

**FIRST COMMUNITY CORPORATION AND
FIRST COMMUNITY BANK OF EAST TENNESSEE**

Rogersville, Tennessee

CONSOLIDATED FINANCIAL STATEMENTS

Years Ended December 31, 2017 and 2016



FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
Rogersville, Tennessee

AUDITED CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

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INDEPENDENT AUDITOR'S REPORT

Board of Directors and Senior Management
First Community Corporation
Rogersville, Tennessee

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of First Community Corporation and First Community Bank of East Tennessee which comprise the consolidated balance sheets as of December 31, 2017 and 2016, and the related consolidated statements of operations, comprehensive income, changes in shareholders' equity, and cash flows for the years then ended, and the related notes to the consolidated financial statements, (collectively, the financial statements).

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these 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 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 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 audits to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the 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 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 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 financial statements referred to above present fairly, in all material respects, the financial position of First Community Corporation and First Community Bank of East Tennessee as of December 31, 2017 and 2016, 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.

Pugh & Company, P.C.

Certified Public Accountants
Knoxville, Tennessee
March 9, 2018



An independently owned member
RSM US Alliance



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Members of the Tennessee Society
Of Certified Public Accountants

**FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
CONSOLIDATED BALANCE SHEETS**

	As of December 31,	<u>2017</u>	<u>2016</u>
ASSETS			
Cash and Cash Equivalents:			
Cash and Due from Banks	\$	17,698,015	\$ 20,782,411
Federal Funds Sold		<u>23,682</u>	<u>0</u>
Total Cash and Cash Equivalents		<u>17,721,697</u>	<u>20,782,411</u>
Securities Available for Sale, at Fair Value		24,088,242	22,613,599
Loans, Net		113,075,168	110,087,853
Premises and Equipment, Net		4,312,085	4,514,449
Accrued Interest Receivable		419,199	326,493
Restricted Equity Investments, at Cost		1,810,800	1,810,800
Cash Surrender Value of Life Insurance		6,996,067	6,768,551
Foreclosed Real Estate		342,028	1,420,914
Deferred Income Tax Benefit		1,985,433	1,896,469
Other Assets		<u>486,534</u>	<u>618,952</u>
Total Assets	\$	<u><u>171,237,253</u></u>	\$ <u><u>170,840,491</u></u>
LIABILITIES AND EQUITY			
LIABILITIES			
Deposits:			
Noninterest-bearing	\$	38,489,540	\$ 28,727,858
Interest-bearing		<u>101,190,600</u>	<u>106,377,993</u>
Total Deposits		139,680,140	135,105,851
Securities Sold under Agreements to Repurchase		6,104,985	5,585,184
Federal Home Loan Bank Advances		880,515	6,226,444
Subordinated Debentures		7,217,000	7,217,000
Accrued Interest Payable		61,113	89,135
Other Liabilities		<u>2,086,462</u>	<u>2,192,140</u>
Total Liabilities		<u>156,030,215</u>	<u>156,415,754</u>
SHAREHOLDERS' EQUITY			
Preferred Stock Class A, \$8.05 Par Value. Authorized 400,000 Shares; Issued 220,080; Outstanding 211,672 Shares in 2017 and 2016		1,776,474	1,776,474
Preferred Stock Class B, \$8.05 Par Value. Authorized 200,000 Shares; Issued 30,071; Outstanding 29,846 Shares in 2017 and 2016		242,072	242,072
Common Stock, No Par Value. Authorized 10,000,000 Shares; Issued 1,679,244; Outstanding 1,630,812 Shares in 2017 and 2016		5,599,948	5,599,948
Treasury Stock, at Cost		(946,998)	(946,998)
Retained Earnings		8,736,950	7,999,202
Accumulated Other Comprehensive Income (Loss)		<u>(201,408)</u>	<u>(245,961)</u>
Total Shareholders' Equity		<u>15,207,038</u>	<u>14,424,737</u>
Total Liabilities and Shareholders' Equity	\$	<u><u>171,237,253</u></u>	\$ <u><u>170,840,491</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
CONSOLIDATED STATEMENTS OF OPERATIONS**

	For the Years Ended December 31,	<u>2017</u>	<u>2016</u>
INTEREST INCOME			
Loans, Including Fees	\$	5,566,739	\$ 5,504,014
Securities			
Taxable		250,301	316,421
Non-taxable		81,356	78,249
Other		<u>302,219</u>	<u>167,867</u>
Total Interest Income		<u>6,200,615</u>	<u>6,066,551</u>
INTEREST EXPENSE			
Deposits		193,512	179,332
Federal Home Loan Bank Advances		133,999	290,380
Subordinated Debentures		223,175	190,035
Other		<u>2,687</u>	<u>3,216</u>
Total Interest Expense		<u>553,373</u>	<u>662,963</u>
NET INTEREST INCOME		5,647,242	5,403,588
PROVISION FOR LOAN LOSSES		<u>0</u>	<u>550,000</u>
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES		<u>5,647,242</u>	<u>5,953,588</u>
NONINTEREST INCOME			
Service Charges on Deposit Accounts		468,950	486,784
Net Gain (Loss) on Sales and Redemptions of Securities Available for Sale		0	34,534
Increase in Cash Surrender Value of Life Insurance		217,676	446,313
Other		<u>485,738</u>	<u>491,188</u>
Total Noninterest Income		<u>1,172,364</u>	<u>1,458,819</u>
NONINTEREST EXPENSE			
Salaries and Employee Benefits		3,031,363	2,911,007
Occupancy		516,445	527,029
Data Processing		423,347	423,500
Furniture and Equipment		187,574	189,915
Advertising and Public Relations		37,334	38,667
Professional Services		205,423	213,242
Foreclosed Real Estate		231,071	601,380
Operating Supplies		98,603	66,558
Computer Software Depreciation		24,137	29,492
Software Maintenance		79,060	65,875
Telephone and Data Communications		100,859	118,447
Director and Committee Fees		56,775	42,975
FDIC and State Assessments		71,726	151,460
Other		<u>641,902</u>	<u>624,482</u>
Total Noninterest Expense		<u>5,705,619</u>	<u>6,004,029</u>
INCOME (LOSS) BEFORE INCOME TAXES		1,113,987	1,408,378
INCOME TAXES (EXPENSE) BENEFIT		<u>95,659</u>	<u>1,363</u>
NET INCOME (LOSS)	\$	<u>1,209,646</u>	\$ <u>1,409,741</u>
EARNINGS PER COMMON SHARE	\$	<u>0.70</u>	\$ <u>0.86</u>
EARNINGS PER COMMON SHARE, ASSUMING DILUTION	\$	<u>0.64</u>	\$ <u>0.75</u>

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME**

	For the Years Ended December 31,	<u>2017</u>	<u>2016</u>
NET INCOME (LOSS)		\$ <u>1,209,646</u>	\$ <u>1,409,741</u>
OTHER COMPREHENSIVE INCOME (LOSS)			
Unrealized Gains (Losses) on Investment Securities Available for Sale		72,197	141,786
Reclassification Adjustment for Realized Gains Included in Net Income (Loss) Above		<u>0</u>	<u>(34,534)</u>
Other Comprehensive Income (Loss) Before Income Taxes		72,197	107,252
Income (Taxes) Benefit Related to Items of Other Comprehensive Income		<u>(27,644)</u>	<u>(41,067)</u>
Other Comprehensive Income (Loss), Net of Income Taxes		<u>44,553</u>	<u>66,185</u>
COMPREHENSIVE INCOME (LOSS)		\$ <u><u>1,254,199</u></u>	\$ <u><u>1,475,926</u></u>

The accompanying notes are an integral part of these consolidated financial statements.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY
Years Ended December 31, 2017 and 2016

	Preferred Stock A	Preferred Stock B	Common Stock	Treasury Stock	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Total Shareholders' Equity
BALANCES, JANUARY 1, 2016	\$ 1,776,474	\$ 242,072	\$ 5,599,948	\$ (946,998)	\$ 6,589,461	\$ (312,146)	\$ 12,948,811
Net Income (Loss)	0	0	0	0	1,409,741	0	1,409,741
Other Comprehensive Income (Loss)	0	0	0	0	0	66,185	66,185
BALANCES, DECEMBER 31, 2016	1,776,474	242,072	5,599,948	(946,998)	7,999,202	(245,961)	14,424,737
Preferred Stock Dividends Paid	0	0	0	0	(63,772)	0	(63,772)
Common Stock Dividends Paid	0	0	0	0	(408,126)	0	(408,126)
Net Income (Loss)	0	0	0	0	1,209,646	0	1,209,646
Other Comprehensive Income (Loss)	0	0	0	0	0	44,553	44,553
BALANCES, DECEMBER 31, 2017	<u>\$ 1,776,474</u>	<u>\$ 242,072</u>	<u>\$ 5,599,948</u>	<u>\$ (946,998)</u>	<u>\$ 8,736,950</u>	<u>\$ (201,408)</u>	<u>\$ 15,207,038</u>

The accompanying notes are an integral part of these consolidated financial statements.

**FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
CONSOLIDATED STATEMENTS OF CASH FLOWS**

	For the Years Ended December 31,	<u>2017</u>	<u>2016</u>
Cash Flows from Operating Activities:			
Net Income (Loss)	\$	1,209,646	\$ 1,409,741
Adjustments to Reconcile Net Income (Loss) to Net Cash Provided by (Used in) Operating Activities			
Depreciation and Amortization		253,507	265,923
Net Amortization of Securities		161,917	156,963
Provision for Loan Losses		0	(550,000)
(Gain) Loss of Sales of Foreclosed Real Estate		(20,271)	(3,962)
Write-downs of Foreclosed Real Estate		209,370	304,090
Deferred Income Taxes (Benefit)		(116,608)	(3,379)
Gain (Loss) on Sales and Redemptions of Securities Available for Sale		0	(34,534)
(Increase) Decrease in Cash Surrender Value of Company Owned Life Insurance		(217,676)	(446,313)
Change in Accrued Interest Receivable and Other Assets		39,712	(50,595)
Change in Accrued Interest Payable and Other Liabilities		(143,540)	(252,927)
Net Cash Provided by (Used in) Operating Activities		<u>1,376,057</u>	<u>795,007</u>
Cash Flows from Investing Activities:			
Purchases of Securities Available for Sale		(8,114,906)	(13,539,400)
Proceeds from Maturities, Redemptions, and Paydowns of Securities Available for Sale		6,550,543	15,680,220
Proceeds from Sales of Securities Available for Sale		0	5,002,855
Net (Increase) Decrease in Loans		(3,097,088)	(1,858,103)
Proceeds from Sales of Foreclosed Real Estate		999,560	1,258,632
Capital Improvements to Foreclosed Real Estate		0	(99,182)
Proceeds from Company Owned Life Insurance		0	606,760
Purchases of Premises and Equipment		(51,143)	(36,556)
Net Cash Provided by (Used in) Investing Activities		<u>(3,713,034)</u>	<u>7,015,226</u>
Cash Flows from Financing Activities:			
Cash Dividends Paid on Preferred Stock		(63,772)	0
Cash Dividends Paid on Common Stock		(408,126)	0
Repayments of FHLB Advances		(5,345,929)	(43,619)
Change in Checking, Savings and Money Market Accounts		9,740,185	3,091,962
Increase (Decrease) in Time Deposits		(5,165,896)	(3,730,927)
Change in Securities Sold under Agreements to Repurchase		519,801	(1,415,110)
Net Cash Provided by (Used in) Financing Activities		<u>(723,737)</u>	<u>(2,097,694)</u>
Net Change in Cash and Cash Equivalents		(3,060,714)	5,712,539
Cash and Cash Equivalents at Beginning of Period		20,782,411	15,069,872
Cash and Cash Equivalents at End of Period	\$	<u>17,721,697</u>	<u>\$ 20,782,411</u>
Supplemental Disclosures of Cash Flow Information:			
Cash Paid During the Year for:			
Interest	\$	581,395	\$ 662,796
Income Taxes		1,800	300
Supplemental Noncash Disclosures:			
Transfers from Loans to Foreclosed Real Estate	\$	109,773	\$ 0
Change in Unrealized Gains/Losses on Securities Available for Sale		72,197	107,252
Change in Deferred Income Taxes Associated with Unrealized Gains/Losses on Securities Available for Sale		27,644	41,067
Change in Unrealized Gains/Losses on Securities Available for Sale, Net of Deferred Income Taxes		44,553	66,185

The accompanying notes are an integral part of these consolidated financial statements.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

General: First Community Corporation (the Holding Company), through its wholly owned subsidiary, First Community Bank of East Tennessee (the Bank), provides a variety of banking services to individuals and businesses from its banking offices in Rogersville, Church Hill, and Kingsport, Tennessee. Its primary deposit products are demand and savings deposits and certificates of deposit, and its primary lending products are commercial, residential real estate and consumer loans. The accounting principles followed and the methods of applying those principles conform with accounting principles generally accepted in the United States of America (GAAP) and to general practices in the banking industry. The significant policies are summarized as follows:

Basis of Presentation: The accompanying consolidated financial statements include the accounts of First Community Corporation, a one-bank holding company and its wholly-owned subsidiary, First Community Bank of East Tennessee, together referred to as "the Company". All material intercompany balances and transactions have been eliminated in consolidation.

Use of Estimates: To prepare consolidated financial statements in conformity with GAAP, management makes estimates and assumptions based on available information. These estimates and assumptions affect the amounts reported in the consolidated financial statements and the disclosures provided, and future results could differ. The allowance for loan losses, fair values of financial instruments, the valuation of real estate acquired through foreclosures, and deferred compensation related to retirement plan liabilities are particularly subject to change.

Cash Flows: Cash and cash equivalents include cash, deposits with other financial institutions with maturities under 90 days, and federal funds sold. Net cash flows are reported for loan, deposit and securities sold under agreements to repurchase transactions.

Cash and Due from Banks: Included in cash and due from banks are legal reserve requirements which must be maintained on an average basis in the form of cash and balances due from the Federal Reserve and other banks. Cash on hand or on deposit with correspondent banks of \$1,780,000 and \$1,392,000 was required to meet regulatory reserve and clearing requirements at December 31, 2017 and 2016, respectively. These balances do not earn interest. The Bank also maintains cash deposits with the Federal Reserve Bank, which totaled approximately \$13,383,000 and \$15,450,000 as of December 31, 2017 and 2016, respectively, and with the Federal Home Loan Bank of Cincinnati, which totaled approximately \$177,000 and \$185,000 as of December 31, 2017 and 2016, respectively. As of December 31, 2017 and 2016, balances in correspondent bank accounts in excess of FDIC insurance limits totaled approximately \$155,000 and \$99,000, respectively.

Securities: Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income (loss).

Interest income includes amortization of purchase premium or discount. Gains and losses on sales are based on the amortized cost of the security sold. Securities are written down to fair value when a decline in fair value is not temporary (see Note 2).

Declines in the fair value of securities below their cost that are other than temporary are reflected as realized losses. In estimating other-than-temporary losses, management considers: (1) the length of time and extent that fair value has been less than cost, (2) the financial condition and near term prospects of the issuer, and (3) the Company's ability and intent to hold the security for a period sufficient to allow for any anticipated recovery in the fair value (see Note 2).

Restricted Equity Investments: The Company's restricted equity investment represents a required investment in the Federal Home Loan Bank (FHLB) of Cincinnati, which is pledged as collateral for FHLB advances (see Note.11). This investment is carried at cost because it does not have a readily determinable fair value.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Loans: Loans that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are reported at the principal balance outstanding, net of an estimated allowance for loan losses.

Interest income is reported on the simple interest accrual method. Interest income on mortgage and commercial loans is discontinued at the time the loan is 90 days delinquent unless the credit is well secured and in process of collection. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued but not received for loans placed on nonaccrual is reversed against interest income. Interest received on such loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to the accrual basis. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Estimated Allowance for Loan Losses: The estimated allowance for loan losses is a valuation allowance for probable incurred credit losses, increased by the provision for loan losses and decreased by charge-offs less recoveries. Management estimates the allowance balance required using past loan loss experience, the nature and volume of the portfolio, information about specific borrower situations and estimated collateral values, economic conditions, and other trends and conditions. The entire estimated allowance is available for any loan that, in management's judgment, should be charged-off. Loan losses are charged against the estimated allowance when management believes the uncollectibility of a loan balance is confirmed.

A general reserve is established that evaluates unimpaired loans by category. Each loan within a group has similar risk characteristics. When estimating credit losses on each group of loans, management considers the bank's historical loss experience on the group, adjusted for changes in trends, conditions, and other relevant factors that affect repayment of the loans as of the evaluation date. These loans are collectively evaluated for estimated credit losses.

Another component of the ALLL is an allocated reserve on individually evaluated loans, as judgmentally determined by management to be impaired. A loan is considered impaired when based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. If a loan is impaired, an allocated allowance is established so that the loan is reported at the net present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from the collateral.

While management uses available information to recognize losses on loans, further reductions in the carrying amounts of loans may be necessary. 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.

Premises and Equipment: Premises and equipment are stated at cost, less accumulated depreciation and amortization. The provision for depreciation is computed principally on the straight-line method over the estimated useful lives of the assets, which range as follows: building-40 years, equipment-3 to 15 years. Computer software is amortized using the straight-line method over the useful life of the asset and ranges from 3 to 10 years.

Foreclosed Real Estate: Real estate acquired through or instead of loan foreclosure is initially recorded at fair value when acquired, establishing a new cost basis. If fair value declines subsequent to foreclosure, a valuation allowance is recorded through expense. Costs after acquisition that do not increase the property's value are expensed. The Company's current average holding period for such properties is approximately 70 months.

Cash Surrender Value of Life Insurance: The Company has purchased life insurance policies on certain key executives and bank officers. Company owned life insurance is recorded at its net cash surrender value, or the amount that can be realized if surrendered.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (Continued)

Securities Sold Under Agreements to Repurchase: Repurchase agreements are treated as financing transactions and are carried at the amounts at which the securities will be subsequently reacquired, as specified in the respective agreements. Securities are pledged to cover these liabilities, which are not covered by federal deposit insurance.

Stock-Based Compensation: Compensation cost is recognized for stock options issued to employees and directors. Compensation cost is measured as the fair value of these awards on their date of grant. A Black-Scholes model is utilized to estimate the fair value of stock options at the date of grant. Compensation cost is recognized over the required service period, generally defined as the vesting period for stock option awards. For awards with graded vesting, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award.

Earnings Per Common Share: Basic earnings per common share is net income less preferred stock dividends divided by the weighted average number of common shares outstanding during the period. Diluted earnings per share includes the effect of all dilutive potential common shares that were outstanding during the period. Earnings and dividends per share are restated for all stock splits and dividends through the date of issue of the consolidated financial statements. See Note 16.

Advertising and Public Relations: Advertising and public relations costs are expensed as incurred.

Income Taxes: Income tax expense is the total of the current year income tax due or refundable and the change in deferred tax assets and liabilities. Deferred tax assets and liabilities are the expected future tax amounts for the temporary differences between carrying amounts and tax bases of assets and liabilities, computed using enacted tax rates.

Employee Benefits: The Company maintains a 401(k) profit-sharing plan that covers substantially all employees. The Company matches a portion of the employee's contribution and records the expense in the period the employee contribution is withheld. The Company has a non-qualified deferred compensation arrangement with certain current and former officers. A contribution may be made or accrued each year based on future benefits to be paid under the arrangement, at the discretion of the Board of Directors if certain financial goals are met.

