognized in earnings | Recognized in other comprehensive income |
| Intended for sale or more likely than not that the Company will be required to sell before recovery of cost basis | Recognized in earnings | |

For held-to-maturity debt securities, the amount of OTTI recorded in other comprehensive income for the noncredit portion of a previous OTTI is amortized prospectively over the remaining life of the security on the basis of the timing of future estimated cash flows of the security.

When a credit loss component is separately recognized in earnings, the amount is identified as the total of principal cash flows not expected to be received over the remaining term of the security, as projected based on cash flow projections.

Edgewater Bancorp, Inc.
Notes to Consolidated Financial Statements
December 31, 2019 and 2018

Loans Held for Sale

Mortgage loans originated and intended for sale in the secondary market are carried at the lower of cost or fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance by charges to noninterest income. Gains and losses on loan sales are recorded in noninterest income and direct loan origination costs and fees are deferred at origination of the loan and are recognized in noninterest income upon sale of the loan.

Loans

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoffs are reported at their outstanding principal balances adjusted for unearned income, charge-offs, the allowance for loan losses, any unamortized deferred fees or costs on originated loans and unamortized premiums or discounts on purchased loans.

For loans amortized at cost, interest income is accrued based on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, as well as premiums and discounts, are deferred and amortized as a level yield adjustment over the respective term of the loan.

The accrual of interest on loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Past-due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not collected for loans that are placed on nonaccrual or charged off are reversed against interest income. The interest on these loans is applied to the principal balance until the loan can be returned to an 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.

For all loan portfolio segments, the Company promptly charges off loans, or portions thereof, when available information confirms that specific loans are uncollectible based on information that includes, but is not limited to, (1) the deteriorating financial condition of the borrower, (2) declining collateral values, and/or (3) legal action, including bankruptcy, that impairs the borrower's ability to adequately meet its obligations. For impaired loans that are considered to be solely collateral dependent, a partial charge-off is recorded when a loss has been confirmed by an updated appraisal or other appropriate valuation of the collateral.

When cash payments are received on impaired loans in each loan class, the Company records the payment as interest income unless collection of the remaining recorded principal amount is doubtful, at which time payments are used to reduce the principal balance of the loan. Troubled debt restructured loans recognize interest income on an accrual basis at the renegotiated rate if the loan is in compliance with the modified terms.

Edgewater Bancorp, Inc.
Notes to Consolidated Financial Statements
December 31, 2019 and 2018

Allowance for Loan Losses

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

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

The allowance consists of allocated and general components. The allocated component relates to loans that are classified as impaired. For those loans that are classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers nonclassified loans and is based on historical charge-off experience and expected loss given default derived from the Company's internal risk rating process. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data.

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

Groups of loans with similar risk characteristics are collectively evaluated for impairment based on the group's historical loss experience adjusted for changes in trends, conditions and other relevant factors that affect repayment of the loans. Accordingly, the Company does not separately identify individual consumer and residential loans for impairment measurements, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

Edgewater Bancorp, Inc.
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In the course of working with borrowers, the Company may choose to restructure the contractual terms of certain loans. In restructuring the loan, the Company attempts to work out an alternative payment schedule with the borrower in order to optimize collectability of the loan. A troubled debt restructuring (TDR) occurs when, for economic or legal reasons related to a borrower's financial difficulties, the Company grants a concession to the borrower that it would not otherwise consider. Terms may be modified to fit the ability of the borrower to repay in line with its current financial status, and the restructuring of the loan may include the transfer of assets from the borrower to satisfy the debt, a modification of loan terms, or a combination of the two.

Nonaccrual loans, including TDRs that have not met the six month minimum performance criterion, are reported in this report as non-performing loans. For all loan classes, it is the Company's policy to have any restructured loans which are on nonaccrual status prior to being restructured remain on nonaccrual status until six months of satisfactory borrower performance, at which time management would consider its return to accrual status. A loan is generally classified as nonaccrual when the Company believes that receipt of principal and interest is questionable under the terms of the loan agreement. Most generally, this is at 90 or more days past due.

With regard to determination of the amount of the allowance for credit losses, restructured loans are considered to be impaired. As a result, the determination of the amount of impaired loans for each portfolio segment within troubled debt restructurings is the same as detailed previously above.

Premises and Equipment, Net

Depreciable assets are stated at cost less accumulated depreciation. Depreciation is charged to expense using the straight-line method over the estimated useful lives of the assets. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on disposition are included in current operations.

The estimated useful lives for premises and equipment are as follows:

| | |
|-----------------------------------|-----------|
| Buildings | 39 years |
| Building and land improvements | 10 years |
| Furniture, fixtures and equipment | 3-7 years |

Federal Home Loan Bank Stock

Federal Home Loan Bank stock is a required investment for institutions that are members of the Federal Home Loan Bank system. The required investment in the common stock is based on a predetermined formula, carried at cost and evaluated for impairment.

Edgewater Bancorp, Inc.
Notes to Consolidated Financial Statements
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Other Real Estate, Net

Assets acquired through, or in lieu of, loan foreclosure are held for sale and are initially recorded at fair value less cost to sell at the date of foreclosure, establishing a new cost basis. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less cost to sell. Revenue and expenses from operations and changes in the valuation allowance are included in net income or expense from other real estate.

Mortgage Servicing Rights

Mortgage servicing assets are recognized separately when rights are acquired through purchase or through sale of financial assets. Under the servicing assets and liabilities accounting guidance (ASC 860-50), servicing rights resulting from the sale or securitization of loans originated by the Company are initially measured at fair value at the date of transfer. The Company subsequently measures each class of servicing asset using either the fair value or the amortization method. Under the fair value method, the servicing rights are carried in the consolidated balance sheet at fair value and the changes in fair value are reported in earnings in the period in which the changes occur. Under the amortization method, servicing rights are amortized in proportion to and over the period of estimated net servicing income. The amortized assets are assessed for impairment or increased obligation based on fair value at each reporting date.

Fair value is based on market prices for comparable mortgage servicing contracts, when available, or alternatively, is based on a valuation model that calculates the present value of estimated future net servicing income. The valuation model incorporates assumptions that market participants would use in estimating future net servicing income, such as the cost to service, the discount rate, the custodial earnings rate, an inflation rate, ancillary income, prepayment speeds and default rates and losses. These variables change from quarter to quarter as market conditions and projected interest rates change, and may have an adverse impact on the value of the mortgage servicing right and may result in a reduction to noninterest income.

Each class of separately recognized servicing assets subsequently measured using the amortization method are evaluated and measured for impairment. Impairment is determined by stratifying rights into tranches based on predominant characteristics, such as interest rate, loan type and investor type. Impairment is recognized through a valuation allowance for an individual tranche, to the extent that fair value is less than the carrying amount of the servicing assets for that tranche. The valuation allowance is adjusted to reflect changes in the measurement of impairment after the initial measurement of impairment. Changes in valuation allowances, if any, are reported with mortgage banking activities on the consolidated statements of income. Fair value in excess of the carrying amount of servicing assets for that stratum is not recognized.

Servicing fee income is recorded for fees earned for servicing loans. The fees are based on a contractual percentage of the outstanding principal or a fixed amount per loan and are recorded as income when earned. The amortization of mortgage servicing rights and servicing fee income are included with mortgage banking activities on the consolidated statements of income.

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Off-Balance Sheet Instruments

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

Transfers of Financial Assets

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

Income Taxes

The Company accounts for income taxes in accordance with income tax accounting guidance (ASC 740, *Income Taxes*). The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur. Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are reduced by a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

Tax positions are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances and information available at the reporting date and is subject to management's judgment. With a few exceptions, the Company is no longer subject to U.S. federal, state and local or non-U.S. income tax examinations by tax authorities for years before 2016.

The Company recognizes interest and penalties, if any, on income taxes as a component of income tax expense.

The Company files consolidated income tax returns with its subsidiary.

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Stock-Based Compensation

The Company recognizes the fair value of stock-based awards to employees as compensation cost over the requisite service period. The share-based employee compensation plan is described more fully in Note 13.

Earnings Per Share

Basic earnings per share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during each period. Diluted earnings per share reflects additional potential common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance.

Unvested stock-based payment awards, which include the right to receive non-forfeitable dividends or dividend equivalents, are considered to participate with common stock in undistributed earnings for purposes of computing EPS. Accordingly, the Company is required to calculate basic and diluted EPS using the two-class method. Restricted stock awards granted by the Company are considered participating securities. Calculations of EPS under the two-class method (i) exclude from the numerator any dividends paid or owed on participating securities and any undistributed earnings considered to be attributable to participating securities and (ii) exclude from the denominator the dilutive impact of the participating securities. Application of the two-class method results in no additional potential dilution in calculating diluted earnings per share, therefore basic and diluted earnings per share are the same.

Unearned ESOP shares, which are not vested, and unvested restricted stock awards are excluded from the computation of average shares outstanding.

Comprehensive Income

Comprehensive income consists of net income and other comprehensive income (loss), net of applicable taxes. Other comprehensive income (loss) includes unrealized appreciation (depreciation) on available-for-sale securities.

Adoption of New Accounting Standards

On January 1, 2019, the Company adopted ASU No. 2016-02, *Leases (Topic 842)* and subsequent amendments thereto, which requires the Company to recognize most leases on the balance sheet.

Adoption of the leasing standard did not have a material impact on the consolidated financial statements. Disclosure's about the Company's leasing activities are presented in Note 14 – Leases.

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Note 2: Restriction on Cash and Due From Banks

The Company is required to maintain reserve funds in cash and/or on deposit with the Federal Reserve Bank. The reserve required was \$1,911,000 and \$1,625,000 at December 31, 2019 and 2018, respectively.

