

PENNS WOODS BANCORP INC  
Form 10-Q  
August 08, 2018  
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UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

for the Quarterly Period Ended June 30, 2018.

o Transition report pursuant to Section 13 or 15 (d) of the Exchange Act

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_ .

No. 0-17077  
(Commission File Number)

PENNS WOODS BANCORP, INC.  
(Exact name of Registrant as specified in its charter)  
PENNSYLVANIA 23-2226454  
(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

300 Market Street, P.O. Box 967 Williamsport, Pennsylvania 17703-0967  
(Address of principal executive offices) (Zip Code)

(570) 322-1111  
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 ý NO o

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 ý NO o

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 definition 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 o Accelerated filer x

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Non-accelerated filer  Small reporting company   
Emerging growth company

If an emerging growth company, indicate by check mark if 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

On August 1, 2018 there were 4,690,564 shares of the Registrant's common stock outstanding.

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

PENNS WOODS BANCORP, INC.  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

	June 30, 2018	December 31, 2017
(In Thousands, Except Share Data)		
<b>ASSETS:</b>		
Noninterest-bearing balances	\$26,134	\$25,692
Interest-bearing balances in other financial institutions	29,873	1,551
Total cash and cash equivalents	56,007	27,243
Investment debt securities, available for sale, at fair value	118,876	108,627
Investment equity securities, at fair value	2,438	2,516
Investment securities, trading	243	190
Restricted investment in bank stock, at fair value	16,716	13,332
Loans held for sale	2,118	1,196
Loans	1,331,073	1,246,614
Allowance for loan losses	(13,034 )	(12,858 )
Loans, net	1,318,039	1,233,756
Premises and equipment, net	27,385	27,386
Accrued interest receivable	4,618	4,321
Bank-owned life insurance	28,315	27,982
Goodwill	17,104	17,104
Intangibles	1,304	1,462
Deferred tax asset	4,941	4,388
Other assets	5,169	4,989
<b>TOTAL ASSETS</b>	<b>\$1,603,273</b>	<b>\$1,474,492</b>
<b>LIABILITIES:</b>		
Interest-bearing deposits	\$879,825	\$843,004
Noninterest-bearing deposits	311,194	303,316
Total deposits	1,191,019	1,146,320
Short-term borrowings	134,637	100,748
Long-term borrowings	123,970	70,970
Accrued interest payable	896	502
Other liabilities	13,616	17,758
<b>TOTAL LIABILITIES</b>	<b>1,464,138</b>	<b>1,336,298</b>
<b>SHAREHOLDERS' EQUITY:</b>		
Preferred stock, no par value, 3,000,000 shares authorized; no shares issued	—	—
Common stock, par value \$8.33, 15,000,000 shares authorized; 5,010,535 and 5,009,339 shares issued; 4,690,385 and 4,689,189 outstanding	41,753	41,744
Additional paid-in capital	50,225	50,173
Retained earnings	66,181	63,364
Accumulated other comprehensive loss:		

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Net unrealized loss on available for sale securities	(2,057	) (54	)
Defined benefit plan	(4,853	) (4,920	)
Treasury stock at cost, 320,150	(12,115	) (12,115	)
TOTAL PENNS WOODS BANCORP, INC. SHAREHOLDERS' EQUITY	139,134	138,192	
Non-controlling interest	1	2	
TOTAL SHAREHOLDERS' EQUITY	139,135	138,194	
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	\$1,603,273	\$1,474,492	

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF INCOME  
(UNAUDITED)

(In Thousands, Except Per Share Data)	Three Months		Six Months Ended	
	Ended June 30, 2018	2017	June 30, 2018	2017
INTEREST AND DIVIDEND INCOME:				
Loans, including fees	\$12,997	\$11,109	\$25,190	\$21,736
Investment securities:				
Taxable	639	570	1,185	1,112
Tax-exempt	230	323	471	621
Dividend and other interest income	245	207	466	422
TOTAL INTEREST AND DIVIDEND INCOME	14,111	12,209	27,312	23,891
INTEREST EXPENSE:				
Deposits	1,490	1,008	2,712	1,910
Short-term borrowings	252	4	476	8
Long-term borrowings	666	373	1,268	813
TOTAL INTEREST EXPENSE	2,408	1,385	4,456	2,731
NET INTEREST INCOME	11,703	10,824	22,856	21,160
PROVISION FOR LOAN LOSSES	335	215	495	545
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	11,368	10,609	22,361	20,615
NON-INTEREST INCOME:				
Service charges	592	559	1,143	1,087
Net debt securities gains (losses), available for sale	14	(12)	5	185
Net equity securities gains (losses)	6	—	(28)	—
Net securities (losses) gains, trading	(5)	—	(2)	2
Bank-owned life insurance	158	161	331	333
Gain on sale of loans	400	503	655	861
Insurance commissions	64	99	181	290
Brokerage commissions	330	361	673	692
Debit card fees	373	501	706	935
Other	430	591	779	1,029
TOTAL NON-INTEREST INCOME	2,362	2,763	4,443	5,414
NON-INTEREST EXPENSE:				
Salaries and employee benefits	4,919	4,608	9,967	9,378
Occupancy	699	614	1,440	1,252
Furniture and equipment	801	664	1,548	1,313
Software amortization	231	242	296	515
Pennsylvania shares tax	278	230	555	468
Professional fees	649	565	1,215	1,256
Federal Deposit Insurance Corporation deposit insurance	200	150	402	320
Marketing	268	204	519	375
Intangible amortization	78	86	158	176
Other	1,394	1,700	2,694	2,995
TOTAL NON-INTEREST EXPENSE	9,517	9,063	18,794	18,048
INCOME BEFORE INCOME TAX PROVISION	4,213	4,309	8,010	7,981
INCOME TAX PROVISION	733	1,223	1,322	2,209

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CONSOLIDATED NET INCOME	\$3,480	\$3,086	\$6,688	\$5,772
Less: Net loss attributable to noncontrolling interest	—	—	(1	) —
NET INCOME ATTRIBUTABLE TO PENNS WOODS BANCORP, INC.	\$3,480	\$3,086	\$6,689	\$5,772
EARNINGS PER SHARE - BASIC	\$0.74	\$0.65	\$1.43	\$1.22
EARNINGS PER SHARE - DILUTED	\$0.74	\$0.65	\$1.43	\$1.22
WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC	4,689,932	4,711,332	4,689,656	4,723,003
WEIGHTED AVERAGE SHARES OUTSTANDING - DILUTED	4,703,339	4,711,332	4,689,656	4,723,003
DIVIDENDS DECLARED PER SHARE	\$0.47	\$0.47	\$0.94	\$0.94

See accompanying notes to the unaudited consolidated financial statements.



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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME  
(UNAUDITED)

(In Thousands)	Three Months		Six Months	
	Ended June 30, 2018	2017	Ended June 30, 2018	2017
Net Income	\$3,480	\$3,086	\$6,689	\$5,772
Other comprehensive (loss) income:				
Change in unrealized (loss) gain on available for sale securities	(391 )	389	(1,852 )	1,128
Tax effect	84	(132 )	390	(382 )
Net realized (gain) loss on available for sale securities included in net income	(14 )	12	(5 )	(185 )
Tax effect	4	(4 )	1	62
Amortization of unrecognized pension gain	42	40	84	84
Tax effect	(9 )	(10 )	(17 )	(28 )
Total other comprehensive (loss) income	(284 )	295	(1,399 )	679
Comprehensive income	\$3,196	\$3,381	\$5,290	\$6,451

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
(UNAUDITED)

(In Thousands, Except Per Share Data)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE LOSS		TREASURY STOCK	NON-CONTROLLING INTEREST	TOTAL SHAREHOLDERS' EQUITY
	SHARES	AMOUNT							
Balance, December 31, 2016	5,007,109	\$41,726	\$50,075	\$61,610	\$(4,928)	\$(10,234)	\$—	\$138,249	
Net income				5,772				5,772	
Other comprehensive income					679			679	
Stock-based compensation			7					7	
Dividends declared (\$0.94 per share)				(4,430)				(4,430)	
Common shares issued for employee stock purchase plan	1,083	9	35					44	
Purchase of treasury stock (47,698 shares)						(1,881)		(1,881)	
Balance, June 30, 2017	5,008,192	\$41,735	\$50,117	\$62,952	\$(4,249)	\$(12,115)	\$—	\$138,440	

(In Thousands, Except Per Share Data)	COMMON STOCK		ADDITIONAL PAID-IN CAPITAL	RETAINED EARNINGS	ACCUMULATED OTHER COMPREHENSIVE LOSS		TREASURY STOCK	NON-CONTROLLING INTEREST	TOTAL SHAREHOLDERS' EQUITY
	SHARES	AMOUNT							
Balance, December 31, 2017	5,009,339	\$41,744	\$50,173	\$63,364	\$(4,974)	\$(12,115)	\$2	\$138,194	
Net income				6,689			(1)	6,688	
Adoption of ASU 2016-01				537	(537)			—	
Other comprehensive loss					(1,399)			(1,399)	
Stock-based compensation			12					12	
Dividends declared (\$0.94 per share)				(4,409)				(4,409)	
Common shares issued for employee stock purchase plan	1,196	9	40					49	
Balance, June 30, 2018	5,010,535	\$41,753	\$50,225	\$66,181	\$(6,910)	\$(12,115)	\$1	\$139,135	

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

(In Thousands)	Six Months Ended	
	June 30, 2018	2017
<b>OPERATING ACTIVITIES:</b>		
Net Income	\$6,689	\$5,772
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,244	1,389
Amortization of intangible assets	158	176
Provision for loan losses	495	545
Accretion and amortization of investment security discounts and premiums	395	465
Net securities gains, available for sale	(5 )	(185 )
Originations of loans held for sale	(23,436 )	(26,087 )
Proceeds of loans held for sale	23,169	27,218
Gain on sale of loans	(655 )	(861 )
Net equity securities losses	28	—
Net securities losses (gains), trading	2	(2 )
Proceeds from the sale of trading securities	254	332
Purchases of trading securities	(309 )	(485 )
Earnings on bank-owned life insurance	(331 )	(333 )
Increase in deferred tax asset	(163 )	(63 )
Other, net	(94 )	(3,461 )
Net cash provided by operating activities	7,441	4,420
<b>INVESTING ACTIVITIES:</b>		
Proceeds from sales of available for sale securities	4,483	9,130
Proceeds from calls and maturities of available for sale securities	3,961	5,388
Purchases of available for sale securities	(21,160 )	(18,434 )
Net increase in loans	(85,338 )	(46,226 )
Acquisition of premises and equipment	(948 )	(2,004 )
Proceeds from the sale of foreclosed assets	181	587
Purchase of bank-owned life insurance	(31 )	(30 )
Security Trades Payable	(3,669 )	—
Proceeds from redemption of regulatory stock	8,744	2,134
Purchases of regulatory stock	(12,128 )	(2,566 )
Net cash used for investing activities	(105,905)	(52,021 )
<b>FINANCING ACTIVITIES:</b>		
Net increase in interest-bearing deposits	36,821	59,119
Net increase (decrease) in noninterest-bearing deposits	7,878	(3,223 )
Proceeds from long-term borrowings	55,000	—
Repayment of long-term borrowings	(2,000 )	(10,000 )
Net increase in short-term borrowings	33,889	2,496
Dividends paid	(4,409 )	(4,430 )
Issuance of common stock	49	51
Purchases of treasury stock	—	(1,881 )
Net cash provided by financing activities	127,228	42,132
<b>NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS</b>	<b>28,764</b>	<b>(5,469 )</b>

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CASH AND CASH EQUIVALENTS, BEGINNING	27,243	43,671
CASH AND CASH EQUIVALENTS, ENDING	\$56,007	\$38,202
SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:		
Interest paid		\$4,062 \$2,772
Income taxes paid		1,500 2,350
Transfer of loans to foreclosed real estate		560 490
Transfer due to adoption of ASU 2016-01, equity securities fair value adjust, reclassification from AOCI to Retained Earnings, net of tax		537 —
See accompanying notes to the unaudited consolidated financial statements.		

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PENNS WOODS BANCORP, INC. AND SUBSIDIARIES  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1. Basis of Presentation

The consolidated financial statements include the accounts of Penns Woods Bancorp, Inc. (the “Company”) and its wholly-owned subsidiaries: Woods Investment Company, Inc., Woods Real Estate Development Company, Inc., Luzerne Bank, and Jersey Shore State Bank (Jersey Shore State Bank and Luzerne Bank are referred to together as the “Banks”) and Jersey Shore State Bank’s wholly-owned subsidiary, The M Group, Inc. D/B/A The Comprehensive Financial Group (“The M Group”). The Company also owns a controlling interest in United Insurance Solutions, LLC. All significant inter-company balances and transactions have been eliminated in the consolidation.

The interim financial statements are unaudited, but in the opinion of management reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017.

Tax Cuts and Jobs Act

Public law No. 115-97, commonly referred to as the Tax Cuts and Jobs Act (the "Tax Act"), enacted on December 22, 2017, reduced the U.S. federal corporate tax rate from 34% to 21% effective January 1, 2018. Also on December 22, 2017, the Securities and Exchange Commission issued Staff Accounting Bulletin No. 118 (“SAB 118”), which provides guidance on accounting for tax effects of the Tax Act. SAB 118 provides a measurement period of up to one year from the enactment date to complete the accounting. Any adjustments during this measurement period will be included in net earnings from continuing operations as an adjustment to income tax expense in the reporting period when such adjustments are determined. Based on the information available and current interpretation of the rules, the Company estimated the impact of the reduction in the corporate tax rate and remeasurement of certain deferred tax assets and liabilities. The amount recorded in the fourth quarter of 2017 related to the remeasurement of the Company's deferred tax balance resulted in additional income tax expense of \$2.7 million.