Consolidated Statement of Comprehensive Income: The objective of this statement is to report a measure of all changes in equity of an enterprise that results from transactions and other economic events of the period other than transactions with owners. Items included in comprehensive income include revenues, gains and losses that under generally accepted accounting principles are directly charged to equity. Examples include foreign currency translations, pension liability adjustments and unrealized gains and losses on investment securities available for sale. The Company has included its comprehensive income in a separate financial statement as part of its consolidated financial statements.

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

Evaluation of Subsequent Events: The Company's management has evaluated subsequent events through March 9, 2018, which is the date the financial statements were available to be issued. See subsequent event Note 12.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 2 - SECURITIES

The fair values of securities available for sale and the related gross unrealized gains and losses recognized in accumulated other comprehensive income (loss) were as follows:

<u>2017</u>	<u>Amortized Cost</u>	<u>Gross Unrealized Gains</u>	<u>Gross Unrealized Losses</u>	<u>Fair Value</u>
U.S. Treasury Securities	\$ 997,096	\$ 0	\$ (7,646)	\$ 989,450
Small Business Admin. Securities	2,827,519	4,308	(47,158)	2,784,669
U.S. Government Agency Securities	7,499,672	0	(106,462)	7,393,210
Residential Mortgage-backed Securities	6,056,435	22,093	(154,682)	5,923,846
Taxable Municipal Securities	398,581	0	(12,089)	386,492
Tax Exempt Municipal Securities	6,635,316	8,014	(32,755)	6,610,575
Total	<u>\$ 24,414,619</u>	<u>\$ 34,415</u>	<u>\$ (360,792)</u>	<u>\$ 24,088,242</u>
<u>2016</u>				
Small Business Admin. Securities	\$ 2,162,146	\$ 4,897	\$ (73,632)	\$ 2,093,411
U.S. Government Agency Securities	3,499,897	0	(69,802)	3,430,095
Residential Mortgage-backed Securities	7,841,756	12,777	(164,828)	7,689,705
Taxable Municipal Securities	398,213	0	(12,157)	386,056
Tax Exempt Municipal Securities	9,110,161	816	(96,645)	9,014,332
Total	<u>\$ 23,012,173</u>	<u>\$ 18,490</u>	<u>\$ (417,064)</u>	<u>\$ 22,613,599</u>

The amortized cost and fair value of securities at December 31, 2017, by contractual maturity is shown below. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations.

	<u>Amortized Cost</u>	<u>Fair Value</u>
Due through One Year	\$ 3,545,035	\$ 3,535,001
Due after One through Five Years	10,726,711	10,590,067
Due after Five through Ten Years	1,258,919	1,254,659
Residential Mortgage-backed and SBA Securities	8,883,954	8,708,515
Total	<u>\$ 24,414,619</u>	<u>\$ 24,088,242</u>

For purposes of the above maturity table, mortgage-backed securities and Small Business Administration securities, which are not due at a single maturity date, are presented on a separate line item.

Proceeds from sales of investment securities available for sale were \$0 and \$5,002,855 during the years ended December 31, 2017 and 2016, respectively. The Company recognized no gross gains or losses from the sales of investment securities in 2017 (\$14,916 of gross gains in 2016).

Securities pledged to secure public deposits and repurchase agreements at December 31, 2017 and 2016 had a carrying amount of approximately \$24,088,000 and \$22,614,000, respectively.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
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NOTE 2 - SECURITIES (Continued)

The following table shows securities with unrealized losses and their fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position at December 31, 2017 and 2016:

	Less than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
2017						
U.S. Treasury Securities	\$ 989,450	\$ (7,646)	\$ 0	\$ 0	\$ 989,450	\$ (7,646)
Small Business Admin. Securities	57,295	(25)	1,560,318	(47,133)	1,617,613	(47,158)
U.S. Government Agency Securities	4,933,455	(66,391)	2,459,755	(40,071)	7,393,210	(106,462)
Residential Mortgage-backed Securities	1,268,044	(8,764)	2,816,394	(145,918)	4,084,438	(154,682)
Taxable Municipal Securities	0	0	386,492	(12,089)	386,492	(12,089)
Tax Exempt Municipal Securities	1,101,823	(8,143)	4,101,683	(24,612)	5,203,506	(32,755)
Total Temporarily Impaired	<u>\$ 8,350,067</u>	<u>\$ (90,969)</u>	<u>\$ 11,324,642</u>	<u>\$ (269,823)</u>	<u>\$ 19,674,709</u>	<u>\$ (360,792)</u>
2016						
Small Business Admin. Securities	\$ 1,758,437	\$ (73,632)	\$ 0	\$ 0	\$ 1,758,437	\$ (73,632)
U.S. Government Agency Securities	3,430,095	(69,802)	0	0	3,430,095	(69,802)
Residential Mortgage-backed Securities	2,465,255	(34,874)	2,575,323	(129,954)	5,040,578	(164,828)
Taxable Municipal Securities	386,056	(12,157)	0	0	386,056	(12,157)
Tax Exempt Municipal Securities	8,812,200	(96,645)	0	0	8,812,200	(96,645)
Total Temporarily Impaired	<u>\$ 16,852,043</u>	<u>\$ (287,110)</u>	<u>\$ 2,575,323</u>	<u>\$ (129,954)</u>	<u>\$ 19,427,366</u>	<u>\$ (417,064)</u>

Unrealized losses on securities have not been recognized into income because the issuer(s) securities are of higher credit quality (rated A3 or higher), management has the intent and ability to hold them for the foreseeable future, and the decline in fair value is largely due to changes in market interest rates. The fair value is expected to recover as the securities approach their maturity date and/or market rates change.

At December 31, 2017, the 40 investment securities in an unrealized loss position have depreciated approximately 1.8% from the Company's amortized cost basis. This unrealized loss relates principally to current interest rates for similar types of securities. In analyzing an issuer's financial condition, management considers whether the securities are issued by the federal government or its agencies, whether downgrades by bond rating agencies have occurred, and the results of reviews of the issuer's financial condition.

NOTE 3 - LOANS

A summary of loans outstanding by category at December 31, 2017 and 2016 follows:

	2017	2016
Secured by Real Estate:		
Commercial - Owner-Occupied	\$ 17,316,686	\$ 18,115,200
Commercial - Other	31,151,963	29,385,601
Construction, Land Development and Vacant Land	12,009,106	10,898,740
Residential Properties	31,204,323	29,518,785
Commercial, Financial and Agricultural	18,685,395	17,686,097
Consumer	4,576,964	6,319,443
	<u>114,944,437</u>	<u>111,923,866</u>
Less: Allowance for Loan and Lease Losses	(1,869,269)	(1,836,013)
Loans, Net	<u>\$ 113,075,168</u>	<u>\$ 110,087,853</u>

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
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NOTE 4 - LOAN QUALITY

Management performs a quarterly evaluation of the adequacy of the allowance for loan and lease losses (ALLL). Consideration is given to a variety of factors in establishing this estimate including, but not limited to, current economic conditions, diversification of the loan portfolio, delinquency statistics, results of internal loan reviews, borrowers' actual or perceived financial and managerial strengths, the adequacy of the underlying collateral (if collateral dependent) and other relevant factors. It is management's general practice to obtain a new appraisal or asset valuation for any loan that it has rated as substandard or lower, including loans on nonaccrual of interest. Management, at its discretion, may determine that additional adjustments to the appraisal or valuation are required. Valuation adjustments will be made as necessary based on other factors including, but not limited to, the economy, maintenance and general condition of the collateral, industry, type of property/equipment/vehicle, and the knowledge management has about a particular situation. In addition, the cost to sell or liquidate the collateral is also estimated when determining the realizable value to the Company.

Certain factors involved in the evaluation are inherently subjective, as they require material estimates that may be susceptible to significant change, including the amounts and timing of future cash flows expected to be received on impaired loans.

For financial statement presentation, the Company segregates its loan portfolio into the following segments based primarily on the type of supporting collateral: commercial – owner-occupied; commercial – other; construction; residential; commercial, financial and agricultural; and consumer loans. The construction and land development segment contains loans to individuals to construct their own homes as well as loans to contractors and developers to construct homes or buildings for resale or develop residential or commercial real estate. This segment has its own unique risk characteristics including the need to periodically inspect the property during construction to ensure the funds disbursed are used properly and the real estate held for collateral maintains its value in relation to the amount owed on it. The construction and land development segment also has risk characteristics related to the probability of eventual sale of the finished project or the ability to generate sufficient rental income to service the debt. The residential real estate segment is segregated from the commercial real estate segment due to the obvious differences in inherent risks in each of these types of properties and borrower types. Consumer loans have risk characteristics including the volatility of the collateral's value and the inherent risk of loaning on collateral that is mobile and subject to damage without proper insurance coverage.

The analysis for determining the ALLL is consistent with guidance set forth in generally accepted accounting principles (GAAP) and the Interagency Policy Statement on the Allowance for Loan and Lease Losses. The analysis has two components: specific and general allocations. The specific component addresses specific reserves established for loans that were individually evaluated and deemed to be impaired. For these impairment evaluations, the Company assesses loan relationships with balances exceeding \$100,000 that show signs of possible impairment based on the payment status, internal risk ratings, or other credit quality factors. A loan is considered to be impaired when, based on current information and events, it is probable that the Company will be unable to collect all interest and principal payments due according to the originally contracted terms of the loan agreement. Expected cash flow or collateral values discounted for market conditions and selling costs are used to establish specific allocations. Loans measured for the ALLL under the specific allocation method normally tend to be impaired construction, real estate, vehicle or unsecured loans.