Note 3: Securities

The amortized cost and approximate fair values, together with gross unrealized gains and losses, of securities are as follows:

| | December 31, 2019 | | | |
|--|----------------------|------------------------------|-------------------------------|----------------------|
| | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available-for-sale securities | | | | |
| U.S. Government and federal agency | \$ 4,982,946 | \$ 24,449 | \$ 2,727 | \$ 5,004,668 |
| State and political subdivisions | 1,045,693 | 35,883 | - | 1,081,576 |
| Corporate bonds | 498,929 | 7,753 | - | 506,682 |
| Mortgage-backed Government - Sponsored Enterprise (GSE) - residential | 1,633,141 | 20,868 | 2,252 | 1,651,757 |
| Collateralized mortgage obligations - GSE | 797,398 | 10,916 | - | 808,314 |
| | <u>\$ 8,958,107</u> | <u>\$ 99,869</u> | <u>\$ 4,979</u> | <u>\$ 9,052,997</u> |
| | | | | |
| | December 31, 2018 | | | |
| | Amortized Cost | Gross Unrealized Gains | Unrealized Losses | Fair Value |
| Available-for-sale securities | | | | |
| U.S. Government and federal agency | \$ 7,720,783 | \$ 1,989 | \$ 99,257 | \$ 7,623,515 |
| State and political subdivisions | 1,042,661 | - | 6,272 | 1,036,389 |
| Corporate bonds | 1,632,428 | - | 9,224 | 1,623,204 |
| Mortgage-backed Government - Sponsored Enterprise (GSE) - residential | 2,238,867 | 612 | 40,138 | 2,199,341 |
| Collateralized mortgage obligations - GSE | 959,298 | 112 | 7,939 | 951,471 |
| | <u>\$ 13,594,037</u> | <u>\$ 2,713</u> | <u>\$ 162,830</u> | <u>\$ 13,433,920</u> |

The amortized cost and fair value of available-for-sale securities at December 31, 2019, by contractual maturity, are shown on the next page. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

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| | December 31, 2019 | |
|---|---------------------------|-----------------------|
| | Amortized Cost | Fair Value |
| Within one year | \$ 1,998,486 | \$ 1,996,697 |
| After one through five years | 4,529,082 | 4,596,229 |
| | 6,527,568 | 6,592,926 |
| Mortgage-backed - GSE residential | 1,633,141 | 1,651,757 |
| Collateralized mortgage obligations - GSE | 797,398 | 808,314 |
| | \$ 8,958,107 | \$ 9,052,997 |

The carrying value of securities pledged as collateral, to secure public deposits and for other purposes, was \$72,963 and \$101,835 at December 31, 2019 and 2018, respectively.

There were no sales of securities available-for-sale for the year ended December 31, 2019. Gross gains of \$524 and gross losses of \$1,033 resulting from sales of available-for-sale securities were realized for the year ended December 31, 2018.

Certain investments in debt securities are reported in the consolidated financial statements at an amount less than their historical cost. Total fair value of these investments at December 31, 2019 and 2018, was \$1,740,690 and \$12,618,746 respectively, which is approximately 19 percent and 94 percent, respectively, of the Company's available-for-sale investment portfolio. These declines primarily resulted from recent increases in market interest rates since the securities were purchased.

Management believes the declines in fair value for these securities are temporary.

The following tables show the Company's investments' gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment class and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2019 and 2018:

| | 2019 | | | | | |
|---|----------------------------|--|----------------------------|--|-----------------------|--|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Available-for-Sale Securities | | | | | | |
| U.S. Government and federal agency | \$ - | \$ - | \$ 997,220 | \$ 2,727 | \$ 997,220 | \$ 2,727 |
| State and political subdivisions | - | - | - | - | - | - |
| Corporate bonds | - | - | - | - | - | - |
| Mortgage-backed -GSE residential | 725,328 | 2,196 | 18,142 | 56 | 743,470 | 2,252 |
| Collateralized mortgage obligations - GSE | - | - | - | - | - | - |
| | \$ 725,328 | \$ 2,196 | \$ 1,015,362 | \$ 2,783 | \$ 1,740,690 | \$ 4,979 |

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| | 2018 | | | | | |
|---|---------------------|-------------------------|---------------------|-------------------------|----------------------|-------------------------|
| | Less than 12 Months | | 12 Months or Longer | | Total | |
| | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| Available-for-Sale Securities | | | | | | |
| U.S. Government and federal agency | \$ 1,492,963 | \$ 7,038 | \$ 5,379,423 | \$ 92,219 | \$ 6,872,386 | \$ 99,257 |
| State and political subdivisions | 1,036,389 | 6,272 | - | - | 1,036,389 | 6,272 |
| Corporate bonds | 1,623,204 | 9,224 | - | - | 1,623,204 | 9,224 |
| Mortgage-backed -GSE residential | 924,133 | 7,951 | 1,237,750 | 32,187 | 2,161,883 | 40,138 |
| Collateralized mortgage obligations - GSE | 924,884 | 7,939 | - | - | 924,884 | 7,939 |
| | <u>\$ 6,001,573</u> | <u>\$ 38,424</u> | <u>\$ 6,617,173</u> | <u>\$ 124,406</u> | <u>\$ 12,618,746</u> | <u>\$ 162,830</u> |

The unrealized losses on the Company's investments in direct obligations of U.S. Government and federal agencies, and state and political subdivisions were caused by interest rate changes. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the amortized cost basis of the investments. Because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2019.

The unrealized losses on the Company's investment in residential mortgage-backed GSE securities and collateralized mortgage obligations GSE were caused by changes in interest rates and illiquidity. The Company expects to recover the amortized cost basis over the term of the securities. Because the decline in market value is attributable to changes in interest rates and illiquidity, and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not the Company will be required to sell the investments before recovery of their amortized cost basis, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2019.

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Note 4: Loans and Allowance for Loan Losses

Classes of loans at December 31, 2019 and 2018, include:

| | <u>2019</u> | <u>2018</u> |
|---------------------------------------|-----------------------|-----------------------|
| Real estate loans | | |
| Residential 1-4 family | \$ 55,247,477 | \$ 52,530,548 |
| Commercial real estate | 51,541,804 | 44,899,334 |
| Construction and land development | 9,054,899 | 8,757,083 |
| Total real estate | <u>115,844,180</u> | <u>106,186,965</u> |
| Commercial and industrial | 24,081,088 | 16,663,308 |
| Warehouse line | 15,000,000 | - |
| Consumer loans | | |
| Home equity loans and lines of credit | 3,735,825 | 4,577,408 |
| Other consumer loans | 1,032,388 | 889,928 |
| Total consumer | <u>4,768,213</u> | <u>5,467,336</u> |
| Total loans | <u>159,693,481</u> | <u>128,317,609</u> |
| Less other items | | |
| Net deferred loan costs | 30,012 | 25,847 |
| Allowance for loan losses | <u>(1,614,390)</u> | <u>(1,401,935)</u> |
| Total loans, net | <u>\$ 158,109,103</u> | <u>\$ 126,941,521</u> |

Risk characteristics applicable to each segment of the loan portfolio are described as follows.

Residential 1-4 Family, Home Equity Loans and Lines of Credit and Other Consumer: The residential 1-4 family real estate loans are generally secured by owner-occupied 1-4 family residences. Home equity loans and lines of credit are typically secured by a subordinate interest in 1-4 family residences and consumer loans are secured by consumer assets such as automobiles and other personal property. Repayment of these loans is primarily dependent on the personal income and credit rating of the borrowers. Credit risk in these loans can be impacted by economic conditions within the Bank's market areas that might impact either property values or a borrower's personal income. Risk is mitigated by the fact that the loans are of smaller individual amounts and spread over a large number of borrowers.

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Commercial Real Estate including Construction and Land Development: Commercial real estate loans typically involve larger principal amounts, and repayment of these loans is generally dependent on the successful operations of the property securing the loan or the business conducted on the property securing the loan. These loans are viewed primarily as cash flow loans and secondarily as loans secured by real estate. Construction and land real estate loans are usually based upon estimates of costs and estimated value of the completed project and include independent appraisal reviews and a financial analysis of the developers and property owners. Sources of repayment of these loans may include permanent loans, sales of developed property or an interim loan commitment from the Bank until permanent financing is obtained. These loans are considered to be higher risk than other real estate loans due to their ultimate repayment being sensitive to interest rate changes, general economic conditions and the availability of long-term financing. Credit risk in these loans may be impacted by the creditworthiness of a borrower, property values and the local economies in the Company's market areas.

Commercial and Industrial: The commercial and industrial portfolio includes loans to commercial customers for use in financing working capital needs, equipment purchases and expansions. The loans in this category are repaid primarily from the cash flow of a borrower's principal business operation. Credit risk in these loans is driven by creditworthiness of a borrower and the economic conditions that impact the cash flow stability from business operations.

Warehouse Line: The residential mortgage warehouse line is a wholesale mortgage line participation. The lending is done with a specific mortgage company that is a customer with the participating bank. The participating bank underwrites each individual mortgage and the related mortgagee. Financing is provided to an approved mortgage company for the origination and sale of residential mortgage loans. A portion of each individual mortgage is assigned to the Bank until the loans is sold on the secondary market. These loans are typically sold within 30 days and are seldom held more than 90 days. Interest income is accrued during this period and collected at the time each loan is sold. The Bank has established several controls to minimize potential risks including reviewing documents provided on the approved mortgage warehouse participants. Also, certain loan documents are received and reviewed on each loan in which the Bank is asked to participate in that allows the Bank to accept or reject the individual loan participation.

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Internal Risk Categories

In adherence with policy, the Bank uses the following internal risk grading categories and definitions for loans:

RISK RATING 1 – EXCELLENT

General: The highest quality asset rating reflects superior, in-depth management, and superior financial flexibility. Conservative balance sheets are both strong and liquid, and historic cash flows (last five years) have provided exceptionally large and stable margins of protection.

Specific: Financial statements are current, audited, of superior quality and in complete detail. Financial condition is superior and compares favorably to the industry average. Cash flow is outstanding relative to historical and projected debt service requirements. The borrower adheres to all loan covenants. Management (or individual) integrity and ability are outstanding.

RISK RATING 2 – STRONG

General: The borrower is fully responsible for the credit. Asset quality and liquidity are very good, and debt capacity and coverage are strong. The company has strong management in all positions, and is highly regarded with excellent financial flexibility including access to other sources of financing.

