

# **SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

Consolidated Financial Statements

December 31, 2016 and 2015  
(with Independent Auditor's Report thereon)



## INDEPENDENT AUDITOR'S REPORT

The Board of Directors  
SouthCrest Financial Group, Inc.  
Tyrone, Georgia

### Report on the Consolidated Financial Statements

We have audited the accompanying consolidated financial statements of SouthCrest Financial Group, Inc. and subsidiary (the "Company"), which comprise the consolidated balance sheets as of December 31, 2016 and 2015, and the related consolidated statements of operations, comprehensive income (loss), changes in stockholders' equity and cash flows for the years then ended and the related notes to the consolidated financial statements.

### Management's Responsibility for the Consolidated 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 SouthCrest Financial Group, Inc. and subsidiary as of December 31, 2016 and 2015, 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.

### Other Matter

The consolidated financial statements of the Company for the year ended December 31, 2014 were audited by other auditors whose report dated March 31, 2015 expressed an unmodified opinion on those statements.

*PORTER KEADLE MOORE, LLC*

Atlanta, Georgia  
March 27, 2017

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**  
**Consolidated Balance Sheets**  
**December 31, 2016 and 2015**  
(Dollars in thousands, except share and per share data)

	2016	2015
<b><u>Assets</u></b>		
Cash and due from banks	\$ 11,442	10,703
Interest-bearing deposits with other banks	23,358	35,515
Federal funds sold	4,299	2,186
Investment securities available-for-sale	167,391	167,116
Investment securities held-to-maturity (fair value of \$6,983 and \$5,927 at December 31, 2016 and December 31, 2015, respectively)	7,000	5,888
Restricted equity securities, at cost	2,332	1,994
Loans held for sale	-	1,122
Loans, net	290,887	293,011
Bank owned life insurance	20,816	20,265
Premises and equipment, net	13,717	18,214
Intangible assets, net	468	618
Other real estate owned	3,581	2,421
Other assets	18,034	7,466
Total assets	\$ 563,325	566,519
<b><u>Liabilities and Stockholders' Equity</u></b>		
Deposits:		
Non-interest bearing	\$ 125,459	130,873
Interest-bearing	371,788	380,303
Total deposits	497,247	511,176
Other liabilities	1,498	2,944
Total liabilities	498,745	514,120
Commitments and contingencies		
Redeemable common stock held by ESOP	-	352
Stockholders' equity:		
Series A Preferred stock, no par value, 4,910 shares issued and outstanding	4,910	4,910
Series B Preferred stock, no par value, 645 shares issued and outstanding	645	645
Series D Preferred stock, no par value, 2,500,000 shares authorized, 2,096,165 shares issued and outstanding	10,304	10,304
Series AAA Preferred stock, \$1 par value, 1,500,000 shares authorized, 128,096 and 190,649 shares issued and outstanding, respectively	128	191
Common stock, \$1 par value; authorized 50,000,000 shares; 6,165,693 and 6,093,523 issued and outstanding, respectively	6,166	6,093
Additional paid-in capital – Series AAA preferred stock	1,630	2,426
Additional paid-in capital	57,946	57,063
Accumulated deficit	(15,402)	(28,917)
Unearned compensation - ESOP	(180)	(308)
Accumulated other comprehensive loss	(1,567)	(360)
Total stockholders' equity	64,580	52,047
Total liabilities and stockholders' equity	\$ 563,325	566,519

See accompanying notes to consolidated financial statements.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**  
**Consolidated Statements of Operations**  
**For the Years Ended December 31, 2016, 2015 and 2014**  
**(Dollars in thousands, except share and per share data)**

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Interest income:			
Loans	\$ 14,149	14,966	18,136
Investment securities – taxable	4,063	3,787	3,609
Investment securities – nontaxable	22	50	144
Federal funds sold	28	15	27
Interest-bearing deposits in other banks	134	85	144
Total interest and dividend income	<u>18,396</u>	<u>18,903</u>	<u>22,060</u>
Interest expense:			
Interest expense – deposits	1,057	1,247	1,356
Interest expense – borrowings	2	1	-
Total interest expense	<u>1,059</u>	<u>1,248</u>	<u>1,356</u>
Net interest income	17,337	17,655	20,704
Provision for loan losses	144	589	170
Net interest income after provision for loan losses	<u>17,193</u>	<u>17,066</u>	<u>20,534</u>
Other income:			
Service charges on deposit accounts	2,901	2,481	2,754
Other service charges and fees	1,238	2,066	2,290
Net gain on sales of investment securities available-for-sale	401	724	615
Net gain on sales of loans	302	1,888	1,821
Income on bank-owned life insurance	551	555	555
Gain on sales and foreclosures of other real estate owned, net	238	32	114
Other operating income	723	924	1,269
Total other income	<u>6,354</u>	<u>8,670</u>	<u>9,418</u>
Other expenses:			
Salaries and employee benefits	9,617	11,930	13,909
Equipment and occupancy expenses	3,408	3,900	3,729
Amortization of intangibles	196	189	320
Loss on calls of investment securities held-to-maturity	331	-	-
Writedowns of other real estate owned	328	308	542
Other	6,459	8,705	13,189
Total other expenses	<u>20,339</u>	<u>25,032</u>	<u>31,689</u>
Income (loss) before income taxes	3,208	704	(1,737)
Income tax benefit	10,455	-	-
Net income (loss)	13,663	704	(1,737)
Preferred dividends	500	680	1,162
Net income (loss) available to common shareholders	<u>\$ 13,163</u>	<u>24</u>	<u>(2,899)</u>
Basic earnings (loss) per common share	<u>\$ 1.57</u>	<u>-</u>	<u>(0.35)</u>
Diluted earnings (loss) per common share	<u>\$ 1.56</u>	<u>-</u>	<u>(0.35)</u>

See accompanying notes to consolidated financial statements.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**  
**Consolidated Statements of Comprehensive Income (Loss)**  
**For the Years Ended December 31, 2016, 2015 and 2014**  
(Dollars in thousands)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Net income (loss)	\$ <u>13,663</u>	<u>704</u>	<u>(1,737)</u>
Other comprehensive (loss) income:			
Unrealized holding (losses) gains on securities available-for-sale arising during period, net of (benefits) taxes of \$(705), \$(87) and \$141	(1,163)	(140)	996
Reclassification adjustments for gains included in operations, net of taxes of \$26, \$273 and \$232	<u>(44)</u>	<u>(451)</u>	<u>(383)</u>
Other comprehensive (loss) income	<u>(1,207)</u>	<u>(591)</u>	<u>613</u>
Comprehensive income (loss)	\$ <u><u>12,456</u></u>	<u><u>113</u></u>	<u><u>(1,124)</u></u>

See accompanying notes to consolidated financial statements.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**  
**Consolidated Statements of Changes in Stockholders' Equity**  
**For the Years Ended December 31, 2016, 2015 and 2014**  
**(Dollars in thousands)**

	Preferred Stock					Additional Paid-In Capital Series AAA Preferred	Common Stock			Accumulated Deficit	Unearned Compensation (ESOP)	Accumulated Other Comprehensive Income (Loss)	Total Stockholders' Equity
	Series A	Series B	Series C	Series D	Series AAA		Shares	Par Value	Additional Paid-In Capital				
Balance, December 31, 2013	\$ 12,820	654	4,877	10,304	191	2,426	5,127,380	\$ 5,127	52,915	(26,072)	(174)	(382)	62,686
Net loss	-	-	-	-	-	-	-	-	-	(1,737)	-	-	(1,737)
Preferred stock dividends declared	-	-	-	-	-	-	-	-	-	(1,091)	-	-	(1,091)
Amortization of preferred stock premiums and discounts	80	(9)	-	-	-	-	-	-	-	(71)	-	-	-
Stock compensation awards	-	-	-	-	-	-	-	-	104	-	-	-	104
Adjustment for shares owned by ESOP	-	-	-	-	-	-	-	-	-	30	-	-	30
Principal reduction of ESOP debt	-	-	-	-	-	-	-	-	-	-	23	-	23
Other comprehensive income	-	-	-	-	-	-	-	-	-	-	-	613	613
Balance, December 31, 2014	12,900	645	4,877	10,304	191	2,426	5,127,380	5,127	53,019	(28,941)	(151)	231	60,628
Net income	-	-	-	-	-	-	-	-	-	704	-	-	704
Preferred stock dividends declared	-	-	-	-	-	-	-	-	-	(680)	-	-	(680)
Principal reduction of preferred stock	(7,990)	-	-	-	-	-	-	-	-	-	-	-	(7,990)
Conversion of Series C preferred stock to common stock	-	-	(4,877)	-	-	-	966,143	966	3,911	-	-	-	-
Stock compensation awards	-	-	-	-	-	-	-	-	133	-	-	-	133
Loan to ESOP	-	-	-	-	-	-	-	-	-	-	(180)	-	(180)
Principal reduction of ESOP debt	-	-	-	-	-	-	-	-	-	-	23	-	23
Other comprehensive income	-	-	-	-	-	-	-	-	-	-	-	(591)	(591)
Balance, December 31, 2015	4,910	645	-	10,304	191	2,426	6,093,523	6,093	57,063	(28,917)	(308)	(360)	52,047
Net income	-	-	-	-	-	-	-	-	-	13,663	-	-	13,663
Preferred stock dividends declared	-	-	-	-	-	-	-	-	-	(500)	-	-	(500)
Conversion of Series AAA preferred stock to common stock	-	-	-	-	(63)	(796)	62,553	63	796	-	-	-	-
Exercise of stock options	-	-	-	-	-	-	9,617	10	(43)	-	-	-	(33)
Stock compensation awards	-	-	-	-	-	-	-	-	130	-	-	-	130
Release of ESOP shares	-	-	-	-	-	-	-	-	-	352	-	-	352
Principal reduction of ESOP debt	-	-	-	-	-	-	-	-	-	-	128	-	128
Other comprehensive income	-	-	-	-	-	-	-	-	-	-	-	(1,207)	(1,207)
Balance, December 31, 2016	\$ 4,910	645	-	10,304	128	1,630	6,165,693	6,166	57,946	(15,402)	(180)	(1,567)	64,580

