GUARANTY BANCSHARES INC /TX/
Form 10-Q
August 11, 2017

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 2017
OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from to .
Commission File Number: 001-38087
GUARANTY BANCSHARES, INC.
(Exact name of registrant as specified in its charter)

Texas	75-1656431
(State or other jurisdiction of incorporation or organization)	(I.R.S. employer identification no.)
201 South Jefferson Avenue Mount Pleasant, Texas	75455
(Address of principal executive offices)	(Zip code)

(903) 572 - 9881
(Registrant's telephone number, including area code)
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 mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

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. (Check one):

Large accelerated filer	Accelerated filer
Non-accelerated filer (Do not check if a smaller reporting company)	Smaller reporting company
	Emerging growth company

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes No

As of August 11, 2017, there were 11,058,956 outstanding shares of the registrant’s common stock, par value $1.00 per share.

GUARANTY BANCSHARES, INC.

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

GUARANTY BANCSHARES, INC.

CONSOLIDATED BALANCE SHEETS

(Dollars in thousands, except share amounts)

	(Unaudited) June 30, 2017	(Audited) December 31, 2016
ASSETS		
Cash and due from banks	$ 36,389	$ 39,605
Federal funds sold	17,700	60,600
Interest-bearing deposits	29,217	27,338
Total cash and cash equivalents	83,306	127,543
Securities available for sale	246,233	156,925
Securities held to maturity	182,248	189,371
Loans held for sale	2,435	2,563
Loans, net	1,284,318	1,233,651
Accrued interest receivable	7,631	7,419
Premises and equipment, net	44,491	44,810
Other real estate owned	1,733	1,692
Cash surrender value of life insurance	18,035	17,804
Deferred tax asset	4,121	4,892
Core deposit intangible, net	3,016	3,308
Goodwill	18,742	18,742
Other assets	16,160	19,616
Total assets	$ 1,912,469	$ 1,828,336
LIABILITIES AND SHAREHOLDERS' EQUITY		
Liabilities		
Deposits		
Noninterest-bearing	$ 387,725	$ 358,752
Interest-bearing	1,258,648	1,218,039
Total deposits	1,646,373	1,576,791
Securities sold under agreements to repurchase	14,153	10,859
Accrued interest and other liabilities	7,921	6,006
Other debt	—	18,286
Federal Home Loan Bank advances	25,161	55,170
Subordinated debentures	14,310	19,310
Total liabilities	1,707,918	1,686,422
Commitments and contingent liabilities		
KSOP-owned shares	—	31,661

See accompanying notes to consolidated financial statements.

GUARANTY BANCSHARES, INC.
CONSOLIDATED BALANCE SHEETS
(Dollars in thousands, except share amounts)

	(Unaudited) June 30, 2017	(Audited) December 31, 2016
Shareholders' equity		
Preferred stock, $5.00 par value, 15,000,000 shares authorized, no shares issued	—	—
Common stock, $1.00 par value, 50,000,000 shares authorized, 11,921,298 and 9,616,275 shares issued, 11,058,956 and 8,751,923 shares outstanding, respectively	11,921	9,616
Additional paid-in capital	155,369	101,736
Retained earnings	62,076	57,160
Treasury stock, 862,342 and 864,352 shares at cost	(20,087)	(20,111)
Accumulated other comprehensive loss	(4,728)	(6,487)
	204,551	141,914
Less KSOP-owned shares	—	31,661
Total shareholders' equity	204,551	110,253
Total liabilities and shareholders' equity	$1,912,469	$1,828,336

See accompanying notes to consolidated financial statements.
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GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF EARNINGS (Unaudited)
(Dollars in thousands, except per share data)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Interest income				
Loans, including fees	$15,214	$13,649	$29,629	$26,563
Securities				
Taxable	1,401	1,393	2,712	3,260
Nontaxable	920	870	1,842	1,385
Federal funds sold and interest-bearing deposits	257	183	745	356
Total interest income	17,792	16,095	34,928	31,564
Interest expense				
Deposits	2,627	2,276	5,031	4,462
FHLB advances and federal funds purchased	58	104	137	168
Subordinated debentures	188	217	395	439
Other borrowed money	120	154	325	348
Total interest expense	2,993	2,751	5,888	5,417
Net interest income	14,799	13,344	29,040	26,147
Provision for loan losses	800	1,950	1,450	2,400
Net interest income after provision for loan losses	13,999	11,394	27,590	23,747
Noninterest income				
Service charges	938	888	1,815	1,711
Net realized gain (loss) on securities transactions	25	(19)	25	18
Net realized gain on sale of loans	472	519	901	745
Other operating income	2,081	1,921	4,057	3,726
Total noninterest income	3,516	3,309	6,798	6,200
Noninterest expense				
Employee compensation and benefits	6,440	6,237	13,427	12,687
Occupancy expenses	1,866	1,729	3,614	3,476
Other operating expenses	3,600	3,417	6,910	6,697
Total noninterest expense	11,906	11,383	23,951	22,860
Income before income taxes	5,609	3,320	10,437	7,087
Income tax provision	1,633	820	2,945	1,910
Net earnings	$3,976	$2,500	$7,492	$5,177
Basic earnings per share	$0.40	$0.27	$0.80	$0.57
Diluted earnings per share	$0.39	$0.27	$0.79	$0.57

See accompanying notes to consolidated financial statements.
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GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (Unaudited)
(Dollars in thousands)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Net earnings	$3,976	$2,500	$7,492	$5,177
Other comprehensive income:				
Unrealized gains on securities				
Unrealized holding gains arising during the period	1,457	1,613	2,686	4,105
Amortization of net unrealized gains on held to maturity securities	17	25	35	50
Reclassification adjustment for net (gains) losses included in net earnings	(25)	19	(25)	(18)
Tax effect	(501)	(224)	(931)	(1,083)
Unrealized gains on securities, net of tax	948	1,433	1,765	3,054
Unrealized holding losses arising during the period on interest rate swaps	(41)	(98)	(6)	(323)
Total other comprehensive income	907	1,335	1,759	2,731
Comprehensive income	$4,883	$3,835	$9,251	$7,908

See accompanying notes to consolidated financial statements.
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GUARANTY BANCSHARES, INC.
CONSOLIDATED STATMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (Unaudited)
(Dollars in thousands, except share amounts)

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Treasury Stock	Accumulated Other Comprehensive Loss	Less: KSOP-Owned Shares	Total Shareholders' Equity
For the Six Months Ended June 30, 2016								
Balance at December 31, 2015	$ —	$9,616	$101,525	$49,654	$(16,486)	$(6,573)	$(35,384)	$102,352
Net earnings	—	—	—	5,177	—	—	—	5,177
Other comprehensive income	—	—	—	—	—	2,731	—	2,731
Purchase of treasury stock	—	—	—	—	(7,261)	—	(3,000)	(10,261)
Sale of treasury stock	—	—	—	—	8,557	—	—	8,557
Stock based compensation	—	—	95	—	—	—	—	95
Net change in fair value of KSOP shares	—	—	—	—	—	—	(1,539)	(1,539)
Dividends:								
Common - $0.26 per share	—	—	—	(2,328)	—	—	—	(2,328)
Balance at June 30, 2016	$ —	$9,616	$101,620	$52,503	$(15,190)	$(3,842)	$(39,923)	$104,784
For the Six Months Ended June 30, 2017								
Balance at December 31, 2016	$ —	$9,616	$101,736	$57,160	$(20,111)	$(6,487)	$(31,661)	$110,253
Net earnings	—	—	—	7,492	—	—	—	7,492
Other comprehensive income	—	—	—	—	—	1,759	—	1,759
Terminated KSOP put option	—	—	—	—	—	—	34,300	34,300
Exercise of stock options	—	5	55	—	24	—	—	84
Sale of common stock	—	2,300	53,455	—	—	—	—	55,755
Stock based compensation	—	—	123	—	—	—	—	123
Net change in fair value of KSOP shares	—	—	—	—	—	—	(2,639)	(2,639)
Dividends:								
Common - $0.26 per share	—	—	—	(2,576)	—	—	—	(2,576)
Balance at June 30, 2017	$ —	$11,921	$155,369	$62,076	$(20,087)	$(4,728)	$ —	$204,551

See accompanying notes to consolidated financial statements.
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GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands)

	For the Six Months Ended June 30, 2017	2016
Cash flows from operating activities		
Net earnings	$7,492	$5,177
Adjustments to reconcile net earnings to net cash provided from operating activities:		
Depreciation	1,599	1,572
Amortization	524	478
Deferred taxes	(160)	(1,126)
Premium amortization, net of discount accretion	2,357	2,495
Net realized gain on securities transactions	(25)	(18)
Gain on sale of loans	(901)	(745)
Provision for loan losses	1,450	2,400
Origination of loans held for sale	(29,330)	(30,652)
Proceeds from loans held for sale	30,359	32,342
Write-down of other real estate and repossessed assets	1	48
Net loss on sale of premises, equipment, other real estate owned and other assets	84	36
Stock based compensation	123	95
Net change in accrued interest receivable and other assets	2,761	(2,505)
Net change in accrued interest payable and other liabilities	1,909	1,591
Net cash provided by operating activities	18,243	11,188
Cash flows from investing activities		
Securities available for sale:		
Purchases	(113,208)	(26,140)
Proceeds from sales	13,839	75,221
Proceeds from maturities and principal repayments	11,675	46,981
Securities held to maturity:		
Purchases	—	(86,642)
Proceeds from sales	923	1,866
Proceeds from maturities and principal repayments	4,950	10,974
Net purchases of premises and equipment	(1,313)	(1,089)
Net proceeds from sale of premises, equipment, other real estate owned and other assets	394	573
Net increase in loans	(52,584)	(116,841)
Net cash used in investing activities	(135,324)	(95,097)
Cash flows from financing activities		
Net change in deposits	69,582	25,718
Net change in securities sold under agreements to repurchase	3,294	1,854
Proceeds from FHLB advances	—	75,000
Repayment of FHLB advances	(30,009)	(5,810)
Proceeds from other debt	2,000	10,000
Repayment of other debt	(20,286)	(18,000)
Repayments of debentures	(5,000)	(1,000)
Purchase of treasury stock	—	(7,261)

Sale of treasury stock	—	8,557

See accompanying notes to consolidated financial statements.

GUARANTY BANCSHARES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS (Unaudited)
(Dollars in thousands)

	For the Six Months Ended June 30,	
	2017	2016
Exercise of stock options	84	—
Sale of common stock	55,755	—
Cash dividends	(2,576)	(2,328)
Net cash provided by financing activities	72,844	86,730
Net change in cash and cash equivalents	(44,237)	2,821
Cash and cash equivalents at beginning of period	127,543	111,379
Cash and cash equivalents at end of period	$83,306	$114,200
Supplemental disclosures of cash flow information		
Interest paid	5,973	5,376
Income taxes paid	2,840	2,210
Supplemental schedule of noncash investing and financing activities		
Transfer loans to other real estate owned and repossessed assets	467	293
Terminated KSOP put option	34,300	—
Net change in fair value of KSOP shares	2,639	1,539

See accompanying notes to consolidated financial statements.
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GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data)

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Nature of Operations: Guaranty Bancshares, Inc. ("Guaranty") is a bank holding company headquartered in Mount Pleasant, Texas that provides, through its wholly-owned subsidiary, Guaranty Bank & Trust, N.A. (the "Bank"), a broad array of financial products and services to individuals and corporate customers, primarily in its markets of East Texas, Bryan/College Station and the Dallas/Fort Worth metroplex. The terms "the Company," "we," "us" and "our" mean Guaranty and its subsidiaries, when appropriate. The Company's main sources of income are derived from granting loans throughout its markets and investing in securities issued by the U.S. Treasury, U.S. government agencies and state and political subdivisions. The Company's primary lending products are real estate, commercial and consumer loans. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' abilities to honor contracts is dependent on the economy of the State of Texas and primarily the economies of East Texas, Bryan/College Station and the Dallas/Fort Worth metroplex. The Company primarily funds its lending activities with deposit operations. The Company's primary deposit products are checking accounts, money market accounts and certificates of deposit.

Basis of Presentation: The consolidated financial statements in this Quarterly Report on Form 10-Q (this "Report") include the accounts of Guaranty, the Bank, and their respective other direct and indirect subsidiaries and any other entities in which Guaranty has a controlling interest. The Bank has five wholly-owned non-bank subsidiaries, Guaranty Company, Inc., G B COM, INC., 2800 South Texas Avenue LLC, Pin Oak Realty Holdings, Inc. and Pin Oak Energy Holdings, LLC. All significant intercompany balances and transactions have been eliminated in consolidation. The accounting and financial reporting policies we follow conform, in all material respects, to accounting principles generally accepted in the United States of America ("GAAP") and to general practices within the financial services industry.
The consolidated financial statements in this Report have not been audited by an independent registered public accounting firm, but in the opinion of management, reflect all adjustments necessary for a fair presentation of the Company's financial position and results of operations. All such adjustments were of a normal and recurring nature. The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q adopted by the Securities and Exchange Commission ("SEC"). Accordingly, the financial statements do not include all of the information and footnotes required by GAAP for complete financial statements and should be read in conjunction with the Company's consolidated financial statements, and notes thereto, for the year ended December 31, 2016, included in the Company's Prospectus filed with the SEC under Rule 424(b) on May 9, 2017, relating to its initial public offering. Operating results for the interim periods disclosed herein are not necessarily indicative of the results that may be expected for a full year or any future period.
All dollar amounts referenced and discussed in the notes to the consolidated financial statements in this Report are presented in thousands, unless noted otherwise.
The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. These estimates and assumptions may also affect disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from these estimates.

KSOP Repurchase Right: In accordance with applicable provisions of the Internal Revenue Code, the terms of Guaranty's employee stock ownership plan with 401(k) provisions ("KSOP"), provided that, for so long as Guaranty was a privately-held company without a public market for its common stock, KSOP participants would have the right, for a specified period of time, to require Guaranty to repurchase shares of its common stock that are distributed to them by the KSOP. This repurchase obligation terminated upon the consummation of Guaranty's initial public offering and listing of its common stock on the NASDAQ Global Select Market in May 2017. However, because Guaranty was privately-held without a public market for its common stock as of and for the year ended December 31, 2016, the shares of common stock held by the KSOP are reflected in the Company's consolidated balance sheet as of December 31, 2016 as a line item called "KSOP-owned shares," appearing between total liabilities and shareholders' equity. As a result, the KSOP-owned shares are deducted from shareholders' equity in the Company's consolidated balance sheet as of December 31, 2016. For all periods following the Company's initial public offering and continued listing of the

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Company's common stock on the NASDAQ Global Select Market, the KSOP-owned shares will be included in, and not be deducted from, shareholders' equity. The termination of the repurchase obligation following the listing of Guaranty's common stock on the NASDAQ Global Select Market is also reflected in the statement of changes in shareholders' equity as "terminated KSOP put option."

Recent Accounting Pronouncements:

In January 2017, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2017-01, Business Combinations (Topic 805): Clarifying the Definition of a Business. The ASU is intended to clarify the definition of a business with the objective of adding guidance to assist entities with evaluating whether transactions should be accounted for as acquisitions (or disposals) of assets or businesses. In addition, the amendments in this update provide a detailed framework to assist entities in evaluating whether a set of assets and activities constitutes a business, as well as clarify the definition of the term output so the term is consistent with how outputs are described in Topic 606. ASU 2017-01 is effective for public companies for annual periods beginning after December 15, 2017, including interim periods within those periods. The Company is in the process of evaluating the impact of this pronouncement, which is not expected to have a significant impact on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. This ASU simplifies the accounting for goodwill impairment for all entities by requiring impairment changes to be based on the first step in today's two-step impairment test, thus eliminating step two from the goodwill impairment test. In addition, the amendment eliminates the requirements for any reporting unit with a zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform step two of the goodwill impairment test. For pubic companies, ASU 2017-04 is effective for fiscal years beginning after December 15, 2019 with early adoption permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company is in the process of evaluating the impact of this pronouncement, which is not expected to have a significant impact on the consolidated financial statements.