Newly Adopted Accounting Standards

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The Update’s core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this Update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This Update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. Upon adoption on January 1, 2018, we have included the related new disclosure requirements in Note 13.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments

(except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates 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; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019.

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All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. Upon adoption on January 1, 2018, the Company made a one-time cumulative effect adjustment from accumulated other comprehensive income to retained earnings of \$537,000. The net effect was an increase to retained earnings.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 40 through 50 of the Form 10-K for the year ended December 31, 2017.

In reference to the attached financial statements, all adjustments are of a normal recurring nature pursuant to Rule 10-01(b) (8) of Regulation S-X.

## Note 2. Accumulated Other Comprehensive Loss

The changes in accumulated other comprehensive loss by component shown net of tax and parenthesis indicating debits, as of June 30, 2018 and 2017 were as follows:

(In Thousands)	Three Months Ended June 30, 2018			Three Months Ended June 30, 2017		
	Net Unrealized Loss on Available for Sale Securities	Defined Benefit Plan	Total	Net Unrealized Gain (Loss) on Available for Sale Securities	Defined Benefit Plan	Total
Beginning balance	\$(1,740)	\$(4,886)	\$(6,626)	\$(281)	\$(4,263)	\$(4,544)
Other comprehensive (loss) gain before reclassifications	(307)	—	(307)	257	—	257
Amounts reclassified from accumulated other comprehensive loss	(10)	33	23	8	30	38
Net current-period other comprehensive (loss) income	(317)	33	(284)	265	30	295
Ending balance	\$(2,057)	\$(4,853)	\$(6,910)	\$(16)	\$(4,233)	\$(4,249)
(In Thousands)	Six Months Ended June 30, 2018			Six Months Ended June 30, 2017		
	Net Unrealized Loss on Available for Sale Securities	Defined Benefit Plan	Total	Net Unrealized Gain (Loss) on Available for Sale Securities	Defined Benefit Plan	Total
Beginning balance	\$(54)	\$(4,920)	\$(4,974)	\$(639)	\$(4,289)	\$(4,928)
Other comprehensive (loss) gain before reclassifications	(1,462)	—	(1,462)	746	—	746
Amounts reclassified from accumulated other comprehensive loss	(4)	67	63	(123)	56	(67)
Net current-period other comprehensive (loss) income	(1,466)	67	(1,399)	623	56	679
Reclassification from adoption of 2016-01	(537)	—	(537)	—	—	—
Ending balance	\$(2,057)	\$(4,853)	\$(6,910)	\$(16)	\$(4,233)	\$(4,249)

The reclassifications out of accumulated other comprehensive loss shown, net of tax and parenthesis indicating debits to net income, as of June 30, 2018 and 2017 were as follows:

Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss in the Consolidated
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	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Statement of Income
Net unrealized gain (loss) on available for sale securities	\$ 14	\$ (12 )	Net securities (losses) gains, available for sale
Income tax effect	(4 )	4	Income tax provision
Total reclassifications for the period	\$ 10	\$ (8 )	
Net unrecognized pension costs	\$ (42 )	\$ (40 )	Salaries and employee benefits
Income tax effect	9	10	Income tax provision
Total reclassifications for the period	\$ (33 )	\$ (30 )	

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Details about Accumulated Other Comprehensive Loss Components	Amount Reclassified from Accumulated Other Comprehensive Loss		Affected Line Item in the Consolidated Statement of Income
	Six months ended June 30, 2018	Six months ended June 30, 2017	
Net unrealized gain on available for sale securities	\$ 5	\$ 185	Net securities gains, available for sale
Income tax effect	(1 )	(62 )	Income tax provision
Total reclassifications for the period	\$ 4	\$ 123	
Net unrecognized pension costs	\$ (84 )	\$ (84 )	Salaries and employee benefits
Income tax effect	17	28	Income tax provision
Total reclassifications for the period	\$ (67 )	\$ (56 )	

## Note 3. Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments - Credit Losses: Measurement of Credit Losses on Financial Instruments, which changes the impairment model for most financial assets. This Update is intended to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations. The underlying premise of the Update is that financial assets measured at amortized cost should be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. The allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. The income statement will be effected for the measurement of credit losses for newly recognized financial assets, as well as the expected increases or decreases of expected credit losses that have taken place during the period. ASU 2016-13 is effective for annual and interim periods beginning after December 15, 2019, and early adoption is permitted for annual and interim periods beginning after December 15, 2018. With certain exceptions, transition to the new requirements will be through a cumulative effect adjustment to opening retained earnings as of the beginning of the first reporting period in which the guidance is adopted. We expect to recognize a one-time cumulative effect adjustment to the allowance for loan losses as of the beginning of the first reporting period in which the new standard is effective, but cannot yet determine the magnitude of any such one-time adjustment or the overall impact of the new guidance on the consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in this Update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting units fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. A public business entity that is a U.S. Securities and Exchange Commission (SEC) filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities, that are adopting the amendments in this Update should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021. This Update is not expected to have a significant impact on the Company's financial statements.

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In February 2017, the FASB issued ASU 2017-06, Plan Accounting: Defined Benefit Pension Plans (Topic 960), Defined Contribution Pension Plans (Topic 962), and Health and Welfare Benefit Plans (Topic 965). This Update relates primarily to the reporting by an employee benefit plan for its interest in a master trust, which is a trust for which a regulated financial institution serves as a trustee or custodian and in which assets of more than one plan sponsored by a single employer or by a group of employers under common control are held. For each master trust in which a plan holds an interest, the amendments in this Update require a plan's interest in that master trust and any change in that interest to be presented in separate line items in the statement of net assets available for benefits and in the statement of changes in net assets available for benefits, respectively. The amendments in this Update remove the requirement to disclose the percentage interest in the master trust for plans with divided interests and require that all plans disclose the dollar amount of their interest in each of those general types of investments, which supplements the existing requirement to disclose the master trusts balances in each general type of investments. There are also increased disclosure requirements for investments in master trusts. The amendments in this Update are effective for fiscal years beginning after December 15, 2018. Early adoption is permitted. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2017, the FASB issued ASU 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20). The amendments in this Update shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. This Update is not expected to have a significant impact on the Company's financial statements.

In July 2017, the FASB issued ASU 2017-11, Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), and Derivative and Hedging (Topic 815). The amendments in Part I of this Update change the classification analysis of certain equity-linked financial instruments (or embedded features) with down-round features. When determining whether certain financial instruments should be classified as liabilities or equity instruments, a down-round feature no longer precludes equity classification when assessing whether the instrument is indexed to an entity's own stock. The amendments also clarify existing disclosure requirements for equity-classified instruments. As a result, a freestanding equity-linked financial instrument (or embedded conversion option) no longer would be accounted for as a derivative liability at fair value as a result of the existence of a down-round feature. For freestanding equity classified financial instruments, the amendments require entities that present earnings per share (EPS) in accordance with Topic 260 to recognize the effect of the down-round feature when it is triggered. That effect is treated as a dividend and as a reduction of income available to common shareholders in basic EPS. Convertible instruments with embedded conversion options that have down-round features are now subject to the specialized guidance for contingent beneficial conversion features (in Subtopic 470-20, Debt-Debt with Conversion and Other Options), including related EPS guidance (in Topic 260). The amendments in Part II of this Update recharacterize the indefinite deferral of certain provisions of Topic 480 that now are presented as pending content in the Accounting Standards Codification, to a scope exception. Those amendments do not have an accounting effect. For public business entities, the amendments in Part I of this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments in Part I of this Update are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period. If an

entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments in Part I of this Update should be applied either retrospectively to outstanding financial instruments with a down-round feature by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in which the pending content that links to this paragraph is effective or retrospectively to outstanding financial instruments with a down-round feature for each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10. The amendments in Part II of this Update do not require any transition guidance because those amendments do not have an accounting effect. This Update is not expected to have a significant impact on the Company's financial statements.

In August 2017, the FASB issued ASU 2017-12, Derivatives and Hedging (Topic 850), the objective of which is to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. In addition, the amendments in this Update make certain targeted improvements to simplify the application and disclosure of the hedge accounting guidance in current general accepted accounting principles. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those

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fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early application is permitted in any period after issuance. For cash flow and net investment hedges existing at the date of adoption, an entity should apply a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year that an entity adopts the amendments in this Update. The amended presentation and disclosure guidance is required only prospectively. This Update is not expected to have a significant impact on the Company's financial statements.

In January 2018, the FASB issued ASU 2018-01, Leases (Topic 842), which provides an optional transition practical expedient to not evaluate under Topic 842 existing or expired land easements that were not previously accounted for as leases under the current lease guidance in Topic 840. An entity that elects this practical expedient should evaluate new or modified land easements under Topic 842 beginning at the date the entity adopts Topic 842; otherwise, an entity should evaluate all existing or expired land easements in connection with the adoption of the new lease requirements in Topic 842 to assess whether they meet the definition of a lease. The effective date and transition requirements for the amendments are the same as the effective date and transition requirements in ASU 2016-02. This Update is not expected to have a significant impact on the Company's financial statements.

In February 2018, the FASB issued ASU 2018-03, Technical Corrections and Improvements to Financial Instruments-Overall (Subtopic 825-10), to clarify certain aspects of the guidance issued in ASU 2016-01. (1) An entity measuring an equity security using the measurement alternative may change its measurement approach to a fair value method in accordance with Topic 820, Fair Value Measurement, through an irrevocable election that would apply to that security and all identical or similar investments of the same issuer. Once an entity makes this election, the entity should measure all future purchases of identical or similar investments of the same issuer using a fair value method in accordance with Topic 820. (2) Adjustments made under the measurement alternative are intended to reflect the fair value of the security as of the date that the observable transaction for a similar security took place. (3) Remeasuring the entire value of forward contracts and purchased options is required when observable transactions occur on the underlying equity securities. (4) When the fair value option is elected for a financial liability, the guidance in paragraph 825-10-45-5 should be applied, regardless of whether the fair value option was elected under either Subtopic 815-15, Derivatives and Hedging-Embedded Derivatives, or 825-10, Financial Instruments-Overall. (5) Financial liabilities for which the fair value option is elected, the amount of change in fair value that relates to the instrument specific credit risk should first be measured in the currency of denomination when presented separately from the total change in fair value of the financial liability. Then, both components of the change in the fair value of the liability should be remeasured into the functional currency of the reporting entity using end-of-period spot rates. (6) The prospective transition approach for equity securities without a readily determinable fair value in the amendments in Update 2016-01 is meant only for instances in which the measurement alternative is applied. An insurance entity subject to the guidance in Topic 944, Financial Services- Insurance, should apply a prospective transition method when applying the amendments related to equity securities without readily determinable fair values. An insurance entity should apply the selected prospective transition method consistently to the entity's entire population of equity securities for which the measurement alternative is elected. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years beginning after June 15, 2018. Public business entities with fiscal years beginning between December 15, 2017, and June 15, 2018, are not required to adopt these amendments until the interim period beginning after June 15, 2018, and public business entities with fiscal years beginning between June 15, 2018, and December 15, 2018, are not required to adopt these amendments before adopting the amendments in Update 2016-01. For all other entities, the effective date is the same as the effective date in Update 2016-01. All entities may early adopt these amendments for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years, as long as they have adopted Update 2016-01. The Company is currently evaluating the impact the adoption of the

standard will have on the Company's financial position or results of operations.

In March 2018, the FASB issued ASU 2018-04, Investments - Debt Securities (Topic 320) and Regulated Operations (Topic 980) - Amendments to SEC Paragraphs Pursuant to SEC Staff Accounting Bulletin No. 117 and SEC Release No. 33-9273, ASU 2018-04 supersedes various SEC paragraphs and adds an SEC paragraph pursuant to the issuance of Staff Accounting Bulletin No. 117.

#### Note 4. Per Share Data

There are no convertible securities which would affect the denominator in calculating basic and dilutive earnings per share. There were a total of 115,000 stock options, with an average exercise price of \$43.94, outstanding on June 30, 2018. A portion of these options were included, on a weighted average basis, in the computation of diluted earnings per share for the period due to the average market price of common shares of \$43.37 exceeding the exercise price of the options issued during 2015. There were a total of 96,500 stock options outstanding for the same period end in 2017 that had an average exercise price of \$43.61 and were excluded, on a weighted average basis, in the computation of diluted earnings per share because the quarterly average closing market price of common shares was \$43.26 for the period. Net income as presented on the consolidated statement of income will

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be used as the numerator. The following table sets forth the composition of the weighted average common shares (denominator) used in the basic and dilutive earnings per share computation.