See accompanying notes to consolidated financial statements.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**  
**Consolidated Statements of Cash Flows**  
**For the Years Ended December 31, 2016, 2015 and 2014**  
(Dollars in thousands)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Cash flows from operating activities:			
Net income (loss)	\$ 13,663	704	(1,737)
Adjustments to reconcile net income (loss) to net cash provided by (used in) operating activities:			
Depreciation	1,781	1,894	1,656
Amortization of intangibles	196	189	320
Other amortization	1,360	1,521	1,066
Provision for loan losses	144	589	170
Deferred tax expense	626	-	-
Stock-based compensation	130	133	104
Deferred compensation expense	(354)	(154)	313
Net gain on sales of investment securities available-for-sale	(401)	(724)	(615)
Loss on calls of investment securities held-to-maturity	331	-	-
Income on bank-owned life insurance	(551)	(555)	(555)
(Increase)/decrease in interest receivable	157	(18)	(546)
(Increase) in income taxes receivable	(7,615)	-	(357)
(Increase) in income taxes payable	(730)	-	(5)
Decrease in interest payable	(28)	(78)	(55)
Net gain on sale of loans	(302)	(1,888)	(1,821)
Originations of mortgage loans held-for-sale	(3,651)	(29,091)	(52,466)
Proceeds from sales of mortgage loans held-for-sale	4,921	30,546	57,630
Originations of SBA loans sold	(866)	(6,685)	-
Proceeds from sales of SBA loans	3,185	5,136	-
Increase in mortgage servicing assets	(44)	(195)	(13)
Loss (gain) on disposal of premises and equipment	73	(6)	-
Writedowns of premises and equipment	393	42	-
Gain on sales of other real estate owned	(126)	(32)	(114)
Gain on transfer of loans to other real estate owned	(112)	-	-
Writedowns of other real estate owned	328	308	542
Payment of benefits to participants in deferred compensation plan	-	(5,449)	-
Change in other assets and other liabilities	(4,604)	(138)	82
Net cash provided by (used in) operating activities	<u>8,634</u>	<u>(2,661)</u>	<u>8,125</u>
Cash flows from investing activities:			
Net change in interest-bearing deposits in other banks	12,157	4,323	68,489
Net change in federal funds sold	(2,113)	(2,186)	-
Purchases of investment securities held-to-maturity	(3,500)	(1,500)	(2,000)
Purchases of investment securities available-for-sale	(90,283)	(77,763)	(138,737)
Proceeds from calls, maturities and paydowns of investment securities available-for-sale	12,979	71,098	22,508
Proceeds from sales of investment securities available-for-sale	74,173	22,584	52,161
Proceeds from sale of investment securities held-to-maturity	2,015	-	-
Purchase of restricted equity securities	(338)	(75)	(806)
Net increase in loans	(654)	(16,567)	(31,320)
Purchases of premises and equipment	(699)	(905)	(2,365)
Proceeds from sales of premises and equipment	162	16	-
Proceeds from sales of other real estate owned	2,007	2,678	2,213
Net cash provided by (used in) investing activities	<u>5,906</u>	<u>1,703</u>	<u>(29,857)</u>
Cash flows from financing activities:			
Net increase (decrease) in deposits	(13,929)	6,008	20,868
Proceeds from FHLB advances	-	5,000	-
Repayments of FHLB advances	-	(5,000)	-
Change in unearned compensation – ESOP	128	(157)	23
Redemption of preferred stock	-	(7,990)	-
Preferred stock dividends paid	-	(758)	(3,318)
Net cash (used in) provided by financing activities	<u>(13,801)</u>	<u>(2,897)</u>	<u>17,573</u>
Net change in cash and due from banks	739	(3,855)	(4,159)
Cash and due from banks at beginning of year	10,703	14,558	18,717
Cash and due from banks at end of year	<u>\$ 11,442</u>	<u>10,703</u>	<u>14,558</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**  
**Consolidated Statements of Cash Flows, continued**  
**For the Years Ended December 31, 2016, 2015 and 2014**  
(Dollars in thousands)

Supplemental disclosures	2016	2015	2014
Cash paid for:			
Interest	\$ 1,087	1,326	1,411
Income taxes	\$ 82	-	5
Noncash transactions:			
Principal balances of loans transferred to other real estate owned	\$ 952	1,439	4,352
Financed sales of other real estate owned	\$ 482	336	2,218
Decrease in redeemable common stock held by ESOP	\$ -	-	(30)
Unrealized (loss) gain on investment securities available-for-sale, net	\$ (1,207)	(591)	613
Accrual of cumulative preferred dividend	\$ 500	680	1,091
Bank premises transferred to other real estate owned	\$ 2,787	-	-

See accompanying notes to consolidated financial statements.



**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements**

**(1) Summary of Significant Accounting Policies**

**Nature of Operations**

SouthCrest Financial Group, Inc. (the "Company") is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary bank, SouthCrest Bank, N.A. (the "Bank"). The Bank is a commercial bank located in Tyrone, Georgia operating branches located in Thomaston, Manchester, Luthersville, Cedartown, Rockmart, Chickamauga, Cumming, and Tyrone, Georgia and Maplesville and Clanton, Alabama. The Bank provides a full range of banking services in its primary market area of Upson, Meriwether, Fayette, Fulton, Polk, and Walker Counties, Georgia and Chilton County, Alabama and the surrounding counties. The Johns Creek branch in Fulton County, Georgia acquired through an FDIC purchase and assumption agreement in 2010 was closed in 2015. The Company considers its banking services to represent a single reporting segment. The Company is regulated by the Federal Reserve Bank and the Bank is regulated by the Office of the Comptroller of the Currency. The Bank's deposits are insured by the Federal Deposit Insurance Corporation ("FDIC").

**Basis of Presentation and Accounting Estimates**

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

In preparing the consolidated financial statements in conformity with accounting principles generally accepted in the United States of America, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet, and reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

Material estimates that are particularly susceptible to significant change in the near term relate to the determination of the allowance for loan losses, the valuation of other real estate and deferred taxes, other-than-temporary impairments of securities, and the fair value of financial instruments.

The determination of the adequacy of the allowance for loan losses is based on estimates that are particularly susceptible to significant changes in the economic environment and market conditions. In connection with the determination of the estimated losses on loans, management obtains independent appraisals for significant collateral.

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

The Company has evaluated all transactions, events, and circumstances for consideration or disclosure through March 27, 2017, the date these consolidated financial statements were available to be issued and has reflected or disclosed those items within the consolidated financial statements and related footnotes as deemed appropriate.

**Cash, Due from Banks and Cash Flows**

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

The Bank is required to maintain reserve balances in cash or on deposit with the Federal Reserve Bank. The total of those reserve balances was approximately \$16,736,000 and \$14,399,000 at December 31, 2016 and 2015, respectively.

Notes to Consolidated Financial Statements, continued

(1) **Summary of Significant Accounting Policies, continued**  
**Securities**

Certain debt securities that management has the positive intent and ability to hold to maturity are classified as “held-to-maturity” and recorded at amortized cost. Securities not classified as held-to-maturity are classified as “available-for-sale” and recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive income (loss). Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

The Company evaluates investment securities for other-than-temporary impairment using relevant accounting guidance specifying that (a) if the Company does not have the intent to sell a debt security prior to recovery and (b) it is more likely than not that it will not have to sell the debt security prior to recovery, the security would not be considered other-than-temporarily impaired unless there is a credit loss that has occurred in the security. If management does not intend to sell the security and it is more likely than not that they will not have to sell the security before recovery of the cost basis, management will recognize the credit component of an other-than-temporary impairment of a debt security in earnings and the remaining portion in other comprehensive income (loss).

**Restricted Equity Securities**

The Company is required to maintain an investment in capital stock of various entities. Based on redemption provisions of these entities, the stock has no quoted market value and is carried at cost. At their discretion, these entities may declare dividends on the stock. Management reviews these stocks for impairment based on the ultimate recoverability of the cost basis in these stocks.

**Loans Held For Sale**

Loans originated and intended for sale in the secondary market are carried at fair value. Gains and losses on loan sales (sales proceeds minus carrying value) 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. The estimated fair value of loans held for sale is based on independent third party quoted prices.

**Loans**

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off are reported at their outstanding principal balances less deferred fees and costs on originated loans and the allowance for loan losses. Interest income is accrued on the outstanding principal balance. Loan origination fees, net of certain direct origination costs of consumer and installment loans are recognized at the time the loan is placed on the books. Loan origination fees for all other loans are deferred and recognized as an adjustment of the yield over the life of the loan using the straight-line method.

Accrual of interest on loans is discontinued when management believes, after considering current economic conditions and collection efforts, that the borrower’s financial condition is such that collection of interest is doubtful. All interest accrued but not collected for loans that are placed on nonaccrual is reversed against interest income for the current year or if the interest was accrued in prior periods, the amount is charged to the allowance for loan losses. Interest income on nonaccrual loans is recognized on the cash basis or cost recovery method, until the loans are returned to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

A loan is considered impaired when it is probable, based on current information and events, the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest when due. Impaired loans are measured by either the present value of expected future cash flows discounted at the loan’s effective interest rate, the loan’s obtainable market price, or the fair value of the collateral if the loan is collateral dependent. Interest on accruing impaired loans is recognized as long as such loans do not meet the criteria for nonaccrual status.

Notes to Consolidated Financial Statements, continued

(1) **Summary of Significant Accounting Policies, continued**

**Loans, continued**

The Bank services mortgage loans that it originates and sells to the Federal Home Loan Mortgage Corporation ("Freddie Mac"). The Bank's servicing obligations include receiving payments, maintaining escrow accounts and paying hazard insurance, mortgage insurance, and taxes from such accounts, collecting past due fees, resolving payment problems and disputes, generating coupon payment books, and reporting loan balances to Freddie Mac each month. The Bank normally receives servicing fees of one quarter of one percent (.0025) of the outstanding loan balance of the loan servicing portfolio from Freddie Mac. The Bank accounts for loan servicing revenues by booking such revenues as they are received. The Bank amortizes mortgage servicing rights over the estimated life of the loans.

**Allowance for Loan Losses**

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

The allowance for loan losses is an amount that management believes will be adequate to absorb estimated losses relating to specifically identified loans, as well as probable credit losses inherent in the balance of the loan portfolio. The allowance for loan losses is evaluated on a regular basis by management and is based upon management's periodic review of the uncollectibility of loans in light of historical experience, the nature and volume of the loan portfolio, overall portfolio quality, review of specific problem loans, current economic conditions that may affect the borrower's ability to pay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. This evaluation does not include the effects of expected losses on specific loans or groups of loans that are related to future events or expected changes in economic conditions. While management uses the best information available to make its evaluation, future adjustments to the allowance may be necessary if there are significant changes in economic conditions. In addition, regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses, and may require the Company to make additions to the allowance based on their judgment about information available to them at the time of their examinations.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired. For impaired loans, an allowance is established when the discounted cash flows, collateral value, or observable market price of the impaired loan is lower than the carrying value of that loan. The general component covers non-impaired loans and is based on historical loss experience adjusted for other qualitative factors. Other adjustments may be made to the allowance for pools of loans after an assessment of internal or external influences on credit quality that are not fully reflected in the historical loss or risk rating data. An unallocated component is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The Company designates loan modifications as troubled debt restructurings ("TDRs") when, for economic or legal reasons related to the borrower's financial difficulties, it grants a concession to the borrower that it would not otherwise consider. TDRs can involve loans remaining on nonaccrual, moving to nonaccrual, or continuing on accrual status, depending on the individual facts and circumstances of the borrower. In circumstances where the TDR involves charging off a portion of the loan balance, the Company typically classifies these restructurings as nonaccrual loans.

In connection with restructurings, the decision to maintain a loan that has been restructured on accrual status is based on a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation includes consideration of the borrower's current capacity to pay, which among other things may include a review of the borrower's current financial statements, an analysis of global cash flow sufficient to pay all debt obligations, a debt to income analysis, and an evaluation of secondary sources of payment from the borrower and any guarantors. This evaluation also includes an evaluation of the borrower's current willingness to pay,

**Notes to Consolidated Financial Statements, continued**

**(1) Summary of Significant Accounting Policies, continued**

**Allowance for Loan Losses, continued**

which may include a review of past payment history, an evaluation of the borrower's willingness to provide information on a timely basis, and consideration of offers from the borrower to provide additional collateral or guarantor support. The credit evaluation also reflects consideration of the borrower's future capacity and willingness to pay, which may include evaluation of cash flow projections, consideration of the adequacy of collateral to cover all principal and interest, and trends indicating improving profitability and collectability of receivables.

