

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-K/A
Amendment No. 1

ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2018

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For transition period from _____ to _____

Commission File Number: 001-37391

SMARTFINANCIAL, INC.
(Exact name of registrant as specified in its charter)

Tennessee
(State or other jurisdiction of
incorporation or organization)

62-1173944
(I.R.S. Employer
Identification No.)

5401 Kingston Pike, Suite 600
Knoxville, Tennessee
(Address of principal executive offices)

37919
(Zip Code)

(865) 437-5700
(Registrant's telephone number, including area code)

Securities registered pursuant to Section 12(b) of the Act:
Common Stock, \$1.00 Par Value

Name of exchange where registered:
The NASDAQ Stock Market, LLC

Securities registered pursuant to Section 12(g) of the Act:
Common Stock, \$1.00 Par Value

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

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

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check whether the Registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§ 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the Registrant was required to submit and post such files).

Yes No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K (§ 229.405 of this chapter) is not contained herein, and will not be contained, to the best of Registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, a smaller reporting company or an emerging growth company. See the definitions of "large accelerated filer", "accelerated filer", "smaller reporting company", and "emerging growth company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company
Emerging Growth Company

If emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act.

Indicate by check mark whether the Registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

As of June 30, 2018, the aggregate market value of the registrant's voting and non-voting common stock held by non-affiliates was approximately \$294.2 million. As of March 6, 2019, there were 13,946,283 shares outstanding of the registrant's common stock, \$1.00 par value.

DOCUMENTS INCORPORATED BY REFERENCE

None in this Amendment No. 1.

EXPLANATORY NOTE

This Amendment No. 1 on Form 10-K/A (this “*Amendment*”) is being filed by SmartFinancial, Inc. (the “*Company*”) to amend the Annual Report on Form 10-K for the fiscal year ended December 31, 2018, filed by the Company with the Securities and Exchange Commission (the “*SEC*”) on March 18, 2019 (the “*Original Filing*”). The Company is filing this Amendment solely for the purpose of including in Part II, Item 8 of its Annual Report on Form 10-K for the fiscal year ended December 31, 2018, the Report of Independent Registered Public Accounting Firm of Mauldin & Jenkins, LLC, dated March 16, 2018, with respect to the 2017 consolidated financial statements of the Company, which was inadvertently omitted from the Original Filing.

As required by Rules 12b-15 and 13a-14 under the Securities Exchange Act of 1934, as amended, new certifications by the Company’s principal executive officer and principal financial officer pursuant to Section 302 and Section 906 of the Sarbanes-Oxley Act of 2002 are filed as exhibits to this Amendment.

Except as described above, no changes have been made to the Original Filing and this Amendment No. 1 does not modify, amend, or update in any way any of the financial or other information contained in the Original Filing. This Amendment speaks as of the date of the Original Filing and does not reflect events that may have occurred subsequent to the Original Filing. There have been no changes to the XBRL data filed in Exhibit 101 of the Original Filing. This Amendment should be read in conjunction with the Original Filing and the Company’s other filings with the SEC.

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PART II

ITEM 8. FINANCIAL STATEMENTS AND SUPPLEMENTARY DATA

SMARTFINANCIAL, INC. AND SUBSIDIARY

Report on Consolidated Financial Statements

For the years ended December 31, 2018 and 2017

SmartFinancial, Inc. and Subsidiary

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MANAGEMENT’S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING

The management of SmartFinancial, Inc. (the “Company”) is responsible for establishing and maintaining adequate internal control over financial reporting as defined in Rule 13a-15(f) under the Securities Exchange Act of 1934. The Company’s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation and fair presentation of the Company’s financial statements for external purposes in accordance with accounting principles generally accepted in the United States of America.

Because of inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Accordingly, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the effectiveness of the Company’s internal control over financial reporting as of December 31, 2018. In making this assessment, management used the criteria set forth in Internal Control – Integrated Framework (2013 edition) issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). As permitted by SEC guidance, management excluded from its assessment the operations of the Southern Community Bank acquisition made during 2018, which is described in Note 2 of the Consolidated Financial Statements. The total assets of Southern Community Bank acquired represented approximately 10 percent of the Company’s total consolidated assets as of December 31, 2018 and 8 percent of consolidated revenue for the year then ended. Based on this assessment, management has determined that the Company’s internal control over financial reporting as of December 31, 2018 is effective based on the specified criteria. As permitted by SEC guidance, management excluded from its assessment the operations of the Foothills Bank & Trust acquisition made during 2018, which is described in Note 2 of the Consolidated Financial Statements. The total assets of Foothills Bank & Trust acquired represented approximately 10 percent of the Company’s total consolidated assets as of December 31, 2018 and 1 percent of consolidated revenue for the year then ended. Based on this assessment, management has determined that the Company’s internal control over financial reporting as of December 31, 2018 is effective based on the specified criteria.

Dixon Hughes Goodman LLP, the independent registered public accounting firm that audited the consolidated financial statements of the Company included in this Annual Report on Form 10-K, has issued an attestation report on the effectiveness of the Company’s internal control over financial reporting as of December 31, 2018. The report, which expresses an unqualified opinion on the effectiveness of the Company’s internal control over financial reporting as of December 31, 2018, is included herein.

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of SmartFinancial, Inc.

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheet of SmartFinancial, Inc. and Subsidiary (the "Company") as of December 31, 2018, the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows, for the year ended December 31, 2018, and the related notes (collectively referred to as the "financial statements"). In our opinion, the financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2018, and the results of their operations and their cash flows for the year ended December 31, 2018, in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) ("PCAOB"), the Company's internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control - Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated March 18, 2019 expressed an unqualified opinion thereon.

Basis for Opinion

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

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether due to error or fraud.

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

/s/ Dixon Hughes Goodman LLP

We have served as the Company's auditor since 2018.

Atlanta, Georgia
March 18, 2019

Report of Independent Registered Public Accounting Firm

To the Stockholders and the Board of Directors of SmartFinancial, Inc.

Opinion on Internal Control Over Financial Reporting

We have audited SmartFinancial, Inc. and Subsidiary (the “Company”)’s internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission. In our opinion, SmartFinancial, Inc. and Subsidiary maintained, in all material respects, effective internal control over financial reporting as of December 31, 2018, based on criteria established in *Internal Control-Integrated Framework (2013)* issued by the Committee of Sponsoring Organizations of the Treadway Commission.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States) (“PCAOB”), the consolidated balance sheet of the Company as of December 31, 2018 and the related consolidated statements of income, comprehensive income, changes in stockholders’ equity and cash flows for the year then ended and our report dated March 18, 2019, expressed an unqualified opinion thereon.

Basis for Opinion

The Company's management is responsible for maintaining effective internal control over financial reporting, and for its assessment of the effectiveness of internal control over financial reporting, included in the accompanying Management’s Report on Internal Control over Financial Reporting. Our responsibility is to express an opinion on the Company's internal control over financial reporting based on our audit. We are a public accounting firm registered with the PCAOB and are required to be independent with respect to the Company in accordance with the U.S. federal securities laws and the applicable rules and regulations of the Securities and Exchange Commission and the PCAOB.

We conducted our audit in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

As described in Management’s Report on Internal Control over Financial Reporting, the scope of management’s assessment of internal control over financial reporting as of December 31, 2018 has excluded Southern Community Bank (“Southern”) acquired on May 1, 2018 and Foothills Bank & Trust (“Foothills”) acquired on November 1, 2018. We have also excluded Southern and Foothills from the scope of our audit of internal control over financial reporting. Southern and Foothills represented 8 percent and 1 percent of consolidated revenues (total interest income and total noninterest income) for the year ended December 31, 2018, and 10 percent and 10 percent of consolidated total assets as of December 31, 2018, respectively.

Definition and Limitations of Internal Control Over Financial Reporting

A company's internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company's internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company's assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

/s/ Dixon Hughes Goodman LLP

Atlanta, Georgia
March 18, 2019



Report of Independent Registered Public Accounting Firm

To the Stockholders and
Board of Directors
SmartFinancial, Inc.
Knoxville, Tennessee

Opinion on the Consolidated Financial Statements

We have audited the accompanying consolidated balance sheets of SmartFinancial, Inc. and Subsidiaries (the “Company”) as of December 31, 2017 and the related consolidated statements of income, comprehensive income, changes in stockholders’ equity, and cash flows for the year ended December 31, 2017, and the related notes to the consolidated financial statements (collectively referred to as the “consolidated financial statements”). In our opinion, the consolidated financial statements present fairly, in all material respects, the financial position of the Company as of December 31, 2017, and the results of its operations and its cash flows for the year ended December 31, 2017, in conformity with accounting principles generally accepted in the United States of America.

Basis for Opinion

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

We conducted our audits in accordance with the standards of the PCAOB. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement, whether due to error or fraud. Our audits included performing procedures to assess the risks of material misstatement of the consolidated financial statements, whether due to error or fraud, and performing procedures that respond to those risks. Such procedures included examining, on test basis, evidence regarding the amounts and disclosures in the consolidated financial statements. Our audits also included evaluating the accounting principles used and significant estimates made by management, as well as, evaluating the overall presentation of the consolidated financial statements. We believe that our audits provide a reasonable basis for our opinion.

/s/ Mauldin & Jenkins, LLC

We served as the Company’s auditor from 2013 to 2018.

Chattanooga, Tennessee
March 16, 2018

SmartFinancial, Inc. and Subsidiary**Consolidated Financial Statements****Consolidated Balance Sheets**

December 31, 2018 and 2017

	2018	2017
ASSETS		
Cash and due from banks	\$ 40,015,438	\$ 64,097,287
Interest-bearing deposits at other financial institutions	75,807,021	41,965,597
Federal funds sold	—	6,964,000
Total cash and cash equivalents	115,822,459	113,026,884
Securities available-for-sale	201,687,683	151,944,567
Restricted investments, at cost	11,499,000	6,430,700
Loans, net of allowance for loan losses of \$8,275,055 in 2018 and \$5,860,291 in 2017	1,768,963,569	1,317,397,909
Bank premises and equipment, net	56,012,184	43,000,249
Foreclosed assets	2,495,458	3,254,392
Goodwill and core deposit intangible, net	79,033,607	50,836,840
Cash surrender value of life insurance	24,381,485	21,646,894
Other assets	14,513,890	13,232,247
Total assets	\$ 2,274,409,335	\$ 1,720,770,682
LIABILITIES AND STOCKHOLDERS' EQUITY		
Deposits:		
Noninterest-bearing demand deposits	\$ 319,861,237	\$ 220,520,287
Interest-bearing demand deposits	311,482,434	231,643,508
Money market and savings deposits	641,944,880	543,644,830
Time deposits	648,675,440	442,774,094
Total deposits	1,921,963,991	1,438,582,719
Securities sold under agreement to repurchase	11,755,923	24,054,730
Federal funds purchased and other borrowings	11,242,533	43,600,000
Subordinated debt	39,176,947	—
Accrued expenses and other liabilities	7,258,460	8,681,393
Total liabilities	1,991,397,854	1,514,918,842
Stockholders' equity:		
Preferred stock - \$1 par value; 2,000,000 shares authorized; None issued and outstanding as of December 31, 2018 and 2017	—	—
Common stock - \$1 par value; 40,000,000 shares authorized; 13,933,504 and 11,152,561 shares issued and outstanding in 2018 and 2017, respectively	13,933,504	11,152,561
Additional paid-in capital	231,851,730	174,008,753
Retained earnings	39,990,990	21,888,575
Accumulated other comprehensive loss	(2,764,743)	(1,198,049)
Total stockholders' equity	283,011,481	205,851,840
Total liabilities and stockholders' equity	\$ 2,274,409,335	\$ 1,720,770,682

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary

Consolidated Statements of Income

For the years ended December 31, 2018 and 2017

	2018	2017
INTEREST INCOME		
Loans, including fees	\$ 86,469,051	\$ 48,805,647
Securities and interest-bearing deposits at other financial institutions	5,147,002	2,862,825
Federal funds sold and other earning assets	594,093	353,924
Total interest income	<u>92,210,146</u>	<u>52,022,396</u>
INTEREST EXPENSE		
Deposits	14,288,090	5,518,350
Securities sold under agreements to repurchase	44,509	61,933
Subordinated debt	603,045	—
Federal funds purchased and other borrowings	630,533	113,070
Total interest expense	<u>15,566,177</u>	<u>5,693,353</u>
Net interest income before provision for loan losses	76,643,969	46,329,043
Provision for loan losses	2,936,472	782,687
Net interest income after provision for loan losses	<u>73,707,497</u>	<u>45,546,356</u>
NONINTEREST INCOME		
Customer service fees	2,416,126	1,374,068
Interchange and debit card transaction fees	573,194	952,294
Gain on sale of securities	1,255	143,508
Gain on sale of loans and other assets	1,432,652	1,275,925
Other noninterest income	2,160,888	1,281,493
Total noninterest income	<u>6,584,115</u>	<u>5,027,288</u>
NONINTEREST EXPENSES		
Salaries and employee benefits	30,629,961	20,743,153
Net occupancy and equipment expense	6,303,466	4,271,289
FDIC insurance	786,105	465,844
Foreclosed assets	775,535	131,703
Advertising	872,547	637,600
Data processing	1,905,777	1,875,462
Professional services	3,647,164	2,084,735
Amortization of intangible assets	976,195	346,435
Software as services contracts	2,054,411	1,398,018
Merger expenses	3,780,785	2,417,070
Other operating expenses	7,223,848	4,758,480
Total noninterest expenses	<u>58,955,794</u>	<u>39,129,789</u>
Income before income tax expense	21,335,818	11,443,855
Income tax expense	3,233,403	6,428,791
Net income	<u>18,102,415</u>	<u>5,015,064</u>
Preferred stock dividends	—	195,000
Net income available to common stockholders	<u>\$ 18,102,415</u>	<u>\$ 4,820,064</u>
EARNINGS PER COMMON SHARE		
Basic	<u>\$ 1.46</u>	<u>\$ 0.56</u>
Diluted	<u>1.45</u>	<u>0.55</u>
Weighted average common shares outstanding		
Basic	<u>12,423,618</u>	<u>8,639,212</u>
Diluted	<u>12,517,640</u>	<u>8,793,527</u>
Dividends per common share	<u>N/A</u>	<u>N/A</u>

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary
Consolidated Statements of Comprehensive Income

For the years ended December 31, 2018 and 2017

	2018	2017
Net income	\$ 18,102,415	\$ 5,015,064
Other comprehensive income (loss), net of tax:		
Unrealized holding gains (losses) arising during the year, net of tax (benefit) expense of \$(514,287) and \$55,405 in 2018 and 2017, respectively	(1,565,719)	90,381
Reclassification adjustment for gains included in net income, net of tax expense of \$280 and \$54,533 in 2018 and 2017, respectively	(975)	(88,975)
	<u>(1,566,694)</u>	<u>1,406</u>
Effect of tax rate change on unrealized gains (losses) on available-for-sale securities	—	(197,215)
Total other comprehensive loss	<u>(1,566,694)</u>	<u>(195,809)</u>
Comprehensive income	<u>\$ 16,535,721</u>	<u>\$ 4,819,255</u>

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary
Consolidated Statements of Changes in Stockholders' Equity
For the years ended December 31, 2018 and 2017

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders' Equity
BALANCE, December 31, 2016	\$ 12,000	\$ 5,896,033	\$ 83,463,051	\$ 16,871,296	\$ (1,002,240)	\$ 105,240,140
Net income	—	—	—	5,015,064	—	5,015,064
Other comprehensive gain	—	—	—	—	1,406	1,406
Reclassification adjustment for tax rate change	—	—	—	197,215	(197,215)	—
Issuance of common stock	—	1,840,000	31,094,676	—	—	32,934,676
Issuance of stock grants	—	1,511	30,280	—	—	31,791
Shares issued to shareholders of Capstone Bancshares, Inc.	—	2,908,094	66,875,727	—	—	69,783,821
Redemption of preferred stock	(12,000)	—	(11,988,000)	—	—	(12,000,000)
Exercise of stock options	—	506,923	4,378,723	—	—	4,885,646
Dividends on preferred stock	—	—	—	(195,000)	—	(195,000)
Stock compensation expense	—	—	154,296	—	—	154,296
BALANCE, December 31, 2017	—	11,152,561	174,008,753	21,888,575	(1,198,049)	205,851,840
Net income	—	—	—	18,102,415	—	18,102,415
Other comprehensive loss	—	—	—	—	(1,566,694)	(1,566,694)
Shares issued to shareholders of FootHills BancCorp, net	—	1,183,232	22,783,563	—	—	23,966,795
Issuance of stock grants and restricted stock	—	5,947	3,115	—	—	9,062
Shares issued to shareholders of TN Bancshares Inc, net	—	1,458,981	33,272,941	—	—	34,731,922
Exercise of stock options	—	132,783	1,386,461	—	—	1,519,244
Stock compensation expense	—	—	396,897	—	—	396,897
BALANCE, December 31, 2018	\$ —	\$ 13,933,504	\$ 231,851,730	\$ 39,990,990	\$ (2,764,743)	\$ 283,011,481

See Notes to Consolidated Financial Statements.