	Three Months Ended		Six Months Ended	
	June 30, 2018	2017	June 30, 2018	2017
Weighted average common shares issued	5,010,082	5,007,747	5,009,806	5,007,503
Weighted average treasury stock shares	(320,150 )	(296,415 )	(320,150 )	(284,500 )
Weighted average common shares outstanding - basic	4,689,932	4,711,332	4,689,656	4,723,003
Dilutive effect of outstanding stock options	13,407	—	—	—
Weighted average common shares outstanding - diluted	4,703,339	4,711,332	4,689,656	4,723,003

## Note 5. Investment Securities

The amortized cost, gross unrealized gains and losses, and fair values of our investment securities portfolio at June 30, 2018 and December 31, 2017 are as follows:

(In Thousands)	June 30, 2018			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale (AFS):				
Mortgage-backed securities	\$5,702	\$ 34	\$ (220 )	\$5,516
State and political securities	65,635	119	(722 )	65,032
Other debt securities	50,143	12	(1,827 )	48,328
Total debt securities	\$121,480	\$ 165	\$ (2,769 )	\$118,876
Investment equity securities:				
Financial institution equity securities	\$487	\$ 730	\$ —	\$1,217
Other equity securities	1,300	—	(79 )	1,221
Investment equity securities	\$1,787	\$ 730	\$ (79 )	\$2,438
Trading:				
Financial institution equity securities	\$—	\$ —	\$ —	\$—
Other equity securities	252	5	(14 )	243
Trading investment equity securities	\$252	\$ 5	\$ (14 )	\$243

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(In Thousands)	December 31, 2017			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
Available for sale (AFS):				
Mortgage-backed securities	\$4,273	\$ 51	\$ (111 )	\$4,213
State and political securities	56,295	411	(198 )	56,508
Other debt securities	48,806	180	(1,080 )	47,906
Total debt securities	\$109,374	\$ 642	\$ (1,389 )	\$108,627
Investment equity securities:				
Financial institution equity securities	\$537	\$ 728	\$ —	\$1,265
Other equity securities	1,300	—	(49 )	1,251
Investment equity securities	\$1,837	\$ 728	\$ (49 )	\$2,516
Trading:				
Financial institution equity securities	\$20	\$ —	\$ —	\$20
Other equity securities	192	2	(24 )	170
Trading investment equity securities	\$212	\$ 2	\$ (24 )	\$190

Total net trading losses of \$5,000 and \$2,000 for the three and six months ended June 30, 2018 compared to net trading gains of zero and \$2,000 for the three and six months ended June 30, 2017 are included in the Consolidated Statement of Income.

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual debt securities have been in a continuous unrealized loss position, at June 30, 2018 and December 31, 2017.

(In Thousands)	June 30, 2018					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Available for sale (AFS):						
Mortgage-backed securities	\$2,750	\$ (56 )	\$ 2,181	\$ (164 )	\$4,931	\$ (220 )
State and political securities	35,049	(544 )	5,180	(178 )	40,229	(722 )
Other debt securities	17,590	(396 )	27,892	(1,431 )	45,482	(1,827 )
Total debt securities	\$55,389	\$ (996 )	\$ 35,253	\$ (1,773 )	\$90,642	\$ (2,769 )

(In Thousands)	December 31, 2017					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
Available for sale (AFS):						
Mortgage-backed securities	\$981	\$ (12 )	\$ 2,276	\$ (99 )	\$3,257	\$ (111 )
State and political securities	15,691	(104 )	3,018	(94 )	18,709	(198 )



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Other debt securities	7,512	(148	)	28,517	(932	)	36,029	(1,080	)
Total debt securities	\$24,184	\$ (264	)	\$ 33,811	\$ (1,125	)	\$57,995	\$ (1,389	)
Other equity securities	\$1,251	\$ (49	)	\$ —	\$ —		\$1,251	\$ (49	)

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At June 30, 2018, there were a total of 66 securities in a continuous unrealized loss position for less than twelve months and 30 individual securities that were in a continuous unrealized loss position for twelve months or greater.

The Company reviews its position quarterly and has determined that, at June 30, 2018, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at June 30, 2018, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(In Thousands)	Amortized Cost	Fair Value
Due in one year or less	\$ 6,665	\$ 6,663
Due after one year to five years	50,070	49,350
Due after five years to ten years	53,355	51,619
Due after ten years	11,390	11,244
Total	\$ 121,480	\$ 118,876

Total gross proceeds from sales of debt securities available for sale for the three and six months ended June 30, 2018 were \$1,120,000 and \$4,483,000, a decrease from the 2017 totals of \$6,478,000 and \$9,130,000.

The following table represents gross realized gains and losses within the available for sale portfolio:

(In Thousands)	Three Months Ended June 30, 2018		Six Months Ended June 30, 2018	
	2018	2017	2018	2017
Available for sale (AFS):				
Gross realized gains:				
Mortgage-backed securities	\$5	\$24	\$5	\$69
State and political securities	19	15	19	29
Total gross realized gains	\$24	\$39	\$24	\$98
Gross realized losses:				
State and political securities	\$—	\$—	\$9	\$—
Other debt securities	10	51	10	51
Total gross realized losses	\$10	\$51	\$19	\$51
Investment equity securities:				
Gross realized gains:				
Financial institution equity securities	\$—	\$—	\$—	\$288
Gross realized losses:				
Other equity securities	\$—	\$—	\$—	\$150

There were no impairment charges included in gross realized losses for the three and six months ended June 30, 2018 and 2017, respectively.

Investment securities with a carrying value of approximately \$72,056,000 and \$95,199,000 at June 30, 2018 and December 31, 2017, respectively, were pledged to secure certain deposits, repurchase agreements, and for other purposes as required by law.

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## Note 6. Loans

Management segments the Banks' loan portfolio to a level that enables risk and performance monitoring according to similar risk characteristics. Loans are segmented based on the underlying collateral characteristics. Categories include commercial, financial, and agricultural, real estate, and installment loans. Real estate loans are further segmented into three categories: residential, commercial, and construction, while installment loans are classified as either consumer automobile loans or other installment loans.

The following table presents the related aging categories of loans, by segment, as of June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018				
	Current	Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	Total
Commercial, financial, and agricultural	\$ 183,476	\$ 64	\$ 59	\$ 136	\$ 183,735
Real estate mortgage:					
Residential	609,415	3,972	281	1,918	615,586
Commercial	350,108	1,224	99	4,600	356,031
Construction	35,879	85	3	—	35,967
Consumer automobile loans	112,982	369	—	10	113,361
Other consumer installment loans	25,271	453	21	5	25,750
	1,317,131	\$ 6,167	\$ 463	\$ 6,669	1,330,430
Net deferred loan fees and discounts	643				643
Allowance for loan losses	(13,034 )				(13,034 )
Loans, net	\$ 1,304,740				\$ 1,318,039
	December 31, 2017				
(In Thousands)	Current	Past Due 30 To 89 Days	Past Due 90 Days Or More & Still Accruing	Non- Accrual	Total
Commercial, financial, and agricultural	\$ 178,022	\$ 663	\$ 86	\$ 114	\$ 178,885
Real estate mortgage:					
Residential	588,278	6,853	318	1,628	597,077
Commercial	325,148	1,823	80	4,968	332,019
Construction	31,547	116	20	—	31,683
Consumer automobile loans	79,595	87	—	32	79,714
Other consumer installment loans	26,740	202	5	17	26,964
	1,229,330	\$ 9,744	\$ 509	\$ 6,759	1,246,342
Net deferred loan fees and discounts	272				272
Allowance for loan losses	(12,858 )				(12,858 )
Loans, net	\$ 1,216,744				\$ 1,233,756

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The following table presents interest income the Banks would have recorded if interest had been recorded based on the original loan agreement terms and rate of interest for non-accrual loans and interest income recognized on a cash basis for non-accrual loans for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30,			
	2018		2017	
	Interest Would Have Recorded Original	Interest That Have Been Recorded on Cash Basis	Interest Income Would Have Recorded Original	Interest Have Recorded Cash Basis
Commercial, financial, and agricultural	\$ 3	\$ 1	\$ 11	\$ 6
Real estate mortgage:				
Residential	37	23	51	32
Commercial	77	22	114	9
Construction	—	—	—	—
Consumer automobile loans	—	—	—	—
Other consumer installment loans	1	1	1	—
	\$ 118	\$ 47	\$ 177	\$ 47

(In Thousands)	Six Months Ended June 30,			
	2018		2017	
	Interest Would Have Recorded Original	Interest That Have Been Recorded on Cash Basis	Interest Income Would Have Recorded Original	Interest Have Recorded Cash Basis
Commercial, financial, and agricultural	\$ 4	\$ 1	\$ 13	\$ 6
Real estate mortgage:				
Residential	68	34	94	51
Commercial	138	39	232	19
Construction	—	—	—	—
Consumer automobile loans	—	—	—	—
Other consumer installment loans	1	1	2	1
	\$ 211	\$ 75	\$ 341	\$ 77

**Impaired Loans**

Impaired loans are loans for which it is probable the Banks will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Banks evaluate such loans for impairment individually and do not aggregate loans by major risk classifications. The definition of “impaired loans” is not the same as the definition of “non-accrual loans,” although the two categories overlap. The Banks may choose to place a loan on non-accrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loan. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$100,000 and if the loan is either on non-accrual status or has a risk rating of substandard. Management

may also elect to measure an individual loan for impairment if less than \$100,000 on a case-by-case basis.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed. Interest income for impaired loans is recorded consistent with the Banks' policy on non-accrual loans.

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The following table presents the recorded investment, unpaid principal balance, and related allowance of impaired loans by segment as of June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018		
	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:			
Commercial, financial, and agricultural	\$ 1,028	\$ 1,028	\$ —
Real estate mortgage:			
Residential	1,902	1,902	—
Commercial	1,507	1,507	—
	4,437	4,437	—
With an allowance recorded:			
Commercial, financial, and agricultural	177	177	73
Real estate mortgage:			
Residential	2,095	2,144	228
Commercial	7,265	7,265	1,563
	9,537	9,586	1,864
Total:			
Commercial, financial, and agricultural	1,205	1,205	73
Real estate mortgage:			
Residential	3,997	4,046	228
Commercial	8,772	8,772	1,563
	\$ 13,974	\$ 14,023	\$ 1,864
	December 31, 2017		
(In Thousands)	Recorded Investment		
	Unpaid Principal Balance	Related Allowance	
With no related allowance recorded:			
Commercial, financial, and agricultural	\$ 1,033	\$ 1,033	\$ —
Real estate mortgage:			
Residential	1,428	1,428	—
Commercial	1,465	1,465	—
	3,926	3,926	—
With an allowance recorded:			
Commercial, financial, and agricultural	235	235	96
Real estate mortgage:			
Residential	2,304	2,353	367
Commercial	7,981	8,031	1,721
	10,520	10,619	2,184
Total:			
Commercial, financial, and agricultural	1,268	1,268	96
Real estate mortgage:			
Residential	3,732	3,781	367
Commercial	9,446	9,496	1,721
	\$ 14,446	\$ 14,545	\$ 2,184





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The following table presents the average recorded investment in impaired loans and related interest income recognized for the three and six months ended for June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018			2017		
	Average Investment in Impaired Loans	Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans	Average Investment in Impaired Loans	Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial, financial, and agricultural	\$1,227	\$ 17	\$ 1	\$394	\$ 3	\$ 6
Real estate mortgage:						
Residential	4,255	29	23	3,199	14	30
Commercial	9,170	36	22	12,885	52	9
Construction	—	—	—	—	—	—
Consumer automobile	—	—	—	—	—	—
Other consumer installment loans	1	—	1	10	—	2
	\$14,652	\$ 82	\$ 47	\$16,488	\$ 69	\$ 47
(In Thousands)	Six Months Ended June 30, 2018			2017		
	Average Investment in Impaired Loans	Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans	Average Investment in Impaired Loans	Interest Income Recognized on an Accrual Basis on Impaired Loans	Interest Income Recognized on a Cash Basis on Impaired Loans
Commercial, financial, and agricultural	\$1,241	\$ 34	\$ 1	\$324	\$ 7	\$ 6
Real estate mortgage:						
Residential	4,080	67	34	3,212	36	46
Commercial	9,211	94	39	12,635	85	19
Construction	—	—	—	—	—	—
Consumer automobile	—	—	—	—	—	—
Other consumer installment loans	1	—	1	8	—	2
	\$14,532	\$ 195	\$ 75	\$16,179	\$ 128	\$ 73

Currently, zero funds are committed to be advanced in connection with impaired loans.

#### Troubled Debt Restructurings

The loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (“TDR”), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower’s sustained repayment performance for a reasonable period, generally six months.



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There were four loan modifications considered TDR's completed during the six months ended June 30, 2018. Loan modifications that are considered TDR's completed during the three and six months ended June 30, 2018 were as follows:

(In Thousands, Except Number of Contracts)	Three Months Ended June 30,			
	2018		2017	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Real estate mortgage:				
Residential	1 \$ 67	\$ 67	—\$	— \$ —
(In Thousands, Except Number of Contracts)	Six Months Ended June 30,			
	2018		2017	
	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment	Pre-Modification Number of Outstanding Recorded Contracts Investment	Post-Modification Outstanding Recorded Investment
Real estate mortgage:				
Residential	3 \$ 169	\$ 169	—\$	— \$ —
Commercial	1 106	106	—	—
	4 \$ 275	\$ 275	—\$	— \$ —

There was one loan modification considered to be a TDR made during the twelve months previous to June 30, 2018 that defaulted during the six months ended June 30, 2018. This defaulted loan type and recorded investment as of June 30, 2018 is as follows: a residential real estate loan with a recorded investment of \$3,750. There were no loan modifications considered TDRs made during the twelve months previous to June 30, 2017 that defaulted during the three and six months ended June 30, 2017.

Troubled debt restructurings amounted to \$8,830,000 and \$9,048,000 as of June 30, 2018 and December 31, 2017.

The amount of foreclosed residential real estate held at June 30, 2018 and December 31, 2017, totaled \$485,000 and \$422,000, respectively. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process at June 30, 2018 and December 31, 2017, totaled \$78,000 and \$378,000, respectively.

## Internal Risk Ratings

Management uses a ten point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The special mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a substandard classification. Loans in the substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are evaluated for substandard classification. Loans in the doubtful category exhibit the same weaknesses found in the substandard loans, however, the weaknesses are more pronounced. Such loans are static and collection in full is improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Loans classified loss are considered uncollectible

and charge-off is imminent.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Banks have a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the pass category unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. An external annual loan review of large commercial relationships is performed, as well as a sample of smaller transactions. Confirmation of the appropriate risk category is included in the review. Detailed reviews, including plans for resolution, are performed on loans classified as substandard, doubtful, or loss on a quarterly basis.