Restructured nonaccrual loans may be returned to accrual status based on a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the modified terms. This evaluation must include consideration of the borrower's sustained historical repayment for a reasonable period, generally a minimum of six months, prior to the date on which the loan is returned to accrual status.

**Premises and Equipment**

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is computed principally by the straight-line method over the estimated useful lives of the assets. When assets are retired or otherwise disposed of, the cost and related accumulated depreciation are removed from the accounts, and any gain or loss is included in current operations. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. The range of estimated useful lives for premises and equipment are generally as follows:

Building and improvements	20–40 Years
Leasehold improvements	5–10 Years
Furniture and equipment	5–10 Years
Computer and software	3–5 Years

**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.

**Other Real Estate Owned**

Other real estate acquired through, or in lieu of, loan foreclosure is held for sale and is initially recorded at fair value less selling costs. Any write-down to fair value at the time of transfer to foreclosed assets is charged to the allowance for loan losses. Subsequent to foreclosure, valuations are periodically performed by management and the assets are carried at the lower of carrying amount or fair value less costs to sell. Costs of improvements are capitalized, whereas costs relating to holding foreclosed assets and subsequent adjustments to the value are expensed.

**Intangible Assets**

Intangible assets consist of core deposit premiums and mortgage servicing rights. The core deposit premiums were acquired in connection with business combinations. The core deposit premium is initially recognized based on a valuation performed as of the consummation date. The core deposit premium is amortized over the average remaining life of the acquired customer deposits, normally 8 to 12 years, using an accelerated or straight-line method, depending on the results of the initial valuation of the specific intangibles. Mortgage servicing rights are recognized initially at fair value as loans are sold into the secondary market with servicing rights retained and are amortized over the estimated life of the underlying loans. All intangible assets are tested annually for potential impairment.

Notes to Consolidated Financial Statements, continued

(1) **Summary of Significant Accounting Policies, continued**  
**Income Taxes**

The Company accounts for income taxes in accordance with income tax accounting guidance. The accounting guidance related to accounting for uncertainty in income taxes sets out a consistent framework to determine the appropriate level of tax reserves to maintain for uncertain tax positions.

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 recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more-likely-than-not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more-likely-than-not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets may be reduced by deferred tax liabilities and a valuation allowance if, based on the weight of evidence available, it is more likely than not that some portion or all of a deferred tax asset will not be realized.

**Stock-Based Compensation**

Stock based compensation accounting guidance requires that the compensation cost relating to share-based payment transactions be recognized in financial statements. That cost will be measured based on the grant date fair value of the equity or liability instruments issued. The stock based compensation accounting guidance covers a wide range of share-based compensation arrangements including stock options, restricted share plans, performance-based awards, share appreciation rights, and employee share purchase plans.

The stock based compensation accounting guidance requires that compensation cost for all stock awards be calculated and recognized over the employees' service period, generally defined as the vesting period. For awards with graded-vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award. A Black-Scholes model is used to estimate the fair value of stock options, while the market price of the Company's common stock at the date of grant is used for restricted stock awards and stock grants. The Company recognized stock-based compensation of \$130,000, \$133,000 and \$104,000, for the years ended December 31, 2016, 2015, and 2014, respectively.

**Profit-Sharing Plan**

Profit-sharing plan costs are based on a percentage of individual employee's salary, not to exceed the amount that can be deducted for federal income tax purposes.

**Earnings (Losses) Per Share**

Basic earnings (losses) per common share are computed by dividing net earnings available to common shareholders by the weighted-average number of shares of common stock outstanding. In calculating the weighted-average shares outstanding, shares secured by the Company's loan to its Employee Stock Ownership Plan (the "ESOP") are subtracted from shares outstanding. Diluted earnings per common share is computed by dividing net income by the effect of the issuance of potential common shares that are dilutive and by the sum of the weighted-average number of shares of common stock outstanding. Anti-dilutive potential common shares are excluded from the diluted earnings per share computation and totaled approximately 66,249 and 91,024 during 2015 and 2014, respectively. During 2016, there were no anti-dilutive potential common shares.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(1) Summary of Significant Accounting Policies, continued**  
**Earnings (Losses) Per Share, continued**

	Years Ended December 31,		
	2016	2015	2014
Net income (loss) available to common shareholders	\$ 13,163	24	(2,899)
Weighted average common shares outstanding	8,374,647	8,373,470	8,372,411
Dilutive effect of stock options	36,023	-	-
Diluted common shares	8,410,670	8,373,470	8,372,411
Basic earnings per common stock	\$ 1.57	-	(0.35)
Diluted earnings per common stock	\$ 1.56	-	(0.35)

**Comprehensive Income (Loss)**

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

**Nonvoting Common Stock**

The Company is authorized to issue 50,000,000 shares of nonvoting common stock. As of December 31, 2016, the Company has not issued any such shares.

**Fair Value of Financial Instruments**

Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 15. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

**Reclassifications**

Certain items on the balance sheets and statements of operations for the years ended December 31, 2015 and 2014 have been reclassified, with no impact on total assets or net income (loss), to be consistent with the classifications adopted for the year ended December 31, 2016.

**Recent Accounting Standards**

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers. The amendments in this ASU provide guidance that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. This ASU is effective prospectively, for annual and interim periods, beginning after December 15, 2017 and 2018, respectively, and is not anticipated to have a material impact on the Company's consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities. The ASU is designed to enhance the reporting model for financial instruments to provide users of financial statements with more decision-useful information. This ASU is effective for annual periods beginning after December 15, 2018, and interim periods within those annual periods beginning after December 15, 2019. The adoption of this ASU is not expected to have a material impact on the Company's consolidated financial statements.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The ASU is designed to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the Consolidated Balance Sheet and disclosing key information about leasing arrangements. The ASU is effective for the annual periods beginning after December 15, 2019, and interim periods within the fiscal year beginning after December 15, 2020. Early adoption is permitted. The Company is currently assessing the impact that this guidance will have on its consolidated financial statements. Adoption of this guidance will increase the assets and liabilities of the Company.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(1) Summary of Significant Accounting Policies, continued**  
**Recent Accounting Standards, continued**

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation (Topic 718). This ASU is designed to simplify the accounting for share-based payment transactions, including income tax consequences, classification of awards as either assets or liabilities and classification on the statement of cash flows. This ASU is effective for annual periods beginning after December 15, 2017 and interim periods within annual periods beginning after December 15, 2018. Early adoption is permitted with the Company adopting in December 2016. The adoption of this ASU did not have a material impact on the Company's consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. The main objective of the ASU is to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments and other commitments to extend credit held by a reporting entity at each reporting date. To achieve this objective, the amendments in the ASU replace the incurred loss impairment methodology in current GAAP with a methodology that reflects expected credit losses and requires consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The ASU is effective for the Company for the fiscal year beginning after December 15, 2020, and interim periods within the fiscal year beginning after December 15, 2021. Early adoption is permitted for the fiscal year beginning after December 15, 2018, including interim periods within this fiscal year. The Company is currently evaluating the impact of ASU 2016-13 on the consolidated financial statements, although the general expectation in the banking industry is that the implementation of this standard will result in higher required balances in the allowance for loan losses.

**(2) Investment Securities**

The amortized cost and fair value of securities available-for-sale with gross unrealized gains and losses are summarized as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>December 31, 2016:</u>				
U.S. Government-sponsored enterprises (GSEs)	\$ 11,862	29	(52)	11,839
State and municipal securities	17,194	36	(421)	16,809
Mortgage-backed				
GSE residential	122,056	225	(2,300)	119,981
Corporate bonds	17,730	126	(219)	17,637
Equity securities	1,066	91	(32)	1,125
Total securities available-for-sale	<u>\$ 169,908</u>	<u>507</u>	<u>(3,024)</u>	<u>167,391</u>
<u>December 31, 2015:</u>				
U.S. Government-sponsored enterprises (GSEs)	\$ 47,398	272	(94)	47,576
State and municipal securities	15,165	126	(62)	15,229
Mortgage-backed				
GSE residential	82,048	520	(362)	82,206
Corporate bonds	19,676	22	(196)	19,502
Equity securities	3,410	142	(949)	2,603
Total securities available-for-sale	<u>\$ 167,697</u>	<u>1,082</u>	<u>(1,663)</u>	<u>167,116</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(2) Investment Securities, continued**

The amortized cost and fair value of securities held-to-maturity with gross unrealized gains and losses are summarized as follows (dollars in thousands):

	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
<u>December 31, 2016:</u>				
Corporate bonds	\$ 7,000	-	(17)	6,983
Total securities held-to-maturity	<u>\$ 7,000</u>	<u>-</u>	<u>(17)</u>	<u>6,983</u>
<u>December 31, 2015:</u>				
U.S. Government-sponsored enterprises (GSEs)	\$ 2,388	39	-	2,427
Corporate bonds	3,500	-	-	3,500
Total securities held-to-maturity	<u>\$ 5,888</u>	<u>39</u>	<u>-</u>	<u>5,927</u>

The amortized cost and fair value of securities available-for-sale and held-to-maturity as of December 31, 2016 by contractual maturity are shown below. Actual maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	Securities Available-for-Sale		Securities Held-to-Maturity	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value
(Dollars in thousands)				
Due within one year	\$ 1,736	1,741	-	-
Due from one to five years	21,463	21,451	-	-
Due from five to ten years	20,025	19,631	7,000	6,983
Due after ten years	3,562	3,462	-	-
Mortgage-backed	122,056	119,981	-	-
Equity securities	1,066	1,125	-	-
	<u>\$ 169,908</u>	<u>167,391</u>	<u>7,000</u>	<u>6,983</u>

Securities with a carrying value of \$118,988,000 and \$113,986,000 at December 31, 2016 and 2015, respectively, were pledged to secure public deposits and for other purposes required or permitted by law.

Gains and losses on sales of securities available-for-sale consisted of the following (dollars on thousands):

	Years Ended December 31,		
	2016	2015	2014
Gross gains	\$ 1,657	768	623
Gross losses	(1,256)	(44)	(8)
Net realized gains	<u>\$ 401</u>	<u>724</u>	<u>615</u>

Gains and losses on calls of securities held to maturity consisted of the following (dollars on thousands):

	Years Ended December 31,		
	2016	2015	2014
Gross gains	\$ -	-	-
Gross losses	(331)	-	-
Net realized losses	<u>\$ (331)</u>	<u>-</u>	<u>-</u>



**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(2) Investment Securities, continued**

On May 25, 2016, the Company sold a held to maturity bond (U.S. Government – sponsored enterprises) with an amortized cost of \$2,346,000 for a loss of \$331,000. The sale of this bond was the result of unusual events provided for by the “safe harbor” provisions and, therefore, did not taint the entire portfolio of held to maturity securities. The position was liquidated due to a change in the capital rules for the bond by the Farm Credit Administration, which caused the structure of the bond to change from a bullet structure to being callable at the next interest payment. This is a highly unusual event and this was the only investment in the portfolio that experienced this change.