In November 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230): Restricted Cash, which requires that the statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. For public companies, ASU 2016-18 is effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted. The Company is in the process of evaluating the impact of this pronouncement, which is not expected to have a significant impact on the consolidated financial statements.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, to address diversity in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments provide guidance on the following nine specific cash flow issues: 1) debt prepayment or debt extinguishment costs; 2) settlement of zero-coupon debt instruments or other debt instruments with coupon interest rates that are insignificant in relation to the effective interest rate of the borrowing; 3) contingent consideration payments made after a business combination; 4) proceeds from the settlement of insurance claims; 5) proceeds from the settlement of corporate-owned life insurance policies, including bank-owned; 6) life insurance policies; 7) distributions received from equity method investees; 8) beneficial interests in securitization transactions; and 9) separately identifiable cash flows and application of the predominance principle. The amendments are effective for public companies for fiscal years beginning after December 31, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The Company does not expect the adoption of this guidance to be material to the consolidated financial statements.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, which sets forth a "current expected credit loss" ("CECL") model requiring 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. For public companies, the amendments in this update are effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. The Company is currently

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in the process of assembling a transition team to assess the adoption of this ASU, which will develop a project plan regarding implementation.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The FASB issued this ASU to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet by lessees for those leases classified as operating leases under current U.S. GAAP and disclosing key information about leasing arrangements. The amendments in this ASU are effective for public companies for annual periods, and interim periods within those annual periods, beginning after December 15, 2018. Early application of this ASU is permitted for all entities. The Company is currently evaluating the impact of adopting the new guidance on its consolidated financial statements.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Liabilities, which is intended to improve the recognition and measurement of financial instruments by requiring: equity investments (other than equity method or consolidation) to be measured at fair value with changes in fair value recognized in net income; public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (i.e., securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; eliminating the requirement to disclose the fair value of financial instruments measured at amortized cost for organizations that are not public business entities; eliminating the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk (also referred to as “own credit”) when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. This ASU is effective for public companies for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. This ASU permits early adoption of the instrument-specific credit risk provision. The Company is currently evaluating the impact of adopting the new guidance on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606), followed by various amendments: ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, ASU 2016-08, Revenue from Contracts with Customers (Topic 606): Principal versus Agent Considerations (Reporting Revenue Gross versus Net), ASU 2016-10, Revenue from Contracts with Customers (Topic 606): Identifying Performance Obligations and Licensing, ASU 2016-11, Revenue Recognition (Topic 605) and Derivatives and Hedging (Topic 815): Rescission of SEC Guidance Because of Accounting Standards Updates 2014-09 and 2014-16 Pursuant to Staff Announcements at the March 3, 2016 EITF Meeting, and ASU 2016-12, Revenue from Contracts with Customers (Topic 606): Narrow-Scope Improvements and Practical Expedients. The amendments in these updates amend existing guidance related to revenue from contracts with customers. The amendments supersede and replace nearly all existing revenue recognition guidance, including industry-specific guidance, establish a new control-based revenue recognition model, change the basis for deciding when revenue is recognized over a time or point in time, provide new and more detailed guidance on specific topics and expand and improve disclosures about revenue. In addition, these amendments specify the accounting for some costs to obtain or fulfill a contract with a customer. The amendments are effective for annual and interim periods beginning after December 15, 2017, and must be retrospectively applied. The majority of the Company's income consists of net interest income on financial assets and financial liabilities, which is explicitly excluded from the scope of the amendments. The Company continues to evaluate the impact of the amendments on the components of noninterest income that have recurring revenue streams; however, the Company does not expect any recognition changes to have a significant impact to the Company's consolidated financial statements.

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GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data)

NOTE 2 - ACQUISITIONS

On August 6, 2016, the Company purchased certain assets and assumed certain liabilities associated with a former branch location of a non-related bank in Denton, Texas (Denton), which resulted in the addition of approximately $4,659 in assets and the assumption of approximately $4,658 in liabilities. The Company acquired the bank premises at 4101 Wind River Lane in Denton and recorded it at fair market value of $2,075. Other assets acquired, at fair value, included cash of $2,399, core deposit intangible of $42, goodwill of $141 and loans of $2. Liabilities assumed included non-interest bearing deposits of $581, interest bearing deposits of $4,047 and other liabilities of $30. As a result of the transaction, the Company paid $66 to the seller, representing the difference in the value of the acquired assets less the value of the liabilities assumed by the Company in the transaction.

Goodwill of $141 arising from the Denton acquisition consisted largely of synergies and the cost savings resulting from the combining of the operations of the companies and is expected to be deductible for income taxes purposes.
NOTE 3 - MARKETABLE SECURITIES

The following tables summarize the amortized cost and fair value of securities available for sale and securities held to maturity as of June 30, 2017 and December 31, 2016 and the corresponding amounts of gross unrealized gains and losses:

June 30, 2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for sale:				
Corporate bonds	$ 18,861	$ 180	$ 8	$ 19,033
Municipal securities	7,793	—	300	7,493
Mortgage-backed securities	95,343	24	902	94,465
Collateralized mortgage obligations	124,833	628	219	125,242
Total available for sale	$ 246,830	$ 832	$ 1,429	$ 246,233
Held to maturity:				
Municipal securities	$ 148,021	$ 2,869	$ 530	$ 150,360
Mortgage-backed securities	24,642	320	93	24,869
Collateralized mortgage obligations	9,585	220	507	9,298
Total held to maturity	$ 182,248	$ 3,409	$ 1,130	$ 184,527

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GUARANTY BANCSHARES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Dollars in thousands, except per share data)

December 31, 2016	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
Available for sale:				
Corporate bonds	$ 25,254	$ 6	$ 377	$ 24,883
Municipal securities	7,841	—	622	7,219
Mortgage-backed securities	61,298	—	1,608	59,690
Collateralized mortgage obligations	65,789	10	666	65,133
Total available for sale	$ 160,182	$ 16	$ 3,273	$ 156,925
Held to maturity:				
Municipal securities	$ 149,420	$ 901	$ 3,889	$ 146,432
Mortgage-backed securities	28,450	318	290	28,478
Collateralized mortgage obligations	11,501	265	521	11,245
Total held to maturity	$ 189,371	$ 1,484	$ 4,700	$ 186,155

The Company’s held to maturity mortgage-backed securities portfolio includes non-agency collateralized mortgage obligations with a carrying value of $1,522, which had unrealized losses of $507 as of June 30, 2017. These non-agency mortgage-backed securities were rated AAA at purchase. The Company monitors to ensure it has adequate credit support, and the Company records other than temporary impairment (OTTI) as appropriate. The Company does not have the intent to sell these securities and it is likely that it will not be required to sell the securities before their anticipated recovery.

Management evaluates securities for OTTI on at least a quarterly basis, and more frequently when economic or market concerns warrant such evaluation. Consideration is given to (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, and (3) the intent and ability of the Company to retain its investment in the issuer for a period of time sufficient to allow for any anticipated recovery in fair value. The Company did not record any other than temporary impairment losses on any of its securities during the six months ended June 30, 2017 or for the year ended December 31, 2016.

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Information pertaining to securities with gross unrealized losses as of June 30, 2017 and December 31, 2016 aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position is detailed in the following tables:

	Less Than 12 Months		12 Months or Longer		Total	
June 30, 2017	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value
Available for sale:						
Corporate bonds	$(8)	$2,981	$—	$—	$(8)	$2,981
Municipal securities	(300)	7,493	—	—	(300)	7,493
Mortgage-backed securities	(569)	75,674	(333)	14,375	(902)	90,049
Collateralized mortgage obligations	(68)	25,407	(151)	8,143	(219)	33,550
Total available for sale	$(945)	$111,555	$(484)	$22,518	$(1,429)	$134,073
Held to maturity:						
Municipal securities	$(406)	$38,442	$(124)	$6,015	$(530)	$44,457
Mortgage-backed securities	(93)	11,154	—	—	(93)	11,154
Collateralized mortgage obligations	—	—	(507)	2,297	(507)	2,297
Total held to maturity	$(499)	$49,596	$(631)	$8,312	$(1,130)	$57,908

	Less Than 12 Months		12 Months or Longer		Total	
December 31, 2016	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value	Gross Unrealized Losses	Estimated Fair Value
Available for sale:						
Corporate bonds	$(377)	$22,529	$—	$—	$(377)	$22,529
Municipal securities	(622)	7,219	—	—	(622)	7,219
Mortgage-backed securities	(1,047)	44,420	(561)	15,270	(1,608)	59,690
Collateralized mortgage obligations	(437)	55,435	(229)	9,049	(666)	64,484
Total available for sale	$(2,483)	$129,603	$(790)	$24,319	$(3,273)	$153,922
Held to maturity:						
Municipal securities	$(3,889)	$98,943	$—	$—	$(3,889)	$98,943
Mortgage-backed securities	(290)	19,983	—	—	(290)	19,983
Collateralized mortgage obligations	—	—	(521)	2,350	(521)	2,350
Total held to maturity	$(4,179)	$118,926	$(521)	$2,350	$(4,700)	$121,276

The number of investment positions in an unrealized loss position totaled 100 and 177 at June 30, 2017 and December 31, 2016, respectively. The securities in a loss position were composed of tax-exempt municipal bonds, corporate bonds, collateralized mortgage obligations and mortgage backed securities. Management believes the unrealized loss on the remaining securities is a function of the movement of interest rates since the time of purchase. Based on evaluation of available evidence, including recent changes in interest rates, credit rating information and

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(Dollars in thousands, except per share data)

information obtained from regulatory filings, management believes the declines in fair value for these securities are temporary. Should the impairment of any of these securities become other-than-temporary, the cost basis of the investment would be reduced and the resulting loss recognized in net income in the period the other-than-temporary impairment is identified. The Company does not have the intent to sell these mortgage-backed securities and it is likely that it will not be required to sell the securities before their anticipated recovery. The Company does not consider these securities to be other-than-temporarily impaired at June 30, 2017.
Mortgage-backed securities and collateralized mortgage obligations are backed by pools of mortgages that are insured or guaranteed by the Federal Home Loan Mortgage Corporation, the Federal National Mortgage Association or the Government National Mortgage Association.

As of June 30, 2017, there were no holdings of securities of any one issuer, other than the U.S. government and its agencies, in an amount greater than 10% of shareholders' equity.

Securities with fair values of approximately $245,600 and $259,499 at June 30, 2017 and December 31, 2016, respectively, were pledged to secure public fund deposits and for other purposes as required or permitted by law.

The proceeds from sales of securities and the associated gains and losses are listed below for:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Proceeds	$14,762	$53,467	$14,762	$77,087
Gross gains	38	72	38	147
Gross losses	(13)	(91)	(13)	(129)

During the six months ended June 30, 2017 and 2016, the Company sold three held to maturity securities each year. The Company sold these municipal securities based upon internal credit analysis, under the belief that they had experienced significant deterioration in creditworthiness. The risk exposure presented by these municipalities had increased beyond acceptable levels, and the Company determined that it was reasonably possible that all amounts due would not be collected. The credit analysis determined that the municipalities had been significantly impacted by the significant decline in market oil prices due to the fact that their tax bases are heavily reliant on the energy industry relative to other sectors of the economy. Specifically, the revenues of these municipalities had been adversely impacted by the sustained low-level of oil prices. The Company believes the sale of these securities were merited and permissible under the applicable accounting guidelines because of the significant deterioration in the creditworthiness of the issuers.

Sale of securities held to maturity were as follows for:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Proceeds from sales	$923	$ —	$923	$1,866
Amortized cost	907	—	907	1,842
Gross realized gains	16	—	16	24
Tax expense related to securities gains/losses	(4)	—	(4)	(7)

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The contractual maturities at June 30, 2017 of available for sale and held to maturity securities at carrying value and estimated fair value are shown below. The Company invests in mortgage-backed securities and collateralized mortgage obligations that have expected maturities that differ from their contractual maturities. These differences arise because borrowers and/or issuers may have the right to call or prepay their obligation with or without call or prepayment penalties.

	Available for Sale		Held to Maturity	
	Amortized Cost	Estimated Fair Value	Amortized Cost	Estimated Fair Value
Due within one year	$—	$—	$2,831	$2,838
Due after one year through five years	1,094	1,104	5,553	5,731
Due after five years through ten years	17,767	17,929	40,659	42,175
Due after ten years	7,793	7,493	98,978	99,616
Mortgage-backed securities	95,343	94,465	24,642	24,869
Collateralized mortgage obligations	124,833	125,242	9,585	9,298
	$246,830	$246,233	$182,248	$184,527

NOTE 4 - LOANS AND ALLOWANCE FOR LOAN LOSSES

The following table summarizes the Company’s loan portfolio by type of loan as of:

	June 30, 2017	December 31, 2016
Commercial and industrial	$217,497	$ 223,997
Real estate:		
Construction and development	177,600	129,366
Commercial real estate	378,722	367,656
Farmland	63,839	62,362
1-4 family residential	356,457	362,952
Multi-family residential	28,833	26,079
Consumer	51,677	53,505
Agricultural	21,854	18,901
Overdrafts	364	317
Total loans	1,296,843	1,245,135
Less:		
Allowance for loan losses	12,525	11,484
Total net loans	$1,284,318	$ 1,233,651

As of June 30, 2017 and December 31, 2016, included in total loans above were $1,127 and $1,210 in unamortized loan costs, net of loan fees, respectively.

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The following table presents the activity in the allowance for loan losses and the recorded investment in loans by portfolio segment and based on impairment method for the six months ended June 30, 2017, for the year ended December 31, 2016 and for the six months ended June 30, 2016:

For the six months ended June 30, 2017	Commercial and industrial	Construction and development	Commercial real estate	Farmland	1-4 family residential	Multi-family residential	Consumer	Agricultural	Overdrafts	Total
Allowance for loan losses:										
Beginning balance	$1,592	$1,161	$3,264	$482	$3,960	$281	$585	$153	$6	$11,484
Provision for loan losses	464	393	284	59	(69)	(12)	66	222	43	1,450
Loans charged-off	(48)	—	(84)	—	(186)	—	(158)	(4)	(70)	(550)
Recoveries	—	—	—	—	21	—	92	—	28	141
Ending balance	$2,008	$1,554	$3,464	$541	$3,726	$269	$585	$371	$7	$12,525
Allowance ending balance:										
Individually evaluated for impairment	$246	$—	$31	$92	$139	$—	$—	$225	$—	$733
Collectively evaluated for impairment	1,762	1,554	3,433	449	3,587	269	585	146	7	11,792
Loans:										
Individually evaluated for impairment	1,174	—	3,751	170	2,726	241	192	789	—	9,043
Collectively evaluated for impairment	216,323	177,600	374,971	63,669	353,731	28,592	51,485	21,065	364	1,287,800
Ending balance	$217,497	$177,600	$378,722	$63,839	$356,457	$28,833	$51,677	$21,854	$364	$1,296,843

For the year ended December 31,	Commercial and industrial	Construction and development	Commercial real estate	Farmland	1-4 family residential	Multi-family residential	Consumer	Agricultural	Overdrafts	Total

2016										
Allowance for loan losses:										
Beginning balance	$1,878	$1,004	$2,106	$400	$2,839	$325	$562	$138	$11	$9,263
Provision for loan losses	910	162	1,158	82	1,117	(44)	171	15	69	3,640
Loans charged-off	(1,213)	(9)	—	—	(71)	—	(269)	—	(200)	(1,762)
Recoveries	17	4	—	—	75	—	121	—	126	343
Ending balance	$1,592	$1,161	$3,264	$482	$3,960	$281	$585	$153	$6	$11,484
Allowance ending balance:										
Individually evaluated for impairment	$64	$—	$—	$47	$108	$—	$34	$—	$—	$253
Collectively evaluated for impairment	1,528	1,161	3,264	435	3,852	281	551	153	6	11,231
Loans:										
Individually evaluated for impairment	231	1,825	1,196	258	2,588	5	200	15	—	6,318
Collectively evaluated for impairment	223,766	127,541	366,460	62,104	360,364	26,074	53,305	18,886	317	1,238,817
Ending balance	$223,997	$129,366	$367,656	$62,362	$362,952	$26,079	$53,505	$18,901	$317	$1,245,135

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For the six months ended June 30, 2016	Commercial and industrial	Construction and development	Commercial real estate	Farmland	1-4 family residential	Multi-family residential	Consumer	Agricultural	Overdrafts	Total
Allowance for loan losses:										
Beginning balance	$1,878	$1,004	$2,106	$400	$2,839	$325	$562	$138	$11	$9,263
Provision for loan losses	1,201	35	433	112	512	58	17	(7)	39	2,400
Loans charged-off	(11)	—	—	—	(22)	—	(89)	—	(67)	(189)
Recoveries	13	4	—	—	—	—	77	—	38	132
Ending balance	$3,081	$1,043	$2,539	$512	$3,329	$383	$567	$131	$21	$11,606
Allowance ending balance:										
Individually evaluated for impairment	$1,773	$—	$—	$47	$93	$—	$70	$—	$—	$1,983
Collectively evaluated for impairment	1,308	1,043	2,539	465	3,236	383	497	131	21	9,623
Loans:										
Individually evaluated for impairment	8,476	39	1,116	302	2,168	—	200	58	—	12,359
Collectively evaluated for impairment	209,921	108,659	346,316	65,872	332,401	36,860	52,827	19,386	560	1,172,802
Ending balance	$218,397	$108,698	$347,432	$66,174	$334,569	$36,860	$53,027	$19,444	$560	$1,185,161

Credit Quality
The Company closely monitors economic conditions and loan performance trends to manage and evaluate the exposure to credit risk. Key factors tracked by the Company and utilized in evaluating the credit quality of the loan portfolio include trends in delinquency ratios, the level of nonperforming assets, borrower's repayment capacity, and collateral coverage.