SmartFinancial, Inc. and Subsidiary

Consolidated Statements of Cash Flows

For the years ended December 31, 2018 and 2017

	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 18,102,415	\$ 5,015,064
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization, and accretion	(3,717,501)	(1,691,396)
Provision for loan losses	2,936,472	782,687
Stock compensation expense	396,897	154,296
Gains from redemption and sale of securities available-for-sale	(1,255)	(143,508)
Deferred income tax expense	2,431,705	1,599,000
Income on bank owned life insurance, net	(595,718)	(295,040)
Loss on disposal of fixed assets	41,215	—
Net gains from sale of loans and other assets	(1,432,652)	(1,275,925)
Net losses from sale of foreclosed assets	643,215	47,795
Loans originated for sale	(52,070,349)	(35,547,322)
Proceeds from sale of loans originated for sale	55,761,398	35,576,882
Changes in other assets and liabilities:		
Accrued interest receivable	(377,666)	(331,347)
Accrued interest payable	816,740	31,488
Other assets and liabilities	(2,110,950)	(2,682,548)
Net cash provided by operating activities	<u>20,823,966</u>	<u>1,240,126</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Purchase of securities available-for-sale	(72,149,260)	(53,998,043)
Proceeds from sales, maturities, and paydowns of securities available-for-sale	93,478,332	82,636,066
(Purchase) redemption of restricted investments	(4,053,000)	246,350
Purchase of bank owned life insurance	—	(10,000,000)
Loan originations and principal collections, net	(117,642,156)	(66,724,124)
Purchase of bank premises and equipment	(3,846,490)	(2,798,898)
Proceeds from sale of foreclosed assets	4,972,526	82,864
Net cash and cash equivalents paid (received) in business combinations	<u>4,365,193</u>	<u>(178,312)</u>
Net cash used in investing activities	<u>(94,874,855)</u>	<u>(50,734,097)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Net increase in deposits	95,073,483	50,474,866
Net decrease in securities sold under agreements to repurchase	(12,599,642)	(2,567,254)
Issuance of common stock	1,528,306	37,852,113
Payment of dividends on preferred stock	—	(195,000)
Redemption of preferred stock	—	(12,000,000)
Net proceeds from subordinated debt	39,158,444	—
Repayment of Federal Home Loan Bank advances and other borrowings	(221,691,352)	(119,196,383)
Proceeds from Federal Home Loan Bank advances and other borrowings	<u>175,377,225</u>	<u>139,404,205</u>
Net cash provided by financing activities	<u>76,846,464</u>	<u>93,772,547</u>

SmartFinancial, Inc. and Subsidiary**Consolidated Statements of Cash Flows**

For the years ended December 31, 2018 and 2017

	2018	2017
NET INCREASE IN CASH AND CASH EQUIVALENTS	2,795,575	44,278,576
CASH AND CASH EQUIVALENTS, beginning of year	113,026,884	68,748,308
CASH AND CASH EQUIVALENTS, end of year	\$ 115,822,459	\$ 113,026,884
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION		
Cash paid during the period for interest	\$ 14,749,437	\$ 5,399,749
Cash paid during the period for income taxes	856,756	3,531,984
NONCASH INVESTING AND FINANCING ACTIVITIES		
Change in unrealized losses on securities available-for-sale	\$ 2,081,261	\$ (2,276)
Acquisition of real estate through foreclosure	4,439,866	588,775
Transfer from Bank premises to foreclosed assets	(1,289,102)	—
Change in goodwill due to acquisitions	23,212,962	38,707,620
Financed sales of foreclosed assets	1,601,471	—

See Notes to Consolidated Financial Statements

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies

Nature of Business:

SmartFinancial, Inc. (the "Company") is a bank holding company whose principal activity is the ownership and management of its wholly-owned subsidiary, SmartBank (the "Bank"). The Company provides a variety of financial services to individuals and corporate customers through its offices in Tennessee, Alabama, Florida, and Georgia. The Company's primary deposit products are interest-bearing demand deposits, savings and money market deposits, and time deposits. Its primary lending products are commercial, residential, and consumer loans.

Basis of Presentation and Accounting Estimates:

The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary. All significant intercompany balances and transactions 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 foreclosed assets and deferred taxes, other than temporary impairments of securities, the fair value of financial instruments, goodwill, and business combination elements (Day 1 and Day 2 Valuation).

The Company has evaluated subsequent events for potential recognition and/or disclosure in the consolidated financial statements and accompanying notes included in this Annual Report through the date of the issued consolidated financial statements.

Cash and Cash Equivalents:

For purposes of reporting consolidated cash flows, cash and due from banks includes cash on hand, cash items in process of collection and amounts due from banks. Cash and cash equivalents also includes interest-bearing deposits in banks and federal funds sold. Cash flows from loans, federal funds sold, securities sold under agreements to repurchase and deposits are reported net.

The Bank is required to maintain average balances in cash or on deposit with the Federal Reserve Bank. The reserve requirement was \$36.7 million and \$16.5 million at December 31, 2018 and 2017, respectively.

The Company places its cash and cash equivalents with other financial institutions and limits the amount of credit exposure to any one financial institution. From time to time, the balances at these financial institutions exceed the amount insured by the Federal Deposit Insurance Corporation. The Company has not experienced any losses on these accounts and management considers this to be a normal business risk.

Securities:

Management has classified all securities as available-for-sale. Securities available-for-sale are recorded at fair value, with unrealized gains and losses excluded from earnings and reported in other comprehensive 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 securities quarterly 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 a credit loss 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 loss.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Securities (continued):

Securities borrowed or purchased under agreements to resell and securities loaned or sold under agreements to repurchase are treated as collateralized financial transactions. These agreements are recorded at the amount at which the securities were acquired or sold plus accrued interest. It is the Company's policy to take possession of securities purchased under resale agreements. The market value of these securities is monitored, and additional securities are obtained when deemed appropriate to ensure such transactions are adequately collateralized. The Company also monitors its exposure with respect to securities sold under repurchase agreements, and a request for the return of excess securities held by the counterparty is made when deemed appropriate.

Restricted Investments:

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 restricted investments for impairment based on the ultimate recoverability of the cost basis in these stocks.

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 without anticipating prepayments.

The accrual of interest on loans is discontinued when, in management's opinion, the borrower may be unable to meet payments as they become due, or at the time the loan is 90 days past due, unless the loan is well-secured and in the process of collection. Unsecured loans are typically charged off no later than 120 days past due. Past due status is based on contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged-off at an earlier date if collection of principal and interest is considered doubtful. All interest accrued but not collected for loans that are placed on nonaccrual or charged off is reversed against interest income or charged to the allowance, unless management believes that the accrual of interest is recoverable through the liquidation of collateral. Interest income on nonaccrual loans is recognized on the cash basis, 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 the loan has been performing according to the contractual terms for a period of not less than six months.

Loans Held for Sale:

Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value. When a loan is placed in the held-for-sale category, we stop amortizing the related deferred fees and costs. The remaining unamortized fees and costs are recognized as part of the cost basis of the loan at the time it is sold. Loans held for sale primarily represent mortgage loans on one-to-four family dwellings ("Mortgage") and to a lesser extent the portion of Small Business Administration ("SBA") loans intended to be sold. Realized gains and losses for Mortgage loans are recognized when legal title to the loans has been transferred to the purchaser and sales proceeds have been received and are reflected in the accompanying consolidated statement of income in gains on sale of loans and other assets. We generally sell the guaranteed portion of SBA loans in the secondary market and retain the unguaranteed portion in our portfolio. Upon sale of the guaranteed portion of an SBA loan, we recognize a portion of the gain on sale into income and defer a portion of the gain related to the relative fair value of the unguaranteed loan balance we retain. The deferred gain is amortized into income over the remaining life of the loan. Gains and losses on sales of loans held for sale are included in the Consolidated Statements of Operations in gains on sale of loans and other assets.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Acquired Loans:

Acquired loans are those acquired in business combinations by the Company or Bank. The fair values of acquired loans with evidence of credit deterioration, Purchased Credit Impaired loans (“PCI loans”), are recorded net of a nonaccretable discount and accretable discount. Any excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized in interest income over the remaining life of the loan when there is reasonable expectation about the amount and timing of such cash flows. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is the nonaccretable discount, which is included in the carrying amount of acquired loans. Subsequent decreases to the expected cash flows will generally result in a provision for loan losses. Subsequent significant increases in cash flows result in a reversal of the provision for loan losses to the extent of prior charges or a reclassification of the difference from nonaccretable to accretable with a positive impact on the accretable discount. Acquired loans are initially recorded at fair value at acquisition date. Accretable discounts related to certain fair value adjustments are accreted into income over the estimated lives of the loans.

The Company accounts for PCI loans acquired in the acquisition using the expected cash flows method of recognizing discount accretion based on the acquired loans' expected cash flows. Management recasts the estimate of cash flows expected to be collected on each acquired impaired loan pool periodically. If the present value of expected cash flows for a pool is less than its carrying value, an impairment is recognized by an increase in the allowance for loan losses and a charge to the provision for loan losses. If the present value of expected cash flows for a pool is greater than its carrying value, any previously established allowance for loan losses is reversed and any remaining difference increases the accretable yield which will be taken into interest income over the remaining life of the loan pool. Acquired impaired loans are generally not subject to individual evaluation for impairment and are not reported with impaired loans, even if they would otherwise qualify for such treatment. Purchased performing loans are recorded at fair value, including a credit discount. Credit losses on acquired performing loans are estimated based on analysis of the performing portfolio. Such estimated credit losses are recorded as nonaccretable discounts in a manner similar to purchased impaired loans. The fair value discount other than for credit loss is accreted as an adjustment to yield over the estimated lives of the loans. A provision for loan losses is recorded for any deterioration in these loans subsequent to the acquisition.

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. Confirmed losses are charged off immediately. Subsequent recoveries, if any, are credited to the allowance.

The allowance 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 and general 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 the Company's 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.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Allowance for Loan Losses (continued):

An unallocated component may be 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. As part of the risk management program, an independent review is performed on the loan portfolio, which supplements management's assessment of the loan portfolio and the allowance for loan losses. The result of the independent review is reported directly to the Audit Committee of the Board of Directors. Loans, for which the terms have been modified at the borrower's request, and for which the borrower is experiencing financial difficulties, are considered troubled debt restructurings and classified as impaired.

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. Loans that experience insignificant payment delays and payment shortfalls are not classified as impaired. 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. Large groups of smaller balance homogeneous loans are collectively evaluated for impairment.

The Company's homogeneous loan pools include consumer real estate loans, commercial real estate loans, construction and land development loans, commercial and industrial loans, and consumer and other 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 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; (5) the impact of competition on loan structuring and pricing; (6) the impact of interest rate changes on portfolio risk and (7) 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 adjusted for qualitative factors and the total dollar amount of the loans in the pool.

Troubled Debt Restructurings:

The Company designates loan modifications as Troubled Debt Restructurings ("TDRs") when for economic and 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.

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, 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.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Foreclosed Assets:

Foreclosed assets acquired through, or in lieu of, loan foreclosure are held for sale and are 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 write-downs to the value are expensed. The amount of residential real estate where physical possession had been obtained included within foreclosed assets at December 31, 2018 and 2017 was \$400 thousand and \$546 thousand, respectively. There was no residential real estate in process of foreclosure at December 31, 2018 and December 31, 2017.

Premises and Equipment:

Land is carried at cost. Premises and equipment are carried at cost less accumulated depreciation computed on the straight-line method over the estimated useful lives of the assets or the expected terms of the leases, if shorter. Expected terms include lease option periods to the extent that the exercise of such options is reasonably assured. Maintenance and repairs are expensed as incurred while major additions and improvements are capitalized. Gains and losses on dispositions are included in current operations.

Buildings and leasehold improvements	15 - 40 years
Furniture and equipment	3-7 years

Goodwill and Intangible Assets:

Goodwill represents the cost in excess of the fair value of net assets acquired (including identifiable intangibles) in transactions accounted for as business combinations. Goodwill has an indefinite useful life and is evaluated for impairment annually, or more frequently if events and circumstances indicate that the asset might be impaired. FASB ASC 350, *Goodwill and Other*, regarding testing goodwill for impairment provides an entity the option to first perform a qualitative assessment to determine whether it is more likely than not that the fair value of a reporting unit is less than its carrying amount. If an entity does a qualitative assessment and determines that this is the case, or if a qualitative assessment is not performed, it is required to perform additional goodwill impairment testing to identify potential goodwill impairment and measure the amount of goodwill impairment loss to be recognized for that reporting unit (if any). Based on a qualitative assessment, if an entity determines that the fair value of a reporting unit is more than its carrying amount, the two-step goodwill impairment test is not required. The Company performs its annual goodwill impairment test as of December 31 of each year. For 2018, the results of the qualitative assessment provided no indication of potential impairment. Goodwill will continue to be monitored for triggering events that may indicate impairment prior to the next scheduled annual impairment test.

Intangible assets consist of core deposit premiums created as a result of Business Combinations by the Company or Bank where deposits are assumed. 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. Amortization expense relating to these intangible assets was \$976 thousand and \$346 thousand for the years ended December 31, 2018 and 2017, respectively. The intangible assets were evaluated for impairment as of December 31, 2018, and based on that evaluation it was determined that there was no impairment.

Transfer 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.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Derivative Instruments:

In accordance with ASC Topic 815, Derivatives and Hedging, all derivative instruments are recorded on the accompanying consolidated balance sheet at their respective fair values. The accounting for changes in fair value (i.e., gains or losses) of a derivative instrument depends on whether it has been designated and qualifies as part of a hedging relationship. If the derivative instrument is not designated as a hedge, changes in the fair value of the derivative instrument are recognized in earnings in the period of change.

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged asset or liability attributable to the hedged risk are recognized in current earnings. The gain or loss on the derivative instrument is presented on the same income statement line item as the earnings effect of the hedged item.

Advertising Costs:

The Company expenses all advertising costs as incurred. Advertising expense was \$873 thousand and \$638 thousand for the years ended December 31, 2018 and 2017, respectively.

Income Taxes:

The income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are 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.

On December 22, 2017, the Tax Cuts and Jobs Act (TCJA) was signed into law by the President of the United States. TCJA is a tax reform act that among other things, reduced corporate tax rates to 21 percent effective January 1, 2018. FASB ASC 740, *Income Taxes*, requires deferred tax assets and liabilities to be adjusted for the effect of a change in tax laws or rates in the year of enactment, which is the year in which the change was signed into law. Accordingly, the Company adjusted its deferred tax assets and liabilities at December 31, 2017, using the new corporate tax rate of 21 percent. See Note 8.

Stock Compensation Plans:

At December 31, 2018, the Company had options outstanding under stock-based compensation plans, which are described in more detail in Note 11. The plans have been accounted for under the accounting guidance (FASB ASC 718, *Compensation - Stock Compensation*) which 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 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 stock or other stock based awards.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Stock Compensation Plans(continued):

The stock 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 value of the Company's common stock at the date of grant is used for restrictive stock awards and stock grants.

Employee Benefit Plan:

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

Variable Interest Entities:

An entity is referred to as a variable interest entity (VIE) if it meets the criteria outlined in ASC Topic 810, which are: (1) the entity has equity that is insufficient to permit the entity to finance its activities without additional subordinated financial support from other parties or (2) the entity has equity investors that cannot make significant decisions about the entity's operations or that do not absorb the expected losses or receive the expected returns of the entity. A VIE must be consolidated by the Company if it is deemed to be the primary beneficiary of the VIE, which is the party involved with the VIE that has a majority of the expected losses, expected residual returns, or both. At December 31, 2017, the Company had an investment in Community Advantage Fund, LLC that qualified as an unconsolidated VIE.

The Company's investment in a partnership consists of an equity interest in a lending partnership for the purposes of loaning funds to an unrelated entity. This entity will use the funds to make loans through the SBA Community Advantage Loan Initiative.

The Company uses the equity method when it owns an interest in a partnership and can exert significant influence over the partnership's operations. Under the equity method, the Company's ownership interest in the partnership's capital is reported as an investment on its consolidated balance sheets in other assets and the Company's allocable share of the income or loss from the partnership is reported in noninterest income or expense in the consolidated statements of income. The Company ceases recording losses on an investment in partnership when the cumulative losses and distributions from the partnership exceed the carrying amount of the investment and any advances made by the Company. After the Company's investment in such partnership reaches zero, cash distributions received from these investments are recorded as income.

Comprehensive Income:

Accounting principles generally require that recognized revenue, expenses, gains and losses be included in net income. 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, are components of comprehensive income. Unrealized gains and losses on available for sale securities are the only component of accumulated other comprehensive loss.

Fair Value of Financial Instruments:

Fair values of financial instruments are estimates using relevant market information and other assumptions, as more fully disclosed in Note 16. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Business Combinations:

Business combinations are accounted for using the acquisition method of accounting. Under the acquisition method of accounting, acquired assets and assumed liabilities are included with the acquirer's accounts as of the date of acquisition at estimated fair value, with any excess of purchase price over the fair value of the net assets acquired (including identifiable intangible assets) capitalized as goodwill. In the event that the fair value of the net assets acquired exceeds the purchase price, an acquisition gain is recorded for the difference in consolidated statements of income for the period in which the acquisition occurred. An intangible asset is recognized as an asset apart from goodwill when it arises from contractual or other legal rights or if it is capable of being separated or divided from the acquired entity and sold, transferred, licensed, rented or exchanged. In addition, acquisition-related costs and restructuring costs are recognized as period expenses as incurred. Estimates of fair value are subject to refinement for a period not to exceed one year from acquisition date as information relative to acquisition date fair values becomes available.

Earnings Per Common Share:

Basic earnings per common share represents income available to common stockholders divided by the weighted-average number of common shares outstanding during the period. Diluted earnings per common share reflects additional common shares that would have been outstanding if dilutive potential common shares had been issued, as well as any adjustment to income that would result from the assumed issuance. Potential common shares that may be issued by the Company relate to restricted stock and outstanding stock options and are determined using the treasury stock method.

Segment Reporting:

ASC Topic 280, Segment Reporting, provides for the identification of reportable segments on the basis of distinct business units and their financial information to the extent such units are reviewed by an entity's chief decision maker (which can be an individual or group of management persons). ASC Topic 280 permits aggregation or combination of segments that have similar characteristics. In the Company's operations, each bank branch is viewed by management as being a separately identifiable business or segment from the perspective of monitoring performance and allocation of financial resources. Although the branches operate independently and are managed and monitored separately, each is substantially similar in terms of business focus, type of customers, products, and services. Accordingly, the Company's consolidated financial statements reflect the presentation of segment information on an aggregated basis in one reportable segment.

Recently Issued Not Yet Effective Accounting Pronouncements:

The following is a summary of recent authoritative pronouncements not yet in effect that could impact the accounting, reporting, and/or disclosure of financial information by the Company.