Restricted equity securities consisted of the following (dollars in thousands):

	December 31,	
	2016	2015
Federal Reserve Bank stock	\$ 1,825	1,488
Federal Home Loan Bank stock	507	506
	\$ 2,332	1,994

**Temporarily Impaired Securities**

The following tables show the gross unrealized losses and fair value of the Company’s investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2016 and 2015. There were no held-to-maturity securities in a material unrealized loss position at December 31, 2016 or 2015 (dollars in thousands).

	Less Than Twelve Months		Over Twelve Months		Total Unrealized Losses
	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	
<b>Securities Available-for-Sale</b>					
<u>December 31, 2016:</u>					
GSEs	\$ (49)	9,389	(3)	426	(52)
State and municipal securities	(421)	13,089	-	-	(421)
Mortgage-backed securities					
GSE residential	(2,284)	100,450	(16)	502	(2,300)
Corporate bonds	(140)	5,420	(79)	4,001	(219)
Equity securities	-	-	(32)	368	(32)
Total	\$ (2,894)	128,348	(130)	5,297	(3,024)
<u>December 31, 2015:</u>					
GSEs	\$ (61)	11,871	(33)	2,483	(94)
State and municipal securities	(59)	4,494	(3)	522	(62)
Mortgage-backed securities					
GSE residential	(331)	35,905	(31)	1,545	(362)
Corporate bonds	(196)	15,431	-	-	(196)
Equity securities	-	-	(949)	1,773	(949)
Total	\$ (647)	67,701	(1,016)	6,323	(1,663)

**GSE debt securities.** The unrealized losses on the 13 investments in GSEs were caused by interest rate increases. The contractual terms of those investments do not permit the issuer to settle the securities at a price less than the par value of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

Notes to Consolidated Financial Statements, continued

(2) **Investment Securities, continued**

**State and municipal securities.** The unrealized losses on the 7 investments in state and municipal securities were caused by interest rate increases. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell these investments and it is more likely than not that the Company will not be required to sell these investments before recovery of its amortized cost bases, which may be maturity, the Company does not consider these investments to be other-than-temporarily impaired at December 31, 2016.

**GSE residential mortgage-backed securities.** The unrealized losses on the Company's investment in 49 GSE mortgage-backed securities were caused by interest rate increases. While the Company purchased those investments at a premium relative to their face amount, such premiums are amortized over the anticipated average life of the securities. Furthermore contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Accordingly, it is expected that the securities would not be settled at a price less than the amortized cost bases of the Company's investments. Because the decline in market value is attributable to changes in interest rates and not credit quality, and because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Company does not consider those investments to be other-than-temporarily impaired at December 31, 2016.

**Corporate bonds.** The Company's unrealized losses on investments in 5 corporate bonds relate to investments in companies within the financial services sector. The unrealized losses are primarily caused by fluctuations in interest rates and not by decreases in profitability and profit forecasts by industry analysts. The contractual terms of those investments do not permit the Company to settle the security at a price less than the par value of the investments. The Company currently does not believe it is probable that it will be unable to collect all amounts due according to the contractual terms of the investments. Because the Company does not intend to sell the investments and it is not more likely than not that the Company will be required to sell the investments before recovery of its par value, which may be maturity, it does not consider these investments to be other-than-temporarily impaired at December 31, 2016.

**Equity securities.** The Company's investment in 1 marketable equity security consists of an investment in trust preferred stock of an entity in the financial services industry. The Company evaluated the prospects of the issuer in relation to the severity and duration of the impairment. Based on that evaluation and the Company's ability and intent to hold this investment for a reasonable period of time sufficient for a forecasted recovery of fair value, the Company does not consider this investment to be other-than-temporarily impaired at December 31, 2016.

**Other-Than-Temporary Impairment**

The Company routinely conducts periodic reviews to identify and evaluate each investment security to determine whether an other-than-temporary impairment has occurred. The most significant factors are default rates and the creditworthiness of the issuer. Other factors may include geographic concentrations, credit ratings, and other performance indicators of the underlying asset. There were no other-than-temporary impairment charges recorded during the years ended December 31, 2016, 2015, and 2014.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(3) Loans and Allowances for Loan Losses**

The composition of loans is summarized as follows (dollars in thousands):

	December 31,	
	2016	2015
Real estate mortgages:		
Commercial	\$ 143,924	125,961
Construction and land development	15,448	16,479
1-4 family first mortgage	82,502	99,641
Other	17,855	19,487
Commercial, financial, and agricultural	27,567	25,855
Consumer and other	6,933	9,533
	294,229	296,956
Deferred loan fees	(307)	(270)
Allowance for loan losses	(2,766)	(3,052)
Non-accretable discount	(134)	(417)
Accretable discount	(135)	(206)
Loans, net	\$ 290,887	293,011

Loans serviced for others totaled \$88,209,000 and \$105,934,000 at December 31, 2016, and 2015, respectively.

The Company has pledged certain loans secured by 1-4 family residential mortgages under a blanket collateral agreement to secure possible future borrowings from the FHLB. The amount of such pledged loans totaled \$83,114,000 and \$98,897,000 at December 31, 2016 and 2015, respectively.

For purposes of the disclosures required pursuant to the FASB Accounting Standards Codification 310 for Receivables, the loan portfolio was disaggregated into segments and then further disaggregated into classes for certain disclosures. A portfolio segment is defined as the level at which an entity develops and documents a systematic method for determining its allowance for credit losses. There are three loan portfolio segments that include real estate, commercial, and consumer. A class is generally determined based on the initial measurement attribute, risk characteristic of the loan, and an entity's method for monitoring and assessing credit risk. Commercial, financial, and agricultural is a separate commercial loan class. Classes within the real estate portfolio segment include construction and land development, 1-4 family first mortgages, commercial, and other. Consumer loans are a class in itself.

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

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

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

Notes to Consolidated Financial Statements, continued

(3) **Loans and Allowances for Loan Losses, continued**

- Other real estate mortgage loans include real estate loans secured by farmland, second liens, or open end real estate loans, such as home equity lines. These are repaid by various means such as a borrower's income, sale of the property, or rental income derived from the property.

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

Consumer and other - The consumer and other loan portfolio segment includes direct consumer installment loans, overdrafts and other revolving credit loans, educational loans, and municipal loans. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

Credit administration and special assets management are both involved in the credit risk management process and assess the accuracy of risk ratings, the quality of the portfolio and the estimation of inherent credit losses in the loan portfolio. This comprehensive process also assists in the prompt identification of problem credits. The Company has taken a number of measures to manage the portfolios and reduce risk, particularly in the more problematic portfolios.

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

Responsibility and accountability for adherence to underwriting policies and accurate risk ratings lie in each portfolio segment. For the consumer portfolio segment, the risk management process focuses on managing customers who become delinquent in their payments. For the commercial and real estate portfolio segments, the risk management process focuses on underwriting new business and, on an ongoing basis, monitoring the credit of the portfolios. To insure problem credits are identified on a timely basis, several specific portfolio reviews occur each quarter to assess the larger adversely rated credits for proper risk rating and accrual status and, if necessary, to ensure such individual credits are transferred to the Special Assets Division.

Credit quality and trends in the loan portfolio segments are measured and monitored regularly. This review includes detailed reports, by product, collateral, and accrual status.

The allowance for loan losses is a valuation reserve established through provisions for loan losses charged against income. The allowance for loan losses, which is evaluated quarterly, is maintained at a level that management deems sufficient to absorb probable losses inherent in the loan portfolio. Loans deemed to be uncollectible are charged against the allowance for loan losses, while recoveries of previously charged-off amounts are credited to the allowance for loan losses. The allowance for loan losses is comprised of specific valuation allowances for loans evaluated individually for impairment, general allocations for pools of homogeneous loans with similar risk characteristics and trends, and an unallocated component that reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

The allowance for loan losses related to specific loans is based on management's estimate of potential losses on impaired loans as determined by (1) the present value of expected future cash flows; (2) the fair value of collateral if the loan is determined to be collateral dependent or (3) the loan's observable market price. The Company's homogeneous loan pools include commercial real estate loans, real estate construction and land development loans, residential real estate loans, real estate other loans, commercial/financial/agricultural, industrial loans, and consumer loans. The general allocations to these loan pools are based on the historical loss rates for specific loan types and the internal risk grade, if applicable, adjusted for both internal and external qualitative risk factors. The qualitative factors

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(3) Loans and Allowances for Loan Losses, continued**

considered by management include, among other factors, (1) changes in local and national economic conditions; (2) changes in asset quality; (3) changes in loan portfolio volume; (4) the composition and concentrations of credit; and (5) effectiveness of the Company's loan policies, procedures and internal controls. The total allowance established for each homogeneous loan pool represents the product of the historical loss ratio (as adjusted for qualitative factors) and the total dollar amount of the loans in the pool.

The following tables detail activity in the allowance for loan losses by portfolio segment for the years ended December 31, 2016 and 2015. Allocation of a portion of the allowance to one category of loans does not preclude its availability to absorb losses in other categories. (Dollars in thousands)

	<u>Real Estate</u>	<u>Commercial</u>	<u>Consumer</u>	<u>Unallocated</u>	<u>Total</u>
<u>December 31, 2016:</u>					
Allowance for loan losses:					
Beginning balance	\$ 2,755	78	111	108	3,052
Charge-offs	(466)	(58)	(201)	-	(725)
Recoveries	111	42	142	-	295
Provision	16	76	45	7	144
Ending balance	<u>\$ 2,416</u>	<u>138</u>	<u>97</u>	<u>115</u>	<u>2,766</u>
Ending balance – individually evaluated for impairment	\$ -	-	-	-	-
Ending balance – collectively evaluated for impairment	<u>\$ 2,416</u>	<u>138</u>	<u>97</u>	<u>115</u>	<u>2,766</u>
Loans:					
Ending balance	<u>\$ 259,071</u>	<u>27,567</u>	<u>6,933</u>		<u>293,571</u>
Ending balance - individually evaluated for impairment	<u>\$ 658</u>	<u>-</u>	<u>-</u>		<u>658</u>
Ending balance – collectively evaluated for impairment	<u>\$ 259,729</u>	<u>27,567</u>	<u>6,933</u>		<u>294,229</u>
<u>December 31, 2015:</u>					
Allowance for loan losses:					
Beginning balance	\$ 3,268	90	124	193	3,675
Charge-offs	(1,295)	(3)	(246)	-	(1,544)
Recoveries	155	38	139	-	332
Provision (Re-allocation)	627	(47)	94	(85)	589
Ending balance	<u>\$ 2,755</u>	<u>78</u>	<u>111</u>	<u>108</u>	<u>3,052</u>
Ending balance – individually evaluated for impairment	\$ 846	-	-	-	846
Ending balance – collectively evaluated for impairment	<u>\$ 1,909</u>	<u>78</u>	<u>111</u>	<u>108</u>	<u>2,206</u>
Loans:					
Ending balance	<u>\$ 261,568</u>	<u>25,855</u>	<u>9,533</u>		<u>296,956</u>
Ending balance - individually evaluated for impairment	<u>\$ 3,794</u>	<u>-</u>	<u>-</u>		<u>3,794</u>
Ending balance – collectively evaluated for impairment	<u>\$ 257,754</u>	<u>25,855</u>	<u>9,533</u>		<u>293,162</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(3) Loans and Allowances for Loan Losses, continued**

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

**Pass:** Loans in this risk category involve borrowers of acceptable-to-strong credit quality and risk who have the apparent ability to satisfy their loan obligations. Loans in this risk grade would possess sufficient mitigating factors, such as adequate collateral or strong guarantors possessing the capacity to repay the debt if required, for any weakness that may exist.