The general component addresses the reserves established for pools of homogenous loans, including primarily non-classified loans. The general component includes a quantitative and qualitative analysis. The quantitative analysis includes the Company's historical loan loss experience (weighted towards most recent periods) and other factors derived from economic and market conditions that have been determined to have an effect on the probability and magnitude of a loss. The qualitative analysis utilizes factors such as: loan volume, loan collateral, management characteristics, levels of nonperforming loans, results of the loan review process, specific credit concentrations, and legal and regulatory issues. Input for these factors is determined on the basis of management's observation, judgment and experience. As a result of this input, additional loss percentages can be assigned to each pool of loans.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
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NOTE 4 - LOAN QUALITY (Continued)

A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. Cash payments received on impaired loans on which the accrual of interest has been discontinued are applied to principal until the loans are returned to accrual status.

The following table presents, by loan segment, the ALLL and changes to the ALLL for the years ended December 31, 2017 and 2016 with the ALLL allocated based on the segment loan volumes:

	Secured by Real Estate							Unallocated	Total
	Commercial - Owner-Occupied	Commercial - Other	Construction, Land Dev. & Vacant Land	Residential Properties	Commercial, Financial and Agricultural	Consumer			
Allowance at									
December 31, 2015	\$ 528,748	\$ 278,053	\$ 415,205	\$ 171,685	\$ 254,912	\$ 14,753	\$ 459,966	\$ 2,123,322	
Provision	(349,230)	(202,099)	29,606	237,068	(46,662)	64,034	(282,717)	(550,000)	
Charge-offs	0	0	0	(56,967)	(838)	(1,611)	0	(59,416)	
Recoveries	38,982	275,175	0	100	7,850	0	0	322,107	
Allowance at									
December 31, 2016	218,500	351,129	444,811	351,886	215,262	77,176	177,249	1,836,013	
Provision	(38,026)	3,219	57,698	37,788	(26,540)	(21,977)	(12,162)	0	
Charge-offs	0	0	0	(22,108)	0	(4,242)	0	(26,350)	
Recoveries	22,353	8,324	4,785	0	20,947	3,197	0	59,606	
Allowance at									
December 31, 2017	<u>\$ 202,827</u>	<u>\$ 362,672</u>	<u>\$ 507,294</u>	<u>\$ 367,566</u>	<u>\$ 209,669</u>	<u>\$ 54,154</u>	<u>\$ 165,087</u>	<u>\$ 1,869,269</u>	

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 4 - LOAN QUALITY (Continued)

The following tables present, by loan segment, loans that were evaluated for the ALLL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) as of December 31, 2017 and 2016.

	Secured by Real Estate							Total
	Commercial - Owner-Occupied	Commercial - Other	Construction, Land Dev. & Vacant Land	Residential Properties	Commercial, Financial and Agricultural	Consumer	Unallocated	
December 31, 2017								
Loans Evaluated for								
Allowance:								
Individually	\$ 174,248	\$ 499,798	\$ 1,690,440	\$ 138,581	\$ 964,733	\$ 0	\$ 0	\$ 3,467,800
Collectively	17,142,438	30,652,165	10,318,666	31,065,742	17,720,662	4,576,964	0	111,476,637
Total	<u>\$ 17,316,686</u>	<u>\$ 31,151,963</u>	<u>\$ 12,009,106</u>	<u>\$ 31,204,323</u>	<u>\$ 18,685,395</u>	<u>\$ 4,576,964</u>	<u>\$ 0</u>	<u>\$ 114,944,437</u>
Allowance Established								
for Loans Evaluated:								
Individually	\$ 0	\$ 0	\$ 385,205	\$ 0	\$ 0	\$ 0	\$ 0	\$ 385,205
Collectively	202,827	362,672	122,089	367,566	209,669	54,154	165,087	1,484,064
Allowance at								
December 31, 2017	<u>\$ 202,827</u>	<u>\$ 362,672</u>	<u>\$ 507,294</u>	<u>\$ 367,566</u>	<u>\$ 209,669</u>	<u>\$ 54,154</u>	<u>\$ 165,087</u>	<u>\$ 1,869,269</u>
December 31, 2016								
Loans Evaluated for								
Allowance:								
Individually	\$ 163,137	\$ 536,528	\$ 992,089	\$ 607,643	\$ 0	\$ 0	\$ 0	\$ 2,299,397
Collectively	17,952,063	28,849,073	9,906,651	28,911,142	17,686,097	6,319,443	0	109,624,469
Total	<u>\$ 18,115,200</u>	<u>\$ 29,385,601</u>	<u>\$ 10,898,740</u>	<u>\$ 29,518,785</u>	<u>\$ 17,686,097</u>	<u>\$ 6,319,443</u>	<u>\$ 0</u>	<u>\$ 111,923,866</u>
Allowance Established								
for Loans Evaluated:								
Individually	\$ 0	\$ 0	\$ 324,234	\$ 0	\$ 0	\$ 0	\$ 0	\$ 324,234
Collectively	218,500	351,129	120,577	351,886	215,262	77,176	177,249	1,511,779
Allowance at								
December 31, 2016	<u>\$ 218,500</u>	<u>\$ 351,129</u>	<u>\$ 444,811</u>	<u>\$ 351,886</u>	<u>\$ 215,262</u>	<u>\$ 77,176</u>	<u>\$ 177,249</u>	<u>\$ 1,836,013</u>

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 4 - LOAN QUALITY (Continued)

The following tables show additional information about those loans considered to be impaired at December 31, 2017 and 2016:

	<u>Recorded Investment</u>	<u>Unpaid Principal Balance</u>	<u>Related Allowance</u>	<u>Average Recorded Investment</u>	<u>Interest Income Recognized</u>
For the Year Ended December 31, 2017					
Impaired Loans with No Specific Allowance:					
Loans Secured by Real Estate:					
Commercial - Owner-Occupied	\$ 174,248	\$ 174,248	\$ 0	\$ 186,760	\$ 12,143
Commercial - Other	499,798	666,963	0	518,163	29,437
Construction, Land Development & Vacant Land	300,698	300,698	0	324,698	12,020
Residential:					
1 - 4 Family	138,581	138,581	0	141,596	6,960
Other Loans:					
Commercial, Financial and Agricultural	964,733	964,733	0	974,102	59,233
Total Impaired Loans with No Specific Allowance	\$ 2,078,058	\$ 2,245,223	\$ 0	\$ 2,145,319	\$ 119,793
Impaired Loans with Specific Allowance:					
Loans Secured by Real Estate:					
Construction, Land Development & Vacant Land	\$ 1,389,742	\$ 1,389,742	\$ 385,205	\$ 1,271,888	\$ 37,797
Total Impaired Loans with Specific Allowance	\$ 1,389,742	\$ 1,389,742	\$ 385,205	\$ 1,271,888	\$ 37,797
Total Impaired Loans	\$ 3,467,800	\$ 3,634,965	\$ 385,205	\$ 3,417,207	\$ 157,590
For the Year Ended December 31, 2016					
Impaired Loans with No Specific Allowance:					
Loans Secured by Real Estate:					
Commercial - Owner-Occupied	\$ 163,137	\$ 163,137	\$ 0	\$ 169,863	\$ 11,189
Commercial - Other	536,528	696,587	0	554,105	23,983
Construction, Land Development & Vacant Land	285,255	285,255	0	321,255	10,441
Residential:					
1 - 4 Family	607,643	607,643	0	608,331	28,217
Total Impaired Loans with No Specific Allowance	\$ 1,592,563	\$ 1,752,622	\$ 0	\$ 1,653,554	\$ 73,830
Impaired Loans with Specific Allowance:					
Loans Secured by Real Estate:					
Construction, Land Development & Vacant Land	\$ 706,834	\$ 706,834	\$ 324,234	\$ 719,469	\$ 25,186
Total Impaired Loans with Specific Allowance	\$ 706,834	\$ 706,834	\$ 324,234	\$ 719,469	\$ 25,186
Total Impaired Loans	\$ 2,299,397	\$ 2,459,456	\$ 324,234	\$ 2,373,023	\$ 99,016

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
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Years Ended December 31, 2017 and 2016

NOTE 4 - LOAN QUALITY (Continued)

The Company categorizes loans into risk categories based on relevant information about the ability of borrowers to service their debt such as: current financial information, historical payment experience, credit documentation, public information, and current economic trends, among other factors. The Company analyzes loans individually by classifying the loans as to credit risk. Loans classified as substandard or management watch are reviewed regularly by the Company to determine if appropriately classified or to determine if the loan is impaired. The Company's loan portfolio is reviewed for credit quality with samples being selected based on loan size, credit grades, etc., to ensure that the Company's management is properly applying credit risk management processes.

Loans excluded from the scope of the annual review process are generally classified as pass credit until: (a) they become past due; (b) management becomes aware of deterioration in the credit worthiness of the borrower; or (c) the customer contacts the Company for a modification. In these circumstances, the customer relationship is specifically evaluated for potential classification as to special mention, substandard or doubtful, or could even be considered for charge-off. The Company uses the following definitions for risk ratings:

Pass – Strong credit with no existing or known potential weaknesses deserving management's close attention.

Management Watch – Loans included in this category are currently protected but are potentially weak. These loans constitute an undue and unwarranted credit risk but do not presently expose the Company to a sufficient degree of risk to warrant adverse classification. As a general rule, for the purpose of calculating a loan loss reserve, loans in this category will have the historical loss reserve percentage applied and will remain in a pool with loans that are considered acceptable or better when determining the general valuation reserves. Loans classified as management watch have potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the loan or of the institution's credit position at some future date.

Substandard – Substandard loans are inadequately protected by the current net worth and financial capacity of the borrower or of the collateral pledged, if any. The borrower or guarantor is unwilling or unable to meet loan terms or loan covenants for the foreseeable future.

Doubtful – Loans classified as doubtful have all the weaknesses inherent in those classified as substandard, with the added characteristic that the weaknesses make collection or liquidation in full highly questionable or improbable, based on currently existing facts, condition, and values.