Specific: Financial statements are current, of excellent quality and in adequate detail. Financial condition is very good and compares favorably to the industry average. Statements reflect a stable record of earnings over time and consistent profitability. Cash flow is strong relative to historical and projected debt service requirements. The borrower consistently adheres to the repayment schedules for both principal and interest. The borrower adheres to all loan covenants. Management (or individual) integrity and ability are outstanding.

RISK RATING 3 – GOOD

General: Asset quality and liquidity are strong, and debt capacity and coverage are good to above average. General financial trends are stable to favorable and financial and profitability ratios are consistent with industry peers. Management strength is apparent. The industry is average. Some modest elements of uncertainty may be present due to liquidity, margin and cash flow stability, asset or customer concentrations, dependence on one business type, or cyclical trends that may affect the borrower.

Specific: The financial statements are generally current, of adequate detail, and of good quality. Publication of statements is at least once annually but in most cases more frequent. Financial condition is good relative to the industry. The earnings record is stable and consistent, although modest year-to-year earnings may fluctuate more than for borrowers rated Excellent (1) or Strong (2). Cash flow may vary during the repayment of the loan but does not fall below debt service requirements. Historical profitability may be inconsistent but losses are typically non-existent or infrequent. Liquidity and leverage are at the industry average. The borrower consistently adheres to repayment schedules for both principal and interest, and adheres to all loan covenants. Any waivers are immaterial, and do not negatively impact the strength of the credit. Management (or individual) integrity and ability are sound. Depth and breadth of management is also sound.

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RISK RATING 4 – ACCEPTABLE

General: Asset quality and liquidity are good, and debt capacity and coverage are average to good. General financial trends are stable to favorable and financial and profitability ratios are consistent with industry peers. Management strength is apparent but may be limited to key positions. The industry is average. Some elements of uncertainty may be present due to liquidity, margin and cash flow stability, asset of customer concentrations, dependence on one business type, or cyclical trends that may affect the borrower. Adverse economic conditions may lead to declining trends.

Specific: The financial statements are generally current, of adequate detail, and of average quality. Publication of statements is at least once annually. Financial condition is average relative to the industry. The earnings record is satisfactory, although year-to-year earnings patterns may fluctuate more than for borrowers rated Good (3). Cash flow may vary during the repayment of the loan but does not fall below debt service requirements. Historical profitability may be inconsistent and may have losses in recent years. Liquidity and leverage may be below the industry average, and the borrower may be highly leveraged. The borrower consistently adheres to repayment schedules for both principal and interest, and adheres to all loan covenants. Any waivers are immaterial, and do not negatively impact the strength of the credit. Management (or individual) integrity and ability are sound. Depth and breadth of management is also sound.

RISK RATING 5 – WATCH

General: Loans in this category are considered to be acceptable credit quality, but contain greater credit risk than Risk Rating 4 loans due to weak balance sheets, marginal earnings or cash flow, lack of financial information, weakening markets, insufficient or questionable collateral coverage or other uncertainties. These loans warrant a higher than average level of monitoring to ensure that potential weaknesses do not emerge. The level of risk in a Watch loan is within acceptable underwriting guidelines so long as the loan is given the proper level of management supervision.

Specific: The financial statements may be missing, outdated, of poor quality or lacking in important details. Financial condition is below the industry average. The borrower may be experiencing negative trends and/or erratic or unstable financial performance. The borrower may have suffered a loss in a recent period; however, losses have not been of the magnitude to have adversely affected the balance sheet. The borrower generally adheres to repayment schedules for principal and consistently for interest. Cash flow from primary sources has generally been adequate but, if existing trends continue may not be adequate to meet projected debt service requirements in the future. The borrower may have violated one or more financial or other covenants, but such has not materially impacted financial condition or performance. Industry outlook may be unfavorable. The integrity and quality of management remains good; however, management depth may be limited.

RISK RATING 6 – SPECIAL MENTION

General: Assets in this category have potential weaknesses that deserve the Bank's close attention. If potential weaknesses are left unchecked or uncorrected, they may result in deterioration of the repayment prospects for the asset or inadequately protect the Bank's credit position at some future date. These assets pose elevated risk, but their weakness does not expose the Bank to sufficient risk to warrant adverse classification.

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Specific: Borrowers may be experiencing adverse operating trends (declining revenues or margins) or an ill-proportioned balance sheet (increasing inventory without an increase in sales, high leverage, tight liquidity). Adverse economic or market conditions, such as interest rate increases or the entry of a new competitor, may also support a Special Mention (6) rating. Nonfinancial reasons for rating a credit Special Mention (6) include management problems, pending litigation, an ineffective loan agreement or other material structural weaknesses, and any other significant deviation from prudent lending practices.

RISK RATING 7 – SUBSTANDARD

General: Assets in this category are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. These assets have a well-defined weakness or weaknesses that jeopardize the timely liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Specific: Substandard assets have a high probability of payment default, or they have other well-defined weaknesses. The financial statements may be missing, seriously outdated, of poor quality, or lacking in important details. Financial condition is less than satisfactory. The borrower is experiencing negative trends and material losses. The primary source of cash flow is inadequate to meet current debt service requirements, and unless present conditions improve is potentially inadequate to meet projected debt service requirements. The borrower may have reached the point of employing its secondary source of cash flow. The borrower inconsistently adheres to repayment schedules for either principal or interest. The borrower may have violated one or more financial or other covenants, reflecting unsatisfactory liquidity and/or capitalization. Either the integrity or the ability of management may be in question. For some Substandard (7) assets, the likelihood of full collection of interest and principal may be in doubt; such assets should be placed on nonaccrual.

RISK RATING 8 – DOUBTFUL

General: Assets in this category have all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Specific: An asset in this category has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as loss is deferred. Doubtful borrowers are usually in default, lack adequate liquidity and capital, and lack the resources necessary to remain an operating entity. Pending events can include mergers, acquisitions, liquidations, capital injections, and the perfection of liens on additional collateral, the valuation of collateral and refinancing. Generally, pending events should be resolved within a relatively short period and the ratings will be adjusted based on new information. Because of high probability of loss, nonaccrual accounting treatment is required for Doubtful (8) assets.

RISK RATING 9 – LOSS

General: Assets in this category are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be obtained in the future.

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Specific: With Loss (9) assets, the underlying borrowers are often in bankruptcy, have formally suspended debt repayments or have otherwise ceased normal business operations. Once an asset is classified Loss (9), there is little prospect of collecting either its principal or interest. Losses are to be recorded in the period an obligation becomes uncollectable.

The following tables present the credit risk profile of the Bank's loan portfolio based on internal rating category and payment activity as of December 31, 2019 and 2018:

| | 2019 | | | | | | | |
|---------------------|---------------------------|---------------------------|--------------------------|------------------------------|----------------------|---------------------|---------------------|-----------------------|
| | Residential 1-4 Family | Commercial Real Estate | Construction and Land | Commercial and Industrial | Warehouse Line | Home Equity | Other Consumer | Total |
| Pass (1-5) | \$ 54,026,670 | \$ 50,707,174 | \$ 9,051,673 | \$ 24,081,088 | \$ 15,000,000 | \$ 3,652,190 | \$ 1,032,388 | \$ 157,551,183 |
| Special Mention (6) | - | 208,793 | - | - | - | - | - | 208,793 |
| Substandard (7) | 1,220,807 | 625,837 | 3,226 | - | - | 83,635 | - | 1,933,505 |
| Doubtful (8) | - | - | - | - | - | - | - | - |
| Loss (9) | - | - | - | - | - | - | - | - |
| Total | <u>\$ 55,247,477</u> | <u>\$ 51,541,804</u> | <u>\$ 9,054,899</u> | <u>\$ 24,081,088</u> | <u>\$ 15,000,000</u> | <u>\$ 3,735,825</u> | <u>\$ 1,032,388</u> | <u>\$ 159,693,481</u> |

| | 2018 | | | | | | | |
|---------------------|---------------------------|---------------------------|--------------------------|------------------------------|-------------------|---------------------|-------------------|-----------------------|
| | Residential 1-4 Family | Commercial Real Estate | Construction and Land | Commercial and Industrial | Warehouse Line | Home Equity | Other Consumer | Total |
| Pass (1-5) | \$ 51,902,302 | \$ 44,025,135 | \$ 8,748,123 | \$ 16,663,308 | \$ - | \$ 4,429,959 | \$ 886,705 | \$ 126,655,532 |
| Special Mention (6) | - | 727,320 | - | - | - | - | - | 727,320 |
| Substandard (7) | 628,246 | 146,879 | 8,960 | - | - | 147,449 | 3,223 | 934,757 |
| Doubtful (8) | - | - | - | - | - | - | - | - |
| Loss (9) | - | - | - | - | - | - | - | - |
| Total | <u>\$ 52,530,548</u> | <u>\$ 44,899,334</u> | <u>\$ 8,757,083</u> | <u>\$ 16,663,308</u> | <u>\$ -</u> | <u>\$ 4,577,408</u> | <u>\$ 889,928</u> | <u>\$ 128,317,609</u> |

The Bank evaluates the loan risk grading system definitions and allowance for loan loss methodology on an ongoing basis. No significant changes were made to either during the past year.