Assets are graded “pass” when the relationship exhibits acceptable credit risk and indicates repayment ability, tolerable collateral coverage and reasonable performance history. Lending relationships exhibiting potentially significant credit risk and marginal repayment ability and/or asset protection are graded “special mention.” Assets classified as “substandard” are inadequately protected by the current net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness that jeopardizes the liquidation of the debt. Substandard graded loans are characterized by the distinct possibility that the Company will sustain some loss if the deficiencies are not corrected. Assets graded “doubtful” are substandard graded loans that have added characteristics that make collection or liquidation in full improbable. The Company typically measures impairment based on the present value of expected future cash flows, discounted at the loan's effective interest rate, or based on the loan's observable market price or the fair value of the collateral if the loan is collateral-dependent.

The following tables summarize the credit exposure in the consumer and commercial loan portfolios as of:

June 30, 2017	Commercial and industrial	Construction and development	Commercial real estate	Farmland	1-4 family residential	Multi-family residential	Consumer and Overdrafts	Agricultural	Total
Grade:									
Pass	$ 212,162	$ 177,333	$ 373,861	$ 63,035	$ 348,212	$ 28,592	$ 50,917	$ 20,396	$ 1,274,508
Special mention	3,977	267	1,063	543	3,376	—	434	656	10,316
Substandard	1,358	—	3,798	261	4,869	241	690	802	12,019
Doubtful	—	—	—	—	—	—	—	—	—
Total	$ 217,497	$ 177,600	$ 378,722	$ 63,839	$ 356,457	$ 28,833	$ 52,041	$ 21,854	$ 1,296,843

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December 31, 2016	Commercial and industrial	Construction and development	Commercial real estate	Farmland	1-4 family residential	Multi-family residential	Consumer and Overdrafts	Agricultural	Total
Grade:									
Pass	$ 218,975	$ 127,537	$ 360,264	$ 61,713	$ 353,483	$ 25,871	$ 52,648	$ 17,965	$ 1,218,456
Special mention	4,299	4	1,927	248	4,311	—	524	478	11,791
Substandard	706	1,825	5,465	401	5,121	208	568	458	14,752
Doubtful	17	—	—	—	37	—	82	—	136
Total	$ 223,997	$ 129,366	$ 367,656	$ 62,362	$ 362,952	$ 26,079	$ 53,822	$ 18,901	$ 1,245,135

The following tables summarize the payment status of loans in the Company's total loan portfolio, including an aging of delinquent loans, loans 90 days or more past due continuing to accrue interest and loans classified as nonperforming as of:

June 30, 2017	30 to 59 Days Past Due	60 to 89 Days Past Due	90 Days and Greater Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial and industrial	$ 168	$ 142	$ 451	$ 761	$ 216,736	$ 217,497	$ —
Real estate:							
Construction and development	135	—	—	135	177,465	177,600	—
Commercial real estate	677	16	—	693	378,029	378,722	—
Farmland	145	122	—	267	63,572	63,839	—
1-4 family residential	3,107	644	1,092	4,843	351,614	356,457	—
Multi-family residential	—	—	192	192	28,641	28,833	—
Consumer	531	139	126	796	50,881	51,677	—
Agricultural	344	—	—	344	21,510	21,854	—
Overdrafts	—	—	—	—	364	364	—
Total	$ 5,107	$ 1,063	$ 1,861	$ 8,031	$ 1,288,812	$ 1,296,843	$ —

December 31, 2016	30 to 59 Days Past Due	60 to 89 Days Past Due	90 Days and Greater Past Due	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial and industrial	$ 941	$ 105	$ 25	$ 1,071	$ 222,926	$ 223,997	$ —
Real estate:							
Construction and development	73	—	1,825	1,898	127,468	129,366	—
Commercial real estate	1,629	32	134	1,795	365,861	367,656	—
Farmland	100	26	7	133	62,229	62,362	—
1-4 family residential	3,724	803	1,041	5,568	357,384	362,952	—
Multi-family residential	207	49	—	256	25,823	26,079	—
Consumer	613	205	87	905	52,600	53,505	—
Agricultural	59	—	15	74	18,827	18,901	—
Overdrafts	—	—	—	—	317	317	—
Total	$ 7,346	$ 1,220	$ 3,134	$ 11,700	$ 1,233,435	$ 1,245,135	$ —

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The following table presents information regarding nonaccrual loans as of:

	June 30, 2017	December 31, 2016
Commercial and industrial	$ 480	$ 82
Real estate:		
Construction and development	—	1,825
Commercial real estate	708	415
Farmland	163	176
1-4 family residential	1,839	1,699
Multi-family residential	241	5
Consumer	215	192
Agricultural	312	15
Total	$ 3,958	$ 4,409

Impaired Loans and Troubled Debt Restructurings

A troubled debt restructuring ("TDR") is a restructuring in which a bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower that it would not otherwise consider. A loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect all amounts due from the borrower in accordance with original contractual terms of the loan. Loans with insignificant delays or insignificant short falls in the amount of payments expected to be collected are not considered to be impaired. Loans defined as individually impaired, based on applicable accounting guidance, include larger balance nonperforming loans and troubled debt restructurings.

The outstanding balances of TDRs are shown below:

	June 30, 2017	December 31, 2016
Nonaccrual TDRs	$ —	$ 43
Performing TDRs	323	462
Total	$ 323	$ 505
Specific reserves on TDRs	$ 21	$ 4

The following tables present loans by class modified as TDRs that occurred during the six months ended June 30, 2017 and 2016:

Six Months Ended June 30, 2017	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial and industrial	1	$ 34	$ 13
1-4 family residential	1	11	11
Total	2	$ 45	$ 24

There were no TDRs that have subsequently defaulted through June 30, 2017. The TDRs described above increased the allowance for loan losses by $21 and resulted in no charge-offs during the six months ended June 30, 2017.

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Six Months Ended June 30, 2016	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	1	$ 796	$ 796
Consumer	4	32	24
1-4 family residential	2	189	189
Total	7	$ 1,017	$ 1,009

There were no TDRs that subsequently defaulted in 2016. The TDRs described above did not increase the allowance for loan losses and resulted in no charge-offs during the six months ended June 30, 2016.

The following table presents information about the Company’s impaired loans as of:

June 30, 2017	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment
With no related allowance recorded:				
Commercial and industrial	$ 712	$ 712	$ —	$ 345
Real estate:				
Construction and development	—	—	—	608
Commercial real estate	3,468	3,468	—	5,177
Farmland	7	7	—	90
1-4 family residential	1,785	1,785	—	1,566
Multi-family residential	241	241	—	172
Consumer	192	192	—	91
Agricultural	490	490	—	387
Subtotal	6,895	6,895	—	8,436
With allowance recorded:				
Commercial and industrial	462	462	246	533
Real estate:				
Commercial real estate	283	283	31	173
Farmland	163	163	92	109
1-4 family residential	941	941	139	505
Consumer	—	—	—	50
Agricultural	299	299	225	82
Subtotal	2,148	2,148	733	1,452
Total	$ 9,043	$ 9,043	$ 733	$ 9,888

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The following table presents information about the Company’s impaired loans as of:

December 31, 2016	Unpaid Principal Balance	Recorded Investment	Related Allowance	Average Recorded Investment
With no related allowance recorded:				
Commercial and industrial	$ 28	$ 28	$ —	$ 809
Real estate:				
Construction and development	1,825	1,825	—	172
Commercial real estate	1,196	1,196	—	871
Farmland	89	89	—	109
1-4 family residential	1,799	1,799	—	1,575
Multi-family residential	5	5	—	2
Consumer	105	105	—	89
Agricultural	15	15	—	68
Subtotal	5,062	5,062	—	3,695
With allowance recorded:				
Commercial and industrial	203	203	64	3,153
Real estate:				
Farmland	169	169	47	169
1-4 family residential	789	789	108	639
Consumer	95	95	34	155
Agricultural	—	—	—	2
Subtotal	1,256	1,256	253	4,118
Total	$ 6,318	$ 6,318	$ 253	$ 7,813

During the six months ended June 30, 2017 and 2016, total interest income and cash-based interest income recognized on impaired loans was minimal.

NOTE 5 - SECURITIES SOLD UNDER AGREEMENTS TO REPURCHASE AND OTHER DEBT

At June 30, 2017 and December 31, 2016, securities sold under agreements to repurchase totaled $14,153 and $10,859, respectively.

During the quarter ended June 30, 2017, the Company used a portion of the proceeds from its initial public offering to repay the outstanding balance on a line of credit with its correspondent bank. The line of credit, which had an outstanding balance of $0 at quarter end, bears interest at the prime rate plus 0.50%, with interest payable quarterly, and matures in March 2018.

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NOTE 6 - SUBORDINATED DEBENTURES

Subordinated debentures are made up of the following as of:

	June 30, 2017	December 31, 2016
Trust II Debentures	$3,093	$ 3,093
Trust III Debentures	2,062	2,062
DCB Trust I Debentures	5,155	5,155
Other debentures	4,000	9,000
	$14,310	$ 19,310

The Company has three trusts, Guaranty (TX) Capital Trust II ("Trust II"), Guaranty (TX) Capital Trust III ("Trust III"), and DCB Financial Trust I ("DCB Trust I") ("Trust II", "Trust III" and together with "DCB Trust I," the "Trusts"). Upon formation, the Trusts issued pass-through securities ("TruPS") with a liquidation value of $1,000 per share to third parties in private placements. Concurrently with the issuance of the TruPS, the Trusts issued common securities to the Company. The Trusts invested the proceeds of the sales of securities to the Company ("Debentures"). The Debentures mature approximately 30 years after the formation date, which may be shortened if certain conditions are met (including the Company having received prior approval of the Federal Reserve and any other required regulatory approvals).

	Trust II	Trust III	DCB Trust I
Formation date	October 30, 2002	July 25, 2006	March 29, 2007
Capital trust pass-through securities			
Number of shares	3,000	2,000	5,000
Original liquidation value	$ 3,000	$2,000	$ 5,000
Common securities liquidation value	93	62	155

The securities held by the Trusts qualify as Tier I capital for the Company under Federal Reserve Board guidelines. The Federal Reserve's guidelines restrict core capital elements (including trust preferred securities and qualifying perpetual preferred stock) to 25% of all core capital elements, net of goodwill less any associated deferred tax liability. Because the Company's aggregate amount of trust preferred securities is less than the limit of 25% of Tier I capital, net of goodwill, the full amount is includable in Tier I capital at June 30, 2017 and December 31, 2016. Additionally, the terms provide that trust preferred securities would no longer qualify for Tier I capital within five years of their maturity, but would be included as Tier 2 capital. However, the trust preferred securities would be amortized out of Tier 2 capital by one-fifth each year and excluded from Tier 2 capital completely during the year prior to maturity of the junior subordinated debentures.

With certain exceptions, the amount of the principal and any accrued and unpaid interest on the Debentures are subordinated in right of payment to the prior payment in full of all senior indebtedness of the Company. Interest on the Debentures is payable quarterly. The interest is deferrable on a cumulative basis for up to five consecutive years following a suspension of dividend payments on all other capital stock. No principal payments are due until maturity for each of the Debentures.

	Trust II Debentures	Trust III Debentures	DCB Trust I Debentures
Original amount	$ 3,093	$ 2,062	$ 5,155
Maturity date	October 30, 2032	October 1, 2036	June 15, 2037
Interest due	Quarterly	Quarterly	Quarterly

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In accordance with ASC 810, "Consolidation," the junior subordinated debentures issued by the Company to the subsidiary trusts are shown as liabilities in the consolidated balance sheets and interest expense associated with the junior subordinated debentures is shown in the consolidated statements of earnings.

Trust II Debentures
Interest is payable at a variable rate per annum, reset quarterly, equal to 3 month LIBOR plus 3.35%.

On any interest payment date on or after October 30, 2012 and prior to maturity date, the debentures are redeemable for cash at the option of the Company, on at least 30, but not more than 60 days' notice, in whole or in part, at a redemption price equal to 100% of the principal amount to be redeemed, plus accrued interest to the date of redemption.

Trust III Debentures
Interest was payable at a variable rate per annum, reset quarterly, equal to 3 month LIBOR plus 1.67%.

On any interest payment date on or after October 1, 2016 and prior to maturity date, the debentures are redeemable for cash at the option of the Company, on at least 30, but not more than 60 days' notice, in whole or in part, at a redemption price equal to 100% of the principal amount to be redeemed, plus accrued interest to the date of redemption.

DCB Trust I Debentures
Interest is payable at a variable rate per annum, reset quarterly, equal to 3 month LIBOR plus 1.80%.

On any interest payment date on or after June 15, 2012 and prior to maturity date, the debentures are redeemable for cash at the option of the Company, on at least 30, but not more than 60 days' notice, in whole or in part, at a redemption price equal to 100% of the principal amount to be redeemed, plus accrued interest to the date of redemption.

Other debentures
In July 2015, the Company issued $4,000 in debentures, of which $3,000 were issued to directors and other related parties. The $3,000 of debentures to related parties were repaid in May 2017. The remaining $1,000 of debentures were issued at par value of $500 each with rates of 2.50% and 4.00% and maturity dates of July 1, 2017 and January 1, 2019, respectively. At the Company's option, and with 30 days advanced notice to the holder, the entire principal amount and all accrued interest may be paid to the holder on or before the due date of any debenture. The redemption price is equal to 100% of the face amount of the debenture redeemed, plus all accrued interest.

In December 2015, the Company issued $5,000 in debentures, of which $2,500 were issued to directors and other related parties. In May 2017, $2,000 of the related party debentures were repaid. The remaining $3,000 of debentures were issued at par value of $500 each with rates ranging from 3.00% to 5.00% and maturity dates from July 1, 2018 to July 1, 2020. At the Company's option, and with 30 days advanced notice to the holder, the entire principal amount and all accrued interest may be paid to the holder on or before the due date of any debenture. The redemption price is equal to 100% of the face amount of the debenture redeemed, plus all accrued interest.

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NOTE 7 - STOCK OPTIONS

The Company’s 2015 Equity Incentive Plan (the “Plan”) executed April 15, 2015, which is shareholder-approved, amended and restated the Company’s 2014 Stock Option Plan. The maximum number of shares of common stock that may be issued pursuant to stock-based awards under the Plan equals 1,000,000 shares, all of which may be subject to incentive stock option treatment. Option awards are generally granted with an exercise price equal to the market price of the Company’s common stock at the date of grant. Currently outstanding option awards have vesting periods ranging from 5 to 10 years and have 10-year contractual terms.

The fair value of each option award is estimated on the date of grant using a closed form option valuation (Black-Scholes) model that uses the assumptions noted in the table below. Expected volatilities are based on historical volatilities of the Company’s common stock and similar peer group averages. The Company uses historical data to estimate option exercise and post-vesting termination behavior. The expected term of options granted is based on historical data and represents the period of time that options granted are expected to be outstanding, which takes in to account that the options are not transferable. The risk-free interest rate for the expected term of the option is based on U.S. Treasury yield curve in effect at the time of the grant.

A summary of activity in the Plan during the six months ended June 30, 2017 and 2016 follows:

Six Months Ended June 30, 2017	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at beginning of year	340,377	$ 23.43	7.34	$ 194
Granted	109,200	27.00	9.90	548
Exercised	(7,033)	11.94	4.73	141
Forfeited	(6,000)	23.17	7.38	53
Balance, June 30, 2017	436,544	$ 24.51	7.63	$ 3,277
Exercisable at end of period	117,484	$ 24.11	7.01	$ 930

Six Months Ended June 30, 2016	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at beginning of year	314,391	$ 23.28	8.00	$ 225
Granted	26,500	23.21	9.59	21
Forfeited	(17,400)	23.17	8.37	14
Balance, June 30, 2016	323,491	$ 23.28	7.63	$ 232
Exercisable at end of period	58,891	$ 21.25	6.79	$ 162

A summary of nonvested activity in the Plan during the six months ended June 30, 2017 and 2016 follows:

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Six Months Ended June 30, 2017	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at beginning of year	250,700	$ 23.73	7.65	$ 69
Granted	109,200	27.00	9.90	548
Vested	(36,840)	25.40	9.16	244
Forfeited	(4,000)	23.17	7.38	53
Balance, June 30, 2017	319,060	$ 24.66	7.86	$ 2,347

Six Months Ended June 30, 2016	Number of Shares	Weighted-Average Exercise Price	Weighted-Average Remaining Contractual Life in Years	Aggregate Intrinsic Value
Outstanding at beginning of year	267,200	$ 23.72	8.22	$ 76
Granted	26,500	23.21	9.59	21
Vested	(12,300)	23.00	8.81	12
Forfeited	(16,800)	23.17	8.37	14
Balance, June 30, 2016	264,600	$ 23.74	7.82	$ 70

Information related to the Plan is as follows for the six months ended:

	June 30, 2017
Intrinsic value of options exercised	$ 141
Cash received from options exercised	84
Tax benefit realized from options exercised	—
Weighted average fair value of options granted	5.25

As of June 30, 2017, there was $1,795 of total unrecognized compensation cost related to nonvested stock options granted under the Plan. The cost is expected to be recognized over a weighted-average period of 4.34 years.