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The following table presents the credit quality categories identified above as of June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018						Totals
	Commercial Financial, and Agricultural	Real Estate Residential	Mortgages Commercial	Construction	Consumer automobile	Other consumer installment loans	
Pass	\$ 181,796	\$ 613,050	\$ 337,974	\$ 35,967	\$ 113,361	\$ 25,750	\$ 1,307,898
Special Mention	657	393	7,074	—	—	—	8,124
Substandard	1,282	2,143	10,983	—	—	—	14,408
	\$ 183,735	\$ 615,586	\$ 356,031	\$ 35,967	\$ 113,361	\$ 25,750	\$ 1,330,430

  

(In Thousands)	December 31, 2017						Totals
	Commercial Financial, and Agricultural	Real Estate Residential	Mortgages Commercial	Construction	Consumer automobile	Other consumer installment loans	
Pass	\$ 175,603	\$ 593,828	\$ 311,209	\$ 31,535	\$ 79,714	\$ 26,964	\$ 1,218,853
Special Mention	738	1,043	7,337	—	—	—	9,118
Substandard	2,544	2,206	13,473	148	—	—	18,371
	\$ 178,885	\$ 597,077	\$ 332,019	\$ 31,683	\$ 79,714	\$ 26,964	\$ 1,246,342

## Allowance for Loan Losses

An allowance for loan losses (“ALL”) is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated future loss experience, and the amount of non-performing loans.

The Banks' methodology for determining the ALL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (previously discussed) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Banks' ALL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. Allowances are segmented based on collateral characteristics previously disclosed, and consistent with credit quality monitoring. Loans that are collectively evaluated for impairment are grouped into two classes for evaluation. A general allowance is determined for “Pass” rated credits, while a separate pool allowance is provided for “Criticized” rated credits that are not individually evaluated for impairment.

For the general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors. A historical charge-off factor is calculated utilizing a twelve quarter moving average. However, management may adjust the moving average time frame by up to four quarters to adjust for variances in the economic cycle. Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency rates and

non-accrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability, and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors. Management also monitors industry loss factors by loan segment for applicable adjustments to actual loss experience.

Management reviews the loan portfolio on a quarterly basis in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

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Activity in the allowance is presented for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018							Unallocated	Totals
	Commercial Financial, and Agricultural	Real Estate Mortgages Residential	Commercial	Construction	Consumer automobile	Other consumer installment			
Beginning Balance	\$ 1,372	\$ 5,656	\$ 4,003	\$ 156	\$ 1,016	\$ 305	\$ 328	\$ 12,836	
Charge-offs	(3 )	(91 )	—	—	(22 )	(47 )	—	(163 )	
Recoveries	8	1	—	3	2	12	—	26	
Provision	(322 )	17	(189 )	(41 )	73	47	750	335	
Ending Balance	\$ 1,055	\$ 5,583	\$ 3,814	\$ 118	\$ 1,069	\$ 317	\$ 1,078	\$ 13,034	

(In Thousands)	Three Months Ended June 30, 2017							Unallocated	Totals
	Commercial Financial, and Agricultural	Real Estate Mortgages Residential	Commercial	Construction	Consumer automobile	Other consumer installment			
Beginning Balance	\$ 1,441	\$ 5,571	\$ 4,466	\$ 187	\$ 202	\$ 346	\$ 692	\$ 12,905	
Charge-offs	200	(287 )	—	—	(15 )	(39 )	—	(141 )	
Recoveries	105	5	1	2	—	17	—	130	
Provision	(15 )	48	(740 )	(17 )	162	106	671	215	
Ending Balance	\$ 1,731	\$ 5,337	\$ 3,727	\$ 172	\$ 349	\$ 430	\$ 1,363	\$ 13,109	

(In Thousands)	Six Months Ended June 30, 2018							Unallocated	Totals
	Commercial Financial, and Agricultural	Real Estate Mortgages Residential	Commercial	Construction	Consumer automobile	Other consumer installment			
Beginning Balance	\$ 1,177	\$ 5,679	\$ 4,277	\$ 155	\$ 804	\$ 271	\$ 495	\$ 12,858	
Charge-offs	(36 )	(142 )	(55 )	—	(52 )	(118 )	—	(403 )	
Recoveries	15	25	—	5	3	36	—	84	
Provision	(101 )	21	(408 )	(42 )	314	128	583	495	
Ending Balance	\$ 1,055	\$ 5,583	\$ 3,814	\$ 118	\$ 1,069	\$ 317	\$ 1,078	\$ 13,034	

(In Thousands)	Six Months Ended June 30, 2017							Unallocated	Totals
	Commercial Financial, and Agricultural	Real Estate Mortgages Residential	Commercial	Construction	Consumer automobile	Other consumer installment			
Beginning Balance	\$ 1,554	\$ 5,383	\$ 4,975	\$ 178	\$ 143	\$ 273	\$ 390	\$ 12,896	
Charge-offs	(13 )	(385 )	—	—	(18 )	(113 )	—	(529 )	
Recoveries	111	35	1	5	—	45	—	197	
Provision	79	304	(1,249 )	(11 )	224	225	973	545	
Ending Balance	\$ 1,731	\$ 5,337	\$ 3,727	\$ 172	\$ 349	\$ 430	\$ 1,363	\$ 13,109	

The shift in allocation of the loan provision is primarily due to portfolio growth in the consumer automobile residential and improved credit metrics within the real estate mortgage portfolio.

The Company grants commercial, industrial, residential, and installment loans to customers primarily throughout north-east and central Pennsylvania. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

The Company has a concentration of the following to gross loans at June 30, 2018 and 2017:

	June 30,	
	2018	2017
Owners of residential rental properties	14.90%	15.64%
Owners of commercial rental properties	13.30%	14.56%





## Note 7. Net Periodic Benefit Cost-Defined Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 13 of the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2017.

The following sets forth the components of the net periodic benefit/cost of the domestic non-contributory defined benefit plan for the three and six months ended June 30, 2018 and 2017, respectively:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2018	2017	2018	2017
(In Thousands)				
Service cost	\$—	\$42	\$—	\$83
Interest cost	177	189	353	378
Expected return on plan assets	(274)	(263)	(548)	(525)
Amortization of net loss	42	40	84	84
Net periodic (benefit) cost	\$(55)	\$8	\$(111)	\$20

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## Employer Contributions

The Company previously disclosed in its consolidated financial statements, included in the Annual Report on Form 10-K for the year ended December 31, 2017, that it expected to contribute a minimum of \$500,000 to its defined benefit plan in 2018. As of June 30, 2018, there were contributions of \$250,000 made to the plan with additional contributions of at least \$250,000 anticipated during the remainder of 2018.

## Note 8. Employee Stock Purchase Plan

The Company maintains an Employee Stock Purchase Plan (“Plan”). The Plan is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the six months ended June 30, 2018 and 2017, there were 1,196 and 1,083 shares issued under the plan, respectively.

## Note 9. Off-Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments are primarily comprised of commitments to extend credit, standby letters of credit, and credit exposure from the sale of assets with recourse. These instruments involve, to varying degrees, elements of credit, interest rate, or liquidity risk in excess of the amount recognized in the Consolidated Balance Sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

The Company’s exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support financial instruments with off-balance sheet credit risk.

Financial instruments whose contract amounts represent credit risk are as follows at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018	December 31, 2017
Commitments to extend credit	\$281,934	\$ 264,982
Standby letters of credit	40,706	10,406
Credit exposure from the sale of assets with recourse	5,497	4,893
	\$328,137	\$ 280,281

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer’s credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, on an extension of credit is based on management’s credit assessment of the counterparty.

Standby letters of credit represent conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid or performance related contracts. The coverage period for these instruments is typically a one year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized upon expiration of the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

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## Note 10. Fair Value Measurements

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value.

- Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.
- Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.
- Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

This hierarchy requires the use of observable market data when available.

The following table presents the assets reported on the Consolidated Balance Sheet at their fair value on a recurring basis as of June 30, 2018 and December 31, 2017, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

(In Thousands)	June 30, 2018			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
Investment securities, available for sale:				
Mortgage-backed securities	\$—\$5,516	\$		—\$5,516
State and political securities	—65,032	—		65,032
Other debt securities	—48,328	—		48,328
Investment equity securities:				
Financial institution equity securities	1,217	—		1,217
Other equity securities	1,221	—		1,221
Investment securities, trading:				
Other equity securities	243	—		243
(In Thousands)	December 31, 2017			
	Level I	Level II	Level III	Total
Assets measured on a recurring basis:				
Investment securities, available for sale:				
Mortgage-backed securities	\$—\$4,213	\$		—\$4,213
State and political securities	—56,508	—		56,508
Other debt securities	—47,906	—		47,906
Financial institution equity securities	1,265	—		1,265
Other equity securities	1,251	—		1,251
Investment securities, trading:				
Other equity securities	190	—		190



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The following table presents the assets reported on the Consolidated Balance Sheet at their fair value on a non-recurring basis as of June 30, 2018 and December 31, 2017, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

(In Thousands)	June 30, 2018		
	Level I	Level II	Level III Total
Assets measured on a non-recurring basis:			
Impaired loans	\$—	—\$ 12,110	\$ 12,110
Other real estate owned	—	485	485

(In Thousands)	December 31, 2017		
	Level I	Level II	Level III Total
Assets measured on a non-recurring basis:			
Impaired loans	\$—	—\$ 12,262	\$ 12,262
Other real estate owned	—	143	143

The following tables present a listing of significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques as of June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018				
	Fair Value	Valuation Technique(s)	Unobservable Inputs	Range	Weighted Average
Impaired loans	\$6,481	Discounted cash flow	Temporary reduction in payment amount	0 to (70)%	(13)%
	5,629	Appraisal of collateral (1)	Appraisal adjustments (1)	0 to (20)%	(17)%
Other real estate owned	\$485	Appraisal of collateral (1)	Appraisal adjustments (1)	(20)%	(20)%

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

(In Thousands)	December 31, 2017				
	Fair Value	Valuation Technique(s)	Unobservable Inputs	Range	Weighted Average
Impaired loans	\$6,583	Discounted cash flow	Temporary reduction in payment amount	3 to (70)%	(4)%
	5,679	Appraisal of collateral (1)	Appraisal adjustments (1)	0 to (20)%	(17)%
Other real estate owned	\$143	Appraisal of collateral (1)	Appraisal adjustments (1)	(20)%	(20)%

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The discounted cash flow valuation technique is utilized to determine the fair value of performing impaired loans, while non-performing impaired loans utilize the appraisal of collateral method.

The significant unobservable inputs used in the fair value measurement of the Company's impaired loans using the discounted cash flow valuation technique include temporary changes in payment amounts and the probability of default. Significant increases (decreases) in payment amounts would result in significantly higher (lower) fair value measurements. The probability of default is 0% for impaired loans using the discounted cash flow valuation

technique because all defaulted impaired loans are valued using the appraisal of collateral valuation technique.

The significant unobservable input used in the fair value measurement of the Company's impaired loans using the appraisal of collateral valuation technique include appraisal adjustments, which are adjustments to appraisals by management for qualitative factors such as economic conditions and estimated liquidation expenses. The significant unobservable input used in the fair value measurement of the Company's other real estate owned are the same inputs used to value impaired loans using the appraisal of collateral valuation technique.



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## Note 11. Fair Value of Financial Instruments

The Company is required to disclose fair values for its financial instruments. Fair values are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Also, it is the Company's general practice and intention to hold most of its financial instruments to maturity and not to engage in trading or sales activities. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These fair values are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the fair values.

Fair values have been determined by the Company using historical data and an estimation methodology suitable for each category of financial instruments. The Company's fair values, methods, and assumptions are set forth below for the Company's other financial instruments.

As certain assets and liabilities, such as deferred tax assets, premises and equipment, and many other operational elements of the Company, are not considered financial instruments but have value, this fair value of financial instruments would not represent the full market value of the Company.

The fair values of the Company's financial instruments not recorded at fair value on a recurring or nonrecurring basis are as follows at June 30, 2018 and December 31, 2017:

(In Thousands)	Carrying Value	Fair Value	Fair Value Measurements at June 30, 2018		
			Level I	Level II	Level III
Financial assets:					
Cash and cash equivalents (1)	\$56,007	\$56,007	\$56,007	\$	—\$—
Restricted investment in bank stock	16,716	16,716	—	16,716	—
Loans held for sale (1)	2,118	2,118	2,118	—	—
Loans, net	1,318,039	1,318,938	—	—	1,318,938
Bank-owned life insurance (1)	28,315	28,315	28,315	—	—
Accrued interest receivable (1)	4,618	4,618	4,618	—	—
Financial liabilities:					
Interest-bearing deposits	\$879,825	\$853,441	\$604,667	\$	—\$248,774
Noninterest-bearing deposits (1)	311,194	311,194	311,194	—	—
Short-term borrowings (1)	134,637	134,637	134,637	—	—
Long-term borrowings	123,970	122,292	—	—	122,292
Accrued interest payable (1)	896	896	896	—	—

(1) The financial instrument is carried at cost at June 30, 2018, which approximate the fair value of the instruments

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(In Thousands)	Carrying Value	Fair Value	Fair Value Measurements at December 31, 2017		
			Level I	Level II	Level III
Financial assets:					
Cash and cash equivalents	\$27,243	\$27,243	\$ 27,243	\$ —	\$ —
Investment securities:					
Available for sale	111,143	111,143	2,516	108,627	—
Trading	190	190	190	—	—
Restricted investment in bank stock	13,332	13,332	—	13,332	—
Loans held for sale	1,196	1,196	1,196	—	—
Loans, net	1,233,756	1,264,584	—	—	1,264,584
Bank-owned life insurance	27,982	27,982	27,982	—	—
Accrued interest receivable	4,321	4,321	4,321	—	—
Financial liabilities:					
Interest-bearing deposits	\$843,004	\$838,441	\$ 611,187	\$ —	\$ 227,254
Noninterest-bearing deposits	303,316	303,316	303,316	—	—
Short-term borrowings	100,748	100,748	100,748	—	—
Long-term borrowings	70,970	70,280	—	—	70,280
Accrued interest payable	502	502	502	—	—

The methods and assumptions used by the Company in estimating fair values of financial instruments at June 30, 2018 is in accordance with ASC Topic 825, Financial Instruments, as amended by ASU 2016-01 which requires public entities to use exit pricing in the calculation of the above tables. Prior period fair value calculations were ran on the assumption of entry pricing and therefore the comparability between the periods above are diminished.