The following tables present the Bank's loan portfolio aging analysis of the recorded investment in loans as of December 31, 2019 and 2018:

| | 2019 | | | | | | Total Loans > 90 Days & Accruing |
|---------------------------|------------------------|------------------------|-------------------------|---------------------|-----------------------|-----------------------|--|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | |
| Residential 1-4 family | \$ 547,447 | \$ 55,000 | \$ 907,109 | \$ 1,509,556 | \$ 53,737,921 | \$ 55,247,477 | \$ - |
| Commercial real estate | - | - | 461,827 | 461,827 | 51,079,977 | 51,541,804 | 461,827 |
| Construction and land | - | - | 3,226 | 3,226 | 9,051,673 | 9,054,899 | - |
| Commercial and industrial | - | - | - | - | 24,081,088 | 24,081,088 | - |
| Warehouse Line | - | - | - | - | 15,000,000 | 15,000,000 | - |
| Home equity | 198,048 | 4,428 | 58,678 | 261,154 | 3,474,671 | 3,735,825 | - |
| Other consumer | - | - | - | - | 1,032,388 | 1,032,388 | - |
| | <u>\$ 745,495</u> | <u>\$ 59,428</u> | <u>\$ 1,430,840</u> | <u>\$ 2,235,763</u> | <u>\$ 157,457,718</u> | <u>\$ 159,693,481</u> | <u>\$ 461,827</u> |

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| | 2018 | | | | | | |
|---|------------------------|------------------------|-------------------------|---------------------|-----------------------|-----------------------|--|
| | 30-59 Days Past Due | 60-89 Days Past Due | Greater Than 90 Days | Total Past Due | Current | Total Loans | Total Loans > 90 Days & Accruing |
| Residential 1-4 family | \$ 285,610 | \$ 131,340 | \$ 159,881 | \$ 576,831 | \$ 51,953,717 | \$ 52,530,548 | \$ - |
| Commercial real estate | 3,667 | 485,598 | - | 489,265 | 44,410,069 | 44,899,334 | - |
| Construction and land | - | - | 8,960 | 8,960 | 8,748,123 | 8,757,083 | - |
| Commercial and industrial Warehouse Line | - | - | - | - | 16,663,308 | 16,663,308 | - |
| Home equity | 66,215 | 4,076 | 66,063 | 136,354 | 4,441,054 | 4,577,408 | - |
| Other consumer | - | - | 3,223 | 3,223 | 886,705 | 889,928 | - |
| | <u>\$ 355,492</u> | <u>\$ 621,014</u> | <u>\$ 238,127</u> | <u>\$ 1,214,633</u> | <u>\$ 127,102,976</u> | <u>\$ 128,317,609</u> | <u>\$ -</u> |

A loan is considered impaired, in accordance with the impairment accounting guidance (ASC 310-10-35-16), when based on current information and events, it is probable the Bank will be unable to collect all amounts due from the borrower in accordance with the contractual terms of the loan. Impaired loans include nonperforming commercial loans but also include loans modified in troubled debt restructurings.

The following tables present impaired loans and specific valuation allowance based on class level for the years ended December 31, 2019 and 2018:

| | 2019 | | | | | | | Total |
|--|---------------------------|---------------------------|--------------------------|------------------------------|-------------------|-------------|-------------------|--------------|
| | Residential 1-4 Family | Commercial Real Estate | Construction and Land | Commercial and Industrial | Warehouse Line | Home Equity | Other Consumer | |
| Impaired Loans Without a Specific Allowance | | | | | | | | |
| Recorded investment | \$ 1,560,882 | \$ - | \$ 3,226 | \$ - | \$ - | \$ 3,725 | \$ - | \$ 1,567,833 |
| Unpaid principal balance | 1,782,080 | - | 7,669 | - | - | 3,853 | - | 1,793,602 |
| Impaired Loans With a Specific Allowance | | | | | | | | |
| Recorded investment | 146,344 | 461,827 | - | - | - | 24,957 | - | 633,128 |
| Unpaid principal balance | 147,303 | 461,827 | - | - | - | 26,918 | - | 636,048 |
| Specific allowance | 4,977 | 3,198 | - | - | - | 502 | - | 8,677 |
| Total Impaired Loans | | | | | | | | |
| Recorded investment | 1,707,226 | 461,827 | 3,226 | - | - | 28,682 | - | 2,200,961 |
| Unpaid principal balance | 1,929,383 | 461,827 | 7,669 | - | - | 30,771 | - | 2,429,650 |
| Specific allowance | 4,977 | 3,198 | - | - | - | 502 | - | 8,677 |
| | | | | | | | | |
| | 2018 | | | | | | | Total |
| | Residential 1-4 Family | Commercial Real Estate | Construction and Land | Commercial and Industrial | Warehouse Line | Home Equity | Other Consumer | |
| Impaired Loans Without a Specific Allowance | | | | | | | | |
| Recorded investment | \$ 1,020,885 | \$ 3,667 | \$ 8,960 | \$ - | \$ - | \$ 75,347 | \$ 3,223 | \$ 1,112,082 |
| Unpaid principal balance | 1,211,388 | 6,223 | 12,777 | - | - | 77,588 | 3,412 | 1,311,388 |
| Impaired Loans With a Specific Allowance | | | | | | | | |
| Recorded investment | 164,525 | - | - | - | - | 72,101 | - | 236,626 |
| Unpaid principal balance | 165,874 | - | - | - | - | 76,162 | - | 242,036 |
| Specific allowance | 6,083 | - | - | - | - | 3,075 | - | 9,158 |
| Total Impaired Loans | | | | | | | | |
| Recorded investment | 1,185,410 | 3,667 | 8,960 | - | - | 147,448 | 3,223 | 1,348,708 |
| Unpaid principal balance | 1,377,262 | 6,223 | 12,777 | - | - | 153,750 | 3,412 | 1,553,424 |
| Specific allowance | 6,083 | - | - | - | - | 3,075 | - | 9,158 |

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The following presents by portfolio class, information related to the average recorded investment and interest income recognized on impaired loans for the years ended December 31, 2019 and 2018:

| | 2019 | | | | | | | Total |
|---|---------------------------|---------------------------|--------------------------|------------------------------|-------------------|-------------|-------------------|--------------|
| | Residential 1-4 Family | Commercial Real Estate | Construction and Land | Commercial and Industrial | Warehouse Line | Home Equity | Other Consumer | |
| Average recorded investment in impaired loans | \$ 1,388,937 | \$ 462,207 | \$ 6,093 | \$ - | \$ - | \$ 29,889 | \$ - | \$ 1,887,126 |
| Interest income recognized | 20,742 | 14,596 | - | - | - | - | - | 35,338 |
| Interest income recognized on a cash basis | 20,141 | 13,710 | - | - | - | - | - | 33,851 |

| | 2018 | | | | | | | Total |
|---|---------------------------|---------------------------|--------------------------|------------------------------|-------------------|-------------|-------------------|--------------|
| | Residential 1-4 Family | Commercial Real Estate | Construction and Land | Commercial and Industrial | Warehouse Line | Home Equity | Other Consumer | |
| Average recorded investment in impaired loans | \$ 1,233,517 | \$ 5,231 | \$ 10,639 | \$ - | \$ - | \$ 65,328 | \$ 4,112 | \$ 1,318,827 |
| Interest income recognized | 21,918 | - | - | - | - | - | - | 21,918 |
| Interest income recognized on a cash basis | 21,178 | - | - | - | - | - | - | 21,178 |

The following table presents the Bank's nonaccrual loans at December 31, 2019 and 2018. This table excludes performing troubled debt restructurings.

| | 2019 | 2018 |
|---------------------------|---------------------|-------------------|
| Residential 1-4 family | \$ 1,220,807 | \$ 628,246 |
| Commercial real estate | - | 3,667 |
| Construction and land | 3,226 | 8,960 |
| Commercial and industrial | - | - |
| Warehouse line | - | - |
| Home equity | 83,636 | 147,448 |
| Other consumer | - | 3,223 |
| | <u>\$ 1,307,669</u> | <u>\$ 791,544</u> |

At December 31, 2019 and 2018, the Company had one loan that was modified in troubled debt restructuring and impaired. The modification of terms of such loan included one or a combination of the following: and extensions of maturity, a reduction of the stated interest rate or a permanent reduction of the recorded investments in the loan.

There were no newly classified troubled debt restructurings for the years ended December 31, 2019 and 2018.

As of December 31, 2019, borrowers with loans designated as TDRs totaled \$570,524, of which \$486,419 met the criteria for placement on accrual status. The criteria is a minimum of six months of payment performance under existing or modified terms.

At December 31, 2019 and 2018, the Company held no real estate properties as foreclosed property. Also, at December 31, 2019 and 2018, there were no consumer mortgage loans in the process of foreclosure according to local requirements of the applicable jurisdictions.

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The Company has had, and may be expected to have in the future, lending transactions in the ordinary course of business with principal stockholder, directors, executive officer and their affiliates (related parties), all of which have been, in the opinion of management, on the same terms, including interest rates and collateral, as those prevailing at the time for comparable transactions with unrelated parties and which do not represent more than the normal risk of collectability or present other unfavorable features.

Aggregate loan balances with related parties for the years ended December 31, 2019 and 2018, totaled \$3,600,862 and \$3,478,502, respectively. None of these loans are past due, in nonaccrual status or have been restructured to provide a reduction or deferral of interest or principal because of deterioration in the financial position of the borrower. These were no loans to a related party that were considered classified at December 31, 2019 and 2018.

Note 5: Premises and Equipment

Major classifications of premises and equipment, stated at cost, are as follows:

| | <u>2019</u> | <u>2018</u> |
|-----------------------------------|---------------------|---------------------|
| Land | \$ 864,420 | \$ 864,420 |
| Land improvements | 325,774 | 325,774 |
| Building and improvements | 4,700,362 | 4,631,031 |
| Furniture, fixtures and equipment | 3,815,890 | 3,482,973 |
| Project in progress | 28,317 | 52,646 |
| Total cost | <u>9,734,763</u> | <u>9,356,844</u> |
| Accumulated depreciation | <u>(6,688,240)</u> | <u>(6,399,041)</u> |
| Net premises and equipment | <u>\$ 3,046,523</u> | <u>\$ 2,957,803</u> |

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Note 6: Loan Servicing

The Company accounts for loan servicing rights applicable to serviced loans originated prior to January 1, 2011, using the fair value method of accounting and are considered a specific class. Loan servicing rights applicable to serviced loans originated after January 1, 2011, are valued using the amortization method and are considered a different specific class. Under both methods, the mortgage servicing rights are recorded at fair value at inception. Under the fair value method, the asset continues to be recorded at fair value each reporting period, with changes in fair value being recorded through noninterest income. Under the amortization method, the recorded asset is amortized over its estimated life.