In February 2016, the FASB issued guidance that requires lessees to recognize almost all leases on their balance sheet as a right of-use asset and a lease liability in *ASU 2016-2: Leases (Topic 842)*. For income statement purposes, the FASB retained a dual model, requiring leases to be classified as either operating or finance. Classification will be based on criteria that are largely similar to those applied in current lease accounting, but without explicit bright lines. Lessor accounting is similar to the current model, but updated to align with certain changes to the lessee model and the new revenue recognition standard. Existing sale-leaseback guidance, including guidance for real estate, is replaced with a new model applicable to both lessees and lessors. The new guidance will be effective for public business entities for annual periods beginning after December 15, 2018 including interim periods within those fiscal years. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore, not recognized on the Company's consolidated statements of condition. The Company expects the new guidance will require these lease agreements to be recognized on the consolidated statements of condition as a right-of-use asset and a corresponding lease liability. Therefore, the Company's preliminary evaluation indicates the provisions of ASU No. 2016-02 are expected to impact the Company's consolidated balance sheets, along with our regulatory capital ratios.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Not Yet Effective Accounting Pronouncements (continued):

In January 2018, the FASB issued *ASU 2018-01, Leases (Topic 842) Land Easement Practical Expedient Transition to Topic 842, an amendment to ASU 2016-2: Leases*. The amendments in this Update permit an entity to elect an optional transition practical expedient to not evaluate under Topic 842 land easements that exist or expired before the entity's adoption of Topic 842 and that were not previously accounted for as leases under Topic 840. An entity that elects this practical expedient should apply the practical expedient consistently to all of its existing or expired land easements that were not previously accounted for as leases under Topic 840. Once an entity adopts Topic 842, it should apply that Topic prospectively to all new (or modified) land easements to determine whether the arrangement should be accounted for as a lease. An entity that does not elect this practical expedient should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. An entity should continue to apply its current accounting policy for accounting for land easements that existed before the entity's adoption of Topic 842. For example, if an entity currently accounts for certain land easements as leases under Topic 840, it should continue to account for those land easements as leases before its adoption of Topic 842. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in Update 2016-02.

In July 2018, the FASB issued *ASU No. 2018-11, Leases - Targeted Improvements* to provide entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Company). The Company expects to elect both transition options.

In December 2018, the FASB also issued *ASU 2018-20, Leases (Topic 842) - Narrow-Scope Improvements for Lessors*, which provides for certain policy elections and changes lessor accounting for sales and similar taxes and certain lessor costs. Upon adoption of ASU 2016-2, ASU 2018-11 and ASU 2018-20 on January 1, 2019, the Company expects to recognize right-of-use assets and related lease liabilities totaling \$2.6 million and \$2.7 million, respectively. The Company expects to elect to apply certain practical expedients provided under ASU 2016-02 whereby the Company will not reassess (i) whether any expired or existing contracts are or contain leases, (ii) the lease classification for any expired or existing leases and (iii) initial direct costs for any existing leases. The Company also do not expect to apply the recognition requirements of ASU 2016-02 to any short-term leases (as defined by related accounting guidance). The Company expect to account for lease and non-lease components separately because such amounts are readily determinable under our lease contracts and because we expect this election will result in a lower impact on our balance sheet. The Company expect to utilize the modified-retrospective transition approach prescribed by ASU 2018-11.

In June 2016, FASB issued *ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*. The ASU changed the credit loss model on financial instruments measured at amortized cost, available for sale securities and certain purchased financial instruments. Credit losses on financial instruments measured at amortized cost will be determined using a current expected credit loss model which requires the Company to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable supportable forecasts. This replaces the existing incurred loss model and is applicable to the measurement of credit losses on financial assets measured at amortized cost and applies to some off-balance sheet credit exposures. Purchased financial assets with more-than insignificant credit deterioration since origination ("PCD assets" which are currently named "PCI Loans") measured at amortized cost will have an allowance for credit losses established at acquisition as part of the purchase price. Subsequent increases or decreases to the allowance for credit losses on PCD assets will be recognized in the income statement. Interest income should be recognized on PCD assets based on the effective interest rate, determined excluding the discount attributed to credit losses at acquisition. Credit losses relating to available-for-sale debt securities will be recognized through an allowance for credit losses. The amount of the credit loss is limited to the amount by which fair value is below amortized cost of the available-for-sale debt security. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years for the Company and other SEC filers. Early adoption is permitted and if early adopted, all provisions must be adopted in the same period. The amendments should be applied through a cumulative-effect adjustment to retained earnings as of the beginning of the period adopted. A prospective approach is required for securities with other than temporary impairment recognized prior to adoption.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Not Yet Effective Accounting Pronouncements (continued):

The Company is continuing its implementation efforts through its company-wide implementation team. The implementation team meets periodically to discuss the latest developments and ensure progress is being made. The team also keeps current on evolving interpretations and industry practices related to ASU 2016-13 via webcasts, publications, conferences, and peer bank meetings. The team continues to evaluate and validate data resources and different loss methodologies. The Company's preliminary evaluation indicates the provisions of ASU No. 2016-13 are expected to impact the Company's consolidated financial statements, in particular an increase to the level of the reserve for credit losses. However, the Company continues to evaluate the extent of the potential impact.

The guidance of ASU 2016-13 was recently amended by *ASU 2018-19, Codification Improvements to Topic 326, Financial Instruments - Credit Losses*, which changed the effective date for non-public companies and clarified that operating lease receivables are not within the scope of the standard.

In January 2017, FASB issued ASU No. 2017-04, *Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment*. The ASU simplifies the subsequent measurement of goodwill and eliminates Step 2 from the goodwill impairment test. The Company should perform its goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An impairment charge should be recognized for the amount by which the carrying amount exceeds the reporting unit's fair value. The impairment charge is limited to the amount of goodwill allocated to that reporting unit. The amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for goodwill impairment tests performed on testing dates after January 1, 2017. The Company does not expect these amendments to have a material effect on its financial statements.

In March 2017, FASB issued ASU No. 2017-08, *Receivables - Nonrefundable Fees and Other Costs (Topic 310-20): Premium Amortization on Purchased Callable Debt Securities*. The ASU shortens the amortization period for certain callable debt securities held at a premium. The premium on individual callable debt securities shall be amortized to the earliest call date. This guidance does not apply to securities for which prepayments are estimated on a large number of similar loans where prepayments are probable and reasonably estimable. The amendments in this update are effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption is permitted. This update should be adopted on a modified retrospective basis with a cumulative-effect adjustment to retained earnings on the date of adoption. The Company does not expect these amendments to have a material effect on its financial statements.

As part of its Simplification Initiative, the FASB has issued *ASU 2018-07, Compensation-Stock Compensation (Topic 718): Improvements to Nonemployee Share-Based Payment Accounting*. ASU No. 2018-07 expands the scope of Topic 718, *Compensation-Stock Compensation* (which previously only included payments to employees), to include share-based payment transactions for acquiring goods and services from non-employees. This required entities to apply the requirements of Topic 718 to non-employee awards, except for specific guidance on inputs to an option pricing model and the attribution of cost (i.e., the period of time over which share-based payment awards vest and the pattern of cost recognition over that period). Additionally, the amendments specify that Topic 718 applies to all share-based payment transactions in which a grantor acquires goods or services to be used or consumed in the grantor's own operations by issuing share-based payment awards, and clarify that Topic 718 does not apply to share-based payments used to effectively provide (1) financing to the issuer, or (2) awards granted in conjunction with selling goods or services to customers as part of a contract accounted for under Topic 606, *Revenue from Contracts with Customers*. The amendments are effective for fiscal years beginning after December 15, 2018, and for the interim periods within those years. The Company does not expect these amendments to have a material effect on its consolidated financial statements.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued Not Yet Effective Accounting Pronouncements (continued):

In August 2018, the FASB issued *ASU No. 2018-13, Disclosure Framework - Changes to the Disclosure Requirements for Fair Value Measurement*. This ASU eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reasons for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements. ASU No. 2018-13 is effective for interim and annual reporting periods beginning after December 15, 2019; early adoption is permitted. Entities are also allowed to elect early adoption of the eliminated or modified disclosure requirements and delay adoption of the new disclosure requirements until their effective date. As ASU No. 2018-13 only revises disclosure requirements, it will not have a material impact on the Company's consolidated financial statements.

ASU 2018-15, Intangibles - Goodwill and Other - Internal-Use Software (Subtopic 350-40) - Customer's Accounting for Implementation Costs Incurred in a Cloud Computing Arrangement That Is a Service Contract. ASU 2018-15 clarifies certain aspects of ASU 2015-05, "Customer's Accounting for Fees Paid in a Cloud Computing Arrangement," which was issued in April 2015. Specifically, ASU 2018-15 aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). ASU 2018-15 does not affect the accounting for the service element of a hosting arrangement that is a service contract. ASU 2018-15 will be effective for us on January 1, 2020, with early adoption permitted, and is not expected to have a significant impact on our financial statements.

ASU 2018-16, "Derivatives and Hedging (Topic 815) - Inclusion of the Secured Overnight Financing Rate (SOFR) Overnight Index Swap (OIS) Rate as a Benchmark Interest Rate for Hedge Accounting Purposes." The amendments in this update permit use of the OIS rate based on SOFR as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815 in addition to the interest rates on direct U.S. Treasury obligations, the LIBOR swap rate, the OIS rate based on the Fed Funds Effective Rate and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate. ASU 2018-16 will be effective for the Company on January 1, 2019 and is not expected to have a significant impact on our financial statements.

Recently Issued and Adopted Accounting Pronouncements:

We adopted *ASU 2014-09, Revenue from Contracts with Customers (Topic 606)* and its related amendments as of January 1, 2018 utilizing the modified retrospective approach. The implementation of the new standard did not have a material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary. Since the guidance does not apply to revenue associated with financial instruments, including loans and securities that are accounted for under other GAAP, the new guidance did not have a material impact on revenue most closely associated with financial instruments, including interest income and expense. The Company completed its overall assessment of revenue streams and review of related contracts potentially affected by the ASU, including, deposit related fees, interchange fees, merchant income, and insurance and brokerage commissions. Based on this assessment, the Company concluded that ASU 2014-09 did not materially change the method in which the Company currently recognizes revenue for these revenue streams.

Under ASU 2014-09, we adopted new policies related to revenue recognition. In general, for revenue not associated with financial instruments, guarantees and lease contracts, we apply the following steps when recognizing revenue from contracts with customers: (i) identify the contract, (ii) identify the performance obligations, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations and (v) recognize revenue when performance obligation is satisfied. Our contracts with customers are generally short term in nature, typically due within one year or less or cancellable by us or our customer upon a short notice period. Performance obligations for our customer contracts are generally satisfied at a single point in time, typically when the transaction is complete, or over time. For performance obligations satisfied over time, we primarily use the output method, directly measuring the value of the products/services transferred to the customer, to determine when performance obligations have been satisfied. We typically receive payment from customers and recognize revenue concurrent with the satisfaction of our performance obligations. In most cases, this occurs within a single financial reporting period. For payments received in advance of the satisfaction of performance obligations, revenue recognition is deferred until such time the performance obligations have been satisfied. In cases where we have not received payment despite satisfaction of our performance obligations, we accrue an estimate of the amount due in the period our performance obligations have been satisfied. For contracts with variable components, only amounts for which collection is probable are accrued. We generally act in a principal capacity, on our own behalf, in most of

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 1. Summary of Significant Accounting Policies, Continued

Recently Issued and Adopted Accounting Pronouncements (continued):

our contracts with customers. In such transactions, we recognize revenue and the related costs to provide our services on a gross basis in our financial statements. In some cases, we act in an agent capacity, deriving revenue through assisting other entities in transactions with our customers. In such transactions, we recognized revenue and the related costs to provide our services on a net basis in our financial statements. These transactions relate to our customers' use of various interchange and ATM/debit card networks.

Based on our underlying contracts, ASU 2014-09 requires us to report network costs associated with debit card and ATM transactions netted against the related fees from such transactions. Previously, such network costs were reported as a component of other noninterest expense. For the twelve months period ended December 31, 2018, gross interchange and debit card transaction fees totaled \$1.6 million while related network costs totaled \$1.0 million. On a net basis, we reported \$573 thousand as interchange and debit card transaction fees in the accompanying Consolidated Statement of Income for the twelve months period ended December 31, 2018.

For the twelve months period ended December 31, 2017 we reported interchange and debit card transaction fees totaling \$952 thousand on a gross basis in the accompanying Consolidated Statement of Income while related network costs totaling \$595 thousand were reported in other operating expenses included as a component of other noninterest expense.

ASU 2016-01 Financial Instruments - Overall (Subtopic 825-10): Recognition of Financial Assets and Financial Liabilities, makes targeted amendments to the guidance for recognition, measurement, presentation and disclosure of financial instruments. ASU 2016-01 requires equity investments, other than equity method investments, to be measured at fair value with changes in fair value recognized in net income. The ASU requires a cumulative-effect adjustment to retained earnings as of the beginning of the reporting period of adoption to reclassify the cumulative change in fair value of equity securities previously recognized in Accumulated Other Comprehensive Income. ASU 2016-01 became effective for the Company on January 1, 2018 and there was no adjustment to retained earnings. ASU 2016-01 also emphasizes the existing requirement to use exit prices to measure fair value for disclosure purposes and clarifies that entities should not make use of a practicability exception in determining the fair value of loans. Accordingly, we refined the calculation used to determine the disclosed fair value of our loans held for investment portfolio as part of adopting this standard. The refined calculation is disclosed Note 16 - Fair Value Disclosures.

ASU 2017-09, Compensation - Stock Compensation (Topic 718) - Scope of Modification Accounting. ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. Under ASU 2017-09, an entity will not apply modification accounting to a share-based payment award if all of the following are the same immediately before and after the change: (i) the award's fair value, (ii) the award's vesting conditions and (iii) the award's classification as an equity or liability instrument. ASU 2017-09 became effective for us on January 1, 2018 and did not have a significant impact on our financial statements.

ASU 2017-12, Derivatives and Hedging (Topic 815) - Targeted Improvements to Accounting for Hedging Activities. ASU 2017-12 amends the hedge accounting recognition and presentation requirements in ASC 815 to improve the transparency and understandability of information conveyed to financial statement users about an entity's risk management activities to better align the entity's financial reporting for hedging relationships with those risk management activities and to reduce the complexity of and simplify the application of hedge accounting. The Company early adopted the standard and it does not have a significant impact on our financial statements.

Reclassifications:

Certain captions and amounts in the 2017 consolidated financial statements were reclassified to conform to the 2018 presentation. Such reclassifications had no effect on net income and shareholders' equity.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 2. Business Combinations

Pending Merger with Entegra Financial, Corp.

On January 15, 2019, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Entegra Financial, Corp., a North Carolina corporation ("Entegra"). The Merger Agreement was approved and adopted by the board of directors of SmartFinancial and the board of directors of Entegra. Under the terms and subject to the conditions of the Merger Agreement each outstanding share of Entegra common stock (other than certain excluded) will be converted into the right to receive 1.215 shares of SmartFinancial common stock. As of January 15, 2019, Entegra had 6,917,703 (unaudited) shares of common stock outstanding.

Acquisition of Foothills Bancorp, Inc.

On November 1, 2018, the Company completed its merger with Foothills Bancorp, Inc., a Tennessee corporation ("Foothills Bancorp"), pursuant to an Agreement and Plan of Merger dated June 27, 2018 (the "Foothills Bancorp merger agreement"), by and among SmartFinancial, Foothills Bancorp, and Foothills Bank, a Tennessee-chartered commercial bank and wholly owned subsidiary of Foothills Bancorp. Foothills Bancorp merged with and into SmartFinancial, with SmartFinancial continuing as the surviving corporation. Immediately following the merger, Foothills Bank merged with and into the Bank continuing as the surviving banking corporation.

Pursuant to the Foothills Bancorp merger agreement, each outstanding share of Foothills Bancorp common stock was converted into and cancelled in exchange to the right to receive \$1.75 in cash and 0.666 shares of SmartFinancial common stock. SmartFinancial issued 1,183,232 shares of SmartFinancial common stock and paid \$3.1 million in cash as consideration for the merger plus \$3.0 million in consideration for Foothills Bancorp Director and management stock options. SmartFinancial did not issue fractional shares of its common stock in connection with the merger, but instead paid cash in lieu of fractional shares based on the volume weighted average closing price of SmartFinancial common stock on the Nasdaq Capital Market for the 10 consecutive trading days ending on (and including) October 31, 2018 (calculated as \$22.46).

After the merger, shareholders of SmartFinancial owned approximately 91 percent of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio.

The merger was effected by the issuance of shares of SmartFinancial stock along with cash consideration to the shareholders of Foothills Bancorp. The assets and liabilities of Foothills Bancorp as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill from the transaction was \$7.5 million, none of which is deductible for income tax purposes.

In periods following the Foothills Bancorp merger, the financial statements of the combined entity will include the results attributable to Foothills Bank beginning on the date the merger was completed. In the twelve months period ended December 31, 2018, the revenues and net income attributable to Foothills Bank were approximately \$1.5 million and \$876 thousand, respectively.

The pro-forma impact to 2018 revenues and net income if the merger had occurred on January 1, 2018 would have been \$11.0 million and \$1.6 million for the twelve months period ending December 31, 2018, respectively. While certain adjustments were made for the estimated impact of certain fair value adjustments, they are not indicative of what would have occurred had the merger taken place on the indicated date nor are they intended to represent or be indicative of future results of operations. In particular, no adjustments have been made to eliminate the amount of Foothills Bank's provision for credit losses or any adjustments to estimate any additional income that would have been recorded as a result of fair value adjustments for 2018 that may have occurred had the acquired loans been recorded at fair value as of the beginning of 2018. In addition there are no adjustments to reflect any expenses that potentially could have been reduced for 2018 had the merger occurred on January 1, 2018. There were \$2.3 million nonrecurring pro forma adjustments to expense included in the reported proforma earnings for twelve month period ending December 31, 2018.