The Company granted options under the Plan during the first six months of 2016 and 2017. Expense of $123 and $94 was recorded during the six months ended June 30, 2017 and 2016, respectively.

NOTE 8 - EMPLOYEE BENEFITS

KSOP
The Company maintains an Employee Stock Ownership Plan containing Section 401(k) provisions covering substantially all employees (“KSOP”). The plan provides for a matching contribution of up to 5% of a participant’s qualified compensation starting January 1, 2016. As of December 31, 2016, the plan included a repurchase obligation, or “put option”, which is a right to demand that the sponsor redeem shares of employer stock distributed to the participant under the terms of the plan, for which there was no public market for such shares, with an established cash price. This put option was terminated upon completion of the Company’s initial public offering and listing of its common stock on the NASDAQ Global Select Market in May 2017. Total contributions accrued or paid during the six

months ended June 30, 2017 and 2016 totaled $445 and $491, respectively.

Benefits under the KSOP generally are distributed to participants in the form of cash, although participants have the right to receive distributions in the form of shares of common stock. Because the Company’s common stock was not yet actively traded as of December 31, 2016, the participants could demand (in accordance with the terms of the KSOP and applicable law) that the Company repurchase any shares of common stock distributed to them at the estimated fair value.

(Continued)

As of December 31, 2016, the fair value of shares of common stock, held by the KSOP, was deducted from permanent shareholders' equity in the consolidated balance sheets, and reflected in a line item below liabilities and above shareholders' equity. This presentation was necessary in order to recognize the put option within the KSOP-owned shares, consistent with SEC guidelines, because the Company was not yet publicly traded. The Company used a valuation by an external third party to determine the maximum possible cash obligation related to those securities. Increases or decreases in the value of the cash obligation were included in a separate line item in the statements of changes in shareholders' equity. The fair value of allocated and unallocated shares subject to the repurchase obligation totaled $31,661 as of December 31, 2016.

As of June 30, 2017 and December 31, 2016, the number of shares held by the KSOP was 1,319,225. Of these shares, there were 50,000 shares unallocated to plan participants as of June 30, 2017 and December 31, 2016. During the six months ended June 30, 2017 and 2016, the Company did not repurchase any shares from KSOP participants that received distributions of shares from the KSOP which were subject to the put option that applied to the KSOP shares before we were publicly traded. All shares held by the KSOP were treated as outstanding at each of the respective period ends.

Executive Incentive Retirement Plan
The Company established a non-qualified, non-contributory executive incentive retirement plan covering a selected group of key personnel to provide benefits equal to amounts computed under an "award criteria" at various targeted salary levels as adjusted for annual earnings performance of the Company. The plan is non-funded.

In connection with the Executive Incentive Retirement Plan, the Company has purchased life insurance policies on the respective officers. The cash surrender value of life insurance policies held by the Company totaled $18,035 and $17,804 as of June 30, 2017 and December 31, 2016, respectively.

Expense related to these plans totaled $317 and $275 for the six months ended June 30, 2017 and 2016, respectively, and is included in employee compensation and benefits on the consolidated statements of earnings. The recorded liability totaled approximately $2,305 and $2,002 as of June 30, 2017 and December 31, 2016, respectively and is included in accrued interest and other liabilities on the consolidated balance sheets.

Bonus Plan
The Company has a Bonus Plan that rewards officers and employees based on performance of individual business units of the Company. Earnings and growth performance goals for each business unit and for the Company as a whole are established at the beginning of the calendar year and approved annually by the board of directors. The Bonus Plan provides for a predetermined bonus amount to be contributed to the employee bonus pool based on (i) earnings target and growth for individual business units and (ii) achieving certain pre-tax return on average equity and pre-tax return on average asset levels for the Company as a whole. These bonus amounts are established annually by the Company's board of directors. The bonus expense under this plan for the six months ended June 30, 2017 and 2016 totaled $1,103 and $931, respectively and is included in employee compensation and benefits on the consolidated statements of earnings.

NOTE 9 - INCOME TAXES

Income tax expenses were as follows for:

	Six Months Ended June 30,	
	2017	2016
Income tax expense for the period	$2,945	$1,910
Effective tax rate	28.22 %	26.95 %

The effective tax rates differ from the statutory federal tax rate of 35% largely due to tax exempt interest income earned on certain investment securities and loans and the nontaxable earnings on bank owned life insurance.

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NOTE 10 - DERIVATIVE FINANCIAL INSTRUMENTS

The Company utilizes certain derivative financial instruments. Stand-alone derivative financial instruments such as interest rate swaps, are used to economically hedge interest rate risk related to the Company's liabilities. These derivative instruments involve both credit and market risk. The notional amounts are amounts on which calculations, payments, and the value of the derivative are based. Notional amounts do not represent direct credit exposures. Direct credit exposure is limited to the net difference between the calculated amounts to be received and paid, if any. Such difference, which represents the fair value of the derivative instruments, is reflected on the Company's consolidated balance sheet in other liabilities.

The Company is exposed to credit related losses in the event of nonperformance by the counterparties to those agreements. The Company controls the credit risk of its financial contracts through credit approvals, limits and monitoring procedures, and does not expect any counterparties to fail their obligations.

The Company entered into interest rate swaps to receive payments at a fixed rate in exchange for paying a floating rate on the debentures discussed in Note 6. Management believes that entering into the interest rate swaps exposed the Company to variability in their fair value due to changes in the level of interest rates. It is the Company's objective to hedge the change in fair value of floating rate debentures at coverage levels that are appropriate, given anticipated or existing interest rate levels and other market considerations, as well as the relationship of change in this liability to other liabilities of the Company. To meet this objective, the Company utilizes interest rate swaps as an asset/liability management strategy to hedge the change in value of the cash flows due to changes in expected interest rate assumptions.

Interest rate swaps with notional amounts totaling $5,000 as of June 30, 2017 and December 31, 2016, were designated as cash flow hedges of the debentures and were determined to be fully effective during all periods presented. As such, no amount of ineffectiveness has been included in net income.

Therefore, the aggregate fair value of the swaps is recorded in accrued interest and other liabilities within the consolidated balance sheets with changes in fair value recorded in other comprehensive income. The amount included in accumulated other comprehensive income would be reclassified to current earnings should the hedges no longer be considered effective. The Company expects the hedges to remain fully effective during the remaining terms of the swaps.

The information pertaining to outstanding interest rate swap agreements used to hedge floating rate debentures was as follows as of:

June 30, 2017:

Notional Amount	Pay Rate	Receive Rate	Effective Date	Maturity in Years	Unrealized Losses
$2,000	5.979%	3 month LIBOR plus 1.67%	October 1, 2016	8.76	$ 353
$3,000	7.505%	3 month LIBOR plus 3.35%	October 30, 2012	5.34	$ 348

December 31, 2016:

Notional Amount	Pay Rate	Receive Rate	Effective Date	Maturity in Years	Unrealized Losses

$2,000	5.979%	3 month LIBOR plus 1.67%	October 1, 2016	9.25	$ 342
$3,000	7.505%	3 month LIBOR plus 3.35%	October 30, 2012	5.83	$ 353

Interest expense recorded on these swap transactions totaled $395 and $439 during the six months ended June 30, 2017 and 2016, respectively, and is reported as a component of interest expense on the debentures. At June 30, 2017, the Company expected none of the unrealized loss to be reclassified as a reduction of interest expense during the remainder of 2017.

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NOTE 11 - COMMITMENTS AND CONTINGENCIES

In the normal course of business, the Company enters into various transactions, which, in accordance with accounting principles generally accepted in the United States of America, are not included in the consolidated balance sheets. These transactions are referred to as "off-balance sheet commitments." The Company enters into these transactions to meet the financing needs of its customers. These transactions include commitments to extend credit and letters of credit, which involve elements of credit risk in excess of the amounts recognized in the consolidated balance sheets. The Company minimizes its exposure to loss under these commitments by subjecting them to credit approval and monitoring procedures.

The Company enters into contractual commitments to extend credit, normally with fixed expiration dates or termination clauses, at specified rates and for specific purposes. Customers use credit commitments to ensure that funds will be available for working capital purposes, for capital expenditures and to ensure access to funds at specified terms and conditions. Substantially all of the Company's commitments to extend credit are contingent upon customers maintaining specific credit standards at the time of loan funding. Management assesses the credit risk associated with certain commitments to extend credit in determining the level of the allowance for credit losses.

Letters of credit are written conditional commitments issued by the Company to guarantee the performance of a customer to a third party. The Company's policies generally require that letters of credit arrangements contain security and debt covenants similar to those contained in loan agreements. In the event the customer does not perform in accordance with the terms of the agreement with the third party, the Company would be required to fund the commitment. The maximum potential amount of future payments the Company could be required to make is represented by the contractual amount shown in the table below. If the commitment were funded, the Company would be entitled to seek recovery from the customer. As of June 30, 2017 and December 31, 2016, no amounts have been recorded as liabilities for the Bank's potential obligations under these guarantees.

Commitments and letters of credit outstanding were as follows as of:

	Contract or Notional Amount	
	June 30, 2017	December 31, 2016
Commitments to extend credit	$343,450	$ 297,607
Letters of credit	8,768	8,879

Litigation
The Company is involved in certain claims and lawsuits occurring in the normal course of business. Management, after consultation with legal counsel, does not believe that the outcome of these actions, if determined adversely, would have a material impact on the consolidated financial statements of the Company.

FHLB Letters of Credit
At June 30, 2017, the Company had letters of credit of $62,000 pledged to secure public deposits, repurchase agreements, and for other purposes required or permitted by law.

NOTE 12 - REGULATORY MATTERS

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

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A comparison of the Company’s and Bank’s actual capital amounts and ratios to required capital amounts and ratios are presented in the following tables as of:

	Actual		Minimum Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
June 30, 2017						
Total capital to risk-weighted assets:						
Consolidated	$210,959	14.54%	$116,085	8.00%		n/a
Bank	197,899	13.64%	116,102	8.00%	$145,127	10.00%
Tier 1 capital to risk-weighted assets:						
Consolidated	198,434	13.68%	87,063	6.00%		n/a
Bank	185,374	12.77%	87,076	6.00%	116,102	8.00 %
Tier 1 capital to average assets:						
Consolidated	198,434	10.68%	74,355	4.00%		n/a
Bank	185,374	9.98 %	74,313	4.00%	92,892	5.00 %
Common equity tier 1 capital to risk-weighted assets:						
Consolidated	188,124	12.96%	65,298	4.50%		n/a
Bank	185,374	12.77%	65,307	4.50%	94,333	6.50 %

	Actual		Minimum Required For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
December 31, 2016						
Total capital to risk-weighted assets:						
Consolidated	$149,468	10.86%	$110,083	8.00%		n/a
Bank	173,528	12.63%	109,947	8.00%	$137,434	10.00%
Tier 1 capital to risk-weighted assets:						
Consolidated	137,984	10.03%	82,562	6.00%		n/a
Bank	162,044	11.79%	82,460	6.00%	109,947	8.00 %
Tier 1 capital to average assets:						
Consolidated	137,984	7.71 %	71,560	4.00%		n/a
Bank	162,044	9.06 %	71,505	4.00%	89,381	5.00 %
Common equity tier 1 capital to risk-weighted assets:						
Consolidated	127,674	9.28 %	61,922	4.50%		n/a
Bank	162,044	11.79%	61,845	4.50%	89,332	6.50 %

In July 2013, the Federal Reserve published final rules for the adoption of the Basel III regulatory capital framework (the “Basel III Capital Rules”). The Basel III Capital Rules, among other things, (i) introduce a new capital measure called “Common Equity Tier I” (“CETI”), (ii) specify that Tier I capital consist of Common Equity Tier I and “Additional

Tier I Capital" instruments meeting specified requirements, (iii) define Common Equity Tier I narrowly by requiring that most deductions/adjustments to regulatory capital measures be made to Common Equity Tier I and not to the other components of capital and (iv) expand the scope of the deductions/adjustments as compared to existing regulations. The Basel III Capital Rules became effective for the Company on January 1, 2015, with certain transition provisions to be fully phased in by January 1, 2019.

Starting in January 2016, the implementation of the capital conservation buffer will be effective for the Company starting at the 0.625% level and increasing 0.625% each year thereafter, until it reaches 2.5% on January 1, 2019. The capital conservation buffer is designed to absorb losses during periods of economic stress and effectively increases the

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minimum required risk-weighted capital ratios. Failure to meet the full amount of the buffer will result in restrictions on the Company’s ability to make capital distributions, including dividend payments and stock repurchases, and to pay discretionary bonuses to executive officers.

Quantitative measures established by regulation to ensure capital adequacy require the Company to maintain minimum amounts and ratios (set forth in the table below) of total, CETI and Tier I capital (as defined in the regulations) to risk-weighted assets (as defined), ad of Tier I capital (as defined) to average assets (as defined). Management believes, as of June 30, 2017 and December 31, 2016 that the Company met all capital adequacy requirements to which it was subject.

As of June 30, 2017 and December 31, 2016, the Bank’s capital ratios exceeded those levels necessary to be categorized as “well capitalized” under the regulatory framework for prompt corrective action. To be categorized as “well capitalized”, the Bank must maintain minimum total risk-based, CETI, Tier 1 risk-based and Tier I leverage ratios as set forth in the table. There are no conditions or events since June 30, 2017 that management believes have changed the Bank’s category.

The Federal Reserve’s guidelines regarding the capital treatment of trust preferred securities limits restricted core capital elements (including trust preferred securities and qualifying perpetual preferred stock) to 25% of all core capital elements, net of goodwill less any associated deferred tax liability. Because the Company’s aggregate amount of trust preferred securities is less than the limit of 25% of Tier I capital, net of goodwill, the rules permit the inclusion of $10,310 of trust preferred securities in Tier I capital at June 30, 2017 and December 31, 2016. Additionally, the rules provide that trust preferred securities would no longer qualify for Tier I capital within five years of their maturity, but would be included as Tier 2 capital. However, the trust preferred securities would be amortized out of Tier 2 capital by one-fifth each year and excluded from Tier 2 capital completely during the year prior to maturity of the subordinated debentures.

Dividends paid by the Company are mainly provided by dividends from its subsidiaries. However, certain regulatory restrictions exist regarding the ability of its bank subsidiary to transfer funds to the Company in the form of cash dividends, loans or advances. The amount of dividends that a subsidiary bank organized as a national banking association, such as the Bank, may declare in a calendar year is the subsidiary bank’s net profits for that year combined with its retained net profits for the preceding two years.

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NOTE 13 - FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. There are three levels of inputs that may be used to measure fair values:

Level 1 - Quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access as of the measurement date.

Level 2 - Significant other observable inputs other than Level 1 prices such as quoted prices for similar assets or liabilities; quoted prices in markets that are not active; or other inputs that are observable or can be corroborated by observable market data.

Level 3 - Significant unobservable inputs that reflect a company’s own assumptions about the assumptions that market participants would use in pricing an asset or liability.

The Company used the following methods and significant assumptions to estimate fair value:

Marketable Securities: The fair values for marketable securities are determined by quoted market prices, if available (Level 1). For securities where quoted prices are not available, fair values are calculated based on market prices of similar securities (Level 2). For securities where quoted prices or market prices of similar securities are not available, fair values are calculated using discounted cash flows or other market indicators (Level 3).

Loans Held For Sale: Loans held for sale are carried at the lower of cost or fair value, which is evaluated on a pool-level basis. The fair value of loans held for sale is determined using quoted prices for similar assets, adjusted for specific attributes of that loan or other observable market data, such as outstanding commitments from third party investors (Level 2).