The fair value method approach of accounting was adopted because the Company believed the fair values of servicing rights were substantially undervalued and thus understated on the consolidated balance sheet. The fair value is determined using prices for similar assets with similar characteristics, when available, or based upon discounted cash flows using market-based assumptions. Subsequent valuation adjustments for servicing assets related to loan originations prior to January 1, 2011, will be made to noninterest income and included in mortgage banking activities in the consolidated statements of income.

Mortgage loans serviced for others are not included in the accompanying consolidated balance sheets. The risks inherent in mortgage servicing assets relate primarily to changes in prepayments that result from shifts in mortgage interest rates. The unpaid principal balances of mortgage loans serviced for others was approximately \$77,550,000 and \$80,560,000 at December 31, 2019 and 2018, respectively.

The following summarizes the activity pertaining to mortgage servicing rights measured using the amortization method. There were no valuation allowance recorded or reversed during 2019 and 2018:

| | <u>2019</u> | <u>2018</u> |
|--|-------------------|-------------------|
| Balance, beginning of year | \$ 296,471 | \$ 306,017 |
| Additions | 98,308 | 80,814 |
| Amortization | <u>(93,764)</u> | <u>(90,360)</u> |
| Balance, end of year | <u>\$ 301,015</u> | <u>\$ 296,471</u> |
| Fair value as of the beginning of the year | \$ 780,642 | \$ 732,223 |
| Fair value as of the end of year | 698,228 | 780,642 |

The following summarizes the activity in mortgage servicing rights measured using the fair value method for the years ended December 31, 2019 and 2018:

| | <u>2019</u> | <u>2018</u> |
|--|------------------|------------------|
| Balance, beginning of year | \$ 68,806 | \$ 66,058 |
| Change in fair value adjusted through earnings | <u>(18,374)</u> | <u>2,748</u> |
| Balance, end of year | <u>\$ 50,432</u> | <u>\$ 68,806</u> |

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Note 7: Deposits

| | <u>2019</u> | <u>2018</u> |
|-------------------------------------|-----------------------|-----------------------|
| Noninterest-bearing demand deposits | \$ 21,195,230 | \$ 22,176,701 |
| Interest-bearing deposits | 63,303,231 | 56,947,210 |
| Money market | 17,387,560 | 19,798,952 |
| Savings accounts | 16,697,486 | 16,118,981 |
| Certificates of deposit | <u>33,475,245</u> | <u>28,709,049</u> |
| Total deposits | <u>\$ 152,058,752</u> | <u>\$ 143,750,893</u> |

Interest-bearing time deposits in denominations of \$250,000 or more were \$11,477,118 at December 31, 2019, and \$8,759,844 at December 31, 2018.

At December 31, 2019 and 2018, the Bank had deposits from executive officers, directors and their affiliates (related parties), of \$1,454,776 and \$1,599,139 respectively. In management's opinion, such deposits were made in the ordinary course of business and were made on substantially the same terms as those prevailing at the time for comparable transactions with other persons.

At December 31, 2019, the scheduled maturities of time deposits are as follows:

| | |
|-------|----------------------|
| 2020 | \$ 22,949,707 |
| 2021 | 6,975,013 |
| 2022 | 1,228,764 |
| 2023 | 1,995,103 |
| 2024 | <u>326,658</u> |
| Total | <u>\$ 33,475,245</u> |

Note 8: Federal Home Loan Bank Advances

Federal Home Loan Bank advances totaled \$13,000,000 and \$7,000,000 at December 31, 2019 and 2018, respectively. Federal Home Loan Bank advances and line of credit are secured by mortgage loans totaling approximately \$16.8 million and \$14.7 million at December 31, 2019 and 2018, respectively. Advances, at interest rates from 1.69 percent to 2.75 percent were subject to restrictions or penalties in the event of prepayment as of December 31, 2019. The Bank has a \$2.0 million line of credit with the Federal Home Loan Bank, none of which was outstanding at December 31, 2019.

Aggregate annual maturities of advances at December 31, 2019 are:

| | |
|-------|----------------------|
| 2020 | \$ 8,000,000 |
| 2021 | <u>5,000,000</u> |
| Total | <u>\$ 13,000,000</u> |

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Note 9: Other Borrowings

Other borrowings consist of the Company's note payable to United Bankers Bank (UBB) which was entered into on June 11, 2018, secured by all collateral held by UBB and all outstanding shares of the Bank, payable in equal quarterly installments of \$64,625, including interest at 5.125 percent, with a final payment due July 1, 2023.

Aggregate annual maturities at December 31, 2019 are:

| | |
|-------|---------------------|
| 2020 | \$ 167,540 |
| 2021 | 176,675 |
| 2022 | 186,036 |
| 2023 | 1,277,657 |
| 2024 | <u>-</u> |
| Total | <u>\$ 1,807,908</u> |

On June 11, 2018, the Company also entered into a \$1,000,000 revolving line of credit with UBB, secured by all collateral held by UBB and all outstanding shares of Bank stock, with interest payable quarterly at prime and the balance due at maturity on July 1, 2020. At December 31, 2019, there were no borrowings outstanding on the line of credit. The Company has a \$2.0 million federal funds line with United Bankers Bank, none of which was outstanding at December 31, 2019.

Note 10: Income Taxes

The benefit for income taxes includes these components:

| | <u>2019</u> | <u>2018</u> |
|--------------------------------------|---------------------|-----------------------|
| Taxes currently payable (refundable) | \$ 19,330 | \$ (19,331) |
| Deferred income taxes | <u>(321,810)</u> | <u>(1,393,336)</u> |
| Income tax benefit | <u>\$ (302,480)</u> | <u>\$ (1,412,667)</u> |

A reconciliation of income tax expense at the statutory rate to the Company's actual income tax expense is shown below:

| | <u>2019</u> | <u>2018</u> |
|---|---------------------|-----------------------|
| Computed at the statutory rate (21% in 2019 and 2018) | \$ 167,080 | \$ (35,039) |
| Decrease resulting from | | |
| Changes in the deferred tax asset valuation allowance | (448,729) | (1,360,769) |
| Other | <u>(20,831)</u> | <u>(16,859)</u> |
| Actual tax benefit | <u>\$ (302,480)</u> | <u>\$ (1,412,667)</u> |

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The tax effects of temporary differences related to deferred taxes shown on the consolidated balance sheets were:

| | <u>2019</u> | <u>2018</u> |
|---|---------------------|---------------------|
| Deferred tax assets | | |
| Allowance for loan losses | \$ 182,680 | \$ 126,448 |
| Net operating loss carryforward | 1,155,370 | 1,430,658 |
| Charitable contribution carryforward | 11,624 | 8,248 |
| Unrealized loss on available-for-sale securities | - | 33,625 |
| Other | 435,677 | 373,809 |
| Total assets | <u>1,785,351</u> | <u>1,972,788</u> |
| Deferred tax liability | | |
| Depreciation | (36,051) | (31,543) |
| Deferred loan fees | (6,374) | (5,468) |
| FHLB stock dividends | (14,349) | (14,294) |
| Unrealized gain on available-for-sale securities | (19,927) | - |
| State taxes | (13,431) | - |
| Total liabilities | <u>(90,132)</u> | <u>(51,305)</u> |
| Net deferred tax asset before valuation allowance | <u>1,695,219</u> | <u>1,921,483</u> |
| Valuation allowance | | |
| Beginning balance | (528,146) | (1,867,655) |
| Decrease during the period | <u>528,146</u> | <u>1,339,509</u> |
| Ending balance | <u>-</u> | <u>(528,146)</u> |
| Net deferred tax asset | <u>\$ 1,695,219</u> | <u>\$ 1,393,337</u> |

As of December 31, 2019, the Company has approximately \$5.2 million of federal net operating loss carryforwards that begin expiring in 2029 and approximately \$1.0 million of state net operating loss carryforwards that begin expiring in 2024.

Retained earnings at December 31, 2019 and 2018, include approximately \$702,000 for which no deferred federal income tax liability has been recognized. These amounts represent an allocation of income to bad debt deductions for tax purposes only. Reduction of amounts so allocated for purposes other than tax bad debt losses or adjustments arising from carryback of net operating losses would create income for tax purposes only, which would be subject to the then-current corporate income tax rate.

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Note 11: Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities and certain off-balance-sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings and other factors. Furthermore, the Bank's regulators could require adjustments to regulatory capital not reflected in these financial statements.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table on the next page). Management believes, as of December 31, 2019 and 2018, that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2019, the most recent notification from Federal Deposit Insurance Corporation categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum total risk-based capital, Tier I risk-based capital, Common Equity Tier I capital and Tier I leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the Bank's category.

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

| | Actual | | Minimum Amount Required for Adequate Capital ¹ | | Minimum Amount To Be Well Capitalized ¹ | |
|---|-----------|---------|---|--------|--|---------|
| | Amount | Ratio | Amount | Ratio | Amount | Ratio |
| December 31, 2019 | | | | | | |
| Total capital ¹ (to risk-weighted assets) | \$ 17,882 | 12.35 % | \$ 11,579 | 8.00 % | \$ 14,474 | 10.00 % |
| Tier I capital ¹ (to risk-weighted assets) | 16,268 | 11.24 | 8,684 | 6.00 | 11,579 | 8.00 |
| Common Equity Tier I capital ¹ (to risk-weighted assets) | 16,268 | 11.24 | 6,513 | 4.50 | 9,408 | 6.50 |
| Tier I capital ¹ (to average assets) | 16,268 | 8.84 | 7,359 | 4.00 | 9,199 | 5.00 |
| December 31, 2018 | | | | | | |
| Total capital ¹ (to risk-weighted assets) | \$ 16,779 | 14.86 % | \$ 9,035 | 8.00 % | \$ 11,294 | 10.00 % |
| Tier I capital ¹ (to risk-weighted assets) | 15,377 | 13.62 | 6,776 | 6.00 | 9,035 | 8.00 |
| Common Equity Tier I capital ¹ (to risk-weighted assets) | 15,377 | 13.62 | 5,082 | 4.50 | 7,341 | 6.50 |
| Tier I capital ¹ (to average assets) | 15,377 | 9.23 | 6,667 | 4.00 | 8,333 | 5.00 |

¹ As defined by regulatory agencies

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The above minimum capital requirements exclude the capital conservation buffer required to avoid limitations on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers. The capital conservation buffer is being phased in from 0.0 percent for 2015 to 2.50 percent by 2019. The capital conservation buffer was 2.50 percent at December 31, 2019. The net unrealized gain or loss on available-for-sale securities is not included in computing regulatory capital.