**Watch:** Loans in this risk grade are the equivalent of the regulatory definition of "Other Assets Especially Mentioned" classification. Loans in this category possess some credit deficiency or potential weakness, which requires a high level of management attention. Potential weaknesses include declining trends in operating earnings and cash flows and /or reliance on the secondary source of repayment. If left uncorrected, these potential weaknesses may result in noticeable deterioration of the repayment prospects for the asset or in the Company's credit position.

**Substandard:** Loans in this risk grade are inadequately protected by the borrower's current financial condition and payment capability or of the collateral pledged, if any. Loans so classified have a well-defined weakness or weaknesses that jeopardize the orderly repayment of debt. They are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected.

**Doubtful:** Loans in this risk grade have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or orderly repayment in full, on the basis of current existing facts, conditions and values, highly questionable and improbable. Possibility of loss is extremely high, but because of certain important and reasonably specific factors that may work to the advantage and strengthening of the exposure, its classification as an estimated loss is deferred until its more exact status may be determined.

**Loss:** Loans in this risk grade are considered to be non-collectible and of such little value that their continuance as bankable assets is not warranted. This does not mean the loan has absolutely no recovery value, but rather it is neither practical nor desirable to defer writing off the loan, even though partial recovery may be obtained in the future. Charge-offs against the allowance for loan losses are taken in the period in which the loan becomes uncollectible. Consequently, the Company typically does not maintain a recorded investment in loans within this category.

The following tables summarize the risk category of the Company's loan portfolio based on the most recent analysis performed as of December 31, 2016 and 2015 (dollars in thousands):

<u>December 31, 2016:</u>	<u>Pass</u>	<u>Watch</u>	<u>Substandard</u>	<u>Doubtful</u>	<u>Total</u>
Real estate mortgages:					
Commercial	\$ 139,704	3,908	312	-	143,924
Construction and land development	14,788	58	602	-	15,448
1-4 family first mortgage	75,834	381	6,287	-	82,502
Other	17,048	-	807	-	17,855
Commercial, financial, and agricultural	27,500	67	-	-	27,567
Consumer and other	6,866	12	55	-	6,933
Total	<u>\$ 281,740</u>	<u>4,426</u>	<u>8,063</u>	<u>-</u>	<u>294,229</u>
<u>December 31, 2015:</u>					
Real estate mortgages:					
Commercial	\$ 121,014	2,909	2,038	-	125,961
Construction and land development	15,665	67	747	-	16,479
1-4 family first mortgage	91,323	422	7,896	-	99,641
Other	18,867	115	505	-	19,487
Commercial, financial, and agricultural	25,815	15	23	2	25,855
Consumer and other	9,288	27	218	-	9,533
Total	<u>\$ 281,972</u>	<u>3,555</u>	<u>11,427</u>	<u>2</u>	<u>296,956</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(3) Loans and Allowances for Loan Losses, continued**

A loan is considered past due if any required principal and interest payments have not been received as of the date such payments were required to be made under the terms of the loan agreement. Generally, management places loans on non-accrual when there is a clear indication that the borrower's cash flow may not be sufficient to meet payments as they become due, which is generally when a loan is 90 days past due. The following tables present the aging of the recorded investment in loans and leases as of December 31, 2016 and 2015 (dollars in thousands):

	<u>Past Due Status (Accruing Loans)</u>					<u>Total</u>
	<u>Current</u>	<u>30-89 Days</u>	<u>90+ Days</u>	<u>Total Past Due</u>	<u>Non- accrual</u>	
<u>December 31, 2016:</u>						
Real estate mortgages:						
Commercial	\$ 143,008	833	-	833	83	143,924
Construction and land development	14,961	40	-	40	447	15,448
1-4 family first mortgage	77,002	2,523	424	2,947	2,553	82,502
Other	17,279	205	-	205	371	17,855
Commercial, financial, and agricultural	27,507	60	-	60	-	27,567
Consumer and other	6,899	34	-	34	-	6,933
Total	<u>\$ 286,656</u>	<u>3,695</u>	<u>424</u>	<u>4,119</u>	<u>3,454</u>	<u>294,229</u>
<u>December 31, 2015:</u>						
Real estate mortgages:						
Commercial	\$ 119,488	4,584	-	4,584	1,889	125,961
Construction and land development	15,836	95	-	95	548	16,479
1-4 family first mortgage	94,231	2,091	-	2,091	3,319	99,641
Other	19,283	117	-	117	87	19,487
Commercial, financial, and agricultural	25,332	521	-	521	2	25,855
Consumer and other	9,408	66	-	66	59	9,533
Total	<u>\$ 283,578</u>	<u>7,474</u>	<u>-</u>	<u>7,474</u>	<u>5,904</u>	<u>296,956</u>

A loan held for investment is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due (both principal and interest) according to the terms of the loan agreement. During 2016, the Bank established a threshold for individual impairment testing of loans and designated a 10% reserve for all nonaccrual loans that are under that the threshold. The following tables detail our impaired loans, by portfolio class as of December 31, 2016 and 2015 (dollars in thousands):

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
<u>December 31, 2016:</u>					
With no related allowance recorded:					
Commercial real estate	\$ -	-	-	-	-
Construction and land development	658	874	-	675	50
Real estate – 1-4 family first mortgage	-	-	-	-	-
Other real estate	-	-	-	-	-
Commercial, financial, and agriculture	-	-	-	-	-
Consumer	-	-	-	-	-
Total with no related allowance recorded	<u>\$ 658</u>	<u>874</u>	<u>-</u>	<u>675</u>	<u>50</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(3) Loans and Allowances for Loan Losses, continued**

<u>December 31, 2015:</u>	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
With no related allowance recorded:					
Commercial real estate	\$ 18	18	-	19	1
Construction and land development	100	894	-	130	14
Real estate – 1-4 family first mortgage	991	1,044	-	1,051	29
Other real estate	69	200	-	75	-
Commercial, financial, and agriculture	-	-	-	-	-
Consumer	-	-	-	-	-
Total with no related allowance recorded	1,178	2,156	-	1,275	44
With an allowance recorded:					
Commercial real estate	1,750	1,877	426	1,813	21
Construction and land development					
Real estate – 1-4 family first mortgage	866	898	241	1,005	26
Other real estate					
Commercial, financial, and agriculture	-	-	-	-	-
Consumer	-	-	-	-	-
Total with an allowance recorded	2,616	2,775	667	2,818	47
Total impaired loans	\$ 3,794	4,931	667	4,093	91

At December 31, 2015, impaired loans included loans that were classified as Troubled Debt Restructurings “TDRs”. The restructuring of a loan is considered a TDR if both (i) the borrower is experiencing financial difficulties and (ii) the creditor has granted a concession.

In assessing whether or not a borrower is experiencing financial difficulties, the Company considers information currently available regarding the financial condition of the borrower. This information includes, but is not limited to, whether (i) the debtor is currently in payment default on any of its debt; (ii) a payment default is probable in the foreseeable future without the modification; (iii) the debtor has declared or is in the process of declaring bankruptcy and (iv) the debtor's projected cash flow is sufficient to satisfy contractual payments due under the original terms of the loan without a modification.

The Company considers all aspects of the modification to loan terms to determine whether or not a concession has been granted to the borrower. Key factors considered by the Company include the debtor's ability to access funds at a market rate for debt with similar risk characteristics, the significance of the modification relative to unpaid principal balance or collateral value of the debt, and the significance of a delay in the timing of payments relative to the original contractual terms of the loan. The most common concessions granted by the Company generally include one or more modifications to the terms of the debt, such as (i) a reduction in the interest rate for the remaining life of the debt, (ii) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (iii) a temporary period of interest-only payments, and (iv) a reduction in the contractual payment amount for either a short period or remaining term of the loan. As of December 31, 2016 and 2015, the Company had \$802,000 and \$870,000, respectively, in loans considered restructured that are not on nonaccrual. Of the nonaccrual loans at December 31, 2016 and 2015, \$170,000 and \$1,938,000, respectively, met the criteria for a TDR. A loan is placed back on accrual status when both principal and interest are current and it is probable that the Company will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.



**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(3) Loans and Allowances for Loan Losses, continued**

There were no loans modified in troubled debt restructuring during the year ending December 31, 2016. The following tables summarize the loans that were modified as a TDR during the year-ending December 31, 2015 (dollars in thousands):

	Troubled-Debt Restructurings			Impact on the Allowance for Loan Losses
	Number of Loans	Recorded Investment Prior to Modification	Recorded Investment After Modification	
<u>December 31, 2015:</u>				
Real estate mortgages:				
Commercial	1	\$ 1,830	1,750	80
Construction and land development	-	-	-	-
1-4 family first mortgages	-	-	-	-
Other	-	-	-	-
Commercial, financial, and agricultural	-	-	-	-
Consumer and other	-	-	-	-
Total	<u>1</u>	<u>\$ 1,830</u>	<u>1,750</u>	<u>80</u>

There were no loans modified in a TDR over the last twelve months that subsequently defaulted during the years ended December 31, 2016 or 2015.

The Company has no additional commitments to lend additional funds to any of the related debtors whose terms have been modified in a TDR.

In the ordinary course of business, the Company has granted loans to certain related parties, including directors, executive officers, and their affiliates. The interest rates on these loans were substantially the same as rates prevailing at the time of the transaction and repayment terms are customary for the type of loan. Changes in related party loans for the years ended December 31, 2016 and 2015 are as follows (dollars in thousands):

	December 31,	
	2016	2015
Balance, beginning of year	\$ 374	574
Repayments	(33)	(200)
Balance, end of year	<u>\$ 341</u>	<u>374</u>

**(4) Premises and Equipment**

Premises and equipment are summarized as follows (dollars in thousands):

	December 31,	
	2016	2015
Land	\$ 2,127	3,899
Buildings	16,298	19,784
Leasehold improvements	738	783
Equipment	9,769	13,565
	<u>28,932</u>	<u>38,031</u>
Accumulated depreciation	15,215	19,817
	<u>\$ 13,717</u>	<u>18,214</u>

**Leases**

The Company leases certain branch and loan production office properties and equipment under operating lease agreements.