Derivative Instruments: The fair values of derivatives are based on valuation models using observable market data as of the measurement date (Level 2).

Impaired Loans: The fair value of impaired loans with specific allocations of the allowance for loan losses is generally based on the present value of estimated future cash flows using the loan's existing rate or, if repayment is expected solely from the collateral, the fair value of collateral, less costs to sell, is determined using recent real estate appraisals. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Such adjustments are usually significant (Level 3). Non-real estate collateral may be valued using an appraisal, net book value per the borrower’s financial statements, or aging reports, adjusted or discounted based on management’s historical knowledge, changes in market conditions from the time of the valuation, and management’s expertise and knowledge of the client and client’s business (Level 3). Impaired loans are evaluated on a quarterly basis for additional impairment and adjusted accordingly.

Other Real Estate Owned: Assets acquired through or instead of loan foreclosure are initially recorded at fair value less costs to sell when acquired, establishing a new cost basis. These assets are subsequently accounted for at lower of cost or fair value less estimated costs to sell. Fair value is commonly based on recent real estate appraisals which are updated no less frequently than annually. These appraisals may utilize a single valuation approach or a combination of approaches including comparable sales and the income approach. Adjustments are routinely made in the appraisal process by the independent appraisers to adjust for differences between the comparable sales and income data available. Real estate owned properties are evaluated on a quarterly basis for additional impairment and adjusted accordingly (Level 3).

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The following tables summarize quantitative disclosures about the fair value measurements for each category of financial assets (liabilities) carried at fair value:

As of June 30, 2017	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets (liabilities) at fair value on a recurring basis:				
Available for sale securities				
Mortgage-backed securities	$94,465	$ —	$ 94,465	$ —
Collateralized mortgage obligations	125,242	—	125,242	—
Municipal securities	7,493	—	7,493	—
Corporate bonds	19,033	—	19,033	—
Derivative instruments	(701)	—	(701)	—
Assets at fair value on a nonrecurring basis:				
Impaired loans	8,310	—	—	8,310
Other real estate owned	1,733	—	—	1,733

As of December 31, 2016	Fair Value	Quoted Prices in Active Markets for Identical Assets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Other Unobservable Inputs (Level 3)
Assets (liabilities) at fair value on a recurring basis:				
Available for sale securities				
Mortgage-backed securities	$59,690	$ —	$ 59,690	$ —
Collateralized mortgage obligations	65,133	—	65,133	—
Municipal securities	7,219	—	7,219	—
Corporate bonds	24,883	—	24,883	—
U.S. treasury securities	—	—	—	—
Derivative instruments	(695)	—	(695)	—
Assets at fair value on a nonrecurring basis:				
Impaired loans	6,065	—	—	6,065
Other real estate owned	1,692	—	—	1,692

There were no transfers between Level 2 and Level 3 during the six months ended 2017 or for the year ended December 31, 2016.

Nonfinancial Assets and Nonfinancial Liabilities

Nonfinancial assets measured at fair value on a nonrecurring basis during the six months ended June 30, 2017 and 2016 include certain foreclosed assets which, upon initial recognition, were remeasured and reported at fair value through a charge-off to the allowance for loan losses and certain foreclosed assets which, subsequent to their initial recognition, were remeasured at fair value through a write-down included in current earnings. The fair value of a foreclosed asset is estimated using Level 2 inputs based on observable market data or Level 3 inputs based on customized discounting criteria.

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The following table presents foreclosed assets that were remeasured and recorded at fair value as of:

	June 30, 2017	December 31, 2016	June 30, 2016
Foreclosed assets remeasured at initial recognition:			
Carrying value of foreclosed assets prior to remeasurement	$ 351	$ 78	$ 43
Charge-offs recognized in the allowance for loan losses	(109)	(11)	(8)
Fair value of foreclosed assets remeasured at initial recognition	$ 242	$ 67	$ 35
Foreclosed assets remeasured subsequent to initial recognition:			
Carrying value of foreclosed assets prior to remeasurement	$ —	$ 170	$ 135
Write-downs included in collection and other real estate owned expense	—	(69)	(58)
Fair value of foreclosed assets remeasured subsequent to initial recognition	$ —	$ 101	$ 77

The following tables present quantitative information about nonrecurring Level 3 fair value measurements as of:

	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
June 30, 2017				
Impaired loans	$ 8,310	Fair value of collateral - sales comparison approach	Selling costs or other normal adjustments: Real estate Equipment	10%-20% (16%) 10%-20% (21%)
Other real estate owned	$ 1,733	Appraisal value of collateral	Selling costs or other normal adjustments	10%-20% (16%)

	Fair Value	Valuation Technique(s)	Unobservable Input(s)	Range (Weighted Average)
December 31, 2016				
Impaired loans	$ 6,065	Fair value of collateral - sales comparison approach	Selling costs or other normal adjustments: Real estate Equipment	10%-20% (16%) 40%-50% (42%)
Other real estate owned	$ 1,692	Appraisal value of collateral	Selling costs or other normal adjustments	10%-20% (16%)

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The carrying amounts and estimated fair values of financial instruments not previously discussed in this note, as of June 30, 2017 and December 31, 2016, are as follows:

	Fair value measurements as of June 30, 2017 using:				
	Carrying Amount	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Financial assets:					
Cash, due from banks, federal funds sold and interest-bearing deposits	$83,306	$54,089	$29,217	$ —	$83,306
Marketable securities held to maturity	182,248	—	184,527	—	184,527
Loans, net	1,284,318	—	—	1,283,241	1,283,241
Accrued interest receivable	7,631	—	7,631	—	7,631
Nonmarketable equity securities	7,679	—	7,679	—	7,679
Cash surrender value of life insurance	18,035	—	18,035	—	18,035
Financial liabilities:					
Deposits	$1,646,373	$1,329,161	$317,418	$ —	$1,646,579
Securities sold under repurchase agreements	14,153	—	14,153	—	14,153
Accrued interest payable	805	—	805	—	805
Federal Home Loan Bank advances	25,161	—	25,156	—	25,156
Subordinated debentures	14,310	—	11,897	—	11,897

	Fair value measurements as of December 31, 2016 using:				
	Carrying Amount	Level 1 Inputs	Level 2 Inputs	Level 3 Inputs	Total Fair Value
Financial assets:					
Cash, due from banks, federal funds sold and interest-bearing deposits	$127,543	$100,205	$27,338	$ —	$127,543
Marketable securities held to maturity	189,371	—	186,155	—	186,155
Loans, net	1,233,651	—	—	1,235,306	1,235,306
Accrued interest receivable	7,419	—	7,419	—	7,419
Nonmarketable equity securities	10,500	—	10,500	—	10,500
Cash surrender value of life insurance	17,804	—	17,804	—	17,804
Financial liabilities:					
Deposits	$1,576,791	$1,234,875	$342,615	$ —	$1,577,490
Securities sold under repurchase agreements	10,859	—	10,859	—	10,859
Accrued interest payable	889	—	889	—	889
Other debt	18,286	—	18,286	—	18,286
Federal Home Loan Bank advances	55,170	—	55,160	—	55,160
Subordinated debentures	19,310	—	16,809	—	16,809

The methods and assumptions, not previously presented, used to estimate fair values are described as follows:

Cash and Cash Equivalents
The carrying amounts of cash and short-term instruments approximate fair values (Level 1).

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Loans, net
The fair value of fixed-rate loans and variable-rate loans that reprice on an infrequent basis is estimated by discounting future cash flows using the current interest rates at which similar loans with similar terms would be made to borrowers of similar credit quality (Level 3).

Cash Surrender Value of Life Insurance
The carrying amounts of bank-owned life insurance approximate their fair value.

Nonmarketable Equity Securities
It is not practical to determine the fair value of Independent Bankers Financial Corporation, Federal Home Loan Bank, Federal Reserve Bank and other stock due to restrictions placed on its transferability.

Deposits and Securities Sold Under Repurchase Agreements
The fair values disclosed for demand deposits (e.g., interest and non-interest checking, passbook savings, and certain types of money market accounts) are, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amount) (Level 1). The fair values of deposit liabilities with defined maturities are estimated by discounting future cash flows using interest rates currently offered for deposits of similar remaining maturities (Level 2).

Other Borrowings
The fair value of borrowings, consisting of lines of credit, Federal Home Loan Bank advances and Subordinated debentures is estimated by discounting future cash flows using currently available rates for similar financing (Level 2).

Accrued Interest Receivable/Payable
The carrying amounts of accrued interest approximate their fair values (Level 2).

Off-balance Sheet Instruments
Fair values for off-balance sheet, credit-related financial instruments are based on fees currently charged to enter into similar agreements, taking into account the remaining terms of the agreements and the counterparties' credit standing. The fair value of commitments is not material.

NOTE 14 - EARNINGS PER SHARE

Basic earnings per share is computed by dividing net earnings available to common shareholders by the weighted-average common shares outstanding for the period. Diluted earnings per share reflects the maximum potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock and would then share in the net earnings of the Company. Dilutive share equivalents include stock-based awards issued to employees.

Stock options granted by the Company are treated as potential shares in computing earnings per share. Diluted shares outstanding include the dilutive effect of in-the-money awards which is calculated based on the average share price for each fiscal period using the treasury stock method. Under the treasury stock method, the amount that the employee must pay for exercising stock options, the amount of compensation cost for future service that the Company has not yet recognized, and the amount of tax impact that would be recorded in additional paid-in capital when the award becomes deductible are assumed to be used to repurchase shares.

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The computations of basic and diluted earnings per share for the Company were as follows for the:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
Numerator:				
Net earnings (basic)	$3,976	$ 2,500	$7,492	$ 5,177
Net earnings (diluted)	$3,976	$ 2,500	$7,492	$ 5,177
Denominator:				
Weighted-average shares outstanding (basic)	10,019,042	9,257,995	9,388,998	9,113,023
Effect of dilutive securities:				
Common stock equivalent shares from stock options	87,776	9,647	60,273	9,647
Weighted-average shares outstanding (diluted)	10,106,818	9,267,642	9,449,271	9,122,670
Net earnings per share				
Basic	$0.40	$ 0.27	$0.80	$ 0.57
Diluted	$0.39	$ 0.27	$0.79	$ 0.57

(Continued)

Item 2. Management’s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with our condensed consolidated financial statements and notes thereto appearing in Item 1 of Part I of this Quarterly Report on Form 10-Q (this “Report”) as well as with our consolidated financial statements and notes thereto appearing in our Prospectus, filed with the SEC on May 9, 2017 pursuant to Rule 424(b) of the Securities Act of 1933, as amended (the “Securities Act”), relating to our initial public offering (the “IPO Prospectus”). Unless the context indicates otherwises, references in this Report to “we,” “our,” “us,” and the “Company” refer to Guaranty Bancshares, Inc., a Texas Corporation, and its consolidated subsidiaries. References in this Report to “Guaranty Bank & Trust” and the “Bank” refer to Guaranty Bank & Trust, N.A., a national banking association and our wholly owned consolidated subsidiary.

This discussion and analysis contains forward-looking statements that are subject to certain risks and uncertainties and are based on certain assumptions that we believe are reasonable but may prove to be inaccurate. Certain risks, uncertainties and other factors, including those set forth under “Forward-Looking Statements” and “Risk Factors” in our IPO Prospectus, may cause actual results to differ materially from those projected results discussed in the forward-looking statements appearing in this discussion and analysis. We assume no obligation to update any of these forward-looking statements. For additional information concerning forward-looking statements, please read “-Special Cautionary Notice Regarding Forward-Looking Statements” below.

General

We were incorporated in 1990 to serve as the holding company for Guaranty Bank & Trust. Since our founding, we have built a reputation based on financial stability and community leadership. In May 2017, we consummated an initial public offering of our common stock, which is traded on the NASDAQ Global Select Market under the symbol “GNTY.”

We currently operate 26 banking locations in the Dallas/Fort Worth metroplex, East Texas and Bryan/College Station markets. Our growth has been consistent and primarily organic. Our principal executive office is located at 201 South Jefferson Street, Mount Pleasant, Texas 75455, and our telephone number is (903) 572-9881. Our website address is www.gnty.com. Information contained on our website does not constitute a part of this Quarterly Report on Form 10-Q and is not incorporated by reference into this filing or any other report.

As a bank holding company that operates through one segment, we generate most of our revenue from interest on loans and investments, customer service and loan fees, fees related to the sale of mortgage loans, and trust and wealth management services. We incur interest expense on deposits and other borrowed funds, as well as noninterest expense, such as salaries and employee benefits and occupancy expenses. We analyze our ability to maximize income generated from interest earning assets and control the interest expenses of our liabilities, measured as net interest income, through our net interest margin and net interest spread. Net interest income is the difference between interest income on interest-earning assets, such as loans and securities, and interest expense on interest-bearing liabilities, such as deposits and borrowings, which are used to fund those assets. Net interest margin is a ratio calculated as net interest income divided by average interest-earning assets. Net interest spread is the difference between rates earned on interest-earning assets and rates paid on interest-bearing liabilities.

Changes in market interest rates and the interest rates we earn on interest-earning assets or pay on interest-bearing liabilities, as well as in the volume and types of interest-earning assets, interest-bearing and noninterest-bearing liabilities and shareholders’ equity, are usually the largest drivers of periodic changes in net interest spread, net interest margin and net interest income. Fluctuations in market interest rates are driven by many factors, including governmental monetary policies, inflation, deflation, macroeconomic developments, changes in unemployment, the money supply, political and international conditions and conditions in domestic and foreign financial markets.

Periodic changes in the volume and types of loans in our loan portfolio are affected by, among other factors, economic and competitive conditions in Texas, as well as developments affecting the real estate, technology, financial services, insurance, transportation, manufacturing and energy sectors within our target markets and throughout the state of

Texas.

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Critical Accounting Policies

Our consolidated financial statements are prepared in accordance with GAAP and with general practices within the financial services industry. Application of these principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. We base our estimates on historical experience and on various other assumptions that we believe to be reasonable under current circumstances. These assumptions form the basis for our judgments about the carrying values of assets and liabilities that are not readily available from independent, objective sources. We evaluate our estimates on an ongoing basis. Use of alternative assumptions may have resulted in significantly different estimates. Actual results may differ from these estimates.

We have identified the following accounting policies and estimates that, due to the difficult, subjective or complex judgments and assumptions inherent in those policies and estimates, and the potential sensitivity of our financial statements to those judgments and assumptions, is critical to an understanding of our financial condition and results of operations. We believe that the judgments, estimates and assumptions used in the preparation of our financial statements are appropriate.

Loans and Allowance for Loan Losses

Loans are stated at the amount of unpaid principal, reduced by unearned income and an allowance for loan losses. Interest on loans is recognized using the simple-interest method on the daily balances of the principal amounts outstanding. Fees associated with the originating of loans and certain direct loan origination costs are netted and the net amount is deferred and recognized over the life of the loan as an adjustment of yield.

The accrual of interest on loans is discontinued 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. When a loan is placed on nonaccrual status, all previously accrued and unpaid interest is reversed. Interest income is subsequently recognized on a cash basis as long as the remaining book balance of the asset is deemed to be collectible. If collectability is questionable, then cash payments are applied to principal. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured in accordance with the terms of the loan agreement.

The allowance for loan losses is an estimated amount management believes is adequate to absorb inherent losses on existing loans that may be uncollectible based upon review and evaluation of our loan portfolio. Management’s periodic evaluation of the allowance is based on general economic conditions, the financial condition of borrowers, the value and liquidity of collateral, delinquency, prior loan loss experience and the results of periodic reviews of the portfolio.

The allowance for loan losses is comprised of two components. The first component, the general reserve, is determined in accordance with current authoritative accounting guidance that considers historical loss rates for the last five years adjusted for qualitative factors based upon general economic conditions and other qualitative risk factors both internal and external to us. Such qualitative factors include current local economic conditions and trends including unemployment, changes in lending staff, policies and procedures, changes in credit concentrations, changes in the trends and severity of problem loans and changes in trends in volume and terms of loans. These qualitative factors serve to compensate for additional areas of uncertainty inherent in the portfolio that are not reflected in our historic loss factors. For purposes of determining the general reserve, the loan portfolio, less cash secured loans, government guaranteed loans and impaired loans, is multiplied by our adjusted historical loss rate. The second component of the allowance for loan losses, the specific reserve, is determined in accordance with current authoritative accounting guidance based on probable and incurred losses on specific classified loans.