**Restricted Stock:**

The carrying value of restricted securities such as stock in the Federal Home Loan Bank ("FHLB") and other bankers' bank stock approximates fair value.

**Loans:**

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, financial, and agricultural, commercial real estate, residential real estate, construction real estate, and installment loans to individuals. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discounted rates are judgmentally determined using available market information and specific borrower information.

**Deposits:**

The fair value of deposits with no stated maturity, such as savings, NOW, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual

cash flows.

**Long Term Borrowings:**

The fair value of long term borrowings is based on the discounted value of contractual cash flows.

**Commitments to Extend Credit, Standby Letters of Credit, and Financial Guarantees Written:**

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items. The contractual amounts of unfunded commitments and letters of credit are presented in Note 9 (Off-Balance Sheet Risk).

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## Note 12. Stock Options

In 2014, the Company adopted the 2014 Equity Incentive Plan designed to help the Company attract, retain, and motivate employees and non-employee directors. Incentive stock options, non-qualified stock options, and restricted stock may be granted as part of the plan.

As of January 1, 2018, the Company had a total of 93,500 stock options outstanding. During the period ended June 30, 2018, the Company issued 25,000 stock options in total, to a group of employees, that have a strike price of \$45.11. The options granted in 2018 all expire ten years from the grant date however; of the 25,000 grants awarded, 12,500 of the options have a three year vesting period while the remaining 12,500 options vest in five years.

## Stock Options Granted

Date	Shares	Forfeited	Outstanding	Strike Price	Vesting Period	Expiration
January 5, 2018	12,500	—	12,500	\$45.11	3 years	10 years
January 5, 2018	12,500	—	12,500	45.11	5 years	10 years
March 24, 2017	46,250	(4,500 )	41,750	44.21	3 years	10 years
March 24, 2017	23,750	—	23,750	44.21	5 years	10 years
August 27, 2015	38,750	(14,250 )	24,500	42.03	5 years	10 years

A summary of stock option activity is presented below:

	June 30, 2018		June 30, 2017	
	Shares	Weighted Average Exercise Price	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	93,500	\$ 43.59	26,500	\$ 42.03
Granted	25,000	45.11	70,000	44.21
Exercised	—	—	—	—
Forfeited	(3,500 )	42.96	—	—
Expired	—	—	—	—
Outstanding, end of period	115,000	\$ 43.94	96,500	\$ 43.61
Exercisable, end of period	—	\$ —	—	\$ —

The estimated fair value of options, including the effect of estimated forfeitures, is recognized as expense on a straightline basis over the options' vesting periods while ensuring that the cumulative amount of compensation cost recognized at least equals the value of the vested portion of the award at that date. The Company determines the fair value of options granted using the Black-Scholes option-pricing model. The risk-free interest rate is based on the United States Treasury bond with a similar term to the expected life of the options at the grant date. Expected volatility was estimated based on the adjusted historic volatility of the Company's shares. The expected life was estimated to equal the contractual life of the options. The dividend yield rate was based upon recent historical dividends paid on shares.

Compensation expense for stock options is recognized using the fair value when the stock options are granted and is amortized over the options' vesting period. Compensation expense, related to stock options was \$4,000 and \$12,000 for the three and six months ended June 30, 2018 compared to \$8,000 and \$13,000 for the same period of 2017. As of June 30, 2018, no stock options were exercisable and the weighted average years to expiration were 8.6 years. The fair

value of options granted during the three and six months ended June 30, 2018 was approximately \$1,103,000 or \$44.11 per award. Total unrecognized compensation cost for non-vested options was \$94,000 and will be recognized over their weighted average remaining vesting period of 3.5 years.

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## Note 13. Revenue Recognition

On January 1, 2018, the Company adopted ASU No. 2014-09 “Revenue from Contracts with Customers” (Topic 606) and all subsequent ASUs that modified Topic 606 using the modified retrospective method, and applied the guidance to all contracts in scope that were not completed as of January 1, 2018. Results for reporting periods beginning after January 1, 2018 are presented under Topic 606, while prior period amounts were not adjusted and continue to be reported in accordance with our historic accounting under Topic 605.

The core principle of Topic 606, Revenue from Contracts with Customers, is that an entity recognize revenue at an amount that reflects the consideration to which the entity expects to be entitled in exchange for transferring goods or services to a customer. Topic 606 requires entities to exercise more judgment when considering the terms of a contract than under Topic 605, Revenue Recognition. Topic 606 applies to all contracts with customers to provide goods or services in the ordinary course of business, except for contracts that are specifically excluded from its scope.

Topic 606 does not apply to revenue associated with interest income on financial instruments, including loans and securities. Additionally, certain noninterest income streams such as certain credit and debit card fees, income from bank owned life insurance, and gain and losses on sales of investment securities are out of scope of Topic 606.

Topic 606 is applicable to noninterest revenue streams such as service charges on deposit accounts, merchant income, wire transfer income, check cashing fees, check printing fees, safe deposit box rental fees, life insurance and brokerage commissions. These revenue streams are largely transactional based and revenue is recognized upon completion of transaction.

## Principal versus Agent Considerations

When more than one party is involved in providing goods or services to a customer, Topic 606 requires the Company to determine whether it is the principal or an agent in these transactions by evaluating the nature of its promise to the customer. An entity is a principal and therefore records revenue on a gross basis if it controls a promised good or service before transferring that good or service to the customer. An entity is an agent and records as revenue the net amount it retains for its agency services if its role is to arrange for another entity to provide the goods or services. The Company most commonly acts as a principal and records revenue on a gross basis, except in certain circumstances. As an example, revenues earned from interchange fees, in which the Company acts as an agent, are recorded as non-interest income, net of the related expenses paid to the principal. Brokerage and insurance commissions are recognized when the M Group's services to the broker dealer and investment representative are complete.

## Debit Card Fees

Interchange fees are one source of debit and credit card income that is comprised of an amount merchants pay card-issuing banks for the processing of their electronic transactions as a form of payment. ATM service charges, check card usage, and POS debit card transactions generate interchange and debit card income. Per Topic 606 interchange and debit card transaction fees are reported net of related network costs. See Note 1 - Newly Adopted Accounting Standards. Prior to the adoption of Topic 606, non-interest expense included network costs. Interchange and debit card transaction fees for the three and six months ended June 30, 2018 reported on a net basis totaled \$373,000 and \$706,000; for the corresponding periods of 2017 such amounts were \$340,000 and \$611,000, respectively. The below table compares gross interchange and debit card transaction fees net network costs for 2018 and 2017:

	Three Months	Six months ended June
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(In Thousands)	Ended June 30,			
	2018	2017	2018	2017
Debit card transaction fees	\$541	\$501	\$1,060	\$935
Other processing service fees	67	63	128	122
Gross interchange and card based transaction fees	608	564	1,188	1,057
Network costs	235	224	482	446
Net interchange and card based transaction fees	\$373	\$340	\$706	\$611

Note 14. Reclassification of Comparative Amounts

Certain comparative amounts for the prior period have been reclassified to conform to current period presentations. Such reclassifications had no effect on net income or shareholders' equity.

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CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report contains certain “forward-looking statements” including statements concerning plans, objectives, future events or performance and assumptions and other statements which are other than statements of historical fact. The Company cautions readers that the following important factors, among others, may have affected and could in the future affect the Company’s actual results and could cause the Company’s actual results for subsequent periods to differ materially from those expressed in any forward-looking statement made by or on behalf of the Company herein: (i) the effect of changes in laws and regulations, including federal and state banking laws and regulations, with which the Company must comply, and the associated costs of compliance with such laws and regulations either currently or in the future as applicable; (ii) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies as well as by the Financial Accounting Standards Board, or of changes in the Company’s organization, compensation and benefit plans; (iii) the effect on the Company’s competitive position within its market area of the increasing consolidation within the banking and financial services industries, including the increased competition from larger regional and out-of-state banking organizations as well as non-bank providers of various financial services; (iv) the effect of changes in interest rates; (v) the effect of changes in the business cycle and downturns in the local, regional or national economies; and (vi) the Risk Factors identified in Item 1A of the Company’s Annual Report on Form 10-K for the year ended December 31, 2017 and in other filings made by the Company under the Securities Exchange Act of 1934.

You should not put undue reliance on any forward-looking statements. These statements speak only as of the date of this Quarterly Report on Form 10-Q, even if subsequently made available by the Company on its website or otherwise. The Company undertakes no obligation to update or revise these statements to reflect events or circumstances occurring after the date of this Quarterly Report on Form 10-Q.

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

EARNINGS SUMMARY

Comparison of the Three and Six Months Ended June 30, 2018 and 2017

Summary Results

Net income for the three and six months ended June 30, 2018 was \$3,480,000 and \$6,689,000 compared to \$3,086,000 and \$5,772,000 for the same periods of 2017, including the effects of an increase in after-tax securities gains of \$20,000 (from a loss of \$8,000 to a gain of \$12,000) for the three-month period ends and a decrease in after after-tax securities gains of \$143,000 (from a gain of \$123,000 to a loss of \$20,000 for the six-month period ends). Basic and diluted earnings per share for the three and six months ended June 30, 2018 was \$0.74 and \$1.43 compared to \$0.65 and \$1.22, respectively, for 2017. Return on average assets and return on average equity were 0.91% and 10.07% for the three months ended June 30, 2018 compared to 0.88% and 8.79% for the corresponding period of 2017. Return on average assets and return on average equity were 0.89% and 9.68% for the six months ended June 30, 2018 compared to the corresponding 2017 returns of 0.83% and 8.24%. Net income from core operations (“operating earnings”) was \$3,468,000 for the three months ended June 30, 2018 and \$6,709,000 for the six months end June 30, 2018 compared to \$3,094,000 and \$5,649,000 for the same periods of 2017. Basic and diluted operating earnings per share for the three and six months ended June 30, 2018 were \$0.74 and \$1.43 compared to \$0.66 and \$1.20 basic and diluted for the corresponding periods of 2017. Impacting the level of operating earnings were several factors including the continued shift of earning assets from the investment portfolio to the loan portfolio as the balance sheet is actively managed to reduce market risk and interest rate risk in a rising rate environment.



Management uses the non-GAAP measure of net income from core operations, or operating earnings, in its analysis of the Company's performance. This measure, as used by the Company, adjusts net income by excluding significant gains or losses that are unusual in nature. Because certain of these items and their impact on the Company's performance are difficult to predict, management believes the presentation of financial measures excluding the impact of such items provides useful supplemental information in evaluating the operating results of the Company's core businesses. For purposes of this Quarterly Report on Form 10-Q, net income from core operations, or operating earnings, means net income adjusted to exclude after-tax net securities gains or losses and bank-owned life insurance gains on death benefit. These disclosures should not be viewed as a substitute for net income determined in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

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## Reconciliation of GAAP and Non-GAAP Financial Measures

(Dollars in Thousands, Except Per Share Data)	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
GAAP net income	\$3,480	\$3,086	\$6,689	\$5,772
Less: net securities gains (losses), net of tax	12	(8)	(20)	123
Non-GAAP operating earnings	\$3,468	\$3,094	\$6,709	\$5,649
	Three Months		Six Months	
	Ended June		Ended June	
	30,		30,	
	2018	2017	2018	2017
Return on average assets (ROA)	0.91%	0.88%	0.89%	0.83%
Less: net securities gains (losses), net of tax	0.01%	—%	—%	0.01%
Non-GAAP operating ROA	0.90%	0.88%	0.89%	0.82%
	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
Return on average equity (ROE)	10.07%	8.79%	9.68%	8.24%
Less: net securities gains (losses), net of tax	0.03%	(0.03)%	(0.03)%	0.18%
Non-GAAP operating ROE	10.04%	8.82%	9.71%	8.06%
	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
Basic earnings per share (EPS)	\$0.74	\$0.65	\$1.43	\$1.22
Less: net securities gains (losses), net of tax	—	(0.01)	—	0.02
Non-GAAP basic operating EPS	\$0.74	\$0.66	\$1.43	\$1.20
	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
Dilutive EPS	\$0.74	\$0.65	\$1.43	\$1.22
Less: net securities gains (losses), net of tax	—	(0.01)	—	0.02
Non-GAAP dilutive operating EPS	\$0.74	\$0.66	\$1.43	\$1.20

## Interest and Dividend Income

Interest and dividend income for the three months ended June 30, 2018 increased to \$14,111,000 compared to \$12,209,000 for the same period of 2017. Current year to date interest and dividend income for 2018 increased \$3,421,000 from the prior year level of \$23,891,000 to \$27,312,000 for 2018. Loan portfolio income increased due to the impact of portfolio growth, primarily in home equity products and indirect auto lending. Investment securities income declined slightly for the six month period due to a decrease in the size of the investment portfolio as the duration in the investment portfolio continues to be shortened in order to reduce interest rate and market risk in the future. This is being undertaken primarily through the sale of long-term municipal and intermediate corporate bonds.