The Bank is subject to certain restrictions on the amount of dividends that it may declare without prior regulatory approval.

In July 2013, the three federal bank regulatory agencies jointly published final rules (the Basel III Capital Rules) establishing a new comprehensive capital framework for U.S. banking organizations. The rules implement the Basel Committee's December 2010 framework known as "Basel III" for strengthening international capital standards as well as certain provisions of the Dodd-Frank Act. These rules substantially revise the risk-based capital requirements applicable to bank holding companies and depository institutions, compared to the current U.S. risk-based capital rules. The Basel III Capital Rules define the components of capital and address other issues affecting the numerator in banking institutions' regulatory capital ratios. These rules also address risk weights and other issues affecting the denominator in banking institutions' regulatory capital ratios and replace the existing risk-weighting approach with a more risk-sensitive approach. The Basel III Capital Rules were effective for the Bank on January 1, 2015 (subject to a four-year phase-in period).

The Basel III Capital Rules, among other things, (i) introduce a new capital measure called "Common Equity Tier 1" (CET1), (ii) specify that Tier 1 capital consist of CET1 and "Additional Tier 1 Capital" instruments meeting specified requirements, (iii) define CET1 narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to CET1 and not to the other components of capital and (iv) expand the scope of the deductions/adjustments as compared to existing regulations.

Note 12: Employee Benefits

The Company has a retirement savings 401(k) plan which covers all full-time employees who are age 21 or older and who have worked 1,000 hours and completed three months of service. Employees may contribute up to 25 percent of their compensation up to a maximum of \$19,000 a year with the Company matching 50 percent of the employee's contribution on the first 6 percent of the employee's compensation. Employer contributions charged to expense for the years ended December 31, 2019 and 2018, were \$69,306 and \$69,152, respectively.

The Company participates in the Pentegra Defined Benefit Plan for Financial Institutions (Pentegra Plan), an industry-wide, tax-qualified defined-benefit pension plan. The Pentegra Plan's Employer Identification Number is 13-5645888 and the Plan Number is 333. The Pentegra Plan operates as a multiemployer plan for accounting purposes and as a multiple employer plan under the *Employee Retirement Income Security Act of 1974* and the Internal Revenue Code. There are no collective bargaining agreements in place that require contributions to the Pentegra Plan. The Pentegra Plan is a single plan under Internal Revenue Code Section 413(c) and, as a result, all of the assets stand behind all of the liabilities.

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The risks of participating in a multiemployer plan are different from a single-employer plan in the following aspects:

1. Assets contributed to the multiemployer plan by one employer may be used to provide benefits to employees of other participating employers.
2. If a participating employer stops contributing to the plan, the unfunded obligations of the plan may be borne by the remaining participating employers.
3. If the Company chooses to stop participating in some of its multiemployer plans, the Company may be required to pay those plans an amount based on the underfunded status of the plan, referred to as a withdrawal liability.

The Company froze the benefits in the Pentegra Plan effective June 1, 2010. Full-time employees of the Company who had attained at least 21 years of age and completed one year of service were eligible to participate in the Pentegra Plan. In addition, employees who would have been eligible after June 1, 2010, are not eligible to participate. No further benefits will accrue subsequent to the freeze, and the freeze does not reduce the benefits accrued up to the date of the freeze.

Pension expense related to this plan was \$20,592 and \$21,317 for years ended December 31, 2019 and 2018, and is included in salaries and benefits on the consolidated statements of income. Also, as discussed below, during the years ended December 31, 2019 and 2018, the Company incurred \$150,068 and \$1,231,000, respectively, of expense related to the estimated contribution necessary for terminating its participation in the plan and is included in multiple employer defined benefit pension termination expense on the consolidated statements of income.

Calculations to determine full-funding status are made annually by the third-party plan administrator as of June 30. At June 30, 2019 and 2018, the funding target, which is defined as the market value of plan assets divided by the plan liabilities, of the Company's portion of the Pentegra Plan was 81.39 percent and 81.50 percent, respectively, funded.

Total contributions by all employer participants in the Pentegra Plan, as reported on Form 5500, totaled \$164,570,408 and \$367,119,418, respectively, for the plan years ended June 30, 2019 and 2018. The Company's contributions to the Pentegra Plan totaled \$139,212 and \$81,656 for the years ended December 31, 2019 and 2018, respectively, and do not represent more than 5 percent of the total contributions made by all employer participants in the Pentegra Plan.

In April 2018, the Company notified Pentegra of its intent to withdraw from the Pentegra Plan. Based on the most recent estimated withdrawal analysis performed by Pentegra, the Company would be required to make an estimated final contribution of \$1,381,068 for the purchase of individual annuities for participants in the Pentegra Plan. This contribution for termination of the plan is included in accrued and other liabilities on the consolidated balance sheets and reported as an expense during the year ended December 31, 2019, but the purchase of individual annuities has not been completed.

Given the potential changes in the interest rate environment, assets valuations, and other factors impacting the Pentegra Plan, the actual contribution for purchase of individual annuities to terminate the plan, may be different than the amount accrued.

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In connection with the conversion to an entity owned by stockholders, the Company established an Employee Stock Ownership Plan (ESOP) for the exclusive benefit of eligible employees (all salaried employees who have completed at least 1,000 hours of service in a consecutive 12-month period and have attained the age of 21). The ESOP borrowed funds from the Company in an amount sufficient to purchase 53,431 shares (approximately 8 percent of the common stock issued in the stock offering). The loan is secured by the shares purchased and will be repaid by the ESOP with funds from contributions made by the Company and dividends received by the ESOP. Contributions will be applied to repay interest on the loan first, then the remainder will be applied to principal. The loan is expected to be repaid over a period of up to 25 years. Shares purchased with the loan proceeds are held in a suspense account for allocation among participants as the loan is repaid. Contributions to the ESOP and shares released from the suspense account are allocated among participants in proportion to their compensation, relative to total compensation of all active participants. Participants will vest in their accrued benefits under the employee stock ownership plan at the rate of 20 percent per year. Vesting is accelerated upon retirement, death or disability of the participant, or a change in control of the Association. Forfeitures will be reallocated to remaining plan participants. Benefits may be payable upon retirement, death, disability, separation from service, or termination of the ESOP.

The debt of the ESOP is eliminated in consolidation. Contributions to the ESOP shall be sufficient to pay principal and interest currently due under the loan agreement. As shares are committed to be released from collateral, the Company reports compensation expense equal to the average market price of the shares for the respective period, and the shares become outstanding for earnings per share computations. Dividends on unallocated ESOP shares, if any, are recorded as a reduction of debt and accrued interest. ESOP compensation expense was \$37,184 and \$35,329 for the years ended December 31, 2019 and 2018.

A summary of ESOP shares as of December 31 are as follows:

| | <u>2019</u> | <u>2018</u> |
|---------------------------------|---------------|---------------|
| Released shares | 10,529 | 8,557 |
| Shares committed for release | 2,119 | 1,972 |
| Unreleased shares | <u>40,783</u> | <u>42,902</u> |
| Total | <u>53,431</u> | <u>53,431</u> |
| Fair value of unreleased shares | \$ 1,007,748 | \$ 815,138 |

In the event the ESOP is unable to satisfy the obligation to repurchase the shares held by each beneficiary upon the beneficiary's termination or retirement, the Company is obligated to repurchase the shares. At December 31, 2019, the fair value of these shares is \$11,540. There are 467 outstanding shares held by former employees that are subject to an ESOP related repurchase option.

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Note 13: Stock-Based Compensation

In 2016, the Company's shareholders approved the Edgewater Bancorp, Inc. 2016 Equity Incentive Plan (2016 Plan) to provide officers, employees and directors of Edgewater Bancorp, Inc. and Edgewater Bank with additional incentives to promote the growth and performance of Edgewater Bancorp, Inc. The 2016 Plan authorizes the issuance or delivery to participants of up to 66,000 shares of the Company's common stock. Each award is subject to conditions established by the Compensation Committee (Committee) that are set forth in the recipient's award agreement, and is subject to vesting conditions and restrictions as determined by the Committee; provided, however, that unless the Committee specifies a different vesting rate, no award shall vest more rapidly than 20 percent per year over a five-year period. To the extent any shares of stock covered by an award (including restricted stock awards) under the 2016 Plan are not delivered to a participant or beneficiary because the award is forfeited or canceled or because a stock option is not exercised, then such shares shall not be deemed to have been delivered for purposes of determining the maximum number of shares of stock available for delivery under the Plan. Upon the occurrence of an involuntary termination of employment following a change in control of the Company, all outstanding options then held by a participant will become fully exercisable and all restricted stock awards shall be fully earned and vested.

In March 2017, the Company awarded 15,300 shares of restricted stock. In March and November 2018, the Company awarded 18,150 and 7,250 shares of restricted stock, respectively. In February and December 2019, the Company awarded 16,550 and 5,400 shares of restricted stock, respectively. The restricted stock vests over a five-year period with the first 20 percent being vested at grant date. Compensation expense is recognized on a straight-line basis over the requisite service period for the entire award based on the fair value of the stock at issue date. The Company recognizes the effect of forfeitures in compensation expense when they occur.

A summary of the status of the Company's nonvested shares under the 2016 Plan as of December 31, 2019, and changes during the year then ended, is presented below:

| | Shares | | Weighted-Average Grant Date Fair Value |
|------------------------------|----------------------|----|---|
| Nonvested, beginning of year | 27,120 | \$ | 17.84 |
| Granted | 21,950 | | 20.80 |
| Vested | (11,640) | | 18.89 |
| Forfeited or expired | <u>(2,010)</u> | | 18.16 |
| Nonvested, end of year | <u><u>35,420</u></u> | \$ | 17.84 |

As of December 31, 2019, there was \$684,014 of unrecognized compensation cost related to nonvested shares granted under the 2016 Plan. The cost is expected to be recognized over a weighted-average period of 2.91 years. The total fair value of shares vested during the year ended December 31, 2019, was \$243,018.