The allowance for loan losses is increased by charges to income and decreased by charge-offs (net of recoveries). Due to our growth over the past several years, a portion of the loans in our portfolio and our lending relationships are of relatively recent origin. The new loan portfolios have limited delinquency and credit loss history and have not yet exhibited an observable loss trend. The credit quality of loans in theses loan portfolios are impacted by delinquency status and debt service coverage generated by the borrowers’ business and fluctuations in the value of real estate collateral. Management considers delinquency status to be the most meaningful indicator of the credit quality of one-to-four single family residential, home equity loans and lines of credit and other consumer loans. In general, loans do

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not begin to show signs of credit deterioration or default until they have been outstanding for some period of time, a process we refers to as “seasoning.” As a result, a portfolio of older loans will usually behave more predictably than a portfolio of newer loans. We consider the majority of our loans to be “seasoned” and that the credit quality and current level of delinquencies and defaults represents the level of reserve needed in the allowance for loan losses. If delinquencies and defaults were to increase, we may be required to increase our provision for loan losses, which would adversely affect our results of operations and financial condition.

Delinquency statistics are updated at least monthly. Internal risk ratings are considered the most meaningful indicator of credit quality for new commercial and industrial, construction, and commercial real estate loans. Internal risk ratings are a key factor in identifying loans that are individually evaluated for impairment and impact management’s estimates of loss factors used in determining the amount of the allowance for loan losses. Internal risk ratings are updated on a continuous basis.

Loans are considered impaired when, based on current information and events, it is probable we will be unable to collect all amounts due in accordance with the original contractual terms of the loan agreement, including scheduled principal and interest payments. If a loan is impaired, a specific valuation allowance is allocated, if necessary. Interest payments on impaired loans are typically applied to principal unless collectability of the principal amount is reasonably assured, in which case interest is recognized on a cash basis. Impaired loans, or portions thereof, are charged off when deemed uncollectible.

Our policy requires measurement of the allowance for an impaired collateral dependent loan based on the fair value of the collateral. Other loan impairments are measured based on the present value of expected future cash flows or the loan’s observable market price. As of June 30, 2017 and December 31, 2016, all significant impaired loans have been determined to be collateral dependent and the allowance for loss has been measured utilizing the estimated fair value of the collateral.

From time to time, we modify our loan agreement with a borrower. A modified loan is considered a troubled debt restructuring when two conditions are met: (i) the borrower is experiencing financial difficulty and (ii) concessions are made by us that would not otherwise be considered for a borrower with similar credit risk characteristics. Modifications to loan terms may include a lower interest rate, a reduction of principal, or a longer term to maturity. We review each troubled debt restructured loan and determine on a case by case basis if the loan is subject to impairment and the need for a specific allowance for loan loss allocation. An allowance for loan loss allocation is based on either the present value of estimated future cash flows or the estimated fair value of the underlying collateral.

We have certain lending policies and procedures in place that are designed to maximize loan income with an acceptable level of risk. Management reviews and approves these policies and procedures on a regular basis and makes changes as appropriate. Management receives frequent reports related to loan originations, quality, concentrations, delinquencies, non-performing and potential problem loans. Diversification in the loan portfolio is a means of managing risk associated with fluctuations in economic conditions, both by type of loan and geography.

Commercial and industrial loans are underwritten after evaluating and understanding the borrower’s ability to operate profitably and effectively. Underwriting standards are designed to determine whether the borrower possesses sound business ethics and practices and to evaluate current and projected cash flows to determine the ability of the borrower to repay their obligations as agreed. Commercial and industrial loans are primarily made based on the identified cash flows of the borrower and, secondarily, on the underlying collateral provided by the borrower. Most commercial and industrial loans are secured by the assets being financed or other business assets, such as accounts receivable or inventory, and include personal guarantees.

Real estate loans are also subject to underwriting standards and processes similar to commercial and industrial loans. These loans are underwritten primarily based on projected cash flows and, secondarily, as loans secured by real estate. The repayment of real estate loans is generally largely dependent on the successful operation of the property securing the loans or the business conducted on the property securing the loan. Real estate loans may be more adversely affected by conditions in the real estate markets or in the general economy. The properties securing our real estate portfolio are generally diverse in terms of type and geographic location throughout the State of Texas. This diversity helps us reduce the exposure to adverse economic events that affect any single market or industry.

We utilize methodical credit standards and analysis to supplement our policies and procedures in underwriting consumer loans. Our loan policy addresses types of consumer loans that may be originated as well as the underlying collateral, if secured, which must be perfected. The relatively small individual dollar amounts of consumer loans that are spread over numerous individual borrowers also minimizes risk.

Marketable Securities

Securities are classified as held to maturity and carried at amortized cost when management has the positive intent and ability to hold them to maturity. Securities are classified as available for sale when they might be sold before maturity. Securities available for sale are carried at fair value, with unrealized holding gains and losses reported in other comprehensive income. Management determines the appropriate classification of securities at the time of purchase. Interest income includes amortization and accretion of purchase premiums and discounts. Gains and losses on sales are recorded on the trade date and determined using the specific identification method.

Management evaluates securities for other-than-temporary impairment ("OTTI") on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components as follows: 1) OTTI related to credit loss, which must be recognized in the income statement and 2) OTTI related to other factors, which is recognized in other comprehensive income. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

Fair Values of Financial Instruments

Fair values of financial instruments are estimated using relevant market information and other assumptions. Fair value estimates involve uncertainties and matters of significant judgment regarding interest rates, credit risk, prepayments, and other factors, especially in the absence of broad markets for particular items. Changes in assumptions or in market conditions could significantly affect the estimates. The fair value estimates of existing on and off-balance sheet financial instruments do not include the value of anticipated future business or the value of assets and liabilities not considered financial instruments.

Emerging Growth Company

The JOBS Act permits an "emerging growth company" to take advantage of an extended transition period to comply with new or revised accounting standards applicable to public companies. However, we have "opted out" of this provision. As a result, we will comply with new or revised accounting standards to the same extent that compliance is required for non-emerging growth companies. Our decision to opt out of the extended transition period under the JOBS Act is irrevocable.

Discussion and Analysis of Results of Operations for the Six Months Ended June 30, 2017 and 2016

Results of Operations

The following discussion and analysis of our results of operations compares our results of operations for the six months ended June 30, 2017 with the six months ended June 30, 2016. The results of operations for the six months ended June 30, 2017 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2017.

Net earnings were $7.5 million for the six months ended June 30, 2017, as compared to $5.2 million for the six months ended June 30, 2016. The following table presents key earnings data for the periods indicated:

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	For the Six Months Ended June 30,			
	2017		2016	
	(Dollars in thousands, except per share data)			
Net earnings	$7,492		$5,177	
Net earnings per common share				
-basic	0.80		0.57	
-diluted	0.79		0.57	
Net interest margin(1)	3.37	%	3.24	%
Net interest rate spread(2)	3.16	%	3.05	%
Return on average assets	0.80	%	0.59	%
Return on average equity	9.23	%	7.22	%
Average equity to average total assets	8.67	%	8.20	%
Dividend payout ratio	32.50	%	45.61	%

(1) Net interest margin is equal to net interest income divided by average interest-earning assets.
(2) Net interest rate spread is the average yield on interest-earning assets minus the average rate on interest-bearing liabilities.

Net Interest Income

Our operating results depend primarily on our net interest income. Fluctuations in market interest rates impact the yield and rates paid on interest-earning assets and interest-bearing liabilities, respectively. Changes in the amount and type of interest-earning assets and interest-bearing liabilities also impact our net interest income. To evaluate net interest income, we measure and monitor (1) yields on our loans and other interest-earning assets, (2) the costs of our deposits and other funding sources, (3) our net interest spread and (4) our net interest margin. Because noninterest-bearing sources of funds, such as noninterest-bearing deposits and shareholders' equity also fund interest-earning assets, net interest margin includes the benefit of these noninterest-bearing sources.

Net interest income for the six months ended June 30, 2017 was $29.0 million compared to $26.1 million for the six months ended June 30, 2016, an increase of $2.9 million, or 11.1%. The increase in net interest income was comprised of a $3.4 million, or 10.7%, increase in interest income offset by a $471,000, or 8.7%, increase in interest expense. The growth in interest income was primarily attributable to a $127.6 million, or 11.3%, increase in average loans outstanding for the six months ended June 30, 2017, compared to the six months ended June 30, 2016, further improved by a 0.03% increase in the average yield on total loans. The increase in average loans outstanding was primarily due to organic growth in all of our markets and continuing maturity of de novo and acquired locations in the Dallas/Fort Worth metroplex and Bryan/College Station markets. The $471,000 increase in interest expense for the six months ended June 30, 2017 was primarily related to a $79.9 million, or 6.81%, increase in average interest-bearing deposits over the same period in 2016. The majority of this increase was due to organic growth, primarily in money market accounts, driven in part by favorable rates that were offered in our Bryan/College Station and Dallas/Fort Worth metroplex markets. For the six months ended June 30, 2017, net interest margin and net interest spread were 3.37% and 3.16%, respectively, compared to 3.24% and 3.05% for the same period in 2016, which reflects the increases in interest income discussed above relative to the increases in interest expense.

Average Balance Sheet Amounts, Interest Earned and Yield Analysis

The following table presents an analysis of net interest income and net interest spread for the periods indicated, including average outstanding balances for each each major category of interest-earning assets and interest-bearing liabilities, the interest earned or paid on such amounts, and the average rate earned or paid on such assets or liabilities, respectively. The table also sets forth the net interest margin on average total interest-earning assets for the same periods. Interest earned on loans that are classified as nonaccrual is not recognized in income; however the balances are reflected in average outstanding balances for the period. For the six months ended June 30, 2017 and 2016, the amount of interest income not recognized on nonaccrual loans was not material. Any nonaccrual loans have been included in the table as loans carrying a zero yield.

	For the Six Months Ended June 30,					
	2017			2016		
	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/ Rate
	(Dollars in thousands)					
Assets						
Interest-earnings assets:						
Total loans[1]	$1,253,670	$29,629	4.77 %	$1,126,049	$26,563	4.74 %
Securities available for sale	202,421	2,302	2.29 %	243,626	2,348	1.94 %
Securities held to maturity	186,064	2,252	2.44 %	171,854	2,297	2.69 %
Nonmarketable equity securities	7,251	320	8.90 %	8,268	132	3.21 %
Interest-bearing deposits in other banks	89,189	425	0.96 %	74,228	224	0.61 %
Total interest-earning assets	1,738,595	$34,928	4.05 %	1,624,025	$31,564	3.91 %
Allowance for loan losses	(11,810)			(10,053)		
Noninterest-earnings assets	144,418			136,638		
Total assets	$1,871,203			$1,750,610		
Liabilities and Stockholders' Equity						
Interest-bearing liabilities:						
Interest-bearing deposits	$1,252,962	$5,031	0.81 %	$1,173,073	$4,462	0.76 %
Advances from FHLB and fed funds purchased	37,209	112	0.61 %	51,603	143	0.56 %
Other debt	13,534	325	4.84 %	15,506	348	4.51 %
Subordinated debentures	18,023	395	4.42 %	20,810	439	4.24 %
Securities sold under agreements to repurchase	12,263	25	0.41 %	12,422	25	0.40 %
Total interest-bearing liabilities	1,333,991	$5,888	0.89 %	1,273,414	$5,417	0.86 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	368,341			328,178		
Accrued interest and other liabilities	6,576			5,516		
Total noninterest-bearing liabilities	374,917			333,694		
Shareholders' equity	162,295			143,502		
Total liabilities and shareholders' equity	$1,871,203			$1,750,610		
Net interest rate spread[2]			3.16 %			3.05 %
Net interest income		$29,040			$26,147	
Net interest margin[3]			3.37 %			3.24 %

(1) Includes average outstanding balances of loans held for sale of $2.8 million and $3.0 million for the six months ended June 30, 2017 and 2016, respectively.
(2) Net interest rate spread is the average yield on interest-earning assets minus the average rate on interest-bearing liabilities.
(3) Net interest margin is equal to net interest income divided by average interest-earning assets.

The following table presents the change in interest income and interest expense for the periods indicated for each major component of interest-earning assets and interest-bearing liabilities and distinguishes between the changes attributable to changes in volume and interest rates. For purposes of this table, changes attributable to both rate and volume that cannot be segregated have been allocated to rate.

	For the Six Months Ended June 30, 2017 vs. 2016 Increase (Decrease)		
	Due to Change in		Total Increase
	Volume	Rate	(Decrease)
	(Dollars in thousands)		
Interest-earning assets:			
Total loans	$6,082	$(3,016)	$ 3,066
Securities available for sale	(945)	899	(46)
Securities held to maturity	347	(392)	(45)
Nonmarketable equity securities	(91)	279	188
Interest-earning deposits in other banks	144	57	201
Total increase (decrease) in interest income	$5,537	$(2,173)	$ 3,364
Interest-bearing liabilities:			
Interest-bearing deposits	$647	$(78)	$ 569
Advances from FHLB and fed funds purchased	(87)	56	(31)
Other debt	(95)	72	(23)
Subordinated debentures	(123)	79	(44)
Securities sold under agreements to repurchase	(1)	1	—
Total increase in interest expense	340	131	471
Increase (decrease) in net interest income	$5,197	$(2,304)	$ 2,893

Provision for Loan Losses

The provision for loan losses is a charge to income in order to bring our allowance for loan losses to a level deemed appropriate by management based on factors such as historical loss experience, trends in classified and past due loans, volume and growth in the loan portfolio, current economic conditions in our markets and value of the underlying collateral. Loans are charged off against the allowance for loan losses when determined appropriate. Although management believes it uses the best information available to make determinations with respect to the provision for loan losses, future adjustments may be necessary if economic conditions differ from the assumptions used in making the determination.

The provision for loan losses for the six months ended June 30, 2017 was $1.5 million compared to $2.4 million for the six months ended June 30, 2016. The decrease in the provision expense was related to one large loan relationship whose repayment ability deteriorated in the prior year, thus increasing a specific reserve allocated to the borrower during the prior year. Net charge offs were $409,000 for the six months ended June 30, 2017 compared to $57,000 for the same period in 2016. The increase in net charge offs was attributable primarily to charge-offs in our one-to-four family and consumer portfolios during the first six months of 2017.

Noninterest Income

Our primary sources of recurring noninterest income are service charges on deposit accounts, merchant and debit card fees, fiduciary income, gains on the sale of loans, and income from bank-owned life insurance. Noninterest income does not include loan origination fees to the extent they exceed the direct loan origination costs, which are generally recognized over the life of the related loan as an adjustment to yield using the interest method.

The following table presents components of noninterest income for the six months ended June 30, 2017 and 2016 and the period-over-period variations in the categories of noninterest income:

	For the Six Months Ended June 30,		Increase (Decrease)
	2017	2016	2017 v. 2016
	(Dollars in thousands)		
Noninterest income:			
Service charges on deposit accounts	$1,815	$1,711	$ 104
Merchant and debit card fees	1,523	1,336	187
Fiduciary income	693	694	(1)
Gain on sales of loans	901	745	156
Bank-owned life insurance income	231	225	6
Gain on sales of investment securities	25	18	7
Loan processing fee income	308	312	(4)
Other noninterest income	1,302	1,159	143
Total noninterest income	$6,798	$6,200	$ 598

Total noninterest income increased $598,000, or 9.65%, for the six months ended June 30, 2017 compared to the same period in 2016. Material changes in the components of noninterest income are discussed below.

Service Charges on Deposit Accounts. We earn fees from our customers for deposit-related services, and these fees constitute a significant and predictable component of our noninterest income. Service charges on deposit accounts were $1.8 million for the six months ended June 30, 2017, which increased over the same period in 2016 by $104,000, or 6.1%. This increase in service charges was due in part to our deposit growth during the same period and a new deposit service charge and fee schedule implemented during February 2017.

Merchant and Debit Card Fees. We earn interchange income related to the activity of our customers' merchant debit card usage. Debit card interchange income was $1.5 million for the six months ended June 30, 2017 compared to $1.3 million for the same period in 2016, an increase of $187,000, or 14.0%. The increase was primarily due to growth in the number of demand deposit accounts and debit card usage volume during 2017.

Gain on Sales of Loans. We originate long-term fixed-rate mortgage loans for resale into the secondary market. We sold 160 loans for $29.4 million for the six months ended June 30, 2017 compared to 138 loans for $27.1 million for the six months ended June 30, 2016. Gain on sale of loans was $901,000 for the six months ended June 30, 2017, an increase of $156,000, or 20.9%, compared to $745,000 for the same period in 2016, which reflects an increase in mortgage volume and the number of loans sold.

Other. This category includes a variety of other income producing activities, including mortgage loan origination fees, wire transfer fees, loan administration fees, and other fee income. Other noninterest income increased $143,000, or 12.3%, for the six months ended June 30, 2017 compared to the same period in 2016 due primarily to the growth in our loan portfolio and increased mortgage origination volume causing an increase in fee income generated from loan administration fees and income from mortgage loan origination and processing fees.