Loss – Loans classified as losses are uncollectible or no longer a bankable asset. This classification does not mean that the asset has absolutely no recoverable value. Certain salvage value is inherent in these loans. Nevertheless, it is not practical or desirable to defer writing off a portion or whole of a perceived asset even though partial recovery may be collected in the future.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 4 - LOAN QUALITY (Continued)

The following table shows the Company's credit quality indicators by type of loan as of December 31, 2017 and 2016:

<u>As of December 31, 2017</u>	Pass	Management Watch	Substandard	Doubtful	Total Loans
Loans Secured by Real Estate:					
Commercial - Owner-Occupied	\$ 13,098,187	\$ 3,908,489	\$ 310,010	\$ 0	\$ 17,316,686
Commercial - Other	27,417,159	3,734,804	0	0	31,151,963
Construction, Land Development & Vacant Land	10,345,431	0	1,663,675	0	12,009,106
Residential:					
1 - 4 Family	25,560,280	2,127,421	425,326	0	28,113,027
Other	3,028,250	0	63,046	0	3,091,296
Other Loans:					
Commercial, Financial and Agricultural	17,173,298	458,949	1,053,148	0	18,685,395
Consumer	4,576,964	0	0	0	4,576,964
Total Loans	\$ 101,199,569	\$ 10,229,663	\$ 3,515,205	\$ 0	\$ 114,944,437
<u>As of December 31, 2016</u>					
Loans Secured by Real Estate:					
Commercial - Owner-Occupied	\$ 13,603,749	\$ 4,180,191	\$ 331,260	\$ 0	\$ 18,115,200
Commercial - Other	25,537,935	3,847,666	0	0	29,385,601
Construction, Land Development & Vacant Land	9,906,651	0	992,089	0	10,898,740
Residential:					
1 - 4 Family	22,415,626	3,146,574	801,767	0	26,363,967
Other	3,154,818	0	0	0	3,154,818
Other Loans:					
Commercial, Financial and Agricultural	16,473,152	1,212,795	150	0	17,686,097
Consumer	6,319,443	0	0	0	6,319,443
Total Loans	\$ 97,411,374	\$ 12,387,226	\$ 2,125,266	\$ 0	\$ 111,923,866

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
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NOTE 4 - LOAN QUALITY (Continued)

The following table provides an aging analysis of the Company's loans as of December 31, 2017 and 2016:

	Current	30-89 Days Past Due	Greater Than 90 Days	Nonaccrual	Total Past Due and Nonaccrual	Total Loans
As of December 31, 2017						
Loans Secured by Real Estate:						
Commercial - Owner-Occupied	\$ 17,001,491	\$ 272,512	\$ 27,678	\$ 15,005	\$ 315,195	\$ 17,316,686
Commercial - Other	31,151,963	0	0	0	0	31,151,963
Construction, Land Development & Vacant Land	11,327,400	0	0	681,706	681,706	12,009,106
Residential:						
1 - 4 Family	27,320,787	542,596	0	249,644	792,240	28,113,027
Other	2,945,564	0	82,686	63,046	145,732	3,091,296
Other:						
Commercial, Financial and Agricultural	17,647,847	11,165	964,733	61,650	1,037,548	18,685,395
Consumer	4,576,964	0	0	0	0	4,576,964
Total Loans	\$ 111,972,016	\$ 826,273	\$ 1,075,097	\$ 1,071,051	\$ 2,972,421	\$ 114,944,437
As of December 31, 2016						
Loans Secured by Real Estate:						
Commercial - Owner-Occupied	\$ 18,087,861	\$ 0	\$ 0	\$ 27,339	\$ 27,339	\$ 18,115,200
Commercial - Other	29,317,032	68,569	0	0	68,569	29,385,601
Construction, Land Development & Vacant Land	10,898,740	0	0	0	0	10,898,740
Residential:						
1 - 4 Family	26,025,217	144,626	0	194,124	338,750	26,363,967
Other	3,154,818	0	0	0	0	3,154,818
Other:						
Commercial, Financial and Agricultural	17,611,516	74,581	0	0	74,581	17,686,097
Consumer	6,309,911	9,382	0	150	9,532	6,319,443
Total Loans	\$ 111,405,095	\$ 297,158	\$ 0	\$ 221,613	\$ 518,771	\$ 111,923,866

Certain loan modifications are considered troubled debt restructurings (TDRs) when the Company, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The Company uses various restructuring techniques, including, but not limited to, deferral of past due interest or principal, implementing A/B note structure, redeeming past due taxes, reduction of interest rates, extending maturities and modification of amortization schedules. The Company typically does not forgive principal balances or past due interest prior to pay off or surrender of the collateral. Loans considered to be TDRs are classified as impaired loans for purposes of determination of the allowance for loans losses, until the Company determines the loans are performing based on terms specified by the restructuring agreements. The allowance for these loans is calculated in the same manner as other impaired loans, as described above. As of December 31, 2017 and 2016, the Company had no commitments to lend funds to borrowers whose terms have been modified as TDRs. Additionally, for the years ending December 31, 2017 and 2016, the Company had no loans modified as TDRs within the previous 12 months for which there was a payment default during the period.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 4 - LOAN QUALITY (Continued)

The following tables present information about TDRs that were modified during the years ending December 31, 2017 and 2016:

	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
<u>For the Year Ended December 31, 2017</u>			
Troubled Debt Restructurings			
Modified During the Year Ended by			
Type of Modification:			
		None	
 <u>For the Year Ended December 31, 2016</u>			
Troubled Debt Restructurings			
Modified During the Year Ended by			
Type of Modification:			
Reduction of Rate			
Loans Secured by Real Estate:			
Residential - 1-4 Family	1	\$ <u>582,696</u>	\$ <u>582,696</u>

NOTE 5 - PREMISES AND EQUIPMENT

Following is a summary of premises and equipment at December 31:

	2017	2016
Land	\$ 1,249,742	\$ 1,249,742
Building	6,298,224	6,298,224
Furniture and Equipment	1,989,564	1,984,602
Computer Software	<u>1,108,952</u>	<u>1,095,837</u>
	10,646,482	10,628,405
Less: Accumulated Depreciation and Amortization	<u>(6,334,397)</u>	<u>(6,113,956)</u>
	<u>\$ 4,312,085</u>	<u>\$ 4,514,449</u>

Depreciation and amortization expense totaled \$253,507 and \$265,923 for 2017 and 2016.

The Company leases space for one of its branches under an operating lease. Rental expense was \$36,719 and \$40,313 for 2017 and 2016. Annual rent commitments under the non-cancelable operating lease are \$36,000. The lease was renewed in January 2017 under the second 5-year renewal option, for the period March 2017 – February 2022.

FIRST COMMUNITY CORPORATION AND FIRST COMMUNITY BANK OF EAST TENNESSEE
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
Years Ended December 31, 2017 and 2016

NOTE 6 - FORECLOSED REAL ESTATE

Foreclosed real estate is carried at estimated fair value less costs to sell the property. An analysis of foreclosed real estate for the years ended December 31, 2017 and 2016 follows:

	<u>2017</u>	<u>2016</u>
Balance at Beginning of Year	\$ 1,420,914	\$ 2,880,492
Additions to Foreclosed Real Estate	109,773	99,182
Foreclosed Real Estate Sold	(979,289)	(1,254,670)
Write-downs of Foreclosed Real Estate	<u>(209,370)</u>	<u>(304,090)</u>
Balance at End of Year	<u>\$ 342,028</u>	<u>\$ 1,420,914</u>

Expenses applicable to foreclosed real estate for the years ended December 31, 2017 and 2016 include the following:

	<u>2017</u>	<u>2016</u>
Net (Gain) Loss on Sales of Foreclosed Real Estate	\$ (20,271)	\$ (3,962)
Write-downs of Foreclosed Real Estate	209,370	304,090
Operating Expenses	<u>41,972</u>	<u>301,252</u>
Total	<u>\$ 231,071</u>	<u>\$ 601,380</u>

NOTE 7 - DEPOSITS

A summary of deposits at December 31 follows:

	<u>2017</u>	<u>2016</u>
Noninterest-Bearing	\$ 38,489,540	\$ 28,727,858
NOW & MMDA	47,030,070	45,064,394
Savings	23,851,409	25,838,582
Certificates of Deposit of \$250,000 or More	4,158,235	4,135,589
Other Time Deposits	<u>26,150,886</u>	<u>31,339,428</u>
	<u>\$ 139,680,140</u>	<u>\$ 135,105,851</u>

Scheduled maturities of time deposits for the next five years are as follows at December 31, 2017:

2018	\$ 20,994,884
2019	5,615,061
2020	1,388,579
2021	793,188
2022	<u>1,517,409</u>
	<u>\$ 30,309,121</u>

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NOTE 8 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE

Securities sold under agreements to repurchase are financing arrangements that do not have a stated maturity, but may be cancelled by either party with a five-day written notice. Information concerning securities sold under agreements to repurchase is summarized as follows:

	<u>2017</u>	<u>2016</u>
Average Daily Balance during the Year	\$ 5,364,000	\$ 6,402,000
Average Interest Rate during the Year	0.05%	0.05%
Maximum Month-End Balance during the Year	\$ 6,138,000	\$ 7,000,300
Weighted Average Interest Rate at Year-End	0.05%	0.05%

NOTE 9 - INCOME TAX EXPENSE (BENEFIT)

The Company files income tax returns in the U.S. federal jurisdiction and various state jurisdictions. The Company has not accrued or expensed any amounts for interest or penalties associated with income taxes for the years ended December 31, 2017 and 2016.