The fair value estimates of Foothills Bancorp assets and liabilities recorded are preliminary and subject to refinement as additional information becomes available. Under current accounting principles, the Company's estimates of fair values may be adjusted for a period of up to one year from the acquisition date. As of December 31, 2018 there were no adjustments initially recorded as part of the business combination.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 2. Business Combination, Continued

The following table details the financial impact of the merger, including the calculation of the purchase price, the allocation of the purchase price to the fair values of net assets assumed, and goodwill recognized:

Calculation of Purchase Price

Shares of SMBK common stock issued to Foothills Bancorp shareholders as of November 1, 2018	1,183,232
Market price of SMBK common stock on November 1, 2018	\$ 20.34
Estimated fair value of SMBK common stock issued (in thousands)	24,067
Cash consideration paid (in thousands)	6,069
Total consideration (in thousands)	<u>\$ 30,136</u>

Allocation of Purchase Price (in thousands)

Total consideration above	<u>\$ 30,136</u>
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	4,882
Investment securities available-for-sale	48,091
Restricted investments	551
Loans	153,692
Premises and equipment	3,622
Core deposit intangible	3,670
Prepaid and other assets	3,944
Deposits	(185,259)
FHLB advances and other borrowings	(10,257)
Payables and other liabilities	(276)
Total fair value of net assets acquired	<u>22,660</u>
Goodwill	<u>\$ 7,476</u>

Acquisition of Tennessee Bancshares, Inc.

On May 1, 2018, the Company completed its merger with Tennessee Bancshares, Inc., a Tennessee corporation (“Tennessee Bancshares”), pursuant to an Agreement and Plan of Merger dated December 12, 2017 (the “Tennessee Bancshares merger agreement”), by and among SmartFinancial, Tennessee Bancshares, and Southern Community Bank, a Tennessee-chartered commercial bank. Tennessee Bancshares merged with and into SmartFinancial, with SmartFinancial continuing as the surviving corporation. Immediately following the merger, Southern Community Bank merged with and into the Bank continuing as the surviving banking corporation.

Pursuant to the Tennessee Bancshares merger agreement, each outstanding share of Tennessee Bancshares common stock was converted into and cancelled in exchange for 0.8065 shares of SmartFinancial common stock. SmartFinancial issued 1,458,981 shares of SmartFinancial common stock as consideration for the merger. SmartFinancial did not issue fractional shares of its common stock in connection with the merger, but instead paid cash in lieu of fractional shares based on the volume weighted average closing price of SmartFinancial common stock on the Nasdaq Capital Market for the 10 consecutive trading days ending on (and including) April 27, 2018 (calculated as \$23.92).

After the merger, shareholders of SmartFinancial owned approximately 89 percent of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 2. Business Combination, Continued

The merger was effected by the issuance of shares of SmartFinancial stock along with cash consideration to the fractional shareholders of Tennessee Bancshares, Inc. The assets and liabilities of Tennessee Bancshares as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill from the transaction was \$15.8 million, none of which is deductible for income tax purposes.

In periods following the Tennessee Bancshares merger, the financial statements of the combined entity will include the results attributable to Southern Community Bank beginning on the date the merger was completed. In the twelve months period ended December 31, 2018, the revenues and net income attributable to Southern Community Bank were approximately \$8.4 million million and \$3.5 million million, respectively.

The pro-forma impact to 2018 revenues and net income if the merger had occurred on January 1, 2018 would have been \$14.7 million and \$3.6 million for the twelve months period ending December 31, 2018, respectively. While certain adjustments were made for the estimated impact of certain fair value adjustments, they are not indicative of what would have occurred had the merger taken place on the indicated date nor are they intended to represent or be indicative of future results of operations. In particular, no adjustments have been made to eliminate the amount of Southern Community Bank's provision for credit losses or any adjustments to estimate any additional income that would have been recorded as a result of fair value adjustments for 2018 that may have occurred had the acquired loans been recorded at fair value as of the beginning of 2018. In addition there are no adjustments to reflect any expenses that potentially could have been reduced for 2018 had the merger occurred on January 1, 2018. There were \$2.0 million nonrecurring pro forma adjustments to expense included in the reported proforma earnings for the twelve months period ending December 31, 2018.

The fair value estimates of Tennessee Bancshares assets and liabilities recorded are preliminary and subject to refinement as additional information becomes available. Under current accounting principles, the Company's estimates of fair values may be adjusted for a period of up to one year from the acquisition date. As of December 31, 2018 there was one adjustment for approximately \$51 thousand to fair values initially recorded as part of the business combination.

The following table details the financial impact of the merger, including the calculation of the purchase price, the allocation of the purchase price to the fair values of net assets assumed, and goodwill recognized:

Calculation of Purchase Price	
Shares of SMBK common stock issued to TN Bancshares shareholders as of May 1, 2018	1,458,981
Market price of SMBK common stock on May 1, 2018	\$ 23.85
Estimated fair value of SMBK common stock issued (in thousands)	34,797
Cash consideration paid (in thousands)	5
Total consideration (in thousands)	\$ 34,802

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 2. Business Combination, Continued

Allocation of Purchase Price (in thousands)	
Total consideration above	\$ 34,802
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	5,723
Investment securities available-for-sale	24,563
Restricted investments	464
Loans	180,490
Premises and equipment	9,470
Core deposit intangible	2,290
Other real estate owned	674
Prepaid and other assets	2,207
Deposits	(202,272)
FHLB advances and other borrowings	(4,000)
Payables and other liabilities	(586)
Total fair value of net assets acquired	19,023
Goodwill	\$ 15,779

Acquisition of Capstone Bancshares, Inc.

On May 22, 2017, the shareholders of the Company approved a merger with Capstone Bancshares, Inc. ("Capstone"), the one bank holding company of Capstone Bank, which became effective November 1, 2017. Capstone shareholders received either: (a) 0.85 shares of SmartFinancial common stock, (b) \$18.50 in cash, or (c) a combination of 80 percent SmartFinancial common stock and 20 percent cash. Elections were limited by the requirement that 80 percent of the total shares of Capstone common stock be exchanged for SmartFinancial common stock and 20 percent be exchanged for cash. Therefore, the allocation of SmartFinancial common stock and cash that a Capstone shareholder received depended on the elections of other Capstone shareholders, and were allocated in accordance with the procedures set forth in the merger agreement. Capstone shareholders also received cash instead of any fractional shares they would have otherwise received in the merger.

After the merger, shareholders of SmartFinancial owned approximately 74 percent of the outstanding common stock of the combined entity on a fully diluted basis, after taking into account the exchange ratio.

The assets and liabilities of Capstone as of the effective date of the merger were recorded at their respective estimated fair values and combined with those of SmartFinancial. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. Goodwill from the transaction was \$38.0 million, none of which is deductible for income tax purposes.

In periods following the merger, the financial statements of the combined entity will include the results attributable to Capstone beginning on the date the merger was completed. In the period ended December 31, 2017, the revenues and net income attributable to Capstone were \$5.0 million and \$186 thousand, respectively. The pro-forma impact to 2017 revenues and net income if the merger had occurred on December 31, 2016 would have been \$24.9 million and \$947 thousand, respectively.

While certain adjustments were made for the estimated impact of certain fair value adjustments, they are not indicative of what would have occurred had the merger taken place on the indicated date nor are they intended to represent or be indicative of future results of operations. In particular, no adjustments have been made to eliminate the amount of Capstone's provision for credit losses or any adjustments to estimate any additional income that would have been recorded as a result of fair value adjustments for the twelve months of 2017 that may have occurred had the acquired loans been recorded at fair value as of the beginning of 2017. In addition there are no adjustments to reflect any expenses that potentially could have been reduced for the twelve months of 2017 had the merger occurred on January 1, 2017. There were \$4.6 million in nonrecurring pro forma adjustments to expense included in the reported proforma revenue and earnings. For the twelve months period ended December 31, 2018, the revenues and net income attributable to Capstone were \$27.8 million and \$13.5 million, respectively. For the twelve months period ended December 31, 2018, there was an \$11 thousand adjustment to reduce fair values initially recorded as part of the business combination.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 2. Business Combination, Continued

The following table details the financial impact of the merger, including the calculation of the purchase price, the allocation of the purchase price to the fair values of net assets assumed, and goodwill recognized:

Calculation of Purchase Price

Shares of SMBK common stock issued to Capstone shareholders as of November 1, 2017	2,908,094
Market price of SMBK common stock on November 1, 2017	\$ 23.49
Estimated fair value of SMBK common stock issued (in thousands)	68,311
Estimated fair value of Capstone stock options (in thousands)	1,585
Cash consideration paid (in thousands)	15,826
Total consideration (in thousands)	<u>\$ 85,722</u>

Allocation of Purchase Price (in thousands)

Total consideration above	<u>\$ 85,722</u>
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	16,810
Investment securities available for sale	51,638
Restricted investments	1,049
Loans	413,012
Premises and equipment	8,668
Bank owned life insurance	10,031
Core deposit intangible	5,530
Other real estate owned	410
Prepaid and other assets	6,360
Deposits	(454,154)
FHLB advances and other borrowings	(4,887)
Payables and other liabilities	(6,803)
Total fair value of net assets acquired	<u>47,664</u>
Goodwill	<u>\$ 38,058</u>

Acquisition of branch from Atlantic Capital Bank, N.A.

On December 8, 2016, the Bank entered into a purchase and assumption agreement with Atlantic Capital Bank, N.A. that provided for the acquisition and assumption by the Bank of certain assets and liabilities associated with Atlantic Capital Bank's branch office located at 3200 Keith Street NW, Cleveland, Tennessee 37312. The purchase was completed on May 19, 2017 for total cash consideration of \$1.2 million. The assets and liabilities as of the effective date of the transaction were recorded at their respective estimated fair values. The excess of the purchase price over the net estimated fair values of the acquired assets and liabilities was allocated to identifiable intangible assets with the remaining excess allocated to goodwill. In the periods following the acquisition, the financial statements will include the results attributable to the Cleveland branch purchase beginning on the date of purchase. For the twelve months period ended December 31, 2018, the revenues and net income attributable to the Cleveland branch were \$1.6 million and \$546 thousand, respectively. For the twelve months period ended December 31, 2017, the revenues and net income attributable to the Cleveland branch were \$903 thousand and \$63 thousand, respectively. It is impracticable to determine the pro-forma impact to the 2017 revenues and net income if the acquisition had occurred on January 1, 2017 as the Company does not have access to those records for a single branch. The following table details the financial impact of the transaction, including the allocation of the purchase price to the fair values of net assets assumed and goodwill recognized:

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 2. Business Combination, Continued

Allocation of Purchase Price (in thousands)

Total consideration in cash	\$ 1,183
Fair value of assets acquired and liabilities assumed:	
Cash and cash equivalents	133
Loans	24,073
Premises and equipment	2,839
Core deposit intangible	310
Prepaid and other assets	77
Deposits	(26,888)
Payables and other liabilities	(21)
Total fair value of net assets acquired	523
Goodwill	\$ 660

As of December 31, 2018 there have not been any changes to the initial fair values recorded as part of the business combination.

Note 3. Securities

The amortized cost and fair value of securities available-for-sale at December 31, 2018 and 2017 are summarized as follow (in thousands):

	December 31, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government-sponsored enterprises (GSEs)	\$ 44,117	\$ 12	\$ (626)	\$ 43,503
Municipal securities	55,248	276	(363)	55,161
Other debt securities	977	—	(67)	910
Mortgage-backed securities	103,875	153	(1,914)	102,114
Total	\$ 204,217	\$ 441	\$ (2,970)	\$ 201,688

	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
U.S. Government-sponsored enterprises (GSEs)	\$ 26,207	\$ 1	\$ (432)	\$ 25,776
Municipal securities	9,122	28	(147)	9,003
Other debt securities	974	—	(24)	950
Mortgage-backed securities	117,263	136	(1,184)	116,215
Total	\$ 153,566	\$ 165	\$ (1,787)	\$ 151,944

The amortized cost and estimated market value of securities at December 31, 2018, by contractual maturity, are shown below (in thousands). Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 3. Securities, Continued

	Amortized Cost	Fair Value
Due in one year or less	\$ —	\$ —
Due from one year to five years	36,112	35,780
Due from five years to ten years	14,588	14,145
Due after ten years	49,642	49,649
	<u>100,342</u>	<u>99,574</u>
Mortgage-backed securities	103,875	102,114
Total	<u>\$ 204,217</u>	<u>\$ 201,688</u>

The following tables present the gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities available-for-sale have been in a continuous unrealized loss position, as of December 31, 2018 and 2017 (in thousands):

	As of December 31, 2018					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government- sponsored enterprises (GSEs)	\$ 14,763	\$ (237)	\$ 13,728	\$ (389)	\$ 28,491	\$ (626)
Municipal securities	16,455	(150)	4,767	(213)	21,222	(363)
Other debt securities	—	—	910	(67)	910	(67)
Mortgage-backed securities	10,516	(155)	69,884	(1,759)	80,400	(1,914)
Total	<u>\$ 41,734</u>	<u>\$ (542)</u>	<u>\$ 89,289</u>	<u>\$ (2,428)</u>	<u>\$ 131,023</u>	<u>\$ (2,970)</u>

	As of December 31, 2017					
	Less than 12 Months		12 Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. Government- sponsored enterprises (GSEs)	\$ 1,358	\$ (1)	\$ 13,420	\$ (431)	\$ 14,778	\$ (432)
Municipal securities	3,418	(43)	2,112	(104)	5,530	(147)
Other debt securities	950	(24)	—	—	950	(24)
Mortgage-backed securities	61,332	(407)	35,048	(777)	96,380	(1,184)
Total	<u>\$ 67,058</u>	<u>\$ (475)</u>	<u>\$ 50,580</u>	<u>\$ (1,312)</u>	<u>\$ 117,638</u>	<u>\$ (1,787)</u>

At December 31, 2018, the categories of temporarily impaired securities, and management's evaluation of those securities, are as follows:

U.S. Government-sponsored enterprises: At December 31, 2018, eight investments in U.S. GSE securities had unrealized losses. These unrealized losses related principally to changes in market interest rates. The contractual terms of the investments does not permit the issuer to settle the securities at a price less than the amortized cost bases of the investments. Because the Bank does not intend to sell the investments and it is more likely than not that the Bank will not be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other-than temporarily impaired at December 31, 2018.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 3. Securities, Continued

Municipal securities: At December 31, 2018, twenty two investments in obligations of municipal securities had unrealized losses. The Bank believes the unrealized losses on those investments were caused by the interest rate environment and do not relate to the underlying credit quality of the issuers. Because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other than temporarily impaired at December 31, 2018.

Other debt securities: At December 31, 2018, one investment in other debt securities had unrealized losses. The Bank believes the unrealized losses on this investment was caused by the interest rate environment and does not relate to the underlying credit quality of the issuers. Because the Bank does not intend to sell the investment and it is not more likely than not that the Bank will be required to sell the investment before recovery of their amortized cost basis, which may be maturity, the Bank does not consider this investment to be other than temporarily impaired at December 31, 2018.

Mortgage-backed securities: At December 31, 2018, sixty six investments in residential mortgage-backed securities had unrealized losses. This impairment is believed to be caused by the current interest rate environment. The contractual cash flows of those investments are guaranteed by an agency of the U.S. Government. Because the decline in market value is attributable to the current interest rate environment and not credit quality, and because the Bank does not intend to sell the investments and it is not more likely than not that the Bank will be required to sell the investments before recovery of their amortized cost bases, which may be maturity, the Bank does not consider these investments to be other than temporarily impaired at December 31, 2018.

Sales of available-for-sale securities for the years ended December 31, 2018 and 2017, were as follows (in thousands):

	2018	2017
Proceeds	\$ 2,970	\$ 12,614
Gains realized	1	145
Losses realized	—	2

Securities with a carrying value of \$103.7 million and \$97.2 million at December 31, 2018 and 2017, respectively, were pledged to secure various deposits, securities sold under agreements to repurchase, as collateral for federal funds purchased from other financial institutions and serve as collateral for borrowings at the Federal Home Loan Bank.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses

Portfolio Segmentation:

At December 31, 2018 and 2017, loans consisted of the following (in thousands):

	December 31, 2018			December 31, 2017		
	PCI Loans	All Other Loans	Total	PCI Loans	All Other Loans	Total
Commercial real estate	\$ 17,682	\$ 842,345	\$ 860,027	\$ 17,903	\$ 625,085	\$ 642,988
Consumer real estate	8,712	398,542	407,254	7,450	286,007	293,457
Construction and land development	4,602	183,293	187,895	5,120	130,289	135,409
Commercial and industrial	2,557	305,697	308,254	858	237,229	238,087
Consumer and other	605	13,204	13,809	1,463	11,854	13,317
Total loans	34,158	1,743,081	1,777,239	32,794	1,290,464	1,323,258
Less: Allowance for loan losses	—	(8,275)	(8,275)	(16)	(5,844)	(5,860)
Loans, net	<u>\$ 34,158</u>	<u>\$1,734,806</u>	<u>\$1,768,964</u>	<u>\$ 32,778</u>	<u>\$1,284,620</u>	<u>\$1,317,398</u>

For purposes of the disclosures required pursuant to the adoption of ASC 310, the loan portfolio was disaggregated into segments. 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 five loan portfolio segments that include commercial real estate, consumer real estate, construction and land development, commercial and industrial, and consumer and other.

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

Commercial Real Estate: Commercial real estate loans include owner-occupied commercial real estate loans and loans secured by income-producing properties. Owner-occupied commercial real estate loans to operating businesses are long-term financing of land and buildings. These 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 rent income derived from the properties. Loans within this portfolio segment are particularly sensitive to the valuation of real estate.

Consumer Real Estate: Consumer real estate loans include real estate loans secured by first liens, 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. One to four 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. Loans within this portfolio segment are particularly sensitive to the valuation of real estate.

Construction and Land Development: Loans for real estate construction and 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. Loans within this portfolio segment are particularly sensitive to the valuation of real estate.