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Interest and dividend income composition for the three and six months ended June 30, 2018 and 2017 was as follows:

(In Thousands)	Three Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$12,997	92.11 %	\$11,109	90.99 %	\$1,888	17.00 %
Investment securities:						
Taxable	639	4.53	570	4.66	69	12.11
Tax-exempt	230	1.63	323	2.65	(93 )	(28.79)
Dividend and other interest income	245	1.73	207	1.70	38	18.36
Total interest and dividend income	\$14,111	100.00%	\$12,209	100.00%	\$1,902	15.58 %
(In Thousands)	Six Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Loans including fees	\$25,190	92.23 %	\$21,736	90.98 %	\$3,454	15.89 %
Investment securities:						
Taxable	1,185	4.34	1,112	4.65	73	6.56
Tax-exempt	471	1.72	621	2.60	(150 )	(24.15)
Dividend and other interest income	466	1.71	422	1.77	44	10.43
Total interest and dividend income	\$27,312	100.00%	\$23,891	100.00%	\$3,421	14.32 %

## Interest Expense

Interest expense for the three months ended June 30, 2018 increased \$1,023,000 to \$2,408,000 compared to \$1,385,000 for the same period of 2017 with the six months ended June 30, 2018 increasing by \$1,725,000 to \$4,456,000 compared to the 2017 level of \$2,731,000. The increase in interest expense is the result of growth within the deposit portfolio and the lengthening of the time deposit portfolio as part of a strategy to build balance sheet protection in a rising rate environment. In addition, short and long-term borrowings have been utilized to assist with the funding of the loan portfolio growth.

Interest expense composition for the three and six months ended June 30, 2018 and 2017 was as follows:

(In Thousands)	Three Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposits	\$1,490	61.88 %	\$1,008	72.78 %	\$482	47.82 %
Short-term borrowings	252	10.47	4	0.29	248	6,200.00
Long-term borrowings	666	27.65	373	26.93	293	78.55
Total interest expense	\$2,408	100.00%	\$1,385	100.00%	\$1,023	73.86 %
(In Thousands)	Six Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Deposits	\$2,712	60.86 %	\$1,910	69.94 %	\$802	41.99 %
Short-term borrowings	476	10.68	8	0.29	468	5,850.00
Long-term borrowings	1,268	28.46	813	29.77	455	55.97
Total interest expense	\$4,456	100.00%	\$2,731	100.00%	\$1,725	63.16 %

## Net Interest Margin

The net interest margin ("NIM") for the three and six months ended June 30, 2018 was 3.32% and 3.31% compared to 3.44% and 3.42% for the corresponding period of 2017. The decrease in the net interest margin was driven by an increase in the cost of interest-bearing liabilities of 30 basis points ("bps") for the three month period and 25 bps for the six month period primarily from an increase in the rate paid on time deposits as the liabilities are lengthened. The impact of the increased cost of funds was limited by an increase in the yield on earning assets of 12 bps and 9 bps for the three and six month periods. The increase in the yield on

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earning assets was driven by an increase in the loan portfolio yield in conjunction with an increase in the average loan portfolio of \$177.4 million and \$169.6 million respectively. The impact of the decreasing investment portfolio balance was offset by growth in the balance of the average loan portfolio from June 30, 2017 to June 30, 2018. The primary funding for the loan growth was an increase in total deposits. Core deposits represent a lower cost funding source than time deposits and comprise 78.80% of total deposits at June 30, 2018 compared to 82.11% at June 30, 2017. Limiting the positive impact on the net interest margin caused by the growth in core deposits was the lengthening of the time deposit portfolio.

The following is a schedule of average balances and associated yields for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	AVERAGE BALANCES AND INTEREST RATES							
	Three Months Ended June 30, 2018				Three Months Ended June 30, 2017			
	Average Balance (1)	Interest	Average Rate		Average Balance (1)	Interest	Average Rate	
<b>Assets:</b>								
Tax-exempt loans (3)	\$75,859	\$563	2.98	%	\$41,685	\$405	3.89	%
All other loans	1,225,343	12,552	4.11	%	1,082,165	10,842	4.02	%
Total loans (2)	1,301,202	13,115	4.04	%	1,123,850	11,247	4.01	%
Taxable securities	93,024	871	3.75	%	83,895	680	3.24	%
Tax-exempt securities (3)	40,300	291	2.89	%	52,850	489	3.70	%
Total securities	133,324	1,162	3.49	%	136,745	1,169	3.42	%
Interest-bearing deposits	3,034	13	1.72	%	36,662	96	1.05	%
Total interest-earning assets	1,437,560	14,290	3.99	%	1,297,257	12,512	3.87	%
Other assets	97,034				100,356			
Total assets	\$1,534,594				\$1,397,613			
<b>Liabilities and shareholders' equity:</b>								
Savings	\$165,231	16	0.04	%	\$158,413	15	0.04	%
Super Now deposits	234,731	242	0.41	%	202,692	131	0.26	%
Money market deposits	243,771	290	0.48	%	288,035	255	0.36	%
Time deposits	253,398	942	1.49	%	205,418	607	1.19	%
Total interest-bearing deposits	897,131	1,490	0.67	%	854,558	1,008	0.47	%
Short-term borrowings	56,530	252	1.76	%	10,579	4	0.15	%
Long-term borrowings	123,970	666	2.12	%	75,998	373	1.95	%
Total borrowings	180,500	918	2.01	%	86,577	377	1.73	%
Total interest-bearing liabilities	1,077,631	2,408	0.89	%	941,135	1,385	0.59	%
Demand deposits	302,742				300,311			
Other liabilities	16,024				15,801			
Shareholders' equity	138,197				140,366			

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Total liabilities and shareholders' equity	\$1,534,594			\$1,397,613		
Interest rate spread		3.10	%		3.28	%
Net interest income/margin	\$11,882	3.32	%	\$11,127	3.44	%

1. Information on this table has been calculated using average daily balance sheets to obtain average balances.
2. Non-accrual loans have been included with loans for the purpose of analyzing net interest earnings.
3. Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard tax rate of 21% for 2018 and 34% for 2017.

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(In Thousands)	AVERAGE BALANCES AND INTEREST RATES							
	Six Months Ended June 30, 2018				Six Months Ended June 30, 2017			
	Average Balance (1)	Interest	Average Rate		Average Balance (1)	Interest	Average Rate	
<b>Assets:</b>								
Tax-exempt loans (3)	\$75,548	\$1,130	3.02	%	\$41,959	\$821	3.95	%
All other loans	1,205,945	24,297	4.06	%	1,069,896	21,194	3.99	%
Total loans (2)	1,281,493	25,427	4.00	%	1,111,855	22,015	3.99	%
Taxable securities	88,670	1,630	3.68	%	86,591	1,365	3.15	%
Tax-exempt securities	41,225	596	2.89	%	49,779	941	3.78	%
Total securities	129,895	2,226	3.43	%	136,370	2,306	3.38	%
Interest-bearing deposits	2,603	21	1.63	%	34,924	169	0.98	%
Total interest-earning assets	1,413,991	27,674	3.94	%	1,283,149	24,490	3.85	%
Other assets	97,318				99,934			
Total assets	\$1,511,309				\$1,383,083			
<b>Liabilities and shareholders' equity:</b>								
Savings	\$164,140	32	0.04	%	\$157,423	30	0.04	%
Super Now deposits	230,930	449	0.39	%	196,032	237	0.24	%
Money market deposits	240,127	500	0.42	%	275,529	446	0.33	%
Time deposits	244,805	1,731	1.43	%	207,722	1,197	1.16	%
Total interest-bearing deposits	880,002	2,712	0.62	%	836,706	1,910	0.46	%
Short-term borrowings	59,152	476	1.60	%	10,962	8	0.15	%
Long-term borrowings	119,274	1,268	2.11	%	79,258	813	2.04	%
Total borrowings	178,426	1,744	1.94	%	90,220	821	1.81	%
Total interest-bearing liabilities	1,058,428	4,456	0.84	%	926,926	2,731	0.59	%
Demand deposits	298,011				300,207			
Other liabilities	16,645				15,770			
Shareholders' equity	138,225				140,180			
Total liabilities and shareholders' equity	\$1,511,309				\$1,383,083			
Interest rate spread			3.10	%			3.26	%
Net interest income/margin		\$23,218	3.31	%		\$21,759	3.42	%

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months		Six Months	
	Ended June 30,		Ended June 30,	
	2018	2017	2018	2017
Total interest income	\$14,111	\$12,209	\$27,312	\$23,891



Total interest expense	2,408	1,385	4,456	2,731
Net interest income	11,703	10,824	22,856	21,160
Tax equivalent adjustment	179	303	362	599
Net interest income (fully taxable equivalent)	\$11,882	\$11,127	\$23,218	\$21,759

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The following table sets forth the respective impact that both volume and rate changes have had on net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2018 and 2017:

(In Thousands)	Three Months Ended June 30, 2018 vs. 2017			Six Months Ended June 30, 2018 vs. 2017		
	Increase (Decrease) Due to Volume	Increase (Decrease) Due to Rate	Increase (Decrease) Due to Net	Increase (Decrease) Due to Volume	Increase (Decrease) Due to Rate	Increase (Decrease) Due to Net
<b>Interest income:</b>						
Tax-exempt loans	\$ 271	\$(113 )	\$ 158	\$ 538	\$(229 )	\$ 309
All other loans	1,463	247	1,710	2,727	376	3,103
Taxable investment securities	79	112	191	33	232	265
Tax-exempt investment securities	(103 )	(95 )	(198 )	(145 )	(200 )	(345 )
Interest bearing deposits	(121 )	38	(83 )	(158 )	10	(148 )
Total interest-earning assets	1,589	189	1,778	2,995	189	3,184
<b>Interest expense:</b>						
Savings deposits	1	—	1	2	—	2
Super Now deposits	24	87	111	47	165	212
Money market deposits	(43 )	78	35	(62 )	116	54
Time deposits	161	174	335	234	300	534
Short-term borrowings	70	178	248	147	321	468
Long-term borrowings	257	36	293	425	30	455
Total interest-bearing liabilities	470	553	1,023	793	932	1,725
Change in net interest income	\$ 1,119	\$(364 )	\$ 755	\$ 2,202	\$(743 )	\$ 1,459

**Provision for Loan Losses**

The provision for loan losses is based upon management's quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Banks. Management remains committed to an aggressive program of problem loan identification and resolution.

The allowance for loan losses is determined by applying loss factors to outstanding loans by type, excluding loans for which a specific allowance has been determined. Loss factors are based on management's consideration of the nature of the portfolio segments, changes in mix and volume of the loan portfolio, and historical loan loss experience. In addition, management considers industry standards and trends with respect to non-performing loans and its knowledge and experience with specific lending segments.

Although management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate at June 30, 2018, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, increased unemployment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets, charge-offs, loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Banks' loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

When determining the appropriate allowance level, management has attributed the allowance for loan losses to various portfolio segments; however, the allowance is available for the entire portfolio as needed.

The allowance for loan losses increased slightly from \$12,858,000 at December 31, 2017 to \$13,034,000 at June 30, 2018. The increase in the allowance for loan losses was driven by a shift in the loan portfolio that resulted in growth of loan categories that traditionally have had a lower loss ratio. The majority of the loans charged-off had a specific allowance within the allowance for losses. At June 30, 2018 and December 31, 2017, the allowance for loan losses to total loans was 0.98% and 1.03%, respectively.

The provision for loan losses totaled \$335,000 and \$495,000 for the three and six months ended June 30, 2018 and the respective periods for 2017 were \$215,000 and \$545,000. The amount of the provision for loan losses was lower for the six months ended

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June 30, 2018 compared to the prior period primarily as a result of a reduction in non-performing loans and a low level of net charge-offs.

Nonperforming loans decreased to \$7,132,000 at June 30, 2018 from \$12,498,000 at June 30, 2017. The majority of nonperforming loans are centered on loans that are either in a secured position and have sureties with a strong underlying financial position or have a specific allocation for any impairment recorded within the allowance for loan losses. The ratio of nonperforming loans to total loans was 0.44% and 1.10% at June 30, 2018 and 2017, respectively, and the ratio of the allowance for loan losses to nonperforming loans was 182.75% and 104.89% at June 30, 2018 and 2017, respectively. Internal loan review and analysis coupled with loan growth dictated a provision for loan losses of \$495,000 for the six months ended June 30, 2018.

The following is a table showing total nonperforming loans as of:

(In Thousands)	Total Nonperforming Loans		
	90 Days Past Due	Non-Due	Total
June 30, 2018	\$ 463	\$ 6,669	\$ 7,132
March 31, 2018	446	7,195	7,641
December 31, 2017	509	6,759	7,268
September 30, 2017	261	8,056	8,317
June 30, 2017	1,329	11,169	12,498

## Non-interest Income

Total non-interest income for the three months ended June 30, 2018 compared to the same period in 2017 decreased \$401,000 to \$2,362,000 and decreased by \$971,000 for the six months ended June 30, 2018 to \$4,443,000. Excluding net securities gains, non-interest income for the three and six months ended June 30, 2018 decreased \$428,000 and \$759,000, respectively, compared to the same periods in 2017. The decrease in gain on sale of loans was driven by decreased volume. The changes in insurance and brokerage commissions are due to a change in the product mix of consumer purchases. Debit cards fees as reported under ASC 606 for the three and six months ended June 30, 2018 was reported on a net basis while the corresponding period for 2017 was reported in accordance with ASC 605 on a gross basis. See note 13 for further information.