Income tax expense (benefit) as shown in the consolidated statements of operations differs from the amount computed using the statutory federal income tax rate follows:

	<u>2017</u>		<u>2016</u>	
	<u>Amount</u>	<u>Pretax Income</u>	<u>Amount</u>	<u>Pretax Income</u>
Federal Income Tax at Statutory Rate	\$ 378,756	34.0 %	\$ 478,849	34.0 %
State Income Tax, Net	35,875	3.2	41,300	2.9
Tax Exempt Interest	(47,649)	-4.3	(47,583)	-3.4
Other Nontaxable Income	(77,316)	-6.9	(157,456)	-11.2
Nondeductible Expenses	8,519	0.8	6,591	0.5
Credits and Other, Net	(25,597)	-2.3	(22,191)	-1.6
Change in Federal Tax Rate	917,578	82.4	0	0.0
Change in Valuation Allowance	(1,285,825)	-115.4	(300,873)	-21.4
	<u>\$ (95,659)</u>	<u>-8.6 %</u>	<u>\$ (1,363)</u>	<u>-0.1 %</u>

Income Taxes (Benefit) Consist of:

	<u>2017</u>	<u>2016</u>
Current (Benefit)	\$ 20,949	\$ 2,016
Deferred (Benefit)	(116,608)	(3,379)
	<u>\$ (95,659)</u>	<u>\$ (1,363)</u>

The components of net deferred tax assets as of December 31 were as follows:

	<u>2017</u>	<u>2016</u>
Deferred Tax Assets	\$ 2,646,701	\$ 4,169,205
Deferred Tax Liabilities	(460,853)	(739,841)
Net Deferred Tax Assets before Valuation Allowance	2,185,848	3,429,364
Valuation Allowance	(200,415)	(1,532,895)
Net Deferred Tax Assets after Valuation Allowance	<u>\$ 1,985,433</u>	<u>\$ 1,896,469</u>

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NOTE 9 - INCOME TAX EXPENSE (BENEFIT) (Continued)

The deferred tax assets above relate primarily to the provision for loan losses, unrealized losses on foreclosed real estate and investment securities available for sale, and net operating loss carry-forwards, and are reduced by a valuation allowance since their realization in the future is uncertain. The deferred tax liabilities relate primarily to depreciation of fixed assets, FHLB stock dividends and certain prepaid expenses.

Included in the 2017 deferred tax assets above is \$85,299 of deferred tax effect on the net unrealized loss on securities available for sale (\$152,614 in deferred tax assets on the net unrealized loss in 2016).

Federal net operating loss carry-forwards are approximately \$6.2 million, which expire at various dates from 2031 to 2035, and state net operating loss carry-forwards are approximately \$6.4 million at December 31, 2017, which expire at various dates from 2026 to 2030.

On December 22, 2017, the Tax Cuts and Jobs Act was signed into law. This legislation reduces the federal corporate tax rate from 34% to 21% for tax years beginning after December 31, 2017. However, in accordance with GAAP, the Company has accounted for the effects of this reduction in the tax rate on deferred taxes in the period of enactment. As a result, the Company's deferred tax assets and liabilities as of December 31, 2017 have been adjusted to reflect the effect of the change in enacted tax rates, resulting in a deferred tax expense adjustment of \$917,578 for the year ending December 31, 2017.

NOTE 10 - RELATED PARTY TRANSACTIONS

The amount of loans to principal officers, directors, and their affiliates at December 31, 2017 and 2016 totaled approximately \$118,000 and \$108,000, respectively.

Deposit account balances owned by principal officers, directors, and their affiliates at December 31, 2017 and 2016 were approximately \$2,437,000 and \$2,706,000, respectively.

NOTE 11 - FEDERAL HOME LOAN BANK ADVANCES

The following table is a maturity schedule of advances from the Federal Home Loan Bank as of December 31, 2017:

<u>Date of Advance</u>	<u>Interest Rate</u>	<u>Final Maturity Date</u>	<u>Amount Outstanding at 12/31/17</u>
12/21/05	5.17%	01/01/31	\$ 880,515

Interest expense associated with the advances from the FHLB totaled \$133,999 for the year ended December 31, 2017 (\$290,380 in 2016). Pursuant to collateral agreements with the FHLB, the advances are secured by the Company's FHLB stock and certain qualifying residential first mortgage loans totaling approximately \$16,600,000 as of December 31, 2017 (\$15,700,000 in 2016), and commercial real estate loans totaling approximately \$6,800,000 as of December 31, 2017 (\$10,300,000 in 2016). All of the fixed rate advances have a prepayment penalty. The prepayment penalty would be based on the market rates and the length of time remaining until maturity at the time of payoff.

Additionally, the Company maintains a line of credit advance agreement with the FHLB which allows borrowings up to \$13,000,000. This line was undrawn as of December 31, 2017 and 2016. The Company also maintains a letter of credit line for the collateralization of public unit deposits up to \$20,000,000, for which balances outstanding as of December 31, 2017 and 2016 were \$500,000.

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NOTE 12 - SUBORDINATED DEBENTURES AND OTHER DEBT / SUBSEQUENT EVENT

On September 20, 2004, the Company borrowed \$3,000,000 of floating rate mandatory redeemable securities through a special purpose entity, Rogersville Statutory Trust II, as part of a private offering. The rate, which varies quarterly with LIBOR, was 3.62% at December 31, 2017. The securities mature on September 20, 2034; however, the maturity may be shortened on a quarterly basis, subject to approval of a repayment or refinancing plan by the Federal Reserve.

On December 14, 2006, the Company borrowed \$4,000,000 of floating rate mandatory redeemable securities through a special purpose entity, Rogersville Statutory Trust III, as part of a private offering. The rate, which varies quarterly with LIBOR, was 3.01% at December 31, 2017. The securities mature on December 14, 2036; the maturity may be shortened on a quarterly basis, subject to approval of a repayment or refinancing plan by the Federal Reserve.

The Company has provided a full, irrevocable, and unconditional guarantee on a subordinated basis of the obligations of the Trusts under the preferred securities in the event of a default, as defined in such guarantees. These subordinated debentures allow the Company to defer the payment of quarterly interest payments for up to 20 consecutive quarters without creating an event of default. Pursuant to the debentures, the Company and its affiliates cannot declare or pay any dividends or distributions on their capital stock (other than the payment of dividends or distributions from the Bank to the Holding Company), or repurchase, redeem, or acquire their capital stock during an interest deferred period until the unpaid interest payments have been paid. Accrued but unpaid interest totaled \$10,422 at December 31, 2017 (\$8,839 at December 31, 2016).

These securities are presented as liabilities on the Company's balance sheet and count as Tier 1 and Tier 2 capital for regulatory capital purposes. In accordance with GAAP, the Trusts are not consolidated with the Company. Accordingly, the Company reports as liabilities the subordinated debentures issued by the Company and held by the Trusts. The Company's equity investment in the Trusts (\$217,000) is included in other assets at year-end 2017 and 2016.

In January 2018, the Company authorized the redemption of 500 shares, at \$1,000 par value per share, of the Rogersville Statutory Trust II securities and 500 shares, at \$1,000 par value per share, of the Rogersville Statutory Trust III securities for a total redemption payment of \$1,000,000. These securities are to be redeemed in March 2018.

The Company also has available federal funds lines (or equivalent thereof) with correspondent banks totaling \$14,800,000 and \$15,750,000 as of December 31, 2017 and 2016, respectively. None of these lines had balances outstanding as of December 31, 2017 and 2016. No collateral was pledged related to these lines as of December 31, 2017 and 2016.

NOTE 13 - SHAREHOLDERS' EQUITY

As of December 31, 2017 and 2016, the Company's charter authorized the issuance of up to 10,000,000 shares of common stock, no par value, 1,000,000 shares of preferred stock, no par value, and 400,000 shares of Series A and 200,000 shares of Series B Preferred Stock, at a par value of \$8.05.

The Series A and Series B preferred stock are noncumulative, have no voting rights, have a dividend and liquidation preference to the common stock, and participate equally with the common stock in a sale or change in control of the Company. Preferred Series A shareholders are entitled to receive a dividend that is 105% of the dividend paid on the common stock. Preferred Series B shareholders are entitled to receive a dividend that is 110% of the dividend paid on the common stock. In the event of a change of control of the corporation, each share of Series A and Series B preferred stock is convertible into one share of common stock. Series A and Series B preferred stock have no redemption rights.

Treasury stock includes 48,432 shares of common stock at a cost of \$809,687; 8,408 shares of Series A preferred stock at a cost of \$133,742; and 225 shares of Series B preferred stock at a cost of \$3,569 at December 31, 2017 and 2016.

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NOTE 14 - REGULATORY CAPITAL REQUIREMENTS

The Bank and Holding Company are subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet the minimum regulatory capital requirements can initiate certain mandatory – and possibly additional discretionary – actions by regulators that, if undertaken, could have a direct material effect on the Bank's and Holding Company's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank and Holding Company must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance-sheet items, as calculated under regulatory accounting practices. The Bank's and Holding Company's capital amounts and classification are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank and Holding Company to maintain minimum amounts and ratios (set forth in the table below) of Total and Tier 1 Capital (as defined in the regulations) to Risk-Weighted Assets (as defined), Common Equity Tier 1 Capital (as defined) to Total Risk-Weighted Assets (as defined), and of Tier 1 Capital (as defined) to Average Assets (as defined). Management believes, as of December 31, 2017 and 2016, that the Bank and Holding Company meet all capital adequacy requirements to which they are subject.

As of December 31, 2017 and 2016, the Bank is categorized as *well capitalized* under the regulatory framework for prompt corrective action. To be categorized as *well capitalized*, the Bank must maintain minimum Total Risk-Based, Tier I Risk-Based, Common Equity Tier 1 Risk-Based Capital, and Tier I Leverage ratios as set forth in the table below. There are no conditions or events since that date that management believes have changed the Bank's category.