Commercial and Industrial: The commercial and industrial loan portfolio segment includes commercial, financial, and agricultural loans. These loans include those 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 loan portfolio segment includes direct consumer installment loans, overdrafts and other revolving credit loans, and educational loans. Loans in this portfolio are sensitive to unemployment and other key consumer economic measures.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management:

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 lies in each portfolio segment. For the consumer real estate and consumer and other portfolio segments, the risk management process focuses on managing customers who become delinquent in their payments. For the other portfolio segments, the risk management process focuses on underwriting new business and, on an ongoing basis, monitoring the credit of the portfolios, including a third party review of the largest credits on an annual basis or more frequently as needed. To ensure problem credits are identified on a timely basis, several specific portfolio reviews occur periodically to assess the larger adversely rated credits for proper risk rating and accrual status.

Credit quality and trends in the loan portfolio segments are measured and monitored regularly. Detailed reports, by product, collateral, accrual status, etc., are reviewed by the Senior Credit Officer and the Directors Loan Committee.

The allowance for loan losses is a valuation reserve allowance 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 and general allocations for pools of homogeneous loans with similar risk characteristics and trends.

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, consumer real estate loans, construction and land development loans, commercial and industrial loans, and consumer and other 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 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; (5) the impact of competition on loan structuring and pricing; (6) the impact of interest rate changes on portfolio risk and (7) 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 adjusted for qualitative factors and the total dollar amount of the loans in the pool.

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.

The Company's loans are generally secured by specific items of collateral including real property, consumer assets, and business assets. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on local economic conditions.

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.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (continued):

The composition of loans by loan classification for impaired and performing loan status at December 31, 2018 and 2017, is summarized in the tables below (amounts in thousands):

December 31, 2018						
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 841,709	\$ 397,306	\$ 182,746	\$ 304,673	\$ 13,088	\$ 1,739,522
Impaired loans	636	1,236	547	1,024	116	3,559
	842,345	398,542	183,293	305,697	13,204	1,743,081
PCI loans	17,682	8,712	4,602	2,557	605	34,158
Total	\$ 860,027	\$ 407,254	\$ 187,895	\$ 308,254	\$ 13,809	\$ 1,777,239

December 31, 2017						
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 624,638	\$ 284,585	\$ 129,742	\$ 237,016	\$ 11,842	\$ 1,287,823
Impaired loans	447	1,422	547	213	12	2,641
	625,085	286,007	130,289	237,229	11,854	1,290,464
PCI loans	17,903	7,450	5,120	858	1,463	32,794
Total loans	\$ 642,988	\$ 293,457	\$ 135,409	\$ 238,087	\$ 13,317	\$ 1,323,258

The following tables show the allowance for loan losses allocation by loan classification for impaired and performing loans as of December 31, 2018 and 2017 (amounts in thousands):

December 31, 2018						
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Performing loans	\$ 3,639	\$ 1,763	\$ 795	\$ 1,304	\$ 240	\$ 7,741
PCI loans	—	—	—	—	—	—
Impaired loans	—	26	—	442	66	534
Total	\$ 3,639	\$ 1,789	\$ 795	\$ 1,746	\$ 306	\$ 8,275

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued
Credit Risk Management (continued):

	December 31, 2017					Total
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	
Performing loans	\$ 2,444	\$ 1,340	\$ 521	\$ 890	\$ 204	\$ 5,399
PCI Loans	16	—	—	—	—	16
Impaired loans	5	256	—	172	12	445
Total	<u>\$ 2,465</u>	<u>\$ 1,596</u>	<u>\$ 521</u>	<u>\$ 1,062</u>	<u>\$ 216</u>	<u>\$ 5,860</u>

The following tables detail the changes in the allowance for loan losses for the year ending December 31, 2018 and December 31, 2017, by loan classification (amounts in thousands):

	December 31, 2018					Total
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	
Beginning balance	\$ 2,465	\$ 1,596	\$ 521	\$ 1,062	\$ 216	\$ 5,860
Loans charged off	(38)	(275)	—	(177)	(370)	(860)
Recoveries of loans charged off	2	100	9	72	156	339
Provision (reallocation) charged to operating expense	1,210	368	265	789	304	2,936
Ending balance	<u>\$ 3,639</u>	<u>\$ 1,789</u>	<u>\$ 795</u>	<u>\$ 1,746</u>	<u>\$ 306</u>	<u>\$ 8,275</u>

	December 31, 2017					Total
	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	
Beginning balance	\$ 2,369	\$ 1,382	\$ 717	\$ 520	\$ 117	\$ 5,105
Loans charged off	—	(111)	—	(24)	(141)	(276)
Recoveries of loans charged off	8	99	13	67	61	248
Provision (reallocation) charged to operating expense	88	226	(209)	499	179	783
Ending balance	<u>\$ 2,465</u>	<u>\$ 1,596</u>	<u>\$ 521</u>	<u>\$ 1,062</u>	<u>\$ 216</u>	<u>\$ 5,860</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (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 category involve borrowers that exhibit characteristics, or are operating under conditions that, if not successfully mitigated as planned, have a reasonable risk of resulting in a downgrade within the next six to twelve months. Loans may remain in this risk category for six months and then are either upgraded or downgraded upon subsequent evaluation.

Special Mention: 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.

Uncollectible: 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 outline the amount of each loan classification and the amount categorized into each risk rating as of December 31, 2018 and 2017 (amounts in thousands):

Non PCI Loans

December 31, 2018

	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 834,912	\$ 394,728	\$ 182,524	\$ 303,805	\$ 12,927	\$ 1,728,896
Watch	6,791	2,678	64	1,090	135	10,758
Special mention	—	14	158	137	—	309
Substandard	642	1,122	547	462	142	2,915
Doubtful	—	—	—	203	—	203
Total	<u>\$ 842,345</u>	<u>\$ 398,542</u>	<u>\$ 183,293</u>	<u>\$ 305,697</u>	<u>\$ 13,204</u>	<u>\$ 1,743,081</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Credit Risk Management (continued):

PCI Loans

December 31, 2018

	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 14,050	\$ 5,617	\$ 4,033	\$ 2,382	\$ 541	\$ 26,623
Watch	1,805	756	569	—	17	3,147
Special mention	1,030	446	—	50	10	1,536
Substandard	797	1,893	—	125	37	2,852
Doubtful	—	—	—	—	—	—
Total	\$ 17,682	\$ 8,712	\$ 4,602	\$ 2,557	\$ 605	\$ 34,158
Total loans	\$ 860,027	\$ 407,254	\$ 187,895	\$ 308,254	\$ 13,809	\$ 1,777,239

Non PCI Loans

December 31, 2017

	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 616,028	\$ 279,464	\$ 129,359	\$ 233,942	\$ 11,624	\$ 1,270,417
Watch	7,673	2,543	383	3,007	62	13,668
Special mention	1,006	2,627	—	64	155	3,852
Substandard	378	1,159	547	157	—	2,241
Doubtful	—	214	—	59	13	286
Total	\$ 625,085	\$ 286,007	\$ 130,289	\$ 237,229	\$ 11,854	\$ 1,290,464

PCI Loans

December 31, 2017

	Commercial Real Estate	Consumer Real Estate	Construction and Land Development	Commercial and Industrial	Consumer and Other	Total
Pass	\$ 14,386	\$ 4,151	\$ 4,134	\$ 68	\$ 819	\$ 23,558
Watch	261	1,345	649	120	262	2,637
Special mention	—	456	—	58	24	538
Substandard	3,084	1,192	337	588	107	5,308
Doubtful	172	306	—	24	251	753
Total	\$ 17,903	\$ 7,450	\$ 5,120	\$ 858	\$ 1,463	\$ 32,794
Total loans	\$ 642,988	\$ 293,457	\$ 135,409	\$ 238,087	\$ 13,317	\$ 1,323,258

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Past Due Loans:

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 a loan on nonaccrual 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, 2018 and 2017 (amounts in thousands):

	December 31, 2018							
	30-59 Days Past Due and Accruing	60-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	PCI Loans	Current Loans	Total Loans
Commercial real estate	\$ 377	\$ 19	\$ —	\$ 272	\$ 668	\$ 17,682	\$ 841,677	\$ 860,027
Consumer real estate	1,168	462	454	844	2,928	8,712	395,614	407,254
Construction and land development	343	—	—	547	890	4,602	182,403	187,895
Commercial and industrial	155	—	101	909	1,165	2,557	304,532	308,254
Consumer and other	117	—	29	124	270	605	12,934	13,809
Total	<u>\$ 2,160</u>	<u>\$ 481</u>	<u>\$ 584</u>	<u>\$ 2,696</u>	<u>\$ 5,921</u>	<u>\$ 34,158</u>	<u>\$ 1,737,160</u>	<u>\$ 1,777,239</u>

	December 31, 2017							
	30-59 Days Past Due and Accruing	60-89 Days Past Due and Accruing	Past Due 90 Days or More and Accruing	Nonaccrual	Total Past Due	PCI Loans	Current Loans	Total Loans
Commercial real estate	\$ 517	\$ —	\$ 728	\$ 128	\$ 1,373	\$ 17,903	\$ 623,712	\$ 642,988
Consumer real estate	769	194	33	991	1,987	7,450	284,020	293,457
Construction and land development	65	—	326	547	938	5,120	129,351	135,409
Commercial and industrial	86	200	131	85	502	858	236,727	238,087
Consumer and other	109	56	291	13	469	1,463	11,385	13,317
Total	<u>\$ 1,546</u>	<u>\$ 450</u>	<u>\$ 1,509</u>	<u>\$ 1,764</u>	<u>\$ 5,269</u>	<u>\$ 32,794</u>	<u>\$ 1,285,195</u>	<u>\$ 1,323,258</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Impaired Loans:

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.

The following is an analysis of the impaired loan portfolio detailing the related allowance recorded as of and for the years ended December 31, 2018 and 2017 (amounts in thousands):

	At December 31, 2018			For the year ended December 31, 2018	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Non PCI Loans:					
Commercial real estate	\$ 636	\$ 648	\$ —	\$ 855	\$ 33
Consumer real estate	1,073	1,089	—	934	29
Construction and land development	547	547	—	547	—
Commercial and industrial	69	70	—	69	6
Consumer and other	29	33	—	15	3
	<u>2,354</u>	<u>2,387</u>	<u>—</u>	<u>2,420</u>	<u>71</u>
PCI loans: None in 2018					
Impaired loans with a valuation allowance:					
Non PCI Loans:					
Commercial real estate	—	—	—	—	—
Consumer real estate	163	205	26	365	—
Construction and land development	—	—	—	—	—
Commercial and industrial	955	973	442	476	37
Consumer and other	87	87	66	86	3
	<u>1,205</u>	<u>1,265</u>	<u>534</u>	<u>927</u>	<u>40</u>
PCI loans:					
Commercial real estate	—	—	—	11	—
	<u>—</u>	<u>—</u>	<u>—</u>	<u>11</u>	<u>—</u>
Total impaired loans	<u>\$ 3,559</u>	<u>\$ 3,652</u>	<u>\$ 534</u>	<u>\$ 3,358</u>	<u>\$ 111</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Impaired Loans (continued):

	At December 31, 2017			For the year ended December 31, 2017	
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
Impaired loans without a valuation allowance:					
Non PCI Loans:					
Commercial real estate	\$ 424	\$ 454	\$ —	\$ 204	\$ 44
Consumer real estate	415	420	—	401	16
Construction and land development	547	547	—	628	—
Commercial and industrial	41	41	—	44	3
Consumer and other	—	—	—	—	—
	<u>1,427</u>	<u>1,462</u>	<u>—</u>	<u>1,277</u>	<u>63</u>
PCI loans: None in 2017					
Impaired loans with a valuation allowance:					
Non PCI Loans:					
Commercial real estate	23	23	5	5	1
Consumer real estate	1,007	1,033	256	601	38
Construction and land development	—	—	—	—	—
Commercial and industrial	172	172	172	117	10
Consumer and other	12	13	12	2	1
	<u>1,214</u>	<u>1,241</u>	<u>445</u>	<u>725</u>	<u>50</u>
PCI loans:					
Commercial real estate	16	123	16	3	16
Total impaired loans	<u>\$ 2,657</u>	<u>\$ 2,826</u>	<u>\$ 461</u>	<u>\$ 2,005</u>	<u>\$ 129</u>

Troubled Debt Restructurings:

At December 31, 2018 and 2017, 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.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Troubled Debt Restructurings (continued):

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, 2018 and 2017, management had approximately \$116 thousand and \$41 thousand, respectively, in loans that met the criteria for restructured. No restructured loans were on nonaccrual as of December 31, 2018 and 2017. A loan is placed back on accrual status when both principal and interest are current and it is probable that management will be able to collect all amounts due (both principal and interest) according to the terms of the loan agreement.

The following table presents a summary of loans that were modified as troubled debt restructurings during the year ended December 31, 2018 (amounts in thousands):

December 31, 2018	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	1	\$ 62	\$ 62
Commercial and industrial	1	18	18

There were no loans modified as troubled debt restructurings during the year ended December 31, 2017.

There were no loans that were modified as troubled debt restructurings during the past twelve months and for which there was a subsequent payment default.

Purchased Credit Impaired Loans:

The Company has acquired loans which there was, at acquisition, evidence of deterioration of credit quality since origination and it was probable, at acquisition, that all contractually required payments would not be collected. The carrying amount of those loans at for the years ended December 31, 2018 and 2017 is as follows (in thousands):

	2018	2017
Commercial real estate	\$ 24,849	\$ 23,366
Consumer real estate	11,108	10,764
Construction and land development	5,731	6,285
Commercial and industrial	5,824	1,452
Consumer and other	892	1,710
Total loans	\$ 48,404	\$ 43,577
Less remaining purchase discount	(14,246)	(10,783)
Total, gross	34,158	32,794
Less: Allowance for loan losses	—	(16)
Carrying amount, net of allowance	\$ 34,158	\$ 32,778

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued*Purchased Credit Impaired Loans (continued):*

The following is a summary of the accretible discount on acquired loans for the years ended December 31, 2018 and 2017 (in thousands):

	2018	2017
Accretible yield, beginning of period	\$ 9,287	\$ 8,950
Additions	2,416	2,581
Accretion income	(5,368)	(4,217)
Reclassification from nonaccretible	1,494	926
Other changes, net	(777)	1,047
Accretible yield, end of period	<u>\$ 7,052</u>	<u>\$ 9,287</u>

The Company increased the allowance for loan losses on purchase credit impaired loans in the amount of approximately \$16 thousand during the year ended December 31, 2017. There were no allowance for loan losses on purchase credit impaired loans at the year ended December 31, 2018.

Purchased credit impaired loans acquired from TN Bancshares during the year ended December 31, 2018 for which it was probable at acquisition that all contractually required payments would not be collected are as follows (in thousands):

	2018
Contractual principal and interest at acquisition	\$ 15,133
Nonaccretible difference	5,302
Expected cash flows at acquisition	9,831
Accretible yield	1,292
Basis in PCI loans at acquisition-estimated fair value	<u>\$ 8,539</u>

Purchased credit impaired loans acquired from Foothills Bancorp during the year ended December 31, 2018 for which it was probable at acquisition that all contractually required payments would not be collected are as follows (in thousands):

	2018
Contractual principal and interest at acquisition	\$ 12,125
Nonaccretible difference	2,748
Expected cash flows at acquisition	9,377
Accretible yield	1,124
Basis in PCI loans at acquisition-estimated fair value	<u>\$ 8,253</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 4. Loans and Allowance for Loan Losses, Continued

Related Party Loans:

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. A summary of activity in loans to related parties is as follows (in thousands):

	2018	2017
Balance, beginning of year	\$ 18,330	\$ 12,999
Disbursements	34,639	14,533
Repayments	(21,723)	(9,202)
Balance, end of year	<u>\$ 31,246</u>	<u>\$ 18,330</u>

At December 31, 2018, the Company had pre-approved but unused lines of credit totaling approximately \$4.5 million to related parties.

Note 5. Premises and Equipment

A summary of premises and equipment at December 31, 2018 and 2017, is as follows (in thousands):

	2018	2017
Land and land improvements	\$ 14,712	\$ 10,854
Building and leasehold improvements	36,640	28,576
Furniture, fixtures and equipment	12,318	10,073
Construction in progress	2,875	1,495
Total, gross	66,545	50,998
Accumulated depreciation	(10,533)	(7,998)
Total, net	<u>\$ 56,012</u>	<u>\$ 43,000</u>

At December 31, 2018 management estimates the cost necessary to complete the construction in progress will be approximately \$542 thousand.

The Company leases several branch locations and also has two ground leases under non-cancelable operating lease agreements. The leases expire between May 2019 and May 2033. Lease expense under the leases was \$795 thousand and \$722 thousand in 2018 and 2017, respectively. At December 31, 2018, the remaining minimum lease payments relating to these leases were as follows (in thousands):

2019	\$ 644
2020	622
2021	462
2022	259
2023	121
Thereafter	864
Total	<u>\$ 2,972</u>

Depreciation expense was \$2.6 million and \$1.8 million for the years ended December 31, 2018 and 2017, respectively.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 6. Deposits

The aggregate amount of time deposits in denominations of \$250,000 or more was approximately \$165.1 million and \$171.3 million at December 31, 2018 and 2017, respectively. At December 31, 2018, the scheduled maturities of time deposits are as follows (in thousands):

2019	\$	449,948
2020		120,376
2021		28,094
2022		20,446
2023		29,053
Thereafter		—
Total	\$	647,917

As of December 31, 2018 and 2017, there was a fair value adjustment of \$759.1 thousand and \$1.1 million, respectively, to time deposits as a result of business combinations.

At December 31, 2018 and 2017, the Company had \$747 thousand and \$155 thousand, respectively, of deposit accounts in overdraft status that have been reclassified to loans on the accompanying consolidated balance sheets. From time to time, the Company engages in deposit transactions with its directors, executive officers and their related interests (collectively referred to as "related parties"). Such deposits are made in the ordinary course of business and on substantially the same terms as those for comparable transactions prevailing at the time and do not present other unfavorable features. The total amount of related party deposits was \$24.3 million and \$16.7 million at December 31, 2018 and 2017, respectively.

Note 7. Goodwill and Intangible Assets

Goodwill and intangible assets:

Past business combinations have created \$66.1 million in goodwill for the Company. Finite lived intangible assets of the Company represent a core deposit premium recorded upon the purchase of certain assets and liabilities from other financial institutions.