Non-interest income composition for the three and six months ended June 30, 2018 and 2017 was as follows:

(In Thousands)	Three Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Service charges	\$592	25.07 %	\$559	20.23 %	\$33	5.90 %
Net debt securities gains (losses), available for sale	14	0.59	(12 )	(0.43 )	26	(216.67)
Net equity securities gains (losses)	6	0.25	—	—	6	(100.00)
Net securities (losses) gains, trading	(5 )	(0.21 )	—	—	(5 )	100.00
Bank-owned life insurance	158	6.69	161	5.83	(3 )	(1.86 )
Gain on sale of loans	400	16.93	503	18.20	(103 )	(20.48 )
Insurance commissions	64	2.71	99	3.58	(35 )	(35.35 )
Brokerage commissions	330	13.97	361	13.07	(31 )	(8.59 )
Debit card fees	373	15.79	501	18.13	(128 )	(25.55 )
Other	430	18.21	591	21.39	(161 )	(27.24 )
Total non-interest income	\$2,362	100.00 %	\$2,763	100.00 %	\$(401)	(14.51 )%



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(In Thousands)	Six Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Service charges	\$1,143	25.73 %	\$1,087	20.08 %	\$56	5.15 %
Net debt securities gains (losses), available for sale	5	0.11	185	3.42	(180 )	(97.30 )
Net equity securities gains (losses)	(28 )	(0.63 )	—	—	(28 )	(100.00)
Net securities (losses) gains, trading	(2 )	(0.05 )	2	0.04	(4 )	(200.00)
Bank-owned life insurance	331	7.45	333	6.15	(2 )	(0.60 )
Gain on sale of loans	655	14.74	861	15.90	(206 )	(23.93 )
Insurance commissions	181	4.07	290	5.36	(109 )	(37.59 )
Brokerage commissions	673	15.15	692	12.78	(19 )	(2.75 )
Debit card fees	706	15.89	935	17.27	(229 )	(24.49 )
Other	779	17.54	1,029	19.00	(250 )	(24.30 )
Total non-interest income	\$4,443	100.00 %	\$5,414	100.00 %	\$(971)	(17.93 )%

## Non-interest Expense

Total non-interest expense increased \$454,000 and \$746,000 for the three and six months ended June 30, 2018 compared to the same period of 2017. The increase in salaries and employee benefits is primarily attributable to routine wage increases coupled with an increase in the cost of health insurance and the opening of two additional branches. Occupancy expense increased primarily due to the opening of additional branches and various maintenance projects to refresh facilities. Furniture and equipment expense increased as the new branches were outfitted. Software amortization decreased as the number of vendors utilized is consolidated. Marketing expenses increased as targeted marketing was increased in the localities where branches opened. The decrease in other expense is due to a decrease in data processing expense along with the adoption of Topic 606 (See Note 13 - Revenue Recognition).

Non-interest expense composition for the three and six months ended June 30, 2018 and 2017 was as follows:

(In Thousands)	Three Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	\$4,919	51.69 %	\$4,608	50.84 %	\$311	6.75 %
Occupancy	699	7.34	614	6.77	85	13.84
Furniture and equipment	801	8.42	664	7.33	137	20.63
Software amortization	231	2.43	242	2.67	(11 )	(4.55 )
Pennsylvania shares tax	278	2.92	230	2.54	48	20.87
Professional fees	649	6.82	565	6.23	84	14.87
Federal Deposit Insurance Corporation deposit insurance	200	2.10	150	1.66	50	33.33
Marketing	268	2.82	204	2.25	64	31.37
Intangible amortization	78	0.82	86	0.95	(8 )	(9.30 )
Other	1,394	14.64	1,700	18.76	(306 )	(18.00)
Total non-interest expense	\$9,517	100.00 %	\$9,063	100.00 %	\$454	5.01 %

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(In Thousands)	Six Months Ended					
	June 30, 2018		June 30, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Salaries and employee benefits	\$9,967	53.03 %	\$9,378	51.95 %	\$589	6.28 %
Occupancy	1,440	7.66	1,252	6.94	188	15.02
Furniture and equipment	1,548	8.24	1,313	7.28	235	17.90
Software amortization	296	1.57	515	2.85	(219 )	(42.52)
Pennsylvania shares tax	555	2.95	468	2.59	87	18.59
Professional fees	1,215	6.46	1,256	6.96	(41 )	(3.26 )
Federal Deposit Insurance Corporation deposit insurance	402	2.14	320	1.77	82	25.63
Marketing	519	2.76	375	2.08	144	38.40
Intangible amortization	158	0.84	176	0.98	(18 )	(10.23)
Other	2,694	14.35	2,995	16.59	(301 )	(10.05)
Total non-interest expense	\$18,794	100.00 %	\$18,048	99.99 %	\$746	4.13 %

## Provision for Income Taxes

Income taxes decreased \$490,000 and \$887,000 for the three and six months ended June 30, 2018 compared to the same periods of 2017. The effective tax rate for the three and six months ended June 30, 2018 was 17.40% and 16.50%, respectively, compared to 28.38% and 27.68% for the same periods of 2017. The changes made to the corporate statutory federal income tax rate, from 34% to 21% effective January 1, 2018, is the primary driver responsible for the aforementioned variance. The Company currently is in a deferred tax asset position. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

## ASSET/LIABILITY MANAGEMENT

## Cash and Cash Equivalents

Cash and cash equivalents increased \$28,764,000 from \$27,243,000 at December 31, 2017 to \$56,007,000 at June 30, 2018 primarily as a result of the following activities during the six months ended June 30, 2018.

## Loans Held for Sale

Activity regarding loans held for sale resulted in sales proceeds trailing loan originations, less \$655,000 in realized gains, by \$922,000 for the six months ended June 30, 2018.

## Loans

Gross loans increased \$84,459,000 since December 31, 2017 due primarily to an increase in consumer automobile loans. Loan growth has also occurred in the residential and commercial real estate portfolios.

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The allocation of the loan portfolio, by category, as of June 30, 2018 and December 31, 2017 is presented below:

(In Thousands)	June 30, 2018		December 31, 2017		Change		
	Amount	% Total	Amount	% Total	Amount	%	
Commercial, financial, and agricultural	\$ 183,735	13.80 %	\$ 178,885	14.35 %	\$ 4,850	2.71	%
Real estate mortgage:							
Residential	615,586	46.25	597,077	47.91	18,509	3.10	%
Commercial	356,031	26.75	332,019	26.63	24,012	7.23	%
Construction	35,967	2.70	31,683	2.54	4,284	13.52	%
Consumer automobile loans	113,361	8.52	79,714	6.39	33,647	42.21	%
Other consumer installment loans	25,750	1.93	26,964	2.16	(1,214 )	(4.50 )	%
Net deferred loan fees and discounts	643	0.05	272	0.02	371	136.40	%
Gross loans	\$ 1,331,073	100.00 %	\$ 1,246,614	100.00 %	\$ 84,459	6.78	%

The following table shows the amount of accrual and non-accrual TDRs at June 30, 2018 and December 31, 2017:

(In Thousands)	June 30, 2018			December 31, 2017		
	Accrual	Non-accrual	Total	Accrual	Non-accrual	Total
Commercial, financial, and agricultural	\$—	\$ 106	\$ 106	\$ 5	\$ 114	\$ 119
Real estate mortgage:						
Residential	2,228	216	2,444	2,151	273	2,424
Commercial	4,076	2,204	6,280	4,429	2,076	6,505
	\$ 6,304	\$ 2,526	\$ 8,830	\$ 6,585	\$ 2,463	\$ 9,048

## Investments

The fair value of the investment debt securities portfolio at June 30, 2018 increased \$10,249,000 since December 31, 2017 while the amortized cost of the portfolio increased \$12,106,000. The portfolio continues to be actively managed in order to reduce interest rate and market risk. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. The proceeds of the bond sales are being deployed into loans and intermediate term corporate bonds and short and intermediate term municipal bonds. The strategy to sell a portion of the long-term bond portfolio does negatively impact current earnings, but this action plays a key role in our long-term asset liability management strategy as the balance sheet is shortened in anticipation of a steadily rising rate environment. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 82.91% of the debt securities portfolio on an amortized cost basis is currently rated A or higher by either S&P or Moody's.

The Company considers various factors, which include examples from applicable accounting guidance, when analyzing the available for sale portfolio for possible other than temporary impairment. The Company primarily considers the following factors in its analysis: length of time and severity of the fair value being less than carrying value; reduction of dividend paid (equities); continued payment of dividend/interest, credit rating, and financial condition of an issuer; intent and ability to hold until anticipated recovery (which may be maturity); and general outlook for the economy, specific industry, and entity in question.

The bond portion of the portfolio review is conducted with emphases on several factors. Continued payment of principal and interest is given primary importance with credit rating and financial condition of the issuer following as the next most important. Credit ratings were reviewed with the ratings of the bonds being satisfactory. Bonds that were not currently rated were discussed with a third party and/or underwent an internal financial review. The Company also monitors whether each of the investments incurred a decline in fair value from carrying value of at least



20% for twelve consecutive months or a similar decline of at least 50% for three consecutive months. Each bond is reviewed to determine whether it is a general obligation bond, which is backed by the credit and taxing power of the issuing jurisdiction, or a revenue bond, which is only payable from specified revenues. Based on the review undertaken by the Company, the Company determined that the decline in value of the various bond holdings were temporary and were the result of the general market downturns and interest rate/yield curve changes, not credit issues. The fact that almost all of such bonds are general obligation bonds further solidified the Company's determination that the decline in the value of these bond holdings is temporary.

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The fair value of the equity portfolio continues to fluctuate as the economic and political environment continues to impact stock pricing. The amortized cost of the available for sale equity securities portfolio has decreased \$50,000 to \$1,787,000 at June 30, 2018 from \$1,837,000 at December 31, 2017 while the fair value decreased \$78,000 over the same time period.

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at June 30, 2018 follows:

(In Thousands)	A- to AAA		B- to BBB+		Not Rated		Total	
	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value	Amortized Cost	Fair Value
Available for sale (AFS):								
Mortgage-backed securities	\$5,702	\$5,516	\$—	\$—	\$—	\$—	\$5,702	\$5,516
State and political securities	65,565	64,962	—	—	70	70	65,635	65,032
Other debt securities	29,481	28,701	15,745	15,034	4,917	4,593	50,143	48,328
Total debt securities AFS	\$100,748	\$99,179	\$15,745	\$15,034	\$4,987	\$4,663	\$121,480	\$118,876

## Financing Activities

## Deposits

Total deposits increased \$44,699,000 from December 31, 2017 to June 30, 2018. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios. While deposit gathering efforts have centered on core deposits, the lengthening of the time deposit portfolio is moving forward as part of the strategy to build balance sheet protection in a rising rate environment. The increase in deposits is the result of our focus on building relationships, not by offering market leading rates.

Deposit balances and their changes for the periods being discussed follow:

(In Thousands)	June 30, 2018		December 31, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Demand deposits	\$311,194	26.13 %	\$303,316	26.46 %	\$7,878	2.60 %
NOW accounts	216,109	18.14	215,021	18.76	1,088	0.51
Money market deposits	245,081	20.58	237,818	20.75	7,263	3.05
Savings deposits	166,183	13.95	160,698	14.02	5,485	3.41
Time deposits	252,452	21.20	229,467	20.01	22,985	10.02
Total deposits	\$1,191,019	100.00 %	\$1,146,320	100.00 %	\$44,699	3.90 %

## Borrowed Funds

Total borrowed funds increased 50.60%, or \$86,889,000, to \$258,607,000 at June 30, 2018 compared to \$171,718,000 at December 31, 2017. The increase in total borrowing was utilized to supplement the growth in deposits as a funding source for the loan portfolio growth. The long-term borrowings originating during the six months ended June 30, 2018 had maturity dates ranging from 2019 to 2022 with a blended interest rate of 2.34%.

(In Thousands)	June 30, 2018		December 31, 2017		Change	
	Amount	% Total	Amount	% Total	Amount	%
Short-term borrowings:						
FHLB repurchase agreements	\$127,063	49.13 %	\$92,870	54.08 %	\$34,193	36.82 %
Securities sold under agreement to repurchase	7,574	2.93	7,878	4.59	(304)	(3.86)

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Total short-term borrowings	134,637	52.06	100,748	58.67	33,889	33.64
Long-term borrowings:						
Long-term FHLB borrowings	123,625	47.80	70,625	41.13	53,000	75.04
Long-term capital lease	345	0.13	345	0.20	—	—
Total long-term borrowings	123,970	47.94	70,970	41.33	53,000	74.68
Total borrowed funds	\$258,607	100.00%	\$171,718	100.00%	\$86,889	50.60 %

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## Short-Term Borrowings

The following table provides further information in regards to secured borrowings that have been accounted for as repurchase agreements.

(In Thousands)	Remaining Contractual Maturity Overnight and Continuous	
	June 30, 2018	December 31, 2017
Investment debt securities pledged, fair value	\$8,933	\$ 17,454
Repurchase agreements	7,574	7,878

## Capital

The adequacy of the Company's capital is reviewed on an ongoing basis with reference to the size, composition, and quality of the Company's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings.

Bank holding companies are required to comply with the Federal Reserve Board's risk-based capital guidelines. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets. Specifically, each is required to maintain certain minimum dollar amounts and ratios of common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital. In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvements Act ("FDICIA") established five capital categories ranging from "well capitalized" to "critically undercapitalized." To be classified as "well capitalized", common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital ratios must be at least 6.5%, 8%, 10%, and 5%, respectively.