Rental expense under all operating leases amounted to \$401,000, \$696,000, and \$686,000 for the years ended December 31, 2016, 2015, and 2014, respectively.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(4) Premises and Equipment, continued  
Leases, continued**

Future minimum lease commitments on noncancelable operating leases, excluding any renewal options, are summarized as follows (dollars in thousands):

2017	\$	350
2018		451
2019		420
2020		320
2021		201
Thereafter		73
	\$	<u>1,815</u>

**(5) Intangible Assets**

Following is a summary of information related to intangible assets (dollars in thousands):

	<u>As of December 31, 2016</u>		<u>As of December 31, 2015</u>	
	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>	<u>Gross Carrying Amount</u>	<u>Accumulated Amortization</u>
Core deposit intangible	\$ 929	(876)	929	(844)

The following reflects the activity in the mortgage servicing assets, net (dollars in thousands):

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Beginning balance, net	\$ 375	495	619
Amounts recognized upon sales	1	26	12
Amortization	(144)	(146)	(136)
Ending balance, net	\$ <u>232</u>	<u>375</u>	<u>495</u>

The following reflects the activity in the SBA mortgage servicing assets, net (dollars in thousands):

	<u>2016</u>	<u>2015</u>
Beginning balance, net	\$ 158	-
Recorded servicing asset	44	164
Amounts recognized upon sales	-	5
Amortization	(20)	(11)
Ending balance, net	\$ <u>182</u>	<u>158</u>

Amortization expense for the core deposit intangibles was \$32,000, \$32,000, and \$184,000 for the years ended December 31, 2016, 2015, and 2014, respectively. Amortization expense for the mortgage servicing rights was \$144,000, \$146,000, and \$136,000 for the years ended December 31, 2016, 2015, and 2014, respectively. Amortization expense for the SBA mortgage servicing rights was \$20,000 and \$11,000 for the years ended December 31, 2016 and 2015, respectively. There was no amortization expense for the SBA mortgage servicing rights recognized for the year ended December 31, 2014. The estimated amortization expense of all intangible assets in future years is as follows (dollars in thousands):

2017	\$	133
2018		114
2019		80
2020		45
2021		22
Thereafter		74
	\$	<u>468</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(6) Deposits**

The composition of deposits is summarized as follows (dollars in thousands):

	December 31,	
	2016	2015
Noninterest bearing deposits	\$ 125,459	130,873
Interest checking	178,009	160,100
Money market	32,271	38,643
Savings	50,495	55,550
Certificates of deposit	111,013	126,010
	\$ 497,247	511,176

The aggregate amount of time deposits in denominations of \$250,000 or more at December 31, 2016 and 2015 was \$15,555,000 and \$17,175,000, respectively. The scheduled maturities of time deposits at December 31, 2016 are as follows (dollars in thousands):

2017	\$ 81,308
2018	11,222
2019	8,014
2020	5,655
2021	4,814
	\$ 111,013

Overdraft demand and savings deposits reclassified to loans totaled \$159,000 and \$111,000 at December 31, 2016 and 2015, respectively.

In the ordinary course of business, the Company holds the deposits of certain related parties, including directors, executive officers, and their affiliates. The interest rates on these deposit liabilities were substantially the same as rates prevailing at the time of the transaction for the type of deposit account. Those deposit liabilities amounted to approximately \$16,282,000 and \$8,607,000 as of December 31, 2016 and 2015, respectively.

**(7) Unused Lines of Credit**

The Company had unused lines of credit totaling approximately \$146,867,000 at December 31, 2016. These lines represent credit for overnight borrowings from correspondent institutions and availability under FHLB and correspondent bank lines of credit.

**(8) Employee Benefit Plans**

The Company maintains two defined contribution retirement plans (the "Plans") for its officers and employees: the SouthCrest Financial Group, Inc. 401(k) and Profit-Sharing Plan (the "401(k) Plan") and the SouthCrest Financial Group, Inc. Employee Stock Ownership Plan (the "ESOP"). Prior to 2009, the Company made an annual contribution to the Plans of approximately 8% of compensation less amounts paid as incentives and bonuses. Once the Company determined the total funds to be contributed to the Plans, funds were first contributed to the 401(k) plan with the remainder contributed to the ESOP. The Company reduced its contributions to both plans, ceasing its 401(k) contribution in the third quarter of 2009 and reducing its ESOP contribution to the minimum amount needed to fund its annual loan payment to the Company.

**401(k) and Profit Sharing Plan**

During February 2016, the Company began matching discretionary profit sharing contributions equal to 50% of the participants' contributions up to 4% of the participants' annual base salary and commissions/bonuses for those eligible to participate in the Plan. Contributions charged to expense for the year ended December 31, 2016, 2015, and 2014, was \$94,118, \$- and \$-, respectively.

## Notes to Consolidated Financial Statements, continued

**(8) Employee Benefit Plans, continued  
Employee Stock Ownership Plan**

During 2016, the Board of Directors made the decision to terminate the ESOP which will include converting the ESOP to a profit sharing plan which is expected to occur during the second quarter of 2017. For the years ended December 31, 2016, 2015, and 2014, the Company contributed \$133,000, \$32,000, and \$33,000, respectively, to the ESOP. These expenses are included in salaries and employee benefits expense in the accompanying consolidated statements of operations. The contributions for 2016 included amounts sufficient to retire the existing acquisition loan held by the ESOP that was secured by the stock of the Company.

At December 31, 2016 and 2015, the ESOP held 0 and 66,466 shares, respectively, of the Company's stock. Shares held by the ESOP considered outstanding for purposes of calculating the Company's earnings per share were 0 and 62,300 shares as of December 31, 2016 and 2015, respectively. In November 2007, the ESOP purchased 15,880 shares funded by a \$349,000 direct loan from the Company. At December 31, 2016 and 2015, the balance of the loan was \$0 and \$128,000, respectively, and was reported on the balance sheet as "Unearned Compensation - ESOP" as a reduction of stockholders' equity. In December 2009, the loan agreement was amended to provide for a fixed interest rate of 5.50%. The loan previously carried an interest rate of Prime minus 0.50%. The loan was to be repaid over a term of fifteen years. Under applicable regulations, the ESOP must receive, either through dividend income or employer contributions, sufficient funds with which to make its required annual payment under the loan. As principal reductions are made to the loan, shares are released from the loan as collateral and allocated to participant accounts. The number of shares originally secured by the loan and allocated to participant accounts totaled 10,070 at December 31, 2015. The loan was repaid on October 14, 2016. With anticipation of the plan termination occurring in the near future and the need to provide liquidity for distributions, the ESOP sold 100% of the common stock held on December 7, 2016.

During December 2015, it was determined that the ESOP needed liquidity for distributions to former employees, and the SouthCrest Financial Group, Inc. Employee Stock Ownership Trust (the "Trust"), (the "Borrower"), entered into promissory note agreements totaling \$180,000 with the Company which were executed on January 22, 2015 and December 28, 2015, respectively. The promissory notes do not bear interest and the entire principal amounts are due and payable on demand.

In accordance with the ESOP, the Company is expected to honor the rights of certain participants to diversify their account balances or to liquidate their ownership of the common stock in the event of termination. The purchase price of the common stock would be based on the fair market value of the Company's common stock as of the annual valuation date, which precedes the date the put option is exercised. No participant has exercised their right to diversify their account balances since the inception of the ESOP, and no significant cash outlay was expected during 2016. However, since the redemption of common stock is outside the control of the Company, the Company's maximum cash obligation based on the approximate market prices of common stock as of the reporting date has been presented outside stockholders' equity. The amount presented as redeemable common stock held by the ESOP in the consolidated balance sheet represents the Company's maximum cash obligation and has been reflected as a reduction of retained earnings.

**Deferred Compensation Plan**

The Company has a deferred compensation plan for death and retirement benefits for certain key officers. The estimated amounts to be paid under the deferred compensation plan have been funded through the purchase of life insurance policies on the officers. The balance of the policy cash surrender values at December 31, 2016 and 2015 is \$20,816,000 and \$20,265,000, respectively. Income recognized on the policies amounted to \$551,000, \$555,000, and \$555,000 for the years ended December 31, 2016, 2015, and 2014, respectively. The balance of deferred compensation included in other liabilities at December 31, 2016 and 2015 is \$384,000 and \$738,000, respectively. Expense recognized for deferred compensation amounted to \$3,000, \$(154,000), and \$328,000 for the years ended December 31, 2016, 2015, and 2014, respectively. During 2015, the deferred compensation plans were terminated. The only benefits currently relate to the post retirement split dollar and death benefit only agreements.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(8) Employee Benefit Plans, continued**  
**Deferred Compensation Plan, continued**

On July 29, 2014, the “Executive Salary Continuation Agreements” for certain key officers were terminated and benefits of \$5,449,000 were paid to the participants in 2015. The remaining balance of \$384,000 and \$738,000 in other liabilities at December 31, 2016 and 2015, respectively, relates to benefits for the post retirement split dollar life insurance policies and death benefit only agreements. In addition, during December 2015, the Company entered into agreements with four participants to terminate the insurance agreements in exchange for a payment of a percentage of the recorded liability. The difference between the payments and the estimated liability for the participants was \$159,000. This amount was recorded as a credit to expense and resulted in deferred compensation income for 2015.

**(9) Stock Compensation Plan**

The Company maintains the SouthCrest Financial Group, Inc. 2005 Stock Incentive Plan (the “Stock Incentive Plan”), which provides for up to 549,000 shares of the Company’s stock to be awarded in the form of stock incentives. Both incentive stock options and non-qualified options may be granted under the Stock Incentive Plan. The exercise price of each option equals the market price of the Company’s stock on the date of grant. The incentive stock options generally vest at the rate of 25% per year over four years, and expire after ten years from the date of grant. At December 31, 2016, 210,130 shares remained available for future grant. Compensation cost related to stock options that has been charged against income was approximately \$130,000, \$133,000, and \$104,000 for the years ended December 31, 2016, 2015, and 2014, respectively. Because all options that are subject to expensing under FASB ASC 718 (Compensation - Stock Compensation) are tax qualifying granted prior to 2012, it is not expected that recognized compensation expense relating to these stock options will result in future tax benefits.

The fair value of each option grant is estimated on the date of grant using the Black-Scholes option pricing model. This model utilizes certain information, such as the interest rate on a risk-free security with a term generally equivalent to the expected life of the option being valued and requires certain other assumptions, such as the expected time an option will be outstanding until it is exercised or expired, to calculate the fair value of stock options granted.

The significant assumptions are as follows:

	2016	2015
Expected volatility	31%	31%
Expected dividends	0%	0%
Expected term (in years)	7	7
Risk-free Rate	1.50%	1.75%
Expected forfeiture rate	0%	0%

The weighted fair value of the options granted during 2016 and 2015 were \$2.67 and \$1.90, respectively. There were no options granted during 2014.

A summary of activity in the Stock Incentive Plan is presented below:

	Options	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Term
Outstanding at December 31, 2014	284,500	\$ 6.41	
Granted	104,000	5.27	
Exercised	-	-	
Forfeited	(98,250)	8.74	
Outstanding at December 31, 2015	290,250	\$ 5.21	
Granted	50,000	7.53	
Exercised	(40,000)	5.05	
Forfeited	(23,000)	6.37	
Outstanding at December 31, 2016	277,250	\$ 5.55	
Options exercisable at December 31, 2016	140,250	\$ 5.08	6.3 years

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(9) Stock Compensation Plan, continued**

The intrinsic value of the options exercised for 2016 was \$108,000. There were no options exercised during 2015 and 2014. As of December 31, 2016, \$271,000 in compensation cost related to share-based compensation arrangements had not been recognized and is expected to be recognized over 4 years.