The Bank and Holding Company must also maintain a capital conservation buffer consisting of additional Common Equity Tier 1 capital greater than 1.25% of risk-weighted assets above the required minimum risk-based capital levels in order to avoid limitations on distributions, including dividend payments, and certain discretionary bonuses to executive officers. The capital conservation buffer requirement began to phase in on January 1, 2016 when a buffer greater than 0.6250% of risk-weighted assets was required, which amount increases each year until the buffer requirement is fully implemented on January 1, 2019. At December 31, 2017, the Bank and Holding Company continued to exceed the minimum required capital ratios applicable to them under the capital adequacy guidelines.

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NOTE 14 - REGULATORY CAPITAL REQUIREMENTS (Continued)

The Holding Company's and Bank's actual capital amounts and ratios as of December 31, 2017 and 2016, are also presented in the following table. All dollar amounts are in thousands of dollars.

			For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
As of December 31, 2017						
Total Capital (to Risk-Weighted Assets):						
Holding Company (Consolidated)	\$ 22,690	18.39%	\$ 9,873	8.00%	N/A	N/A
Bank	\$ 21,083	17.10%	\$ 9,864	8.00%	\$ 12,330	10.00%
Common Equity Tier I Capital (to Risk-Weighted Assets):						
Holding Company (Consolidated)	\$ 12,262	9.94%	\$ 5,553	4.50%	N/A	N/A
Bank	\$ 19,535	15.84%	\$ 5,549	4.50%	\$ 8,015	6.50%
Tier I Capital (to Risk-Weighted Assets):						
Holding Company (Consolidated)	\$ 17,994	14.58%	\$ 7,404	6.00%	N/A	N/A
Bank	\$ 19,535	15.84%	\$ 7,398	6.00%	\$ 9,864	8.00%
Tier I Capital (to Average Assets):						
Holding Company (Consolidated)	\$ 17,994	10.35%	\$ 6,951	4.00%	N/A	N/A
Bank	\$ 19,535	11.25%	\$ 6,949	4.00%	\$ 8,686	5.00%
As of December 31, 2016						
Total Capital (to Risk-Weighted Assets):						
Holding Company (Consolidated)	\$ 22,455	17.78%	\$ 10,102	8.00%	N/A	N/A
Bank	\$ 22,493	17.81%	\$ 10,101	8.00%	\$ 12,626	10.00%
Common Equity Tier I Capital (to Risk-Weighted Assets):						
Holding Company (Consolidated)	\$ 11,990	9.49%	\$ 5,683	4.50%	N/A	N/A
Bank	\$ 20,908	16.56%	\$ 5,682	4.50%	\$ 8,207	6.50%
Tier I Capital (to Risk-Weighted Assets):						
Holding Company (Consolidated)	\$ 17,538	13.89%	\$ 7,577	6.00%	N/A	N/A
Bank	\$ 20,908	16.56%	\$ 7,576	6.00%	\$ 10,101	8.00%
Tier I Capital (to Average Assets):						
Holding Company (Consolidated)	\$ 17,538	10.15%	\$ 6,912	4.00%	N/A	N/A
Bank	\$ 20,908	12.10%	\$ 6,910	4.00%	\$ 8,638	5.00%

The Bank and Holding Company are also subject to federal and state regulations restricting the amount of dividends paid.

NOTE 15 - STOCK COMPENSATION PLANS

The Company has two stock option plans, the 1994 Employee Stock Option Plan (the employee plan), and the 1994 Outside Directors' Stock Option Plan (the directors' plan), which are described below. The exercise price is the market price at date of grant. In accordance with GAAP, the fair value of any options granted after January 1, 2006 will be recognized as an expense in the income statement, as services by employees and Directors are performed for the Company. All options expire within ten years from the date of grant.

1994 Employee Stock Option Plan - This plan provides for the granting of options to purchase up to 475,000 shares by officers and key employees of the Company. No options were granted in 2017 or 2016. As of December 31, 2017, there are 142,000 options remaining to be granted under this plan. As of December 31, 2016, there are 142,000 options remaining to be granted under this plan.

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NOTE 15 - STOCK COMPENSATION PLANS (Continued)

Outside Directors' Stock Option Plan - Adopted in 1994, this plan originally provided for the granting of options to purchase up to 150,000 (as adjusted for stock split) shares of Common Stock by non-employee directors of the Company. These options became exercisable over 5 years. In 2006 this plan was amended upon approval of the shareholders to increase the number of shares of Common Stock that may be issued pursuant to options from 150,000 to 225,000 shares. This Plan has also been amended to extend the Plan through June 30, 2026. No options were granted in 2017 or 2016. As of December 31, 2017, there are 123,000 options remaining to be granted under this plan.

A summary of the status of the Company's stock option plans for the two years ended December 31, 2017 and the changes during those years is presented below:

	Total Option Shares Outstanding	Average Exercise Price	Exercisable Options Outstanding
<u>Options Outstanding at January 1, 2016</u>	20,000	\$ 4.75	20,000
Options Granted	0		0
Options which became Exercisable	0		0
Options Expired or Rescinded	0		0
Options Exercised	0		0
<u>Options Outstanding at December 31, 2016</u>	20,000	4.75	20,000
Options Granted	0		0
Options which became Exercisable	0		0
Options Expired or Rescinded	0		0
Options Exercised	0		0
<u>Options Outstanding at December 31, 2017</u>	<u>20,000</u>	4.75	<u>20,000</u>

The following table summarizes information about the stock options outstanding under the Company's plans at December 31, 2017:

Exercise Price	Number Outstanding	Average Remaining Life	Number Exercisable
\$ 4.75	20,000	4 years	20,000

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NOTE 16 - EARNINGS PER SHARE

The following table illustrates the computation of basic and diluted earnings per share of common stock for the years ended December 31, 2017 and 2016.

	2017			2016		
	Income	Weighted Average Shares	Per Share Amount	Income	Weighted Average Shares	Per Share Amount
Net Income	\$ 1,209,646			\$ 1,409,741		
Less: Dividends Paid to Preferred Shareholders	<u>(63,772)</u>			<u>0</u>		
Basic Earnings Per Share						
Net Income Available to Common Shareholders	1,145,874	1,630,812	<u>\$ 0.70</u>	1,409,741	1,630,812	<u>\$ 0.86</u>
<u>Effect of Dilutive Securities</u>						
Incremental Shares - Exercise of Stock Options		3,363			N/A	
Convertible Preferred Stock	<u>63,772</u>	<u>241,518</u>		<u>0</u>	<u>241,518</u>	
Diluted Earnings per Share						
Net Income Available to Common Shareholders						
Plus Assumed Conversions	<u>\$ 1,209,646</u>	<u>1,875,693</u>	<u>\$ 0.64</u>	<u>\$ 1,409,741</u>	<u>1,872,330</u>	<u>\$ 0.75</u>

Stock options outstanding during the year ended December 31, 2016 were not included in the computation of diluted earnings per share because the options' exercise price was greater than the average market price of the common shares.

NOTE 17 - EMPLOYEE BENEFITS

The Company maintains a 401(k) plan for all employees who have attained the age of 21 and have at least three months of service. The plan provides for a discretionary employer matching contribution, in which the employee is 100% vested. The Company may also make additional discretionary contributions (qualified non-elective or profit sharing contributions) as determined by the Board of Directors. For these contributions, employees begin to vest in the second year and are fully vested after six years. The Company's employer matching contribution to the 401(k) plan amounted to \$41,368 in 2017 and \$37,714 in 2016.

The Company is providing post-retirement pension benefits to a former employee. A present value based charge, which is included in non-interest expense, is made each year based on the future benefits to be paid to the employee (or beneficiary) under the plan. Total amounts paid or accrued during the year under such arrangements amounted to approximately \$10,511 and \$42,000 in both 2017 and 2016.

The Company has a Supplemental Executive Retirement Plan which provides retirement benefits to several retired officers. In addition, the Company also has an Executive Deferred Compensation Plan which provides deferred compensation benefits for certain key officers. The accrued retirement liability for these plans was \$1,684,107 at December 31, 2017 (\$1,709,672 at December 31, 2016). Expense related to these plans was \$121,134 in 2017 and \$58,982 in 2016, and is included in salaries and employee benefits expense.

The Company also provides life insurance benefits to certain employees under split-dollar insurance contracts. Accrued liabilities were \$229,017 at December 31, 2017 (\$211,153 at December 31, 2016). Expense related to this plan was \$17,864 in 2017 and \$12,137 in 2016, and is included in salaries and employee benefits expense.

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NOTE 18 - OFF-BALANCE SHEET ACTIVITIES

Certain financial instruments, such as loan commitments, credit lines, letters of credit, and overdraft protection, are issued to meet customer financing needs. These are agreements to provide credit or to support the credit of others, as long as conditions established in the contract are met, and usually have expiration dates. Commitments may expire without being used. Off-balance-sheet risk to credit loss exists up to the face amount of these instruments, although material losses are not anticipated. The same credit policies are used to make such commitments as are used for loans, including obtaining collateral at exercise of the commitment.

The approximate contractual amounts of financial instruments with off-balance sheet risk were as follows at December 31:

	2017		2016	
	Fixed Rate	Variable Rate	Fixed Rate	Variable Rate
Commitments to Make Loans	\$ 2,624,000	\$ 10,984,000	\$ 3,415,000	\$ 15,525,000
Unused Letters of Credit	0	359,000	0	520,000

Commitments to make loans are generally made for periods of 1 year or less. The fixed rate loan commitments have interest rates ranging from 3.50% to 10.00% and maturities ranging from 1 year to 10 years. Approximately \$9,661,000 of the commitments to make loans were collateralized, primarily by real estate, at December 31, 2017 (\$11,228,000 at December 31, 2016).

NOTE 19 - FAIR VALUE DISCLOSURES

GAAP establishes a framework for using fair value. It also defines fair value rules as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. GAAP generally permits the measurement of selected eligible financial instruments at fair value at specified election dates. The Company did not elect to adopt the fair value option for any financial instruments. However, other accounting pronouncements require the Company to measure certain financial instruments at fair value as described below.