The Company's capital ratios as of June 30, 2018 and December 31, 2017 were as follows:

(In Thousands)	June 30, 2018		December 31, 2017	
	Amount	Ratio	Amount	Ratio
Common Equity Tier I Capital (to Risk-weighted Assets)				
Actual	\$128,260	10.340%	\$125,513	11.254%
For Capital Adequacy Purposes	55,819	4.500	50,187	4.500
Minimum To Maintain Capital Conservation Buffer At Reporting Date	79,077	6.375	64,128	5.750
To Be Well Capitalized	80,628	6.500	72,493	6.500
Total Capital (to Risk-weighted Assets)				
Actual	\$137,199	11.061%	\$132,094	11.844%
For Capital Adequacy Purposes	99,231	8.000	89,223	8.000
Minimum To Maintain Capital Conservation Buffer At Reporting Date	122,488	9.875	103,164	9.250
To Be Well Capitalized	124,039	10.000	111,528	10.000
Tier I Capital (to Risk-weighted Assets)				
Actual	\$128,260	10.340%	\$125,513	11.254%
For Capital Adequacy Purposes	74,426	6.000	66,916	6.000
Minimum To Maintain Capital Conservation Buffer At Reporting Date	97,684	7.875	80,857	7.250
To Be Well Capitalized	99,234	8.000	89,222	8.000

Tier I Capital (to Average Assets)

Actual	\$128,260	8.442 %	\$125,513	8.766 %
For Capital Adequacy Purposes	60,772	4.000	57,273	4.000
To Be Well Capitalized	75,965	5.000	71,591	5.000

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Jersey Shore State Bank's capital ratios as of June 30, 2018 and December 31, 2017 were as follows:

(In Thousands)	June 30, 2018		December 31, 2017	
	Amount	Ratio	Amount	Ratio
Common Equity Tier I Capital (to Risk-weighted Assets)				
Actual	\$91,192	10.071 %	\$88,289	10.120 %
For Capital Adequacy Purposes	40,747	4.500	39,259	4.500
Minimum To Maintain Capital Conservation Buffer At Reporting Date	57,725	6.375	50,164	5.750
To Be Well Capitalized	58,857	6.500	56,707	6.500
Total Capital (to Risk-weighted Assets)				
Actual	\$98,688	10.899 %	\$93,145	10.677 %
For Capital Adequacy Purposes	72,438	8.000	69,791	8.000
Minimum To Maintain Capital Conservation Buffer At Reporting Date	89,416	9.875	80,696	9.250
To Be Well Capitalized	90,548	10.000	87,239	10.000
Tier I Capital (to Risk-weighted Assets)	-			
Actual	\$91,192	10.071 %	\$88,289	10.120 %
For Capital Adequacy Purposes	54,329	6.000	52,345	6.000
Minimum To Maintain Capital Conservation Buffer At Reporting Date	71,307	7.875	63,251	7.250
To Be Well Capitalized	72,439	8.000	69,794	8.000
Tier I Capital (to Average Assets)				
Actual	\$91,192	7.963 %	\$88,289	8.235 %
For Capital Adequacy Purposes	45,808	4.000	42,885	4.000
To Be Well Capitalized	57,260	5.000	53,606	5.000

Luzerne Bank's capital ratios as of June 30, 2018 and December 31, 2017 were as follows:

(In Thousands)	June 30, 2018		December 31, 2017	
	Amount	Ratio	Amount	Ratio
Common Equity Tier I Capital (to Risk-weighted Assets)				
Actual	\$32,849	9.863 %	\$31,116	9.731 %
For Capital Adequacy Purposes	14,987	4.500	14,389	4.500
Minimum To Maintain Capital Conservation Buffer At Reporting Date	21,232	6.375	18,386	5.750
To Be Well Capitalized	21,648	6.500	20,785	6.500
Total Capital (to Risk-weighted Assets)				
Actual	\$34,292	10.297 %	\$32,533	10.174 %
For Capital Adequacy Purposes	26,642	8.000	25,581	8.000
Minimum To Maintain Capital Conservation Buffer At Reporting Date	32,887	9.875	29,578	9.250
To Be Well Capitalized	33,303	10.000	31,977	10.000
Tier I Capital (to Risk-weighted Assets)				
Actual	\$32,849	9.863 %	\$31,116	9.731 %
For Capital Adequacy Purposes	19,983	6.000	19,186	6.000
Minimum To Maintain Capital Conservation Buffer At Reporting Date	26,228	7.875	23,183	7.250
To Be Well Capitalized	26,644	8.000	25,581	8.000
Tier I Capital (to Average Assets)				
Actual	\$32,849	8.580 %	\$31,116	8.384 %
For Capital Adequacy Purposes	15,314	4.000	14,845	4.000
To Be Well Capitalized	19,143	5.000	18,557	5.000

In July 2013, the federal bank regulatory agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. The July 2013 final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-

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adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered “well capitalized”) and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered “well capitalized”); the total capital ratio remains at 8.0% under the new rules (10.0% to be considered “well capitalized”). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements were effective beginning on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016. The Company and the Banks will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Banks.

Liquidity; Interest Rate Sensitivity and Market Risk

The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

The following liquidity measures are monitored for compliance and were within the limits cited, except for net loans to total deposits, at June 30, 2018:

1. Net Loans to Total Assets, 85% maximum
2. Net Loans to Total Deposits, 100% maximum
3. Cumulative 90 day Maturity GAP %, +/- 20% maximum
4. Cumulative 1 Year Maturity GAP %, +/- 25% maximum

Fundamental objectives of the Company’s asset/liability management process are to maintain adequate liquidity while minimizing interest rate risk. The maintenance of adequate liquidity provides the Company with the ability to meet its financial obligations to depositors, loan customers, and shareholders. Additionally, it provides funds for normal operating expenditures and business opportunities as they arise. The objective of interest rate sensitivity management is to increase net interest income by managing interest sensitive assets and liabilities in such a way that they can be repriced in response to changes in market interest rates.

The Banks, like other financial institutions, must have sufficient funds available to meet liquidity needs for deposit withdrawals, loan commitments and originations, and expenses. In order to control cash flow, the Banks estimate future cash flows from deposits, loan payments, and investment security payments. The primary sources of funds are deposits, principal and interest payments on loans and investment securities, FHLB borrowings, and brokered deposits. Management believes the Banks have adequate resources to meet their normal funding requirements.

Management monitors the Company’s liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale and trading investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core funding to satisfy depositor, borrower, and creditor needs.

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential, as well as the current cost of borrowing funds. The



Company has a total current maximum borrowing capacity at the FHLB of \$316,929,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$57,000,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$250,688,000 as of June 30, 2018.

Interest rate sensitivity, which is closely related to liquidity management, is a function of the repricing characteristics of the Company's portfolio of assets and liabilities. Asset/liability management strives to match maturities and rates between loan and investment security assets with the deposit liabilities and borrowings that fund them. Successful asset/liability management results in a balance sheet structure which can cope effectively with market rate fluctuations. The matching process by segments both assets and liabilities into future time periods (usually 12 months, or less) based upon when repricing can be effected. Repriceable assets are subtracted from repriceable liabilities, for a specific time period to determine the "gap", or difference. Once known, the gap is managed based on predictions about future market interest rates. Intentional mismatching, or gapping, can enhance net interest income if market rates move as predicted. However, if market rates behave in a manner contrary to predictions, net interest income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to

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determine the effects of interest rate movements on shareholders' equity and a simulation analysis to monitor the effects of interest rate changes on the Company's balance sheet.

The Company currently maintains a gap position of being asset sensitive. The Company has strategically taken this position as it has decreased the duration of the earning asset portfolio by adding quality short and intermediate term loans such as home equity loans and the selling of long-term municipal bonds. Lengthening of the liability portfolio is being undertaken to build protection in a rising rate environment.

A market value at risk calculation is utilized to monitor the effects of interest rate changes on the Company's balance sheet and more specifically shareholders' equity. The Company does not manage the balance sheet structure in order to maintain compliance with this calculation. The calculation serves as a guideline with greater emphases placed on interest rate sensitivity. Changes to calculation results from period to period are reviewed as changes in results could be a signal of future events. As of the most recent analysis, the results of the market value at risk calculation were within established guidelines due to the strategic direction being taken.

## Interest Rate Sensitivity

In this analysis the Company examines the result of a 100, 200, 300, and 400 basis point change in market interest rates and the effect on net interest income. It is assumed that the change is instantaneous and that all rates move in a parallel manner. Assumptions are also made concerning prepayment speeds on mortgage loans and mortgage securities.

The following is a rate shock forecast for the twelve month period ending June 30, 2019 assuming a static balance sheet as of June 30, 2018.

(In Thousands)	Parallel Rate Shock in Basis Points							
	-200	-100	Static	+100	+200	+300	+400	
Net interest income	\$47,310	\$49,414	\$51,181	\$52,032	\$52,711	\$53,226	\$53,769	
Change from static	(3,871 )	(1,767 )	—	851	1,530	2,045	2,588	
Percent change from static	-7.56	% -3.45	% —	1.66	% 2.99	% 4.00	% 5.06	%

The model utilized to create the report presented above makes various estimates at each level of interest rate change regarding cash flow from principal repayment on loans and mortgage-backed securities and/or call activity on investment securities. Actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change. In addition, the limits stated above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

## Inflation

The asset and liability structure of a financial institution is primarily monetary in nature. Therefore, interest rates rather than inflation have a more significant impact on the Company's performance. Interest rates are not always affected in the same direction or magnitude as prices of other goods and services, but are reflective of fiscal policy initiatives or economic factors which are not measured by a price index.

## New Banking Reform Legislation

On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Act”), which was designed to ease certain restrictions imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Most of the changes made by the new Act can be grouped into five general areas: mortgage lending; certain regulatory relief for “community” banks; enhanced consumer protections in specific areas, including subjecting credit reporting agencies to additional requirements; certain regulatory relief for large financial institutions, including increasing the threshold at which institutions are classified a systemically important financial institutions (from \$50 billion to \$250 billion) and therefore subject to stricter oversight, and revising the rules for larger institution stress testing; and certain changes to federal securities regulations designed to promote capital formation. Some of the key provisions of the Act as it relates to community banks and bank holding companies include, but are not limited to: (i) designating mortgages held in portfolio as “qualified mortgages” for banks with less than \$10 billion in assets, subject to certain documentation and product limitations; (ii) exempting banks with less than \$10 billion in assets (and total trading assets and trading liabilities of 5% or less of total assets) from Volcker Rule requirements relating to proprietary trading; (iii) simplifying capital calculations for banks with less than \$10 billion in assets by requiring federal banking

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agencies to establish a community bank leverage ratio of tangible equity to average consolidated assets of not less than 8% or more than 10%, and provide that banks that maintain tangible equity in excess of such ratio will be deemed to be in compliance with risk-based capital and leverage requirements; (iv) assisting smaller banks with obtaining stable funding by providing an exception for reciprocal deposits from FDIC restrictions on acceptance of brokered deposits; (v) raising the eligibility for use of short-form Call Reports from \$1 billion to \$5 billion in assets; (vi) clarifying definitions pertaining to high volatility commercial real estate loans (HVCRE), which require higher capital allocations, so that only loans with increased risk are subject to higher risk weightings; and (vii) changing the eligibility for use of the small bank holding company policy statement from institutions with under \$1 billion in assets to institutions with under \$3 billion in assets. The Company continues to analyze the changes implemented by the Act, but does not believe that such changes will materially impact the Company's business, operations, or financial results.

### Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at both the level of the Company and the Banks. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's gap analysis or simulation analysis compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2017. Additional information and details are provided in the "Liquidity, Interest Rate Sensitivity, and Market Risk" section of "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Generally, management believes the Company is well positioned to respond in a timely manner when the market interest rate outlook changes.

### Item 4. Controls and Procedures

#### Evaluation of Disclosure Controls and Procedures

An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2018.

#### Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2018, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## Part II. OTHER INFORMATION

## Item 1. Legal Proceedings

None.

## Item 1A. Risk Factors

There are no material changes to the risk factors set forth in Part I, Item 1A, "Risk Factors," of the Company's Annual Report on Form 10-K for the year ended December 31, 2017. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

## Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

The following table provides certain information with respect to the Company's repurchase of common stock during the quarter ended June 30, 2018.

Period	Total Number of Shares (or Units) Purchased	Average Price Paid per Share (or Units) Purchased	Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs
Month #1 (April 1 - April 30, 2018)	—	—	—	342,446
Month #2 (May 1 - May 31, 2018)	—	—	—	342,446
Month #3 (June 1 - June 30, 2018)	—	—	—	342,446

On April 20, 2018, the Board of Directors extended the previously approved authorization to repurchase up to 482,000 shares, or approximately 10%, of the outstanding shares of the Company for an additional year to April 30, 2019. As of June 30, 2018 there have been 139,554 shares repurchased under this plan.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

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Item 6. Exhibits

3(i) Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Quarterly Report on Form 10-Q for the period ended March 31, 2012).

3(ii) Bylaws of the Registrant (incorporated by reference to Exhibit 3(ii) of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011).

31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer.

31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer.

32(i) Section 1350 Certification of Chief Executive Officer.

32(ii) Section 1350 Certification of Chief Financial Officer.

101 Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2018 and December 31, 2017; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2018 and 2017; (iii) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2018 and 2017; (iv) the Consolidated Statement of Shareholders' Equity for the three and six months ended June 30, 2018 and 2017; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2018 and 2017 and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

PENNS WOODS BANCORP, INC.  
(Registrant)

Date: August 8, 2018 /s/ Richard A. Grafmyre  
Richard A. Grafmyre, Chief Executive Officer  
(Principal Executive Officer)

Date: August 8, 2018 /s/ Brian L. Knepp  
Brian L. Knepp, President and Chief Financial Officer  
(Principal Financial Officer and Principal Accounting  
Officer)

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EXHIBIT INDEX

- Exhibit 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer
- Exhibit 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer
- Exhibit 32(i) Section 1350 Certification of Chief Executive Officer
- Exhibit 32(ii) Section 1350 Certification of Chief Financial Officer
- Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2018 and December 31, 2017; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2018 and 2017; (iii) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2018 and 2017; (iv) the Consolidated Statement of Shareholders' Equity for the three and six months ended June 30, 2018 and 2017; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2018 and 2017 and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.
- Exhibit 101