The following table presents information about our core deposit premium intangible asset at December 31 (in thousands):

	2018		2017	
	Gross Carrying Amount	Accumulated Amortization	Gross Carrying Amount	Accumulated Amortization
Amortized intangible asset:				
Core deposit intangible	\$ 14,549	\$ 1,602	\$ 8,589	\$ 626

The following table presents information about aggregate amortization expense for 2018 and 2017 and for the succeeding fiscal years as follows (in thousands):

	2018	2017
Aggregate amortization expense of core deposit premium intangible	\$ 976	\$ 346

Note 7. Goodwill and Intangible Assets, Continued

Goodwill and intangible assets (continued):

Estimated aggregate amortization expense of the core deposit premium intangible for the year ending December 31 (in thousands):

2019	\$ 1,368
2020	1,351
2021	1,334
2022	1,317
2023	1,301
Thereafter	6,276
Total	\$ 12,947

Note 8. Income Taxes

Income tax expense in the consolidated statements of income for the years ended December 31, 2018 and 2017, includes the following (in thousands):

	<u>2018</u>	<u>2017</u>
Current tax expense		
Federal	\$ 661	\$ 1,962
State	141	428
Deferred tax expense (benefit) related to:		
Federal	1,992	1,441
State	439	158
Change in tax rate	—	2,440
Total income tax expense	\$ 3,233	\$ 6,429

The income tax expense is different from the expected tax expense computed by multiplying income before income tax expense by the statutory income tax rate of 21 percent in 2018 and 34 percent in 2017. The reasons for this difference are as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Federal income tax expense computed at the statutory rate	\$ 4,481	\$ 3,891
State income taxes, net of federal tax benefit	551	491
Nondeductible acquisition expenses	138	364
Tax benefit from stock options	(1,786)	—
Change in tax rate	—	2,440
Other	(151)	(757)
Total income tax expense	\$ 3,233	\$ 6,429

During 2018, the Company identified an error in the computation and disclosure of deferred taxes for 2017. The error resulted from exclusion of a tax benefit from non-qualified options exercised in 2017. The Company has elected to correct the error in its current year financial statements which reduced tax provision by approximately \$1.6 million for the year ended December 31, 2018.

Note 8. Income Taxes, Continued

The components of the net deferred tax asset as of December 31, 2018 and 2017, were as follows (in thousands):

	<u>2018</u>	<u>2017</u>
Deferred tax assets:		
Allowance for loan losses	\$ 2,172	\$ 1,561
Fair value adjustments	6,086	4,829
Unrealized losses on investment securities	659	424
Unrealized losses on hedges	280	—
Foreclosed real estate	271	301
Deferred compensation	833	849
Federal net operating loss carryforward	350	—
Other	440	849
Total deferred tax assets	<u>11,091</u>	<u>8,813</u>
Deferred tax liabilities:		
Accumulated depreciation	1,875	1,194
Core deposit intangible	3,332	1,945
Other	286	223
Total deferred tax liabilities	<u>5,493</u>	<u>3,362</u>
Net deferred tax asset	<u>\$ 5,598</u>	<u>\$ 5,451</u>

The Company has a Federal net operating loss carryforward of \$1.7 million acquired with the acquisition of Foothills Bancorp. This federal net operating loss does not expire. The income tax returns of the Company for 2017, 2016, and 2015 are subject to examination by the federal and state taxing authorities, generally for three years after they were filed.

Note 9. Federal Home Loan Bank Advances and Other Borrowings

Line of Credit:

On October 31, 2017, the Company entered into a loan agreement (the “Loan Agreement”) with CapStar Bank (the “Lender”) providing for a revolving line of credit of up to \$15 million. The Company may borrow and reborrow under the revolving line of credit until the line of credit termination date of January 15, 2019, after which no advances under the revolving line of credit may be reborrowed. The balance of the line on January 15, 2019 when it converted to a term loan was \$0 and there may be no further borrowings. The term loan commencement date would have begun on January 16, 2019. Line of Credit borrowings and the term loan will accrue interest at the Lender’s prime rate minus 0.25 percent, subject to a 3.50 percent floor.

Beginning 90 days after the effective date of the revolving line of credit, the Company is required to pay quarterly payments of interest. In addition, commencing on January 15, 2019, the Company must pay quarterly principal amortization payments of \$262.5 thousand for each fiscal quarter in 2019, \$287.5 thousand for each fiscal quarter in 2020, \$312.5 thousand for each fiscal quarter in 2021 and \$337.5 thousand for each fiscal quarter in 2022 until and including the maturity date. The scheduled principal amortization payments are based upon the assumption that the revolving line of credit is fully drawn, and the required payments will be reduced on a pro-rata basis relative to the amount borrowed if the revolving line of credit is not fully drawn. The loan will mature on October 15, 2022, at which time all outstanding amounts under the loan agreement will become due and payable. In connection with entering into the Loan Agreement, the Company issued to the Lender a line of credit note dated as of October 31, 2017.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 9. Federal Home Loan Bank Advances and Other Borrowings, Continued

Line of Credit (continued):

The Loan Agreement contains typical representations, warranties and covenants for a revolving line of credit, and the loan agreement has certain financial covenants and capital ratio requirements. Pursuant to the Loan Agreement, the Bank may not permit non-performing assets to be greater than 3.25 percent of total assets. The Bank must not permit its Texas ratio (nonperforming assets divided by the sum of tangible equity plus the allowance for loan and lease losses) to be greater than 35.00 percent, and must not permit its liquidity ratio to be less than 9.00 percent (or less than 10.00 percent for two consecutive quarters). The Bank shall not permit, at the end of each quarter, its returns on average assets to be less than 0.45 percent from December 31, 2017 through and including September 30, 2018 and 0.50 percent at December 31, 2018 and thereafter. The Bank shall not permit the debt service coverage ratio, as of June 30 and December 31 of each fiscal year, commencing on December 31, 2017, to be less than 1.25:1.00.

The regulatory covenant states the Company will be "well capitalized," or such other successor term with a similar meaning, for all applicable state and federal regulatory purposes at all times, and will not be subject to any written agreement, order, capital directive or prompt corrective action directive by any Governmental Authority having regulatory authority over the Company, except where such order, capital directive or prompt corrective action directive does not result in, nor could reasonably be expected to result in, a Material Adverse Effect, or if required by any Governmental Authority having regulatory authority over the Borrower in order to remain "well capitalized" and in compliance with all applicable regulatory requirements, will have such higher amounts of Total Risk-based Capital and Tier 1 Risk-based Capital and/or such greater Tier 1 Leverage Ratio as specified by such Governmental Authority. Each Financial Institution Subsidiary of the Company will be "well capitalized," or such other successor term with a similar meaning, for all applicable state and federal regulatory purposes at all times, and such Financial Institution Subsidiary (i) will have a Total Risk-based Capital Ratio of 10.50 percent or greater, a Tier 1 Risk based Capital Ratio of 9.50 percent or greater, and a Tier 1 Leverage Ratio of 8.00 percent or greater (each as defined by applicable federal and state regulations or orders) and not be subject to any written agreement, order, capital directive or prompt corrective action directive by any Governmental Authority having regulatory authority over such Financial Institution Subsidiary, except where such order, capital directive or prompt corrective action directive does not result in, nor could reasonably be expected to result in, a Material Adverse Effect, or (ii) if required by any Governmental Authority having regulatory authority over such Financial Institution Subsidiary in order to remain "well capitalized" and in compliance with all applicable regulatory requirements, will have such higher amounts of Total Risk-based Capital and Tier 1 Risk-based Capital and/or such greater Tier 1 Leverage Ratio as specified by such Governmental Authority. Notwithstanding the foregoing, if at any time any such Governmental Authority changes the definition of "well capitalized" either by amending such ratios or otherwise, such amended definition, and any such amended or new ratios, shall automatically, and in lieu of the existing definitions and ratios set forth in this Section, be incorporated by reference into this Agreement as the minimum standard for the Company or any Financial Institution Subsidiary, as the case may be, on and as of the date that any such amendment becomes effective by applicable statute, regulation, order or otherwise.

The interest coverage ratio covenant states the Company shall not permit, as of June 30 and December 31 of each fiscal year, commencing December 31, 2017, its interest coverage ratio to be less than 2.50:1.00.

As of December 31, 2018, the Company and the Bank were in compliance with all of the loan covenants. As of December 31, 2017, the Company and the Bank were in compliance with all loan covenants except for the return on assets. The return on assets covenant was not met due to the tax law enacted in December 2017 which caused the Company to write down the deferred tax asset to the new tax rate. Capstar waived the covenant for December 2017 since the non-compliance was due to the tax law change and not caused by operations of the Company or Bank.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 9. Federal Home Loan Bank Advances and Other Borrowings, Continued

Line of Credit (continued):

The Loan Agreement has standard and commercially reasonable events of default, such as non-payment, failure to perform any covenant or agreement, breach of any representation or warranty, failure to pay other material indebtedness, bankruptcy, insolvency, any ERISA event, any material judgment, any material adverse effect, any change in control, any failure to be insured by the FDIC or any action by a governmental or regulatory authority, etc. The Lender has the right to accelerate the indebtedness upon an event of default.

The obligations of the Company under the Loan Agreement are secured by a pledge of all of the capital stock of the Bank pursuant to stock pledge and security agreements. In the event of a default by the Company under the loan Agreement, the lender may terminate the commitments made under the loan agreement, declare all amounts outstanding to be payable immediately, and exercise or pursue any other remedy permitted under the loan agreement or the pledge agreements, or conferred to the lender by operation of law.

As of December 31, 2017, the outstanding borrowings under the line of credit were \$10 million and the rate was 4.25 percent. The Loan Agreement was paid in full on September 28, 2018 and no borrowings were outstanding as of December 31, 2018.

The primary source of liquidity for the Company is the payment of dividends from the Bank. As of December 31, 2018 and 2017, the Bank was under no dividend restrictions that requires regulatory approval prior to the payment of a dividend from the Bank to the Company.

FHLB borrowings:

The Bank has agreements with the Federal Home Loan Bank of Cincinnati (FHLB) that can provide advances to the Bank in an amount up to \$59.4 million. All of the loans are secured by first mortgages on 1-4 family residential, multi-family properties and commercial properties and are pledged as collateral for these advances. Additionally, the Bank pledged securities to FHLB with a carrying amount of \$16.3 million at December 31, 2017. There were no securities pledged to FHLB at December 31, 2018.

At December 31, 2018 and 2017, there were no advances from the FHLB.

Borrowings:

On May 1, 2018, the Company entered into a loan agreement with Waters & Waters, LLC in the amount of \$500 thousand at a rate of 4.75 percent with semi-annual payments of principal plus accrued interest over an amortization period of ten years. The outstanding principal balance and accrued interest will be due and payable on April 30, 2028.

Scheduled maturities:

At December 31, 2018, scheduled maturities of the federal funds purchased of \$10.8 million, and other borrowings of \$480.3 thousand are as follows (amounts in thousands):

2019	\$	10,803
2020		43
2021		45
2022		47
2023		50
Thereafter		254
Total	\$	<u>11,242</u>

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 10. Subordinated debt

On September 28, 2018, the Company completed an offering of \$40 million in aggregate principal amount of fixed-to-floating rate subordinated notes due 2028 (the "Notes") to certain institutional accredited investors. The Company used the net proceeds of the offering to repay the outstanding balance on the Company's existing revolving line of credit to Capstar Bank in the amount of \$15 million. The additional proceeds were used to pay the cash consideration to holders of Foothills Bancorp, Inc. common stock and holders of options to purchase Foothills Bancorp, Inc. common stock in connection with the Company's acquisition of Foothills Bancorp, Inc., and for other general corporate purposes, including improving the Company's and the Bank's liquidity position. As a result \$12 million was downstreamed to the Bank.

The Notes initially bears interest at a rate of 5.625 percent per annum from and including September 28, 2018, to but excluding October 2, 2023, with interest during this period payable semi-annually in arrears. From and including October 2, 2023, to but excluding the maturity date or early redemption date, the interest rate will reset quarterly to an annual floating rate equal to three-month LIBOR, or an alternative rate determined in accordance with the terms of the Notes if three-month LIBOR cannot be determined, plus 255 basis points, with interest during this period payable quarterly in arrears. The Notes are redeemable by the Company, in whole or in part, on or after October 2, 2023, and at any time, in whole but not in part, upon the occurrence of certain events. The Notes have been structured to qualify initially as Tier 2 capital for the Company for regulatory capital purposes.

The Notes debt issuance costs totaled \$842 thousand and will be amortized through the Notes' maturity date. Amortization expense totaled \$19 thousand during the twelve month period December 31, 2018.

As of December 31, 2018, the principal balance was \$40 million and debt issuance cost balance was \$823 thousand.

Note 11. Employee Benefit Plans

401(k) Plan:

The Company provides a deferred salary reduction plan ("Plan") under Section 401 (k) of the Internal Revenue Code covering substantially all employees. After one year of service the Company matches 100 percent of employee contributions up to 3 percent of compensation and 50 percent of employee contributions on the next 2 percent of compensation. The Company's contribution to the Plan was \$715,698 in 2018 and \$427,975 in 2017.

Stock Option Plans:

The Company has one currently active equity incentive plan administered by the Board of Directors, the 2015 Stock Incentive plan, and four plans or programs, pursuant to which the Company has outstanding prior grants. These plans are described below:

Legacy Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan – The plan provided Cornerstone Bancshares, Inc. officers and employees incentive stock options or non-qualified stock options to purchase shares of common stock. The exercise price for incentive stock options was not less than 100 percent of the fair market value of the common stock on the date of the grant. The exercise price of the non-qualified stock options was equal to or more or less than the fair market value of the common stock on the date of the grant. This plan expired in 2012.

Legacy Cornerstone Non-Qualified Plan Options — During 2013 and 2014, Cornerstone issued non-qualified options to employees and directors. The options were originally documented in 2013 as being issued out of the Cornerstone Bancshares, Inc. 2002 Long Term Incentive Plan but that plan expired in 2012. The non-qualified options are governed by the grant document issued to the holders which incorporate the terms of the plan by reference.

2015 Stock Incentive Plan – This plan provides for incentive stock options, nonqualified stock options, and restricted stock. The maximum number of shares of common stock that can be sold or optioned under the plan is 2,000,000 shares. The term of each option shall be no more than ten years from the date of grant. In the case of an incentive stock option granted to a participant who, at the time the option is granted, owns stock representing more than ten percent of the voting power of all classes of stock of the Company or any parent or subsidiary thereof, the term of the option shall be five years from the date of grant or such shorter term as may be provided in the award agreement.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 11. Employee Benefit Plans, Continued

Stock Option Plans (continued):

The per share exercise price for the shares to be issued upon exercise of an option shall be such price as is determined by the plan administrator, subject to the following: In the case of an incentive stock option: (1) granted to an employee who, at the time of grant of such option, owns stock representing more than ten percent of the voting power of all classes of stock of the company or any parent or subsidiary thereof, the exercise price shall be no less than one hundred and ten percent of the fair market value per share on the date of grant; or (2) granted to any other employee, the per share exercise price shall be no less than one hundred percent of the fair market value per share on the date of grant. In the case of a nonstatutory stock option, the per share exercise price shall be no less than one hundred percent of the fair market value per share on the date of grant, unless otherwise determined by the Administrator.

The incentive stock options vest 30 percent on the second anniversary of the grant date, 30 percent on the third anniversary of the grant date and 40 percent on the fourth anniversary of the grant date. Director non-qualified stock options vest 50 percent on the first anniversary of the grant date and 50 percent on the second anniversary of the grant date.

Legacy Capstone Stock Option Plan - This plan was assumed by the Company on November 3, 2017 and subsequently closed. The plan provided for incentive stock options and nonqualified stock options. Under the plan, the exercise price of each option could not be less than 100 percent of the fair market value of the common stock on the date of grant.

A summary of the status of these stock option plans is presented in the following table:

	Number	Weighted Average Exercisable Price
Outstanding at December 31, 2017	316,574	\$ 11.82
Granted	—	—
Exercised	(132,783)	11.39
Forfeited	(13,166)	31.96
Outstanding at December 31, 2018	<u>170,625</u>	<u>\$ 10.61</u>
	Number	Weighted Average Exercisable Price
Outstanding at December 31, 2016	717,524	\$ 10.57
Granted	—	—
Exercised	(506,923)	9.64
Forfeited	(24,496)	19.90
Capstone options assumed in business combination	130,469	11.76
Outstanding at December 31, 2017	<u>316,574</u>	<u>\$ 11.82</u>

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
December 31, 2018 and 2017

Note 11. Employee Benefit Plans, Continued

Stock Option Plans (continued):

Information pertaining to options outstanding at December 31, 2018, is as follows:

Exercise Prices	Options Outstanding			Options Exercisable		
	Number Outstanding	Weighted-Average Remaining Contractual Life	Weighted-Average Exercise Price	Number Exercisable	Weighted-Average Exercise Price	
6.60	30,000	3.2 years	6.60	30,000	6.60	
6.80	14,250	2.2 years	6.80	14,250	6.80	
9.48	25,625	4.2 years	9.48	25,625	9.48	
9.60	35,125	5.2 years	9.60	35,125	9.60	
11.76	13,599	2.4 years	11.76	13,599	11.76	
14.40	11,792	0.2 years	14.40	11,792	14.40	
15.05	40,234	6.8 years	15.05	26,827	15.05	
Outstanding, end of year	<u>170,625</u>	4.2 years	10.61	<u>157,218</u>	10.23	

The Company recognized stock option compensation expense of \$133,884 and \$97,966 for the periods ended December 31, 2018 and 2017, respectively. Stock appreciation rights compensation expense of \$33,916 and \$21,829 was recognized for the period ended December 31, 2018 and 2017, respectively. Direct stock grant expense issued to local advisory board members of \$9,062 and \$31,791 was included in salary and benefit expense for the period ended December 31, 2018 and 2017, respectively. The total fair value of shares underlying the options which vested during the periods ended December 31, 2018 and 2017, was \$243,831 and \$313,977, respectively. The income tax benefit recognized for the exercise of options for the periods ended December 31, 2018 and 2017 was \$318,826 and \$1,331,689 respectively.