**(10) Income Tax**

The components of income tax (benefit) expense are as follows (dollars in thousands):

	Years Ended December 31,		
	2016	2015	2014
Current			
Federal	\$ 80	-	-
State	-	-	-
Total current	<u>80</u>	<u>-</u>	<u>-</u>
Deferred			
Federal	374	(3)	(787)
State	252	(140)	(124)
Total deferred	<u>626</u>	<u>(143)</u>	<u>(911)</u>
Valuation allowance	<u>(11,161)</u>	<u>143</u>	<u>911</u>
	<u>\$ (10,455)</u>	<u>-</u>	<u>-</u>

The Company's income tax (benefit) expense differs from the amounts computed by applying the Federal income tax statutory rates to income (loss) before income taxes. A reconciliation of the differences is as follows:

	Years Ended December 31,		
	2016	2015	2014
Tax provision at statutory rate	\$ 1,091	239	(591)
State income taxes, net of federal benefit	76	(110)	(77)
Tax-exempt income	(49)	(78)	(275)
Stock-based compensation	(10)	-	36
Change in valuation allowance	(11,161)	143	911
Life insurance death benefits	(191)	(241)	-
Other	(211)	47	(4)
Income tax (benefit) expense	<u>\$ (10,455)</u>	<u>-</u>	<u>-</u>

The components of deferred income taxes are as follows:

	Years Ended December 31,	
	2016	2015
Deferred tax assets:		
Loan loss reserves	\$ 1,044	1,152
Security impairment	145	-
Stock based compensation	114	97
State tax credit carryforward	470	519
Charitable contributions	-	11
Other real estate	92	89
Alternative minimum tax credit	179	116
Securities available-for-sale	950	219
Net operating loss carryforward	13,518	14,511
Other	51	-
Valuation allowance	<u>(470)</u>	<u>(11,631)</u>
	<u>16,093</u>	<u>5,083</u>
Deferred tax liabilities:		
Depreciation	568	812
Intangibles	20	32
	<u>588</u>	<u>844</u>
Net deferred tax asset	<u>\$ 15,505</u>	<u>4,239</u>

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(10) Income Tax, continued**

The years 2013 through 2015 are still subject to audit for the Company's Federal, Georgia, and Alabama income tax returns. No material tax uncertainties exist as of December 31, 2016 or 2015. At December 31, 2016, the Company had remaining net operating loss carryforwards of approximately \$36 million for federal and \$38 million for state income tax purposes which begin to expire in 2030, unless previously utilized.

In connection with assessing the ability of the Company to realize its net deferred tax asset, management considered probability based future taxable income calculations (five years) and tax planning strategies that could be used to generate taxable income. Additionally, asset quality trends and regulatory examination results and trends were factored into the evaluation. Management imposed a valuation allowance of \$470,000 as of December 31, 2016 against certain components of the deferred tax asset related to certain state income tax credits and certain amounts of the operating loss carry forwards. These tax credit attributes have short carryforward periods which have a high risk of expiration and certain portions of the operating loss attribute at present cannot be deemed by accounting standards to meet the more likely than not criteria for realization because of statutory tax limitations affecting its use.

**(11) Commitments and Contingencies**

**Loan Commitments**

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Such commitments involve, to varying degrees, elements of credit risk and interest rate risk in excess of the amount recognized in the balance sheets. The majority of all commitments to extend credit and standby letters of credit are variable rate instruments.

The Company's exposure to credit loss is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments as it does for on-balance sheet instruments. A summary of the Company's commitments is as follows (dollars in thousands):

	December 31,	
	2016	2015
Commitments to extend credit	\$ 26,330	27,492
Credit card commitments	5,975	6,103
Financial standby letters of credit	495	220
Commercial letters of credit	40	2,249
	\$ 32,840	36,064

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management's credit evaluation of the customer. Collateral held varies, but may include accounts receivable, inventory, property and equipment, residential real estate, and income-producing commercial properties.

Credit card commitments are unsecured.

Standby letters of credit are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those letters of credit are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. Collateral held varies and is required in instances which the Company deems necessary.

At December 31, 2016 and 2015, the carrying amount of liabilities related to the Company's obligation to perform under standby letters of credit was insignificant. The Company has not been required to perform on any standby letters of credit, and the Company has not incurred any losses on financial standby letters of credit for the years ended December 31, 2016, 2015, and 2014.

Notes to Consolidated Financial Statements, continued

(11) **Commitments and Contingencies, continued**  
**Contingencies**

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

(12) **Stockholders' Equity**  
**Preferred Stock**

The Company is authorized to issue a total of 10,000,000 shares of preferred stock. As of December 31, 2016, 3,486,455 shares remain unallocated to any issue.

**Preferred Stock Series A and B**

On July 17, 2009, the Company entered into an agreement with the United States Department of the Treasury (the "Treasury"), pursuant to which the Company issued and sold to the Treasury for an aggregate purchase price of \$12,900,000 in cash (i) 12,900 shares of the Company's 5% Fixed Rate Cumulative Perpetual Preferred Stock, Series A, no par value, having a liquidation preference of \$1,000 per share (the "Series A Preferred Stock"), and (ii) a ten-year warrant to purchase 645 shares of the Company's 9% Fixed Rate Cumulative Perpetual Preferred Stock, Series B, no par value ("Series B Preferred Stock"), at an initial exercise price of \$0.01 per share (the "Warrant"). The Warrant was exercised in full by the Treasury at closing.

Dividends of the Series A Preferred Stock are to be paid on the liquidation preferences at a rate of 5% per annum for the first five years, and at a rate of 9% per annum thereafter. The Series A Preferred Stock has no maturity date and ranks senior to the Company's Common Stock with respect to the payment of dividends and distributions and amount payable upon liquidations, dissolution and winding up the Company. The Series A Preferred Stock is generally non-voting. The Series B Preferred Stock has the same rights, preferences, privileges, voting rights, and other terms as the Series A Preferred Stock, except that the Series B Preferred Stock (1) will pay dividends at a rate of 9% per annum from the date of issuance, and (2) may not be redeemed until all the Series A Preferred Stock has been redeemed.

On March 1, 2013, the United States Department of the Treasury announced that the Company's Series A and B preferred stock, which it sold to the Treasury in 2009, had been auctioned to private investors. This transaction closed on March 11, 2013.

The Company may redeem the Series A and Series B Preferred Stock in whole or in part at \$1,000 per share, provided, however, that no Series B Preferred Stock may be redeemed until all of the Series A Preferred Stock has been redeemed. On March 31, 2015, the Company redeemed 7,990 shares of Series A Preferred Stock for \$8,077,890 which included \$87,890 of accrued dividends.

**Preferred Stock Series C**

In 2012, the Company issued and sold 737,448 shares of Series C 6.5% non-cumulative convertible perpetual preferred stock for \$4,240,000. The Series C preferred stock ranks senior to voting and non-voting common stock and Series AAA preferred stock but ranks junior to the Series A and Series B preferred stock with respect to dividend and liquidation rights. The Series C preferred stock does not have the voting rights of common stock, except under very limited circumstances. The Series C preferred stock may be converted at any time after the one year anniversary date of issuance by the Series C preferred shareholders to common stock at a rate of one share of common stock for each share of preferred stock. The Company has no right to redeem the preferred stock without the consent of the shareholder. On the thirty month anniversary of the issuance date, the preferred stock will automatically convert to common stock at the same conversion rate.

During 2013, the Company sold an additional 228,695 shares of Series C preferred stock for \$1,315,000, bringing the total to 966,143 shares issued for total proceeds of \$5,555,000. The sale of the Series C preferred stock was closed on January 31, 2013.

During 2015, 966,143 shares of Series C preferred stock converted to common stock in accordance with their thirty month anniversary.



Notes to Consolidated Financial Statements, continued

**(12) Stockholders' Equity, continued**  
**Preferred Stock Series AAA**

On December 10, 2009, the stockholders approved the reclassification of certain shares of common stock to a new class of Series AAA preferred stock. All stockholders owning fewer than 2,000 shares of common stock received one share of Series AAA preferred stock for each share of common stock owned. Series AAA preferred stock has limited voting rights such as in the event of a merger, sale, or other change of control of the Company. Series AAA preferred stock will receive cash dividends in an amount 10% greater than any cash dividends paid on common stock and on any stock dividends at least equal to stock dividends paid on common stock.

Shareholders owning a total of 28,856 shares dissented from the reclassification process. During 2010, the Company purchased 26,356 shares of these for \$191,000 and 2,500 shares were reclassified to common shares. Of the shares purchased, the Company reissued 22,056 common shares for total consideration of \$134,000.

During 2016, the Board of Directors voted to offer all holders of record of preferred AAA stock an opportunity to exchange all of their shares of preferred AAA stock for shares of common stock on a one-for-one basis. As a result, 62,553 shares of preferred AAA stock were exchanged for common shares.

**Preferred Stock Series D**

On September 27, 2013, the Company sold 2,096,165 shares of Series D convertible perpetual preferred stock for \$10,585,000 and 1,369,181 shares of common stock for \$6,914,000 for total combined proceeds of \$17,499,000. The Series D preferred stock ranks equal with common stock but is subordinate to the various preferred stock issued by the Company. The Series D preferred stock does not have the voting rights of common stock, except under very limited circumstances, but it has equal dividend rights with common. The Company has no right to redeem the preferred stock without the consent of the shareholder. Shares may be converted to common at the request of either the shareholder or the Company provided that no holder will own more than 9.9% of the common stock.

**(13) Concentration of Credit Risk**

The Company originates primarily commercial, residential, and consumer loans to customers in its respective markets. The ability of the majority of the Company's customers to honor their contractual loan obligations is dependent on the economy in the Company's primary market area.

A substantial portion of the Company's loan portfolio is concentrated in loans secured by real estate, of which a substantial portion is secured by real estate in the Company's primary market area. Accordingly, the ultimate collectability of the loan portfolio and recovery of the carrying amount of foreclosed assets is susceptible to changes in real estate conditions in the Company's primary market area. The other concentrations of credit by type of loan are set forth in Note 4.

The Bank's legal lending limit was approximately \$7,917,000 as of December 31, 2016. As a matter of policy, the Bank does not extend credit to any single borrower or group of related borrowers in excess of approximately \$5,000,000.

**(14) Regulatory Matters**

The Company's bank subsidiary is subject to certain restrictions on the amount of dividends that may be declared without prior regulatory approval. At December 31, 2016, no dividends could be declared without regulatory approval.

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

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(14) Regulatory Matters, continued**

Quantitative measures established by regulation to ensure capital adequacy require the Company and the Bank to maintain minimum amounts and ratios of Common Equity Tier 1, total and Tier 1 capital to risk-weighted assets, as defined, and of Tier 1 capital to average assets, as defined. Management believes, as of December 31, 2016 and 2015, that the Company and the Bank met all capital adequacy requirements to which they are subject. If, in the opinion of the regulators, the Company or a subsidiary bank engaged in unsafe or unsound practices, the regulators could subject the Company or its subsidiary bank to a variety of enforcement remedies, including issuance of a capital directive, a prohibition on accepting brokered deposits, and other restrictions.

The Bank is subject to various regulatory capital requirements administered by 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 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 assets, liabilities and certain off-balance-sheet items as calculated and is also subject to qualitative judgments by the regulators about components, risk weightings and other factors.