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Note 14: Leases

The Company enters into leases in the normal course of business primarily for branch buildings. Leases are classified as operating or finance leases at the lease commencement date. Lease expense for operating leases and short-term leases is recognized on a straight-line basis over the lease term. Right-of-use assets represent our right to use an underlying asset for the lease term and lease liabilities represent our obligation to make lease payments arising from the lease. Right-of-use assets and lease liabilities are recognized at the lease commencement date based on the estimated present value of lease payments over the lease term.

The Company uses its incremental borrowing rate at lease commencement to calculate the present value of lease payments when the rate implicit in a lease is not known. The Company's incremental borrowing rate is based on the FHLB amortizing advance rate, adjusted for the lease term and other factors.

Right-of-use assets and lease liabilities by lease type, and the associated consolidated balance sheet classifications are as follows as of December 31, 2019:

| | <u>Consolidated Balance Sheet Classification</u> | <u>2019</u> |
|-------------------------------------|--|-------------|
| Operating lease right of use assets | Other assets | \$ 51,271 |
| Operating lease liabilities | Accrued and other liabilities | 51,271 |

The following table shows the components of operating leases expenses for the year ended December 31, 2019

| | <u>Consolidated Statement of Income</u> | <u>2019</u> |
|----------------------|---|-------------|
| Operating lease cost | Occupancy and equipment expense | \$ 15,983 |

Future undiscounted lease payments for operating leases with initial terms of one year or more as of December 31, 2019, are as follows:

| | |
|--|------------------|
| 2020 | \$ 20,650 |
| 2021 | 13,950 |
| 2022 | 13,950 |
| 2023 | 5,813 |
| 2024 | - |
| Thereafter | - |
| Total lease payments | <u>54,363</u> |
| Less: imputed interest | <u>3,092</u> |
| Present value of operating lease liabilities | <u>\$ 51,271</u> |

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Note 15: Disclosures About Fair Value of Assets and Liabilities

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 measurements must maximize the use of observable inputs and minimize the use of unobservable inputs. There is a hierarchy of three levels of inputs that may be used to measure fair value:

- Level 1** Quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date
- Level 2** Observable inputs other than Level 1 prices, such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the assets or liabilities
- Level 3** Unobservable inputs supported by little or no market activity and are significant to the fair value of the assets or liabilities

Recurring Measurements

The following tables present the fair value measurements of assets recognized in the accompanying consolidated balance sheets measured at fair value on a recurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2019 and 2018:

| Assets | December 31, 2019 | | | |
|---|---|--|--|--------|
| | Fair Value Measurements Using | | | |
| Fair Value | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) | |
| Available-for-sale securities | | | | |
| U.S. Government and federal agency | \$ 5,004,668 | \$ - | \$ 5,004,668 | \$ - |
| State and political subdivisions | 1,081,576 | - | 1,081,576 | - |
| Corporate bonds | 506,682 | - | 506,682 | - |
| Mortgage-backed - GSE residential | 1,651,757 | - | 1,651,757 | - |
| Collateralized mortgage obligations - GSE | 808,314 | - | 808,314 | - |
| Mortgage servicing rights | 50,432 | - | - | 50,432 |

Edgewater Bancorp, Inc.
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| Assets | December 31, 2018 | | | |
|---|-------------------|--|---|--|
| | Fair Value | Fair Value Measurements Using | | |
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| Available-for-sale securities | | | | |
| U.S. Government and federal agency | \$ 7,623,515 | \$ - | \$ 7,623,515 | \$ - |
| State and political subdivisions | 1,036,389 | - | 1,036,389 | - |
| Corporate bonds | 1,623,204 | - | 1,623,204 | - |
| Mortgage-backed - GSE residential | 2,199,341 | - | 2,199,341 | - |
| Collateralized mortgage obligations - GSE | 951,471 | - | 951,471 | - |
| Mortgage servicing rights | 68,806 | - | - | 68,806 |

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a recurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy. There have been no significant changes in the valuation techniques during the years ended December 31, 2019 and 2018. For assets classified within Level 3 of the fair value hierarchy, the process used to develop the reported fair value is described below.

Available-for-Sale Securities

Where quoted market prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. If quoted market prices are not available, then fair values are estimated by using quoted prices of securities with similar characteristics or independent asset pricing services and pricing models, the inputs of which are market-based or independently sourced market parameters, including, but not limited to, yield curves, interest rates, volatilities, prepayments, defaults, cumulative loss projections and cash flows. Such securities are classified in Level 2 of the valuation hierarchy including U.S. Government and federal agencies, state and political subdivisions, mortgage-backed securities and collateralized mortgage obligations. In certain cases where Level 1 or Level 2 inputs are not available, securities are classified within Level 3 of the hierarchy. The Company has no securities classified as Level 3.

Mortgage Servicing Rights

Mortgage servicing rights do not trade in an active, open market with readily observable prices. Accordingly, fair value is estimated using discounted cash flow models having significant inputs of discount rate, prepayment speed and default rate. Due to the nature of the valuation inputs, mortgage servicing rights are classified within Level 3 of the hierarchy.

Mortgage servicing rights are tested for impairment on a quarterly basis. The Chief Financial Officer's (CFO) office contracts with a pricing specialist to generate fair value estimates on at least an annual basis. The CFO's office challenges the reasonableness of the assumptions used and reviews the methodology to ensure the estimated fair value complies with accounting standards generally accepted in the United States of America.

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Level 3 Reconciliation

The following is a reconciliation of the beginning and ending balances of recurring fair value measurements for mortgage servicing rights recognized in the accompanying consolidated balance sheets using significant unobservable (Level 3) inputs:

| | <u>2019</u> | <u>2018</u> |
|--|------------------|------------------|
| Balance, beginning of year | \$ 68,806 | \$ 66,058 |
| Total changes in fair value included in earnings | <u>(18,374)</u> | <u>2,748</u> |
| Balance, end of year | <u>\$ 50,432</u> | <u>\$ 68,806</u> |

Nonrecurring Measurements

The following table presents the fair value measurement of assets and liabilities measured at fair value on a nonrecurring basis and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2019 and 2018:

| <u>Assets</u> | <u>Fair Value</u> | <u>Fair Value Measurements Using</u> | | |
|--|-------------------|---|--|--|
| | | <u>Quoted Prices in Active Markets for Identical Assets (Level 1)</u> | <u>Significant Other Observable Inputs (Level 2)</u> | <u>Significant Unobservable Inputs (Level 3)</u> |
| December 31, 2019 | | | | |
| Collateral-dependent impaired loans, Net of ALLL | \$ 501,409 | \$ - | \$ - | \$ 501,409 |
| December 31, 2018 | | | | |
| Collateral-dependent impaired loans, Net of ALLL | \$ 100,331 | \$ - | \$ - | 100,331 |

Following is a description of the valuation methodologies and inputs used for assets measured at fair value on a nonrecurring basis and recognized in the accompanying consolidated balance sheets, as well as the general classification of such assets pursuant to the valuation hierarchy. For assets classified within Level 3 of the fair value hierarchy, the process used to develop the reported fair value is described below.

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Collateral-Dependent Impaired Loans, Net of ALLL

The estimated fair value of collateral-dependent impaired loans is based on the appraised fair value of the collateral, less estimated cost to sell. Collateral-dependent impaired loans are classified within Level 3 of the fair value hierarchy.

The Company considers the appraisal or evaluation as the starting point for determining fair value and then considers other factors and events in the environment that may affect the fair value. Appraisals of the collateral underlying collateral-dependent loans are obtained when the loan is determined to be collateral-dependent and subsequently as deemed necessary by the CFO's Office. Appraisals are reviewed for accuracy and consistency by the CFO's Office. Appraisers are selected from the list of approved appraisers maintained by management. The appraised values are reduced by discounts to consider lack of marketability and estimated cost to sell if repayment or satisfaction of the loan is dependent on the sale of the collateral. These discounts and estimates are developed by the CFO's Office by comparison to historical results.

Unobservable (Level 3) Inputs

The following tables present quantitative information about unobservable inputs used in recurring and nonrecurring Level 3 fair value measurements:

| | Fair Value | Valuation Technique | Unobservable Inputs | Weighted Average |
|---|-------------------|---------------------------------|--|---|
| At December 31, 2019 | | | | |
| Collateral-dependent impaired loans, net of ALLL | 501,409 | Market comparable properties | Marketability discount | 10.0% - 30.0% (-26.0%) |
| Mortgage servicing rights | 50,432 | Discounted cash flow | Constant prepayment rate Discount rate | 10.45% - 13.97% (12.6%) 8.5% - 8.8% (8.6%) |
| At December 31, 2018 | | | | |
| Collateral-dependent impaired loans, net of ALLL | 100,331 | Market comparable properties | Marketability discount | 2.0% - 5.0% (3.8%) |
| Mortgage servicing rights | 68,806 | Discounted cash flow | Constant prepayment rate Discount rate | 8.0% - 24.3% (13.0%) 9.0% - 13.0% (10.7%) |

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Fair Value of Financial Instruments

The following tables present estimated fair values of the Company's financial instruments and the level within the fair value hierarchy in which the fair value measurements fall at December 31, 2019 and 2018:

| | Carrying Amount | Fair Value Measurements Using | | |
|---|-----------------|--|---|---|
| | | Quoted Prices in Active Markets for Identical Assets (Level 1) | Significant Other Observable Inputs (Level 2) | Significant Unobservable Inputs (Level 3) |
| At December 31, 2019 | | | | |
| Financial assets | | | | |
| Cash and cash equivalents | \$ 7,355,990 | \$ 7,355,990 | \$ - | \$ - |
| Loans, net of allowance for loan losses | 158,109,103 | - | - | 157,436,000 |
| FHLB stock | 686,200 | - | 686,200 | - |
| Accrued interest receivable | 511,209 | - | 511,209 | - |
| Mortgage servicing rights | 301,015 | - | - | 698,228 |
| Financial liabilities | | | | |
| Deposits | 152,058,752 | 21,195,230 | 131,034,522 | - |
| Federal Home Loan Bank advances | 13,000,000 | - | 13,050,000 | - |
| Other borrowings | 1,807,908 | - | 1,807,908 | - |
| Accrued interest payable | 39,143 | - | 39,143 | - |
| At December 31, 2018 | | | | |
| Financial assets | | | | |
| Cash and cash equivalents | \$ 21,292,059 | \$ 21,292,059 | \$ - | \$ - |
| Loans, net of allowance for loan losses | 126,941,521 | - | - | 124,522,000 |
| FHLB stock | 686,200 | - | 686,200 | - |
| Accrued interest receivable | 462,536 | - | 462,536 | - |
| Mortgage servicing rights | 296,471 | - | - | 780,642 |
| Financial liabilities | | | | |
| Deposits | 143,750,893 | 22,176,701 | 121,357,192 | - |
| Federal Home Loan Bank advances | 7,000,000 | - | 7,013,000 | - |
| Other borrowings | 1,967,263 | - | 1,967,263 | - |
| Accrued interest payable | 8,349 | - | 8,349 | - |

The following methods were used to estimate the fair value of all other financial instruments recognized in the accompanying consolidated balance sheets at amounts other than fair value.