The intrinsic value of options exercised during the periods ended December 31, 2018 and 2017 was \$1,523,014 and \$5,468,780, respectively. The aggregate intrinsic value of total options outstanding and exercisable options at December 31, 2018 was \$1,307,043 and \$1,263,872, respectively. Cash received from options exercised under all share-based payment arrangements for the period ended December 31, 2018 was \$1,519,244.

Information related to non-vested options for the period ended December 31, 2018, is as follows:

	Number	Weighted Average Grant-Date Fair Value
Nonvested at December 31, 2017	23,455	\$ 12.31
Granted	—	—
Vested	(13,346)	15.05
Forfeited/expired	3,298	15.05
Nonvested at December 31, 2018	<u>13,407</u>	<u>\$ 15.05</u>

As of December 31, 2018, there was approximately \$124,450 of total unrecognized compensation cost related to nonvested stock-based compensation arrangements granted under the Plans. The cost is expected to be recognized over a weighted-average period of 1.0 year. There were no stock options granted during the twelve months period ended December 31, 2018 and December 31, 2017.

SmartFinancial, Inc. and Subsidiary
Notes to Consolidated Financial Statements
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Note 11. Employee Benefit Plans, Continued

Restricted Stock Awards:

On August 4, 2017, the Board of Directors of the Company made grants of 27,500 shares of restricted stock under the Company's 2015 Stock Incentive Plan to certain executives of the Company. The restricted shares of stock, which are subject to the terms of a Restricted Stock Grant Agreement between the Company and each recipient, will fully vest on the fifth anniversary of the grant date. Prior to vesting, the recipient will be entitled to vote the shares and receive dividends, if any, declared by the Company with respect to its common stock. Compensation expense for restricted stock is based on the fair value of the restricted stock awards at the time of the grant, which is equal to the market value of the Company's common stock on the date of grant. The value of the restricted stock grants that are expected to vest is amortized monthly into compensation expense over the five year vesting period. The restricted shares had a fair value of \$24.58 per share on the date of issuance.

On January 25, 2018, the Board of Directors of the Company made grants of 7,553 shares of restricted stock under the Company's 2015 Stock Incentive Plan to certain executives and directors of the Company. Restricted shares of stock are subject to the terms of a Restricted Stock Grant Agreement between the Company and each recipient. Two thousand (2000) shares will fully vest on the fifth anniversary of the grant date, 4627 shares vested within six months, and 926 shares vested upon two directors' retirement. Prior to vesting, the recipient will be entitled to vote the shares and receive dividends, if any, declared by the Company with respect to its common stock. Compensation expense for restricted stock is based on the fair value of the restricted stock awards at the time of the grant, which is equal to the market value of the Company's common stock on the date of grant. The value of the restricted stock grants that are expected to vest is amortized monthly into compensation expense over the five year and six month vesting periods. The restricted shares had a fair value of \$21.61 per share on the date of issuance.

For the period ended December 31, 2018 and 2017, compensation expense of \$263,013 and \$56,330, respectively, was recognized related to restricted stock awards. As of December 31, 2018, there was \$519,727 of unrecognized compensation cost related to non-vested restricted stock awards granted under the plan.

The following table summarizes activity relating to non-vested restricted stock awards:

	Number
Nonvested at December 31, 2017	27,500
Granted	7,553
Vested	(5,553)
Forfeited/expired	—
Nonvested at December 31, 2018	<u>29,500</u>

Note 12. Securities Sold Under Agreements to Repurchase

Securities sold under repurchase agreements, which are secured borrowings, generally mature within one to four days from the transaction date. Securities sold under repurchase agreements are reflected at the amount of cash received in connection with the transaction. The Company may be required to provide additional collateral based on the fair value of the underlying securities. The Company monitors the fair value of the underlying securities on a daily basis.

At December 31, 2018 and 2017, the Company had securities sold under agreements to repurchase of \$11.8 million and \$24.1 million, respectively, with commercial checking customers which were secured by \$11.8 million and \$24.1 million of agency and of mortgage-backed securities, respectively.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 13. 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 and depository 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 are variable rate instruments while the standby letters of credit are primarily fixed 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 total contractual amount for all off-balance sheet commitments at December 31, 2018 is as follows:

Commitments to extend credit	\$	333.9 million
Standby letters of credit		12.2 million

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.

Standby letters of credit issued by the Company are conditional commitments 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, 2018 and 2017, 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 standby letters of credit for the years ended December 31, 2018 and 2017.

Contingencies:

In the normal course of business, the Company may become 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.

Note 14. Regulatory Matters

Regulatory Capital Requirements:

The Company and the Bank are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities, and certain off-balance-sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing Basel Committee on Banking Supervision's capital guidelines for U.S. banks (Basel III rules) became effective for the Company on January 1, 2015, with full compliance with all of the requirements being phased in over a multi-year schedule, and fully phased in by January 1, 2019. Under Basel III rules, the Company must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer is being phased in at the rate of 0.625 percent per year from 0.0 percent in 2015 to 2.50 percent on January 1, 2019. The capital conservation buffer for 2017 is 1.25 percent and for 2018 is 1.875 percent. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes as of December 31, 2018, the Company and Bank meet all capital adequacy requirements to which they are subject.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 14. Regulatory Matters, Continued

Regulatory Capital Requirements (continued):

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At year end 2018 and 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category. Management currently believes, based on internal capital analysis and earnings projections, the Bank's capital position is adequate to meet current and future regulatory minimum capital requirements.

Regulatory Restrictions on Dividends:

Pursuant to Tennessee banking law, the Bank may not, without the prior consent of the Commissioner of the Tennessee Department of Financial Institutions (TDFI), pay any dividends to the Company in a calendar year in excess of the total of the Bank's retained net income for that year plus the retained net income for the preceding two years. During the year ended December 31, 2018, SmartBank paid no dividends to the Company. As of December 31, 2018, the Bank could pay approximately \$33.4 million of additional dividends to the Company without prior approval of the Commissioner of the TDFI.

Regulatory Capital Levels:

Actual and required capital levels at December 31, 2018 and 2017 are presented below (dollars in thousands):
are

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized under prompt corrective action provisions (1)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2018						
SmartFinancial, Inc. (2)						
SmartBank						
Total Capital (to Risk-Weighted Assets)	\$ 243,774	12.74%	\$ 153,017	8.00%	\$ 191,271	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	235,499	12.31%	114,763	6.00%	153,017	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	235,499	12.31%	86,072	4.50%	124,326	6.50%
Tier 1 Capital (to Average Assets)	235,499	11.17%	84,300	4.00%	105,375	5.00%

(1) The prompt corrective action provisions are applicable at the Bank level only.

(2) Reporting regulations were revised during 2018 the capital ratios reported for SmartFinancial Inc. at December 31, 2017 were not required to be reported at December 31, 2018.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 14. Regulatory Matters, Continued

Regulatory Capital Levels (continued):

	Actual		Minimum for capital adequacy purposes		Minimum to be well capitalized under prompt corrective action provisions (1)	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2017						
SmartFinancial, Inc.						
Total Capital (to Risk-Weighted Assets)	\$ 163,683	10.98%	\$ 119,257	8.00%		
Tier 1 Capital (to Risk-Weighted Assets)	157,823	10.59%	89,442	6.00%		
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	157,823	10.59%	67,082	4.50%		
Tier 1 Capital (to Average Assets)	157,823	10.78%	58,562	4.00%		
SmartBank						
Total Capital (to Risk-Weighted Assets)	\$ 168,148	11.29%	\$ 119,111	8.00%	\$ 148,889	10.00%
Tier 1 Capital (to Risk-Weighted Assets)	162,288	10.90%	89,333	6.00%	119,111	8.00%
Common Equity Tier 1 Capital (to Risk-Weighted Assets)	162,288	10.90%	67,000	4.50%	96,778	6.50%
Tier 1 Capital (to Average Assets)	162,288	11.26%	57,656	4.00%	72,070	5.00%

(1) The prompt corrective action provisions are applicable at the Bank level only.

Note 15. Concentrations of Credit Risk

The Company originates primarily commercial, residential, and consumer loans to customers in Tennessee, Florida, Georgia and Alabama. The ability of the majority of the Company's customers to honor their contractual loan obligations is dependent on the economy in these areas.

Eighty-two percent 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 areas. Commercial real estate, including commercial construction loans, represented 55 percent of the loan portfolio at December 31, 2018, and 56 percent of the loan portfolio at December 31, 2017. 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 areas. The other concentrations of credit by type of loan are set forth in Note 4.

The Bank, as a matter of policy, does not generally extend credit to any single borrower or group of related borrowers in excess of 25 percent of statutory capital, or approximately \$77.8 million.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities

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” ASC Topic 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. 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.

ASC Topic 820 provides a consistent definition of fair value, which focuses on exit price in an orderly transaction 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 I 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.

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 disclosures for financial instruments:

Cash and Cash Equivalents: For cash and due from banks, interest-bearing deposits, and federal funds sold, the carrying amount is a reasonable estimate of fair value based on the short-term nature of the assets and are considered Level 1 inputs.

Securities Available-for-Sale: Where quoted prices are available in an active market, management classifies the securities within Level 1 of the valuation hierarchy. If quoted market prices are not available, management estimates fair values using pricing models that use observable inputs or quoted prices at securities with similar characteristics. Examples of such instruments, which would generally be classified within Level 2 of the valuation hierarchy, including GSE obligations, corporate bonds, 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.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities, Continued

Fair Value Hierarchy (continued):

Restricted Investments: It is not practicable to determine the fair value of restricted investments due the restrictions placed on its transferability.

Loans: With the adoption of ASU 2016-01 on January 1, 2018, we refined our methodology to estimate the fair value of our loan portfolio to use the exit price notion as required by the ASU. The guidance was applied on a prospective approach resulting in prior-periods no longer being comparable. See “Note 1 – Presentation of Financial Information” for further information. 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 fixed rate loans are estimated using discounted cash flow analyses, using market interest rates for comparable loans. Fair values for nonperforming loans are estimated using discounted cash flow analyses or underlying collateral values, where applicable. These methods are considered Level 3 inputs.

Deposits: The fair values disclosed for demand deposits (for example, interest and noninterest checking, 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) and are considered Level 2 inputs. Fair values for fixed-rate time deposits 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, and are considered Level 2 inputs.

Securities Sold Under Agreement to Repurchase: The carrying value of these liabilities approximates their fair value, and are considered Level 1 inputs.

Federal Home Loan Bank (“FHLB”) Advances, Subordinated Debt and Other Borrowings: The fair value of the FHLB fixed rate borrowings are estimated using discounted cash flows, based on the current incremental borrowing rates for similar types of borrowing arrangements, and are considered Level 2 inputs. The carrying value of FHLB floating rate borrowings and floating rate other borrowings and subordinated debt approximates their fair value and are considered Level 1 inputs. The fair value of the subordinated debt borrowings are estimated using discounted cash flows and are considered Level 3 inputs

Derivative Financial Instruments - Fair value is estimated using pricing models of derivatives with similar characteristics or discounted cash flow models where future floating cash flows are projected and discounted back; and accordingly, these derivatives are classified within Level 2 of the fair value hierarchy. See Note 21—Derivative Financial Instruments for additional information.

Commitments to Extend Credit and Standby Letters of Credit: Because commitments to extend credit and standby letters of credit are made using variable rates and have short maturities, the carrying value and the fair value are immaterial for disclosure.

Measurements of Fair Value:

Assets recorded at fair value on a recurring basis are as follows, in thousands

	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Securities available-for-sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 43,503	\$ —	\$ 43,503	\$ —
Municipal securities	55,161	—	55,161	—
Other debt securities	910	—	910	—
Mortgage-backed securities	102,114	—	102,114	—
Total securities available-for-sale	\$ 201,688	\$ —	\$ 201,688	\$ —
Derivative financial instruments	\$ 1,174	\$ —	\$ 1,174	—

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities, Continued

	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Securities available-for-sale:				
U.S. Government-sponsored enterprises (GSEs)	\$ 25,776	\$ —	\$ 25,776	\$ —
Municipal securities	9,003	—	9,003	—
Other debt securities	950	—	950	—
Mortgage-backed securities	116,215	—	116,215	—
Total securities available-for-sale	<u>\$ 151,944</u>	<u>\$ —</u>	<u>\$ 151,944</u>	<u>\$ —</u>

The Company has no assets or liabilities whose fair values are measured on a recurring basis using Level 3 inputs. Additionally, there were no transfers between Level 1 and Level 2 in the fair value hierarchy.

Assets Measured at Fair Value on a Nonrecurring Basis:

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

	Balance as of December 31, 2018	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 671	\$ —	\$ —	\$ 671
Foreclosed assets	2,495	—	—	2,495

	Balance as of December 31, 2017	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Impaired loans	\$ 769	\$ —	\$ —	\$ 769
Foreclosed assets	3,254	—	—	3,254

For Level 3 assets measured at fair value on a non-recurring basis as of December 31, 2018 and 2017, the significant unobservable inputs used in the fair value measurements are presented below.

	Balance as of December 31, 2018 (in thousands)	Valuation Technique	Significant Other Unobservable Input	Weighted Average of Input
Impaired loans	\$ 671	Third Party Appraisal	Appraisal Discounts	44.3%
Foreclosed assets	2,495	Third Party Appraisal	Appraisal Discounts	23.3%

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities, Continued

	Balance as of December 31, 2017 (in thousands)	Valuation Technique	Significant Other Unobservable Input	Weighted Average of Input
Impaired loans	\$ 769	Cash Flow	Discounted Cash Flow / Appraisal Discounts	35.5%
Foreclosed assets	3,254	Appraisal	Appraisal Discounts	17.8%

Impaired Loans: Loans considered impaired under ASC 310-10-35, *Receivables*, are loans for which, based on current information and events, it is probable that the Company will be unable to collect all principal and interest payments due in accordance with the contractual terms of the loan agreement. Impaired loans can be measured based on the present value of expected payments using the loan's original effective rate as the discount rate, the loan's observable market price, or the fair value of the collateral less selling costs if the loan is collateral dependent. The fair value of impaired loans were measured based on the value of the collateral securing these loans or the discounted cash flows of the loans, as applicable. Impaired loans are classified within Level 3 of the fair value hierarchy. Collateral may be real estate and/or business assets including equipment, inventory, and/or accounts receivable. The Company determines the value of the collateral based on independent appraisals performed by qualified licensed appraisers. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Appraised values are discounted for costs to sell and may be discounted further based on management's historical knowledge, changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts by management are subjective and are typically significant unobservable inputs for determining fair value. Impaired loans are reviewed and evaluated on at least a quarterly basis for additional impairment and adjusted accordingly, based on the same factors discussed above.

Foreclosed assets: Foreclosed assets, consisting of properties obtained through foreclosure or in satisfaction of loans, are initially recorded at fair value less estimated costs to sell upon transfer of the loans to other real estate. Subsequently, other real estate is carried at the lower of carrying value or fair value less costs to sell. Fair values are generally based on third party appraisals of the property and are classified within Level 3 of the fair value hierarchy. The appraisals are sometimes further discounted based on management's historical knowledge, and/or changes in market conditions from the date of the most recent appraisal, and/or management's expertise and knowledge of the customer and the customer's business. Such discounts are typically significant unobservable inputs for determining fair value. In cases where the carrying amount exceeds the fair value, less estimated costs to sell, a loss is recognized in noninterest expense.

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities, Continued

Carrying value and estimated fair value:

The carrying amount and estimated fair value of the Company's financial instruments at December 31, 2018 and December 31, 2017 are as follows (in thousands):

	December 31, 2018				
	Carrying Amount	Fair Value Measurements Using			Estimated Fair Value
		Level 1	Level 2	Level 3	
Assets:					
Cash and cash equivalents	\$ 115,822	115,822	—	—	\$ 115,822
Securities available-for-sale	201,688	—	201,688	—	201,688
Restricted investments	11,499	N/A	N/A	N/A	N/A
Loans, net	1,768,964	—	—	1,766,838	1,766,838
Liabilities:					
Noninterest-bearing demand deposits	319,861	—	319,861	—	319,861
Interest-bearing demand deposits	311,482	—	311,482	—	311,482
Money Market and Savings deposits	641,945	—	641,945	—	641,945
Time deposits	648,675	—	649,169	—	649,169
Securities sold under agreements to repurchase	11,756	—	11,756	—	11,756
Federal Home Loan Bank advances and other borrowings	11,243	—	11,243	—	11,243
Subordinated debt	39,177	—	—	39,190	39,190
Derivative financial instruments	1,174	—	1,174	—	1,174
December 31, 2017					
	Carrying Amount	Fair Value Measurements Using			Estimated Fair Value
		Level 1	Level 2	Level 3	
Assets:					
Cash and cash equivalents	\$ 113,027	113,027	—	—	\$ 113,027
Securities available-for-sale	151,944	—	151,944	—	151,944
Restricted investments	6,431	N/A	N/A	N/A	N/A
Loans, net	1,317,398	—	—	1,292,303	1,292,303
Liabilities:					
Noninterest-bearing demand deposits	220,520	—	220,520	—	220,520
Interest-bearing demand deposits	231,644	—	231,644	—	231,644
Money Market and Savings deposits	543,645	—	543,645	—	543,645
Time deposits	442,774	—	443,547	—	443,547
Securities sold under agreements to repurchase	24,055	—	24,055	—	24,055
Federal Home Loan Bank advances and other borrowings	43,600	—	43,600	—	43,600

SmartFinancial, Inc. and Subsidiary

Notes to Consolidated Financial Statements

December 31, 2018 and 2017

Note 16. Fair Value of Assets and Liabilities, Continued

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. Significant assets and liabilities that are not considered financial instruments include deferred income taxes and premises and equipment. In addition, the tax ramifications related to the realization of the unrealized gains and losses can have a significant effect on fair value estimates and have not been considered in the estimates.