Noninterest Expense

Generally, noninterest expense is composed of all employee expenses and costs associated with operating our facilities, obtaining and retaining customer relationships and providing bank services. The largest component of noninterest expense is salaries and employee benefits. Noninterest expense also includes operational expenses, such as occupancy expenses, depreciation and amortization of our facilities and our furniture, fixtures and office equipment, professional and regulatory fees, including FDIC assessments, data processing expenses, and advertising and promotion expenses.

For the six months ended June 30, 2017, noninterest expense totaled $24.0 million, an increase of $1.1 million million, or 4.77%, compared to $22.9 million for the six months ended June 30, 2016. The following table presents, for the periods indicated, the major categories of noninterest expense:

	For the Six Months Ended June 30,		Increase (Decrease)
	2017	2016	2017 v. 2016
	(Dollars in thousands)		
Employee compensation and benefits	$13,427	$12,687	$ 740
Non-staff expenses:			
Occupancy expenses	3,614	3,476	138
Amortization	523	479	44
Software and Technology	1,000	917	83
FDIC insurance assessment fees	365	600	(235)
Legal and professional fees	780	877	(97)
Advertising and promotions	576	474	102
Telecommunication expense	284	308	(24)
ATM and debit card expense	513	502	11
Director and committee fees	507	458	49
Other noninterest expense	2,362	2,082	280
Total noninterest expense	$23,951	$22,860	$ 1,091

Material changes in the components of noninterest expense are discussed below.

Employee Compensation and Benefits. Salaries and employee benefits are the largest component of noninterest expense and include payroll expense, the cost of incentive compensation, benefit plans, health insurance and payroll taxes. Salaries and employee benefits were $13.4 million for the six months ended June 30, 2017, an increase of $740,000, or 5.8%, compared to $12.7 million for the same period in 2016. The increase was due primarily to an increase in per employee salaries, as well as increased health insurance expenses, bonus expense, benefit plan expenses and payroll taxes. As of June 30, 2017 and 2016, we had 395 and 399 full-time equivalent employees, respectively, a decrease of four employees.

Occupancy Expenses. Occupancy expenses were $3.6 million and $3.5 million for the six months ended June 30, 2017 and 2016, respectively. The increase of $138,000, or 4.0%, resulted primarily from additional lease expense of banking centers totaling $94,000 and an increase in ad valorem taxes of $66,000, primarily associated with repossessed assets.

FDIC Insurance Assessment Fees. FDIC assessment fees were $365,000 and $600,000 for the six months ended June 30, 2017 and 2016, respectively. The decrease of $235,000, or 39.2%, resulted from the effect of an update in our accounting methodology during 2016 related to accrual of the assessment fees and an increased one time expense in the prior period.

Advertising and Promotions. Advertising and promotion related expenses were $576,000 and $474,000 for the six months ended June 30, 2017 and 2016, respectively. The increase of $102,000, or 21.5%, was primarily due to additional advertising expenses related to our two locations in Denton, Texas and three locations in Bryan/College Station, Texas.

Other. This category includes operating and administrative expenses, such as stock option expense, expenses and losses related to repossession of assets, small hardware and software purchases, expense of the value of stock appreciation rights, losses incurred on problem assets, OREO related expenses, gains or losses on the sale of OREO, business development expenses (i.e., travel and entertainment, charitable contributions and club memberships), insurance and security expenses. Other noninterest expense increased to $2.4 million for the six months ended June 30, 2017, compared to $2.1 million for the same period in 2016, an increase of $280,000, or 13.4%. The increase was primarily due to additional stock appreciation rights and stock option expenses of $256,000 during the comparable periods.

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Income Tax Expense

The amount of income tax expense we incur is influenced by the amounts of our pre-tax income, tax-exempt income and other nondeductible expenses. Deferred tax assets and liabilities are reflected at current income tax rates in effect for the period in which the deferred tax assets and liabilities are expected to be realized or settled. As changes in tax laws or rates are enacted, deferred tax assets and liabilities are adjusted through the provision for income taxes. Valuation allowances are established when necessary to reduce deferred tax assets to the amount expected to be realized.

For the six months ended June 30, 2017 and 2016, income tax expense totaled $2.9 million and $1.9 million, respectively. Our effective tax rates for the six months ended June 30, 2017 and 2016 were 28.22% and 26.95%, respectively.

Discussion and Analysis of Results of Operations for the Three Months Ended June 30, 2017 and 2016

Results of Operations

The following discussion and analysis of our results of operations compares our results of operations for the three months ended June 30, 2017 with the three months ended June 30, 2016. The results of operations for the three months ended June 30, 2017 are not necessarily indicative of the results of operations that may be expected for the year ending December 31, 2017.

Net earnings were $4.0 million for the three months ended June 30, 2017, as compared to $2.5 million for the three months ended June 30, 2016. The following table presents key earnings data for the periods indicated:

	For the Three Months Ended June 30,			
	2017		2016	
	(Dollars in thousands, except per share data)			
Net earnings	$3,976		$2,500	
Net earnings per common share				
-basic	0.40		0.27	
-diluted	0.39		0.27	
Net interest margin(1)	3.40	%	3.27	%
Net interest rate spread(2)	3.17	%	3.08	%
Return on average assets	0.85	%	0.57	%
Return on average equity	8.85	%	6.83	%
Average equity to average total assets	9.55	%	8.27	%

(1) Net interest margin is equal to net interest income divided by average interest-earning assets.

(2) Net interest rate spread is the average yield on interest-earning assets minus the average rate on interest-bearing liabilities.

Net Interest Income

Net interest income for the three months ended June 30, 2017 was $14.8 million compared to $13.3 million for the three months ended June 30, 2016, an increase of $1.5 million, or 10.9%. The increase in net interest income was comprised of a $1.7 million, or 10.5%, increase in interest income offset by a $242,000, or 8.8%, increase in interest expense. The growth in interest income was primarily attributable to a $113.1 million, or 9.7%, increase in average loans outstanding for the three months ended June 30, 2017, compared to the three months ended June 30, 2016, and further improved by a 0.06% increase in the average yield on total loans. The increase in average loans outstanding was primarily due to organic growth in all of our markets and continuing maturity of de novo and acquired locations in the Dallas/Fort Worth metroplex and Bryan/College Station markets. The $242,000 increase in interest expense for the three months ended June 30, 2017 was primarily related to a $92.0 million, or 7.9%, increase in average interest-bearing deposits over the same period in 2016, and an increase in the average rate of 0.05%. The majority of this increase was due to organic growth, primarily in money market accounts, driven in part by favorable rates that were offered in our Bryan/College Station and Dallas/Fort Worth metroplex markets. For the three months ended June 30, 2017, net interest margin and net interest spread were 3.40% and 3.17%, respectively, compared to 3.27% and

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3.08% for the same period in 2016, which reflects the increases in interest income discussed above relative to the increases in interest expense.

Average Balance Sheet Amounts, Interest Earned and Yield Analysis

The following table presents an analysis of net interest income and net interest spread for the periods indicated, including average outstanding balances for each each major category of interest-earning assets and interest-bearing liabilities, the interest earned or paid on such amounts, and the average rate earned or paid on such assets or liabilities, respectively. The table also sets forth the net interest margin on average total interest-earning assets for the same periods. Interest earned on loans that are classified as nonaccrual is not recognized in income; however the balances are reflected in average outstanding balances for the period. For the three months ended June 30, 2017 and 2016, the amount of interest income not recognized on nonaccrual loans was not material. Any nonaccrual loans have been included in the table as loans carrying a zero yield.

	For the Three Months Ended June 30,					
	2017			2016		
	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/ Rate	Average Outstanding Balance	Interest Earned/ Interest Paid	Average Yield/ Rate
	(Dollars in thousands)					
Assets						
Interest-earnings assets:						
Total loans[(1)]	$1,273,989	$15,214	4.79 %	$1,160,885	$13,649	4.73 %
Securities available for sale	217,031	1,198	2.21 %	206,302	927	1.81 %
Securities held to maturity	184,524	1,123	2.44 %	199,985	1,336	2.69 %
Nonmarketable equity securities	5,774	64	4.45 %	8,808	85	3.88 %
Interest-bearing deposits in other banks	66,272	193	1.17 %	66,325	98	0.59 %
Total interest-earning assets	1,747,590	$17,792	4.08 %	1,642,305	$16,095	3.94 %
Allowance for loan losses	(12,054)			(10,653)		
Noninterest-earnings assets	144,489			137,411		
Total assets	$1,880,025			$1,769,063		
Liabilities and Stockholders’ Equity						
Interest-bearing liabilities:						
Interest-bearing deposits	$1,251,623	$2,627	0.84 %	$1,159,625	$2,276	0.79 %
Advances from FHLB and fed funds purchased	25,163	44	0.70 %	79,448	91	0.46 %
Other debt	8,431	120	5.71 %	13,007	154	4.76 %
Subordinated debentures	16,750	188	4.50 %	20,310	217	4.30 %
Securities sold under agreements to repurchase	13,437	14	0.42 %	13,501	13	0.39 %
Total interest-bearing liabilities	1,315,404	$2,993	0.91 %	1,285,891	$2,751	0.86 %
Noninterest-bearing liabilities:						
Noninterest-bearing deposits	377,994			330,887		
Accrued interest and other liabilities	6,991			5,967		
Total noninterest-bearing liabilities	384,985			336,854		
Shareholders’ equity	179,636			146,318		
Total liabilities and shareholders’ equity	$1,880,025			$1,769,063		
Net interest rate spread[(2)]			3.17 %			3.08 %
Net interest income		$14,799			$13,344	
Net interest margin[(3)]			3.40 %			3.27 %

(1) Includes average outstanding balances of loans held for sale of $1.4 million and $1.5 million for the three months ended June 30, 2017 and 2016, respectively.

(2) Net interest rate spread is the average yield on interest-earning assets minus the average rate on interest-bearing liabilities.
(3) Net interest margin is equal to net interest income divided by average interest-earning assets.

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The following table presents the change in interest income and interest expense for the periods indicated for each major component of interest-earning assets and interest-bearing liabilities and distinguishes between the changes attributable to changes in volume and interest rates. For purposes of this table, changes attributable to both rate and volume that cannot be segregated have been allocated to rate.

	For the Three Months Ended June 30, 2017 vs. 2016 Increase (Decrease)		
	Due to Change in		Total Increase
	Volume	Rate	(Decrease)
	(Dollars in thousands)		
Interest-earning assets:			
Total loans	$5,418	$(3,853)	$ 1,565
Securities available for sale	238	33	271
Securities held to maturity	(377)	164	(213)
Nonmarketable equity securities	(135)	114	(21)
Interest-earning deposits in other banks	(1)	96	95
Total increase (decrease) in interest income	$5,143	$(3,446)	$ 1,697
Interest-bearing liabilities:			
Interest-bearing deposits	$774	$(423)	$ 351
Advances from FHLB and fed funds purchased	(381)	334	(47)
Other debt	(261)	227	(34)
Subordinated debentures	(160)	131	(29)
Securities sold under agreements to repurchase	—	1	1
Total increase (decrease) in interest expense	(28)	270	242
Increase (decrease) in net interest income	$5,171	$(3,716)	$ 1,455

Provision for Loan Losses

The provision for loan losses for the three months ended June 30, 2017 was $800,000 compared to $2.0 million for the three months ended June 30, 2016. The decrease in the provision expense was related to one large loan relationship whose repayment ability deteriorated in the prior year, thus increasing a specific reserve allocated to the borrower during the prior year. Net charge offs were $203,000 for the three months ended June 30, 2017 compared to $9,000 for the same period in 2016.

Noninterest Income

The following table presents components of noninterest income for the three months ended June 30, 2017 and 2016 and the period-over-period variations in the categories of noninterest income:

	For the Three Months Ended June 30,		Increase (Decrease)
	2017	2016	2017 v. 2016
	(Dollars in thousands)		
Noninterest income:			
Service charges on deposit accounts	$938	$888	$ 50
Merchant and debit card fees	791	686	105
Fiduciary income	343	345	(2)
Gain on sales of loans	472	519	(47)
Bank-owned life insurance income	114	107	7
Gain (loss) on sales of investment securities	25	(19)	44
Loan processing fee income	163	170	(7)
Other noninterest income	670	613	57
Total noninterest income	$3,516	$3,309	$ 207

Total noninterest income increased $207,000, or 6.3%, for the three months ended June 30, 2017 compared to the same period in 2016. Material changes in the components of noninterest income are discussed below.

Service Charges on Deposit Accounts. We earn fees from our customers for deposit-related services, and these fees constitute a significant and predictable component of our noninterest income. Service charges on deposit accounts were $938,000 for the three months ended June 30, 2017, which increased over the same period in 2016 by $50,000, or 5.6%. This increase in service charges was due in part to our deposit growth during the same period and a new deposit service charge and fee schedule implemented during February 2017.

Merchant and Debit Card Fees. We earn interchange income related to the activity of our customers' merchant debit card usage. Debit card interchange income was $791,000 for the three months ended June 30, 2017 compared to $686,000 for the same period in 2016, an increase of $105,000, or 15.3%. The increase was primarily due to growth in the number of demand deposit accounts and debit card usage volume during 2017.

Other. This category includes a variety of other income producing activities, including mortgage loan origination fees, wire transfer fees, loan administration fees, and other fee income. Other noninterest income increased $57,000, or 9.3%, for the three months ended June 30, 2017 compared to the same period in 2016 due primarily to the growth in our loan portfolio and increased mortgage origination volume causing an increase in fee income generated from loan administration fees and income from mortgage loan origination and processing fees.

Noninterest Expense

For the three months ended June 30, 2017, noninterest expense totaled $11.9 million, an increase of $523,000, or 4.6%, compared to $11.4 million for the three months ended June 30, 2016. The following table presents, for the periods indicated, the major categories of noninterest expense:

	For the Three Months Ended June 30,		Increase (Decrease)
	2017	2016	2017 v. 2016
	(Dollars in thousands)		
Employee compensation and benefits	$6,440	$6,237	$ 203
Non-staff expenses:			
Occupancy expenses	1,866	1,729	137
Amortization	259	237	22
Software and Technology	517	441	76
FDIC insurance assessment fees	174	300	(126)
Legal and professional fees	419	426	(7)
Advertising and promotions	335	272	63
Telecommunication expense	141	146	(5)
ATM and debit card expense	264	233	31
Director and committee fees	248	230	18
Other noninterest expense	1,243	1,132	111
Total noninterest expense	$11,906	$11,383	$ 523

Material changes in the components of noninterest expense are discussed below.

Employee Compensation and Benefits. Salaries and employee benefits are the largest component of noninterest expense and include payroll expense, the cost of incentive compensation, benefit plans, health insurance and payroll taxes. Salaries and employee benefits were $6.4 million for the three months ended June 30, 2017, an increase of $203,000, or 3.3%, compared to $6.2 million for the same period in 2016. The increase was due primarily to an increase in per employee salaries, as well as increased health insurance expenses, benefit plan expenses and payroll taxes. As of June 30, 2017 and 2016, we had 395 and 399 full-time equivalent employees, respectively, a decrease of four employees.

Occupancy Expenses. Occupancy expenses were $1.9 million and $1.7 million for the three months ended June 30, 2017 and 2016, respectively. The increase of $137,000, or 7.9%, resulted primarily from additional lease expense of banking centers of $53,000 and an increase in ad valorem taxes of $72,000, primarily associated with repossessed assets.

Software and Technology Fees. Software and technology fees consist of fees paid to third parties for support of software and technology products. Software support fee expense was $517,000 for the three months ended June 30, 2017, compared to $441,000 for the same period in 2016, an increase of $76,000, or 17.2%. The increase resulted primarily from the addition of new technology related to remote deposit capture and general increases in support and technology contract costs.

FDIC Insurance Assessment Fees. FDIC assessment fees were $174,000 and $300,000 for the three months ended June 30, 2017 and 2016, respectively. The decrease of $126,000, or 42.0%, resulted from the effect of an update in our accounting methodology during 2016 related to accrual of the assessment fees and an increased one time expense in the prior period.

Advertising and Promotions. Advertising and promotion related expenses were $335,000 and $272,000 for the three months ended June 30, 2017 and 2016, respectively. The increase of $63,000, or 23.2%, was primarily due to additional advertising expenses related to our two locations in Denton, Texas and three locations in Bryan/College Station, Texas.