In July 2013, the Federal bank regulatory agencies issued a final rule that revised their risk-based capital requirements and the method for calculating components of capital and of computing risk-weighted assets to make them consistent with agreements that were reached by the Basel Committee on Banking Supervision and certain provisions of the Dodd-Frank Act. The final rule applies to all depository institutions, top-tier bank holding companies with total consolidated assets of \$500 million or more and top-tier savings and loan holding companies. The rule established a new common equity Tier 1 minimum capital requirement, increased the minimum capital ratios and assigns a higher risk weight to certain assets based on the risk associated with these assets. The final rule includes a transition period that implements the new regulations over a five year period. These changes were phased in beginning in January 2015. Management continues to evaluate this final rule and its potential impact on the Bank. Preliminary assessments indicate that the Bank will continue to exceed all regulatory capital requirements under the phased in requirements of the new rule.

Quantitative measures established by regulation to ensure capital adequacy require the maintenance of minimum amounts and ratios of Common Equity Tier 1, total and Tier I capital to risk-weighted assets, and Tier I capital to average assets, all as defined in the regulations. Management believes as of December 31, 2016 and 2015 that the Bank meets all capital adequacy requirements to which it is subject.

As of December 31, 2016 and 2015, the most recent notification from the federal banking agencies categorized the Bank as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized,” the Bank must maintain minimum total risk-based, Tier I risk-based, Common Equity Tier I risk based and Tier I leverage ratios. 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 presented in the following table for 2016 and 2015 (dollars in thousands):

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>As of December 31, 2016:</u>						
Total Capital to Risk Weighted Assets	\$ 52,782	14.31%	\$ 29,503	8.00%	\$ 36,878	10.00%
Tier 1 (Core) Capital to Risk Weighted Assets	50,021	13.56%	22,127	6.00%	29,503	8.00%
Common Equity Tier 1 (CET1)	50,021	13.56%	16,595	4.50%	23,971	6.50%
Tier 1 (Core) Capital to Average Assets	50,021	9.26%	21,599	4.00%	26,999	5.00%

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(14) Regulatory Matters, continued**

	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
<u>As of December 31, 2015:</u>						
Total Capital to Risk Weighted Assets Consolidated	\$ 49,053	12.94%	\$ 30,337	8.00%	\$ 37,921	10.00%
Tier 1 (Core) Capital to Risk Weighted Assets	46,006	12.13%	22,753	6.00%	30,337	8.00%
Common Equity Tier 1 (CET1)	46,006	12.13%	17,064	4.50%	24,649	6.50%
Tier 1 (Core) Capital to Average Assets	46,006	8.33%	22,092	4.00%	27,615	5.00%

**(15) Fair Value of Financial Instruments  
Determination of Fair Value**

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

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

**Fair Value Hierarchy**

In accordance with this guidance, the Company groups its financial assets and financial liabilities generally measured at fair value in three levels, based on the markets in which the assets and liabilities are traded and the reliability of the assumptions used to determine fair value.

- Level 1 - Valuation is based on quoted prices in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Level 1 assets and liabilities generally include debt and equity securities that are traded in an active exchange market. Valuations are obtained from readily available pricing sources for market transactions involving identical assets or liabilities.
- Level 2 - Valuation is based on inputs other than quoted prices included within level 1 that are observable for the asset or liability, either directly or indirectly. The valuation may be based on quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data for substantially the full term of the asset or liability.
- Level 3 - Valuation is based on unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. Level 3 assets and liabilities include financial instruments whose value is determined using pricing models, discounted cash flow methodologies, or similar techniques, as well as instruments for which determination of fair value requires significant management judgment or estimation.

Notes to Consolidated Financial Statements, continued

(15) **Fair Value of Financial Instruments, continued**

**Fair Value Hierarchy, continued**

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

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

**Cash, Due From Banks, Interest-Bearing Deposits in Banks, and Federal Funds Sold**

The carrying amounts of cash, due from banks, interest-bearing deposits in banks, and federal funds sold approximate fair values.

**Investment Securities**

Where quoted prices are available in an active market, the Company classifies the securities within level 1 of the valuation hierarchy. Level 1 securities include highly liquid government bonds and exchange-traded equities.

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

The carrying amount of restricted equity securities with no readily determinable fair value approximates fair value.

**Loans**

For variable-rate loans that reprice frequently and with no significant change in credit risk, fair values are based on carrying values. Fair value for other loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for impaired loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable.

**Mortgage Loans Held-for-Sale**

Fair value measurement for committed residential mortgage loans held-for-sale is determined by outstanding commitments from investors and the fair value of uncommitted loans is based on current delivery prices in the secondary mortgage market.

**Bank-Owned Life Insurance**

The fair value of Bank Owned Life Insurance approximates its carrying amount.

**Deposits**

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

**Off-balance Sheet Credit-Related Instruments**

Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. Because these instruments are generally short term and made using variable rates, the carrying value and estimated fair value of these instruments are immaterial.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(15) Fair Value of Financial Instruments, continued**

**Assets Measured at Fair Value on a Recurring Basis**

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

	Fair Value Measurements Using			Total Carrying Value
	Quoted Prices In Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
<u>December 31, 2016:</u>				
Assets:				
Securities available-for-sale	\$ -	165,053	2,338	167,391
<u>December 31, 2015:</u>				
Assets:				
Securities available-for-sale	\$ 1,432	164,855	829	167,116

The securities measured as Level 3 include investment in common stock of a bank holding company that is not listed on an exchange. Its fair value is measured as a factor of book value.

For those securities available-for-sale with fair values that are determined by reliance on significant unobservable inputs, the following table identifies the factors causing the change in fair value for the year ended December 31, 2016 and 2015 (dollars in thousands):

	Investment Securities Available-for-sale	
	2016	2015
Beginning balance	\$ 829	6,057
Total gains (losses) realized or unrealized:		
Included in earnings	2	2
Included in other comprehensive income (loss)	(51)	28
Net purchases (calls/paydowns)	1,558	(5,258)
Ending balance	\$ 2,338	829

**Assets Measured at Fair Value on a Nonrecurring Basis**

Under certain circumstances management makes adjustments to fair value for assets although they are not measured at fair value on an ongoing basis. The following tables present the financial instruments carried on the consolidated balance sheet by caption and by level in the fair value hierarchy for which a nonrecurring change in fair value has been recorded:

	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)
<u>December 31, 2016:</u>			
Impaired loans	\$ -	-	658
Other real estate owned	-	-	3,581
Total	\$ -	-	4,239
<u>December 31, 2015</u>			
Impaired loans	\$ -	-	2,189
Other real estate owned	-	-	2,421
Total	\$ -	-	4,610

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(15) Fair Value of Financial Instruments, continued**

The estimated fair values and related carrying amounts of the Company's financial instruments were as follows (dollars in thousands):

	December 31,			
	2016		2015	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash, due from banks, interest-bearing deposits in other banks and federal funds sold	\$ 34,800	34,800	46,219	46,219
Securities available-for-sale	167,391	167,391	167,116	167,116
Securities held-to-maturity	7,000	6,983	5,888	5,927
Restricted equity securities	2,332	2,332	1,994	1,994
Loans and loans held for sale, net	290,887	290,696	294,133	294,653
Bank-owned life insurance	20,816	20,816	20,265	20,265
Financial liabilities:				
Deposits	\$ 497,247	495,883	511,176	509,756

**Limitations**

Fair value estimates are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time, the Company's entire holdings of a particular financial instrument. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on many judgments. These estimates are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions could significantly affect the estimates.

Fair value estimates are based on existing on- and off-balance-sheet financial instruments without attempting to estimate the value of anticipated future business and the value of assets and liabilities that are not considered financial instruments. Premises and equipment are significant assets that are not considered financial instruments. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimate.

**(16) Subsequent Events**

On October 28, 2016, the Company signed an agreement for the sale of its credit card portfolio to The Independent Bankers Bank in Texas. The total amount of the credit card loan accounts total approximately \$2 million. The sale is expected to be closed during the second quarter of 2017.

On November 16, 2016, the Company reached an agreement for the sale of the two branches in Alabama and all related deposits and assets to Guardian Credit Union in Alabama. The sale is subject to regulatory approval and is expected to close in the second quarter of 2017. Guardian Credit Union will pay a 5% premium on the total deposits transferred, which are expected to be about \$45 million, and will purchase over \$6 million worth of loans.

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(17) Parent Company Financial Information**

The following information presents the condensed balance sheets of SouthCrest Financial Group, Inc. as of December 31, 2016 and 2015 and the condensed statements of operations and cash flows for each of the three years ended December 31, 2016 (dollars in thousands):

**CONDENSED BALANCE SHEETS**

		December 31,	
		2016	2015
Assets			
Cash		\$ 2,413	2,508
Investment in subsidiary		58,885	49,134
Securities available-for-sale		291	366
Loans, net of allowance for loan losses		163	169
Other real estate owned		117	135
Other assets		2,859	268
Total assets		\$ 64,728	52,580
Liabilities and Stockholders' Equity			
Other liabilities		\$ 148	181
Redeemable common stock and stockholders' equity:			
Redeemable common stock held by ESOP		-	352
Stockholders' equity		64,580	52,047
Total liabilities, redeemable common stock, and stockholders' equity		\$ 64,728	52,580

**CONDENSED STATEMENTS OF OPERATIONS**

		Years Ended December 31,		
		2016	2015	2014
Income:				
Interest		\$ 14	21	51
Other income		57	12	215
Total income		71	33	266
Expenses:				
Provision for loan losses		-	-	5
Other real estate owned write downs		18	16	29
Other expense		236	242	745
Total expenses		254	258	779
Loss before income tax and equity in undistributed earnings (loss) of subsidiary		(183)	(225)	(513)
Income tax benefit		2,921	-	-
Earnings (loss) before equity in undistributed earnings (loss) of subsidiary		2,738	(225)	(513)
Equity in undistributed earnings (loss) of subsidiary		10,925	929	(1,224)
Net income (loss)		\$ 13,663	704	(1,737)

**SOUTHCREST FINANCIAL GROUP, INC. AND SUBSIDIARY**

**Notes to Consolidated Financial Statements, continued**

**(17) Parent Company Financial Information, continued**

CONDENSED STATEMENTS OF CASH FLOWS

	Years Ended December 31,		
	2016	2015	2014
Operating Activities:			
Net income (loss)	\$ 13,663	704	(1,737)
Adjustments to reconcile net income (loss) to net cash used in operating activities:			
Equity in undistributed (earnings) loss of subsidiary	(10,925)	(929)	1,224
Stock-based compensation	130	133	104
Provision for loan losses	-	-	5
Net gain on sales of other real estate owned	-	1	-
Write downs of other real estate owned	18	16	29
Depreciation	1	1	-
Increase in income tax receivable	(2,854)	-	-
Change in other assets and liabilities	(286)	(268)	(515)
Net cash used in operating activities	(253)	(342)	(890)
Investing Activities:			
Investment in subsidiary	-	-	(2,200)
Decrease in loans	6	6	3
Proceeds from sales of securities	24	-	-
Proceeds from sales of other real estate owned	-	298	-
Net cash provided by (used in) investing activities	30	304	(2,197)
Financing Activities:			
Dividends paid on preferred stock	-	(758)	(3,318)
Change in unearned compensation-ESOP	128	(157)	23
Redemption of preferred stock	-	(7,990)	-
Net cash provided by (used in) financing activities	128	(8,905)	(3,295)
Net decrease in cash	(95)	(8,943)	(6,382)
Cash at beginning of year	2,508	11,451	17,833
Cash at end of year	\$ 2,413	2,508	11,451