Note 17. Small Business Lending Fund

In connection with the Company's merger with Legacy SmartFinancial, Inc. in 2015, the Company assumed Legacy SmartFinancial's obligations under a stock purchase agreement with the U.S. Department of the Treasury and issued 12,000 shares of preferred stock at \$1,000 per share under the Small Business Lending Fund Program (the "SBLF Program"). The Company paid cash dividends at a one percent rate or \$120 thousand for the year ended December 31, 2015 on the preferred shares. On February 4, 2016 the dividend rate for the preferred shares increased to nine percent and as a result the Company incurred preferred stock dividends of \$1.0 million for the year ended December 31, 2016 .

On January 30, 2017, the Company completed a public offering of 2,010,084 shares of its common stock, par value \$1.00 per share, with the gross proceeds to the Company of approximately \$33.2 million. On March 6, 2017, the Company used proceeds from the offering to redeem the \$12 million of preferred stock and pay the \$195 thousand accrued dividend.

Note 18. Concentration in Deposits

The Company had a concentration in its deposits of three customers totaling approximately \$116.1 million at December 31, 2017 and three customers totaling approximately \$160.6 million concentration of deposits at December 31, 2018.

Note 19. Earnings Per Share

Basic earnings per share is computed by dividing net income available to common stockholders by the weighted average number of common shares outstanding. Diluted earnings per share is computed by dividing net income available to common shareholders by the weighted average number of common shares outstanding and dilutive common share equivalents using the treasury stock method. Dilutive common share equivalents include common shares issuable upon exercise of outstanding stock options and restricted stock. The effect from the stock options and restricted stock on incremental shares from the assumed conversions for net income per share-basic and net income per share-diluted are presented below. There were antidilutive shares of 13,166 for the year ended December 31, 2017. There were no antidilutive shares at December 31, 2018.

(Dollars in thousands, except share amounts)

	2018	2017
Basic earnings per share computation:		
Net income available to common stockholders	\$ 18,102	\$ 4,820
Average common shares outstanding – basic	12,423,618	8,639,212
Basic earnings per share	\$ 1.46	\$ 0.56
Diluted earnings per share computation:		
Net income available to common stockholders	\$ 18,102	\$ 4,820
Average common shares outstanding – basic	12,423,618	8,639,212
Incremental shares from assumed conversions:		
Stock options and restricted stock	94,022	154,315
Average common shares outstanding - diluted	12,517,640	8,793,527
Diluted earnings per share	\$ 1.45	\$ 0.55

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 20. Condensed Parent Information

(Dollars in thousands)

CONDENSED BALANCE SHEETS		
	December 31, 2018	December 31, 2017
ASSETS		
Cash	\$ 13,684	\$ 3,936
Investment in subsidiaries	308,422	168,104
Other assets	99	42,766
Total assets	\$ 322,205	\$ 214,806
LIABILITIES AND STOCKHOLDERS' EQUITY		
Other liabilities	\$ 17	\$ (1,046)
Other borrowings	39,177	10,000
Total liabilities	39,194	8,954
Stockholders' equity	283,011	205,852
Total liabilities and stockholders' equity	\$ 322,205	\$ 214,806

CONDENSED STATEMENTS OF INCOME		
	Years Ended December 31,	
	2018	2017
INCOME		
Interest income	\$ 21	\$ —
EXPENSES		
Interest expense	1,005	69
Other operating expenses	2,822	2,657
(Loss) before equity in undistributed earnings of subsidiaries and income tax benefit	(3,806)	(2,726)
Equity in undistributed earnings of subsidiaries	22,741	7,134
Income tax (benefit) expense	(833)	607
Net income	18,102	5,015
Preferred stock dividend requirements	—	195
Net income available to common stockholders	\$ 18,102	\$ 4,820

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 20. Condensed Parent Information, Continued

STATEMENTS OF CASH FLOWS	Years Ended December 31,	
	2018	2017
CASH FLOWS FROM OPERATING ACTIVITIES		
Net income	\$ 18,102	\$ 5,015
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Equity in undistributed income of subsidiary	(22,741)	(7,134)
Other	1,631	(2,449)
Net cash used in operating activities	<u>(3,008)</u>	<u>(4,568)</u>
CASH FLOWS FROM FINANCING ACTIVITIES		
Proceeds from issuance of note payable	—	10,000
Repayment of note payable	(10,000)	—
Redemption of preferred stock	—	(12,000)
Issuance of subordination debt	39,158	—
Proceeds from issuance of common stock	1,528	37,853
Payment of dividends on preferred stock	—	(195)
Net cash provided by financing activities	<u>30,686</u>	<u>35,658</u>
CASH FLOWS FROM INVESTING ACTIVITIES		
Net cash paid for business combinations	(5,930)	(14,222)
Equity contribution to subsidiary	(12,000)	(15,000)
Net cash used in investing activities	<u>(17,930)</u>	<u>(29,222)</u>
NET INCREASE IN CASH AND CASH EQUIVALENTS	9,748	1,868
CASH AND CASH EQUIVALENTS, beginning of year	3,936	2,068
CASH AND CASH EQUIVALENTS, end of year	<u>\$ 13,684</u>	<u>\$ 3,936</u>

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 21. Derivatives

Financial derivatives are reported at fair value in other assets or other liabilities. The accounting for changes in the fair value of a derivative depends on whether it has been designated and qualifies as part of a hedging relationship. For derivatives not designated as hedges, the gain or loss is recognized in current period earnings.

Derivatives designated as fair value hedges:

For derivative instruments that are designated and qualify as a fair value hedge, the gain or loss on the derivative instrument as well as the offsetting loss or gain on the hedged asset or liability attributable to the hedged risk are recognized in current earnings. The gain or loss on the derivative instrument is presented on the same income statement line item as the earnings effect of the hedged item. The Company utilizes interest rate swaps designated as fair value hedges to mitigate the effect of changing interest rates on the fair values of fixed rate callable securities available-for-sale. The hedging strategy on securities converts the fixed interest rates to LIBOR-based variable interest rates. These derivatives are designated as partial term hedges of selected cash flows covering specified periods of time prior to the call dates of the hedged securities. The Company has elected early adoption of FASB ASU 2017-12, which allows such partial term hedge designations.

On September 14, 2018 and December 4, 2018, the Company entered into fifteen swap transactions with a notional amount of \$35 million designated as fair value hedges. These derivatives are intended to protect against the effects of changing interest rates on the fair values of fixed rate securities.

A summary of the Company's fair value hedge relationships as of December 31, 2018 are as follows (in thousands):

					December 31, 2018	
	Balance Sheet Location	Weighted Average Remaining Maturity (In Years)	Weighted Average Pay Rate	Receive Rate	Notional Amount	Estimated Fair Value
Liability derivatives						
Interest rate swap agreements - securities	Other liabilities	9.23	3.10%	3 month LIBOR	\$35,000	-\$1,174

There were no fair value hedge relationships as of December 31, 2017.

SmartFinancial, Inc. and Subsidiary*Notes to Consolidated Financial Statements*

December 31, 2018 and 2017

Note 21. Derivatives, ContinuedDerivatives designated as fair value hedges (continued):

The effects of the Company's fair value hedge relationships on the income statement during the twelve months ended December 31, 2018 were as follows (in thousands):

	Twelve Months Ended December 31, 2018
	<u>Interest Income</u>
Total amount of income and expense line items presented in the consolidated statements of income	\$92,210
Gain (loss) on fair value hedging relationship	
Interest rate swap agreements - securities:	
Hedged items	(1,174)
Derivative designated as hedging instruments	1,174

The following amounts were recorded on the balance sheet related to cumulative basis adjustments for fair value hedges at December 31, 2018:

Line item on the balance sheet	Carrying Amount of the Hedged Assets (in thousands)	Cumulative Amount of Fair Value Hedging Adjustment Included in the Carrying Amount of the Hedged Assets
	December 31, 2018	December 31, 2018
Securities available-for-sale	\$39,730	\$1,174

PART IV**ITEM 15. EXHIBITS AND FINANCIAL STATEMENT SCHEDULES**

The following documents are filed as part of this report:

- (1) Financial Statements

The following report and consolidated financial statements of SmartFinancial and Subsidiary are included in Item 8:

Reports of Independent Registered Public Accounting Firms
 Consolidated Balance Sheets as of December 31, 2018 and 2017
 Consolidated Statements of Income for the years ended December 31, 2018 and 2017
 Consolidated Statements of Comprehensive Income for the years ended December 31, 2018 and 2017
 Consolidated Statements of Changes in Stockholders' Equity for the years ended December 31, 2018 and 2017
 Consolidated Statements of Cash Flows for the years ended December 31, 2018 and 2017
 Notes to Consolidated Financial Statements

- (2) Financial Statement Schedules:

Schedule II: Valuation and Qualifying Accounts

All other schedules for which provision is made in the applicable accounting regulation of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

- (3) The following documents are filed, furnished or incorporated by reference as exhibits to this report:

Exhibit Index		
Exhibit No.	Description	Location
2.1	Agreement and Plan of Merger, dated as of May 22, 2017, by and among SmartFinancial, Inc., SmartBank, Capstone Bancshares, Inc. and Capstone Bank†	Incorporated by reference to Exhibit 2.1 to Form 8-K filed November 7, 2017
2.2	Agreement and Plan of Merger, dated as of December 12, 2017, by and among SmartFinancial, Inc., Tennessee Bancshares, Inc., and Southern Community Bank†	Incorporated by reference to Exhibit 2.1 to Form 8-K filed December 13, 2017
2.3	Agreement and Plan of Merger, dated as of June 27, 2018, by and among SmartFinancial, Inc., Foothills Bancorp, Inc., and Foothills Bank & Trust†	Incorporated by reference to Exhibit 2.1 to Form 8-K filed June 27, 2018
3.1	Second Amended and Restated Charter of SmartFinancial, Inc.	Incorporated by reference to Exhibit 3.3 to Form 8-K filed September 2, 2015
3.2	Second Amended and Restated Bylaws of SmartFinancial, Inc.	Incorporated by reference to Exhibit 3.1 to Form 8-K filed October 26, 2015
4.1	The right of securities holders are defined in the Charter and Bylaws provided in exhibits 3.1 and 3.2	
4.2	Specimen Common Stock Certificate	Incorporated by reference to Exhibit 4.2 to Form 10-K filed March 30, 2016

4.3	Form of Fixed-to-Floating Rate Subordinated Note due October 2, 2028	Incorporated by reference to Exhibit 4.1 to Form 8-K filed October 1, 2018
10.1**	SmartFinancial, Inc. 2015 Stock Incentive Plan	Incorporated by reference to Exhibit H to the Form S-4 filed April 16, 2015
10.2**	Form of 2015 Stock Incentive Agreement	Incorporated by reference to Exhibit 10.2 to Form 10-K filed March 30, 2016
10.3**	SmartFinancial, Inc. 2010 Incentive Plan	Incorporated by reference to Exhibit 10.6 to Form 8-K filed September 2, 2015
10.4**	Form of Incentive Stock Option Certificate under SmartFinancial, Inc. 2010 Incentive Plan	Incorporated by reference to Exhibit 10.7 to Form 8-K filed September 2, 2015
10.5**	SmartBank Stock Option Plan	Incorporated by reference to Exhibit 10.5 to Form 8-K filed September 2, 2015
10.6**	Form of Management Incentive Stock Option Agreement under SmartBank Stock Option Plan	Incorporated by reference to Exhibit 10.8 to Form 8-K filed September 2, 2015
10.7**	Employment Agreement, dated as of February 1, 2015, by and among William Y. Carroll, Jr., SmartFinancial, Inc. and SmartBank	Incorporated by reference to Exhibit 10.2 to Form 8-K filed September 2, 2015
10.8**	Employment Agreement, dated as of February 1, 2015, by and among William Y. Carroll, Sr., SmartFinancial, Inc. and SmartBank	Incorporated by reference to Exhibit 10.3 to Form 8-K filed September 2, 2015
10.9**	Employment Agreement, dated as of April 15, 2015, by and among C. Bryan Johnson, SmartFinancial, Inc. and SmartBank	Incorporated by reference to Exhibit 10.4 to Form 8-K filed September 2, 2015
10.10**	Employment Agreement with Gary W. Petty, Jr. dated as of December 5, 2014, by and between Cornerstone Bancshares, Inc., Cornerstone Community Bank, and Gary W. Petty, Jr.	Incorporated by reference to Exhibit 10.3 to Form 8-K filed December 10, 2014
10.11**	First Amendment to Employment Agreement by and among Gary W. Petty, Jr., SmartFinancial, Inc. and Cornerstone Community Bank dated December 8, 2015	Incorporated by reference to Exhibit 10.2 to Form 8-K filed December 9, 2015
10.12	Form of Subscription Agreement for 2015 Equity Financing	Incorporated by reference to Exhibit 10.1 to Form 8-K filed August 20, 2015
10.13	Form of Registration Rights Agreement for 2015 Equity Financing	Incorporated by reference to Exhibit 10.2 to Form 8-K filed August 20, 2015
10.14**	Employment Agreement with Nathaniel F. Hughes, dated as of December 5, 2014, by and between Cornerstone Bancshares, Inc. and Nathaniel F. Hughes	Incorporated by reference to Exhibit 10.2 to Form 8-K filed December 10, 2014

10.15**	Cornerstone Bancshares, Inc. 2002 Long-Term Incentive Plan	Incorporated by reference to Exhibit 99.1 to Form S-8 filed on March 5, 2004
10.16**	Form of Unqualified Stock Option Award Agreement under 2002 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.22 to Form 10-K filed March 30, 2016
10.17**	Form of Stock Appreciation Rights Agreement	Incorporated by reference to Exhibit 10.1 to Form 8-K filed August 8, 2017
10.18**	Form of Restricted Stock Award Agreement	Incorporated by reference to Exhibit 10.2 to Form 8-K filed August 8, 2017
10.19**	Employment Agreement, dated as of February 1, 2015, by and among Rhett Jordan, SmartFinancial, Inc. and SmartBank	Incorporated by Reference to Exhibit 10.21 to Form 10-K filed March 16, 2018
10.20**	Employment Agreement, dated as of February 1, 2015, by and among Greg L. Davis and SmartBank	Incorporated by Reference to Exhibit 10.22 to Form 10-K filed March 16, 2018
10.21**	Employment Agreement, dated as of May 22, 2017, by and between SmartBank and Robert Kuhn	Incorporated by reference to Exhibit 10.1 to Form 10-Q filed November 7, 2017
10.22*	Capstone Bancshares, Inc. 2008 Long-Term Equity Incentive Plan	Incorporated by reference to Exhibit 10.2 to Form 10-Q filed November 7, 2017
10.23*	Form of Award Agreement under Capstone Bancshares, Inc. 2008 Long-Term Incentive Plan	Incorporated by reference to Exhibit 10.3 to Form 8-K filed November 7, 2017
10.24*	Salary Continuation Agreement, dated August 11, 2010, by and between Capstone Bank and Robert W. Kuhn	Incorporated by reference to Exhibit 10.4 to Form 8-K filed November 7, 2017
10.25	Loan Agreement, dated as of October 31, 2017, by and between SmartFinancial, Inc. and CapStar Bank	Incorporated by reference to Exhibit 2.2 to Form 10-Q filed November, 14, 2017
10.26	Stock Pledge and Security Agreement, dated as of October 31, 2017, by and between SmartFinancial, Inc. and CapStar Bank	Incorporated by reference to Exhibit 2.3 to Form 10-Q filed November, 14, 2017
10.27	Line of Credit Note, dated as of October 31, 2017, executed by SmartFinancial, Inc. in favor of CapStar Bank	Incorporated by reference to Exhibit 2.4 to Form 10-Q filed November, 14, 2017
10.28	Form of Subordinated Note Purchase Agreement dated September 28, 2018, for SmartFinancial, Inc. Fixed-to-Floating Rate Subordinate Notes due October 2, 2028	Incorporated by reference to Exhibit 10.1 to Form 8-K filed October 1, 2018
16.1	Letter to the Securities and Exchange Commission from Mauldin & Jenkins, LLC	Incorporated by reference to Exhibit 16.1 to Form 8-K filed March 27, 2018

21.1	SmartFinancial, Inc. List of Subsidiaries	Previously filed as Exhibit 21.1 to the Original Filing
23.1	Consent of Dixon Hughes Goodman LLP	Filed herewith
23.2	Consent of Mauldin & Jenkins, LLC	Filed herewith
31.1	Certification of Principal Executive Officer	Filed herewith
31.2	Certification of Principal Financial Officer	Filed herewith
32.0	Section 906 certifications of Principal Executive Officer and Principal Financial Officer	Filed herewith
101.INS*	XBRL Instance Document	(previously filed as Exhibit 101 to the Original Filing)
101.SCH*	XBRL Taxonomy Extension Schema	(previously filed as Exhibit 101 to the Original Filing)
101.CAL*	XBRL Taxonomy Extension Calculation Linkbase	(previously filed as Exhibit 101 to the Original Filing)
101.DEF*	XBRL Taxonomy Extension Definition Linkbase	(previously filed as Exhibit 101 to the Original Filing)
101.LAB*	XBRL Taxonomy Extension Label Linkbase	(previously filed as Exhibit 101 to the Original Filing)
101.PRE*	XBRL Taxonomy Extension Presentation Linkbase	(previously filed as Exhibit 101 to the Original Filing)

† Schedules and exhibits to which have been omitted pursuant to Items 601(b)(2) of Regulations S-K. SmartFinancial agrees to furnish supplementally a copy of any omitted schedule to the Securities and Exchange Commission.

* Pursuant to Rule 406T of Regulation S-T, these interactive data files are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, or Section 18 of the Securities and Exchange Act of 1934, as amended and otherwise are not subject to liability under those sections.

** Indicates management contract or compensatory plan or arrangement

SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

SMARTFINANCIAL, INC.

Date: March 20, 2019 By: /s/ William Y. Carroll, Jr.
William Y. Carroll, Jr.
President and Chief Executive Officer
(principal executive officer)

By: /s/ C. Bryan Johnson
C. Bryan Johnson
Executive Vice President and Chief Financial Officer
(principal financial officer and accounting officer)