Cash and Cash Equivalents

The carrying amount approximates fair value.

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Loans Receivable, Net

As of December 31, 2019 and 2018, fair values of loans are estimated on an exit price basis incorporating discounts for credit, liquidity and marketability factors.

FHLB Stock

FHLB Stock is a required investment for institutions that are members of the Federal Home Loan Bank system. The required investment in the common stock is based on a predetermined formula, carried at cost and evaluated for impairment.

Accrued Interest Receivable and Payable

The carrying amount approximates fair value. The carrying amount is determined using the interest rate, balance and last payment date.

Deposits

Fair value of term deposits is estimated by discounting the future cash flows using rates of similar deposits with similar maturities. The market rates used were obtained from a knowledgeable independent third party and reviewed by the Company. The rates were the average of current rates offered by local competitors of the Company.

The estimated fair value of demand, savings and money market deposits is the book value since rates are regularly adjusted to market rates and amounts are payable on demand at the reporting date.

Federal Home Loan Bank Advances and Other Borrowings

Fair value is estimated by discounting the future cash flows using rates of similar borrowings with similar maturities.

Note 16: Significant Estimates and Concentrations

Accounting principles generally accepted in the United States of America require disclosure of certain significant estimates and current vulnerabilities due to certain concentrations. Estimates related to the allowance for loan losses are reflected in the footnote regarding loans. Current vulnerabilities due to certain concentrations of credit risk are discussed in the footnote on commitments and credit risk. Significant estimates associated with financial instruments are discussed in the footnote on fair value of financial instruments.

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Investments

The Company invests in various investment securities. Investment securities are exposed to various risks such as interest rate, market and credit risks. Due to the level of risk associated with certain investment securities, it is at least reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the accompanying consolidated balance sheets.

Note 17: Commitments and Credit Risk

The Company maintains off-balance sheet investments in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Loan 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. Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

The instruments involve, to varying degrees, elements of credit risk in excess of the amount recognized, if any, in the balance sheet. The Company's maximum exposure to loan loss in the event of nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the face amount of these instruments. Commitments to extend credit are recorded when they are funded and standby letters of credit are carried at fair value.

The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance-sheet instruments. Collateral, such as accounts receivable, securities, inventory, property and equipment, is generally obtained based on management's credit assessment of the borrower.

Fair value of the Company's off-balance-sheet instruments (commitments to extend credit and standby letters of credit) is based on rates currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. At December 31, 2019 and 2018, the rates on existing off-balance-sheet instruments were equivalent to current market rates, considering the underlying credit standing of the counterparties.

Loan commitments and standby letters of credit outstanding as December 31, 2019 and 2018, were as follows:

| | 2019 | 2018 |
|--|---------------|---------------|
| Commitments to extend credit - variable rate | \$ 25,467,148 | \$ 24,080,713 |
| Commitments to extend credit - fixed rate | 16,050,209 | 12,952,753 |
| Standby letters of credit | 4,000 | 4,000 |

Edgewater Bancorp, Inc.
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Note 18: Recent Accounting Pronouncements

The Financial Accounting Standards Board issued Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses (Topic 326)*. The ASU introduces a new credit loss model, the current expected credit loss model (CECL), which requires earlier recognition of credit losses, while also providing additional transparency about credit risk.

The CECL model utilizes a lifetime “expected credit loss” measurement objective for the recognition of credit losses for loans, held-to-maturity securities and other receivables at the time the financial asset is originated or acquired. The expected credit losses are adjusted each period for changes in expected lifetime credit losses. For available-for-sale securities where fair value is less than cost, credit-related impairment, if any, will be recognized in an allowance for credit losses and adjusted each period for changes in expected credit risk. This model replaces the multiple existing impairment models, which generally require that a loss be incurred before it is recognized.

The CECL model represents a significant change from existing practice and may result in material changes to the Corporation’s accounting for financial instruments. The Corporation is evaluating the effect ASU 2016-13 will have on its consolidated financial statements and related disclosures. The impact of the ASU will depend upon the state of the economy and the nature of our portfolios at the date of adoption. The new standard is effective for public business entities, which do not meet the definition of an SEC filer, for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

Note 19: Earnings Per Share

Earnings per share amount is based on the weighted average number of shares outstanding for the period and the new income applicable to common stockholders. ESOP shares are excluded from shares outstanding until they have been committed to be released:

| | <u>2019</u> | <u>2018</u> |
|--|---------------------|---------------------|
| Net income | \$ 1,098,100 | \$ 1,245,811 |
| Dividends and undistributed earnings allocated to participating securities | <u>(52,668)</u> | <u>(42,041)</u> |
| Net income available to common stockholders | <u>\$ 1,045,432</u> | <u>\$ 1,203,770</u> |
| Weighted average shares outstanding including participating securities | 775,743 | 703,628 |
| Average unearned ESOP and unvested restricted stock | <u>(79,007)</u> | <u>(67,637)</u> |
| Weighted average common shares outstanding | <u>696,736</u> | <u>635,991</u> |
| Basic and diluted earnings per share | <u>\$ 1.50</u> | <u>\$ 1.89</u> |

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Notes to Consolidated Financial Statements
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Condensed Financial Information (Parent Company Only)

Presented below is condensed financial information as to the financial position, results of operations and cash flows of the Company:

Condensed Balance Sheet

| | 2019 | 2018 |
|---|----------------------|----------------------|
| Assets | | |
| Cash and due from banks | \$ 453,695 | \$ 697,957 |
| Investment in bank | 18,211,795 | 16,621,203 |
| Other assets | 134,588 | 73,049 |
| Total assets | \$ 18,800,078 | \$ 17,392,209 |
| Liabilities | | |
| Note payable | \$ 1,807,908 | \$ 1,967,263 |
| Other | 26,081 | 26,298 |
| | 1,833,989 | 1,993,561 |
| Temporary Equity | | |
| ESOP shares subject to mandatory redemption | 180,006 | 142,822 |
| Stockholders' Equity | | |
| | 16,786,083 | 15,255,826 |
| Total liability and stockholders' equity | \$ 18,800,078 | \$ 17,392,209 |

Edgewater Bancorp, Inc.
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Condensed Statement of Operations and Comprehensive Income

| | 2019 | 2018 |
|--|--------------|--------------|
| Income | | |
| Other income | \$ - | \$ - |
| Expense | | |
| Other expenses | 360,055 | 276,937 |
| Loss Before Income Tax and Equity in Undistributed Income of Subsidiary | (360,055) | (276,937) |
| Income Tax Benefit | 69,018 | 58,630 |
| Loss Before Equity in Undistributed Income of Subsidiary | (291,037) | (218,307) |
| Equity in Undistributed Income of Subsidiary | 1,389,137 | 1,464,118 |
| Net Income | \$ 1,098,100 | \$ 1,245,811 |
| Comprehensive Income | \$ 1,299,555 | \$ 1,179,283 |

Edgewater Bancorp, Inc.
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Condensed Statement of Cash Flows

| | <u>2019</u> | <u>2018</u> |
|---|-------------------|--------------------|
| Operating Activities | | |
| Net income | \$ 1,098,100 | \$ 1,245,811 |
| Items not requiring (providing) cash | | |
| Equity in undistributed income of subsidiary | (1,389,137) | (1,464,118) |
| Compensation expense on allocated ESOP shares | 37,184 | 35,329 |
| Compensation expense on restricted stock shares | 243,019 | 120,210 |
| Change in other assets | (61,539) | (70,864) |
| Change in other liabilities | (217) | 25,834 |
| Net cash used in operating activities | <u>(72,590)</u> | <u>(107,798)</u> |
| Investing Activities | | |
| Investment in Bank | <u>-</u> | <u>(1,500,000)</u> |
| Financing Activities | | |
| Repurchase of common stock | (12,317) | (10,026) |
| Proceeds from other borrowings | - | 2,000,000 |
| Repayment of other borrowings | <u>(159,355)</u> | <u>(32,737)</u> |
| Net cash provided by (used in) financing activities | <u>(171,672)</u> | <u>1,957,237</u> |
| Net Change in Cash and Due From Banks | (244,262) | 349,439 |
| Cash and Due From Banks at Beginning of Year | <u>697,957</u> | <u>348,518</u> |
| Cash and Due From Banks at End of Year | <u>\$ 453,695</u> | <u>\$ 697,957</u> |

Note 20: Subsequent Events

Subsequent events have been evaluated through March 24, 2020, which is the date the consolidated financial statements were available to be issued.

There has been significant volatility in the economy both nationally and globally since December 31, 2019, resulting in overall economic uncertainty that may impact the Company.



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