GAAP defines fair value as the exchange price that would be received for an asset or paid to transfer a liability (an exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. GAAP also establishes a fair value hierarchy which requires an entity to maximize the use of observable inputs and minimize the use of unobservable inputs when measuring fair value. The standard describes three levels of inputs that may be used to measure fair value:

- Level 1: Inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. An active market for the asset and liability is a market in which transactions for the asset or liability occur with sufficient frequency and volume to provide pricing information on an ongoing basis.
- Level 2: Inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or the liability, either directly or indirectly. If the asset or liability has a specified (contractual) term, a Level 2 input must be observable for substantially the full term of the asset or liability. Level 2 inputs include quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active, inputs other than quoted prices that are observable for the asset or liability, and inputs that are derived principally from or corroborated by observable market data by correlation or other means.
- Level 3: Inputs are unobservable inputs for the asset or liability. Unobservable inputs are used to measure fair value to the extent that observable inputs are not available, thereby allowing for situations in which there is little, if any, market activity for the asset or liability at the measurement date. Unobservable inputs reflect the reporting entity's own assumptions about the assumptions that market participants would use in pricing the asset or liability.

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NOTE 19 - FAIR VALUE DISCLOSURES (Continued)

A description of valuation methodologies used for assets and liabilities recorded at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is shown below. The categorization within the valuation hierarchy is based upon the lowest level of input that is significant to the fair value measurement.

Investment Securities Available for Sale - Investment securities available for sale are recorded at fair value in accordance with GAAP on a recurring basis. Fair value measurement for these securities is based upon quoted prices of like or similar securities, utilizing Level 2 inputs. These measurements are obtained from a service provider who considers observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the securities' terms and conditions, among other things.

Impaired Loans - The Company does not record loans at fair value on a recurring basis. However, from time to time, a loan is considered impaired in accordance with GAAP and an allowance for loan losses is established. Loans for which it is probable that payment of interest and principal will not be made in accordance with the contractual terms of the loan agreement are considered impaired. If the recorded investment in the impaired loan exceeds the measure of fair value, a valuation allowance is established as a component of the allowance for loan losses. The fair value of individually identified impaired loans is measured based on the present value of expected payments or the collateral value if the loan is collateral dependent. Impaired loans are classified within Level 3 of the valuation hierarchy.

Foreclosed Real Estate - Foreclosed real estate is recorded at fair value on a nonrecurring basis. Fair value measurement is based on management's estimate of the amount that will be realized when the property is sold and is classified within Level 3 of the valuation hierarchy.

Assets Recorded at Fair Value on a Recurring Basis

Below is a table that presents information about certain assets measured at fair value:

	Carrying Amount in the Balance Sheet	Fair Value Measurements Using		
		Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>As of December 31, 2017</u>				
U.S. Treasury Securities	\$ 989,450	\$ 989,450	\$ 0	\$ 0
Small Business Admin. Securities	2,784,669	0	2,784,669	0
U.S. Government Agency Securities	7,393,210	0	7,393,210	0
Residential Mortgage-backed Securities	5,923,846	0	5,923,846	0
Taxable Municipal Securities	386,492		386,492	
Tax Exempt Municipal Securities	6,610,575	0	6,610,575	0
Investment Securities Available for Sale	<u>\$ 24,088,242</u>	<u>\$ 989,450</u>	<u>\$ 23,098,792</u>	<u>\$ 0</u>
<u>As of December 31, 2016</u>				
Small Business Admin. Securities	\$ 2,093,411	\$ 0	\$ 2,093,411	\$ 0
U.S. Government Agency Securities	3,430,095	0	3,430,095	0
Residential Mortgage-backed Securities	7,689,705	0	7,689,705	0
Taxable Municipal Securities	386,056	0	386,056	0
Tax Exempt Municipal Securities	9,014,332	0	9,014,332	0
Investment Securities Available for Sale	<u>\$ 22,613,599</u>	<u>\$ 0</u>	<u>\$ 22,613,599</u>	<u>\$ 0</u>

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NOTE 19 - FAIR VALUE DISCLOSURES (Continued)

Assets Recorded at Fair Value on a Nonrecurring Basis

The Company may be required, from time to time, to measure certain assets at fair value on a nonrecurring basis in accordance with U.S. generally accepted accounting principles. These include assets that are measured at the lower of cost or market that were recognized at fair value below cost at the end of the period. Assets measured at fair value on a nonrecurring basis are included in the table below.

	Carrying Amount in the Balance Sheet	Fair Value Measurements Using		
		Quoted Prices in Active Market for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
<u>As of December 31, 2017</u>				
Impaired Loans, Net of Allowance	\$ 3,082,595	\$ 0	\$ 0	\$ 3,082,595
Foreclosed Real Estate	342,028	0	0	342,028
	<u>\$ 3,424,623</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 3,424,623</u>
<u>As of December 31, 2016</u>				
Impaired Loans, Net of Allowance	\$ 1,975,163	\$ 0	\$ 0	\$ 1,975,163
Foreclosed Real Estate	1,420,914	0	0	1,420,914
	<u>\$ 3,396,077</u>	<u>\$ 0</u>	<u>\$ 0</u>	<u>\$ 3,396,077</u>

GAAP also requires the Company to disclose the fair value of financial instruments, both assets and liabilities recognized and not recognized in the consolidated balance sheets, for which it is practicable to estimate fair value, and which are not already recorded at fair value.

A financial instrument is defined as cash, evidence of an ownership interest in an entity, or a contract that both: (1) imposes on one entity a contractual obligation to deliver cash or another financial instrument to a second entity, or to exchange other financial instruments on potentially unfavorable terms with the second entity, and (2) conveys to that second entity a contractual right to receive cash or another financial instrument from the first entity, or to exchange other financial instruments on potentially favorable terms with the first entity.

For the Company, as for most financial institutions, the majority of its assets and liabilities are considered financial instruments as defined above. However, a large majority of those assets and liabilities do not have an active trading market nor are their characteristics similar to other financial instruments for which an active trading market exists. In addition, it is the Company's practice and intent to hold the majority of its financial instruments to maturity and not to engage in trading or sales activities. Therefore, much of the information as well as the amounts disclosed below are highly subjective and judgmental in nature. The subjective factors include estimates of cash flows, risk characteristics, credit quality, and interest rates, all of which are subject to change. Because the fair value is estimated as of December 31, 2017 and 2016, the amounts which will actually be realized or paid upon settlement or maturity of the various financial instruments could be significantly different.

The estimates of fair value are based on existing financial instruments without attempting to estimate the value of anticipated future business or activity nor the value of assets and liabilities that are not considered financial instruments. For example, the value of mortgage loan servicing rights and the value of the Company's long-term relationships with depositors, commonly known as core deposit intangibles, have not been considered in the estimates of fair values presented below. In addition, the tax implications related to the realization of unrealized gains and losses can have a significant effect on fair value estimates and have not been included in the estimated fair values below.

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NOTE 19 - FAIR VALUE DISCLOSURES (Continued)

Assets Recorded at Fair Value on a Nonrecurring Basis (Continued)

The recorded book value and estimated fair value of the Company's financial instruments which are not carried at fair value as of December 31, 2017 and 2016 are as follows:

	2017		2016	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial Assets				
Cash and Cash Equivalents	\$ 17,721,697	\$ 17,721,697	\$ 20,782,411	\$ 20,782,411
Net Loans, Excluding Net Impaired Loans	109,992,573	109,137,573	108,112,690	108,010,690
Cash Surrender Value of Life Insurance	6,996,067	6,996,067	6,768,551	6,768,551
Financial Liabilities				
Deposits	\$ 139,680,140	\$ 139,278,140	\$ 135,105,851	\$ 134,904,851
Securities Sold Under				
Agreements to Repurchase	6,104,985	6,104,985	5,585,184	5,585,184
Federal Home Loan Bank Advances	880,515	1,001,515	6,226,444	6,417,444
Subordinated Debentures	7,217,000	7,217,000	7,217,000	7,217,000

The methods and assumptions used to estimate fair value are described as follows.

The carrying amount approximates the estimated fair value for cash and cash equivalents, short-term borrowings, demand deposits, variable rate loans or deposits that reprice frequently, and securities sold under agreements to repurchase. For fixed rate loans or deposits and for variable rate loans or deposits with infrequent repricing or repricing limits, fair value is based on discounted cash flows using current market rates applied to the estimated life and credit risk. Recorded book value of cash surrender value of life insurance is a reasonable estimate of fair value. Fair value of FHLB advances and subordinated debentures is based on current rates for similar financing. The fair value of off-balance sheet loan commitments is considered nominal and not disclosed above. Management does not consider it practicable to estimate the fair value of equity investments carried at cost. Therefore, no estimate of fair value for these investments is disclosed.

NOTE 20 - SIGNIFICANT GROUP CONCENTRATIONS OF CREDIT RISK

Most of the Company's business activity is with customers located within East Tennessee. As of December 31, 2017 and 2016, the Company had concentrations of loans in residential real estate, commercial real estate and commercial lending. Generally, these loans are secured by the underlying real estate or commercial assets. The usual risks associated with such concentrations are generally mitigated by being spread over numerous borrowers and by adequate loan to collateral value ratios. The Company has concentrations in U.S. Government agency and residential mortgage-backed securities that are guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Association, the Federal Farm Credit Company and the Federal Home Loan Bank. The Company also has a concentration in municipal bonds, which are issued by instrumentalities across the State of Tennessee.

NOTE 21 - COMMITMENTS AND CONTINGENCIES

The Company is subject to claims and lawsuits which arise primarily in the ordinary course of business. It is the opinion of management that the disposition or ultimate resolution of such claims and lawsuits will not have a material adverse effect on the financial position of the Company.