Other. This category includes operating and administrative expenses, such as stock option expense, expenses and losses related to repossession of assets, small hardware and software purchases, expense of the value of stock appreciation rights, losses incurred on problem assets, OREO related expenses, gains or losses on the sale of OREO, business development expenses (i.e., travel and entertainment, charitable contributions and club memberships), insurance and security expenses. Other noninterest expense increased to $1.2 million for the three months ended

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June 30, 2017, compared to $1.1 million for the same period in 2016, an increase of $111,000, or 9.81%. The increase was primarily due to additional stock appreciation rights expense of $138,000 during the three months ended June 30, 2017.

Income Tax Expense

For the three months ended June 30, 2017 and 2016, income tax expense totaled $1.6 million and $820,000, respectively. Our effective tax rates for the three months ended June 30, 2017 and 2016, were 29.11% and 24.70%, respectively.

Discussion and Analysis of Financial Condition as of June 30, 2017

Assets

Our total assets increased $84.1 million, or 4.6%, from $1.8 billion as of December 31, 2016 to $1.9 billion as of June 30, 2017. Our asset growth was primarily due to increases in our loan and securities portfolios, offset by decreases in federal funds sold and other assets.

Loan Portfolio

Our primary source of income is derived through interest earned on loans to small- to medium-sized businesses, commercial companies, professionals and individuals located in our primary market areas. A substantial portion of our loan portfolio consists of commercial and industrial loans and real estate loans secured by commercial real estate properties located in our primary market areas. Our loan portfolio represents the highest yielding component of our earning asset base.

Our loan portfolio is the largest category of our earning assets. As of June 30, 2017, total loans were $1.30 billion, an increase of $51.7 million, or 4.2%, from the December 31, 2016 balance of $1.25 billion. In addition to these amounts, $2.4 million and $2.6 million in loans were classified as held for sale as of June 30, 2017 and December 31, 2016, respectively.

Total loans, excluding those held for sale, as a percentage of deposits were 78.8% and 79.0% as of June 30, 2017 and December 31, 2016, respectively. Total loans, excluding those held for sale, as a percentage of total assets were 67.8% and 68.1% as of June 30, 2017 and December 31, 2016, respectively.

The following table summarizes our loan portfolio by type of loan and dollar and percentage change from December 31, 2016 to June 30, 2017:

	As of June 30, 2017	As of December 31, 2016	Dollar Change	Percent Change
	(Dollars in thousands)			
Commercial and industrial	$217,497	$ 223,997	$(6,500)	(2.90)%
Real estate:				
Construction and development	177,600	129,366	48,234	37.28 %
Commercial real estate	378,722	367,656	11,066	3.01 %
Farmland	63,839	62,362	1,477	2.37 %
1-4 family residential	356,457	362,952	(6,495)	(1.79)%
Multi-family residential	28,833	26,079	2,754	10.56 %
Consumer and overdrafts	52,041	53,822	(1,781)	(3.31)%
Agricultural	21,854	18,901	2,953	15.62 %
Total loans held for investment	$1,296,843	$ 1,245,135	$51,708	4.15 %
Total loans held for sale	$2,435	$ 2,563	$(128)	(4.99)%

Nonperforming Assets

Loans are considered past due if the required principal and interest payments have not been received as of the date such payments were due. Loans are placed on nonaccrual status when, in management's opinion, the borrower may be unable to meet payment obligations as they become due, as well as when required by regulatory provisions. Loans may be placed on nonaccrual status regardless of whether or not such loans are considered past due. In general, we place loans on nonaccrual status when they become 90 days past due. We also place loans on nonaccrual status if they are less than 90 days past due if the collection of principal or interest is in doubt. When interest accrual is discontinued, all unpaid accrued interest is reversed from income. Interest income is subsequently recognized only to the extent cash payments are received in excess of principal due. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are, in management's opinion, reasonably assured.

We believe our conservative lending approach and focused management of nonperforming assets has resulted in sound asset quality and timely resolution of problem assets. We have several procedures in place to assist us in maintaining the overall quality of our loan portfolio. We have established underwriting guidelines to be followed by our bankers, and we also monitor our delinquency levels for any negative or adverse trends. There can be no assurance, however, that our loan portfolio will not become subject to increasing pressures from deteriorating borrower credit due to general economic conditions.

We had $9.2 million in nonperforming assets as of June 30, 2017, compared to $9.6 million as of December 31, 2016. We had $4.0 million in nonperforming loans as of June 30, 2017, compared to $4.4 million as of December 31, 2016. The $0.5 million, or 10.2%, decrease in our nonperforming (nonaccrual) loans from December 31, 2016 to June 30, 2017 primarily relates to one loan relationship in the amount of $1.7 million that was previously classified as nonaccrual but returned to accrual status in accordance with the terms of our loan policy, which was partially offset by smaller balance loans that entered non-accrual status during the period.

The following table presents information regarding nonperforming assets and loans as of:

	June 30, 2017	December 31, 2016
	(Dollars in thousands)	
Nonaccrual loans	$3,958	$ 4,409
Accruing loans 90 or more days past due	—	—
Total nonperforming loans	3,958	4,409
Other real estate owned:		
Commercial real estate, construction and development, and farmland	1,046	1,074
Residential real estate	687	618
Total other real estate owned	1,733	1,692
Repossessed assets owned	3,501	3,530
Total other assets owned	5,234	5,222
Total nonperforming assets	$9,192	$ 9,631
Restructured loans-nonaccrual	$—	$ 43
Restructured loans-accruing	323	462
Ratio of nonperforming loans to total loans(1)(2)	0.31 %	0.35 %
Ratio of nonperforming assets to total assets	0.48 %	0.53 %

(1) Excludes loans held for sale of $2.4 million and $2.6 million as of June 30, 2017 and December 31, 2016, respectively.
(2) Restructured loans-nonaccrual are included in nonaccrual loans which are a component of nonperforming loans.

The following table presents nonaccrual loans by category as of:

	June 30, 2017	December 31, 2016
	(Dollars in thousands)	
Nonaccrual loans by category:		
Real estate:		
Construction and development	$—	$ 1,825
Commercial real estate	708	415
Farmland	163	176
1-4 family residential	1,839	1,699
Multi-family residential	241	5
Commercial and industrial	480	82
Consumer	215	192
Agricultural	312	15
Total	$3,958	$ 4,409

Potential Problem Loans

From a credit risk standpoint, we classify loans in one of five categories: pass, special mention, substandard, doubtful or loss. Within the pass category, we classify loans into one of the following four subcategories based on perceived credit risk, including repayment capacity and collateral security: superior, excellent, good and acceptable. The classifications of loans reflect a judgment about the risks of default and loss associated with the loan. We review the ratings on credits monthly. Ratings are adjusted to reflect the degree of risk and loss that is believed to be inherent in each credit as of each monthly reporting period. Our methodology is structured so that specific reserve allocations are increased in accordance with deterioration in credit quality (and a corresponding increase in risk and loss) or decreased in accordance with improvement in credit quality (and a corresponding decrease in risk and loss).

Credits rated special mention show clear signs of financial weaknesses or deterioration in creditworthiness; however, such concerns are not so pronounced that we generally expect to experience significant loss within the short-

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term. Such credits typically maintain the ability to perform within standard credit terms and credit exposure is not as prominent as credits with a lower rating.

Credits rated substandard are those in which the normal repayment of principal and interest may be, or has been, jeopardized by reason of adverse trends or developments of a financial, managerial, economic or political nature, or important weaknesses which exist in collateral. A protracted workout on these credits is a distinct possibility. Prompt corrective action is therefore required to reduce exposure and to assure that adequate remedial measures are taken by the borrower. Credit exposure becomes more likely in such credits and a serious evaluation of the secondary support to the credit is performed.

Credits rated as doubtful have the weaknesses of substandard assets with the additional characteristic that the weaknesses make collection or liquidation in full questionable and there is a high probability of loss based on currently existing facts, conditions and values.

Credits rated as loss are charged-off. We have no expectation of the recovery of any payments in respect of credits rated as loss.

The following table summarizes the internal ratings of our loans as of:

	June 30, 2017					
	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(Dollars in thousands)					
Real estate:						
Construction and development	$177,333	$267	$ —	$ —	$ —	$177,600
Commercial real estate	373,861	1,063	3,798	—	—	378,722
Farmland	63,035	543	261	—	—	63,839
1-4 family residential	348,212	3,376	4,869	—	—	356,457
Multi-family residential	28,592	—	241	—	—	28,833
Commercial and industrial	212,162	3,977	1,358	—	—	217,497
Consumer and overdrafts	50,917	434	690	—	—	52,041
Agricultural	20,396	656	802	—	—	21,854
Total	$1,274,508	$10,316	$ 12,019	$ —	$ —	$1,296,843

	December 31, 2016					
	Pass	Special Mention	Substandard	Doubtful	Loss	Total
	(Dollars in thousands)					
Real estate:						
Construction and development	$127,537	$4	$ 1,825	$ —	$ —	$129,366
Commercial real estate	360,264	1,927	5,465	—	—	367,656
Farmland	61,713	248	401	—	—	62,362
1-4 family residential	353,483	4,311	5,121	37	—	362,952
Multi-family residential	25,871	—	208	—	—	26,079
Commercial and industrial	218,975	4,299	706	17	—	223,997
Consumer and overdrafts	52,648	524	568	82	—	53,822
Agricultural	17,965	478	458	—	—	18,901
Total	$1,218,456	$11,791	$ 14,752	$ 136	$ —	$1,245,135

Allowance for Loan Losses

We maintain an allowance for loan losses that represents management's best estimate of the loan losses and risks inherent in our loan portfolio. The amount of the allowance for loan losses should not be interpreted as an indication that charge-offs in future periods will necessarily occur in those amounts, or at all. In determining the allowance for loan losses, we estimate losses on specific loans, or groups of loans, where the probable loss can be identified and reasonably determined. The balance of the allowance for loan losses is based on internally assigned risk classifications of loans, historical loan loss rates, changes in the nature of our loan portfolio, overall portfolio quality, industry concentrations, delinquency trends, current economic factors and the estimated impact of current economic conditions on certain historical loan loss rates. Please see "-Critical Accounting Policies-Allowance for Loan Losses."

In connection with the review of our loan portfolio, we consider risk elements attributable to particular loan types or categories in assessing the quality of individual loans. Some of the risk elements we consider include:

- for commercial and industrial loans, the debt service coverage ratio (income from the business in excess of operating expenses compared to loan repayment requirements), the operating results of the commercial, industrial or professional enterprise, the borrower's business, professional and financial ability and expertise, the specific risks and volatility of income and operating results typical for businesses in that category and the value, nature and marketability of collateral;
- for commercial mortgage loans and multifamily residential loans, the debt service coverage ratio, operating results of the owner in the case of owner occupied properties, the loan to value ratio, the age and condition of the collateral and the volatility of income, property value and future operating results typical of properties of that type;
- for 1-4 family residential mortgage loans, the borrower's ability to repay the loan, including a consideration of the debt to income ratio and employment and income stability, the loan-to-value ratio, and the age, condition and marketability of the collateral; and
- for construction and development loans, the perceived feasibility of the project including the ability to sell developed lots or improvements constructed for resale or the ability to lease property constructed for lease, the quality and nature of contracts for presale or prelease, if any, experience and ability of the developer and loan to value ratio.

As of June 30, 2017, the allowance for loan losses totaled $12.5 million, or 0.97%, of total loans, excluding those held for sale. As of December 31, 2016, the allowance for loan losses totaled $11.5 million, or 0.92%, of total loans, excluding those held for sale. The increase in allowance is due to general reserves for organic loan growth, specific allocations on impaired assets and slightly higher qualitative factors in general allocation in recognition of certain macroeconomic trends in consumer and commercial real estate lending.

The following table presents, as of and for the periods indicated, an analysis of the allowance for loan losses and other related data:

	For the Six Months Ended June 30,		For the Year Ended December 31,
	2017	2016	2016
	(Dollars in thousands)		
Average loans outstanding(1)	$1,253,670	$1,126,049	$1,179,938
Gross loans outstanding at end of period(2)	$1,296,843	$1,185,161	$1,245,135
Allowance for loan losses at beginning of the period	11,484	9,263	9,263
Provision for loan losses	1,450	2,400	3,640
Charge-offs:			
Real Estate:			
Construction and development	—	—	9
Commercial real estate	84	—	—
Farmland	—	—	—
1-4 family residential	186	22	71
Multi-family residential	—	—	—
Commercial and industrial	48	11	1,213
Consumer	158	89	269
Agriculture	4	—	—
Overdrafts	70	67	200
Total charge-offs	550	189	1,762
Recoveries:			
Real Estate:			
Construction and development	—	4	4
Commercial real estate	—	—	—
Farmland	—	—	—
1-4 family residential	21	—	75
Multi-family residential	—	—	—
Commercial and industrial	—	13	17
Consumer	92	77	121
Agriculture	—	—	—
Overdrafts	28	38	126
Total recoveries	141	132	343
Net charge-offs	409	57	1,419
Allowance for loan losses at end of period	$12,525	$11,606	$11,484
Ratio of allowance to end of period loans(2)	0.97 %	0.98 %	0.92 %
Ratio of net charge-offs to average loans(1)	0.07 %	0.01 %	0.12 %

(1) Includes average outstanding balances of loans held for sale of $2.8 million, $3.0 million and $3.0 million for the six months ended June 30, 2017 and 2016 and for the year ended December 31, 2016, respectively.
(2) Excludes loans held for sale of $2.4 million, $2.9 million and $2.6 million for the six months ended June 30, 2017 and 2016 and for the year ended December 31, 2016, respectively.

The allowance for loan losses to non-performing loans has increased from 260.5% at December 31, 2016 to 316.4% at June 30, 2017. Non-performing loans decreased to $4.0 million at June 30, 2017 compared to $4.4 million at December 31, 2016 due primarily to one large loan totaling $1.7 million that was removed from nonaccrual status in the first quarter of 2017, and offset by smaller loans added to non-accrual status.

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Although we believe that we have established our allowance for loan losses in accordance with GAAP and that the allowance for loan losses was adequate to provide for known and inherent losses in the portfolio at all times shown above, future provisions for loan losses will be subject to ongoing evaluations of the risks in our loan portfolio. If our primary market areas experience economic declines, if asset quality deteriorates or if we are successful in growing the size of our loan portfolio, our allowance could become inadequate and material additional provisions for loan losses could be required.

The following table shows the allocation of the allowance for loan losses among loan categories and certain other information as of the dates indicated. The allocation of the allowance for loan losses as shown in the table should neither be interpreted as an indication of future charge-offs, nor as an indication that charge-offs in future periods will necessarily occur in these amounts or in the indicated proportions. The total allowance is available to absorb losses from any loan category.

	As of June 30, 2017		As of December 31, 2016	
	Amount	Percent to Total	Amount	Percent to Total
	(Dollars in thousands)			
Real estate:				
Construction and development	$1,554	13.69 %	$1,161	10.39 %
Commercial real estate	3,464	29.20 %	3,264	29.53 %
Farmland	541	4.92 %	482	5.01 %
1-4 family residential	3,726	27.49 %	3,960	29.15 %
Multi-family residential	269	2.22 %	281	2.09 %
Total real estate	9,554	77.53 %	9,148	76.17 %
Commercial and industrial	2,008	16.77 %	1,592	17.99 %
Consumer	592	4.01 %	591	4.32 %
Agricultural	371	1.69 %	153	1.52 %
Total allowance for loan losses	$12,525	100.00%	$11,484	100.00%

Securities

We use our securities portfolio to provide a source of liquidity, provide an appropriate return on funds invested, manage interest rate risk, meet collateral requirements and meet regulatory capital requirements. As of June 30, 2017, the carrying amount of our investment securities totaled $428.5 million, an increase of $82.2 million, or 23.7%, compared to $346.3 million as of December 31, 2016. Investment securities represented 22.4% and 18.9% of total assets as of June 30, 2017 and December 31, 2016, respectively.

Our investment portfolio consists of securities classified as available for sale and held to maturity. As of June 30, 2017, securities available for sale and securities held to maturity totaled $246.2 million and $182.2 million, respectively. As of December 31, 2016, securities available for sale and securities in held to maturity totaled $156.9 million and $189.4 million, respectively. Held to maturity percentages represented 42.5% of our investment portfolio as of June 30, 2017 and 54.7% as of December 31, 2016. While we generally seek to maintain 50.0% or less of our portfolio in held to maturity securities, the Company has the intent and ability to hold its held to maturity securities until maturity or call and the December 31, 2016 policy exception was approved by our board of directors. The carrying values of our investment securities classified as available for sale are adjusted for unrealized gain or loss, and any gain or loss is reported on an after-tax basis as a component of other comprehensive income in shareholders' equity.

The following tables summarize the amortized cost and estimated fair value of our investment securities:

	As of June 30, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
	(Dollars in thousands)			
Corporate bonds	$18,861	$ 180	$ 8	