

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
November 08, 2018  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10 Q

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

For the quarterly period ended September 30, 2018  
Or

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

For the transition period from \_\_\_\_\_ to \_\_\_\_\_

Commission file number 0 13222

CITIZENS FINANCIAL SERVICES, INC.  
(Exact name of registrant as specified in its charter)

PENNSYLVANIA  
(State or other jurisdiction of incorporation or  
organization)

23 2265045  
(I.R.S. Employer Identification No.)

15 South Main Street  
Mansfield, Pennsylvania 16933  
(Address of principal executive offices)(Zip Code)

Registrant's telephone number, including area code: (570) 662 2121

N/A  
(Former Name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes  No

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

Large accelerated  
filer  Accelerated  
filer

Non-accelerated filer  Smaller  
reporting company

Emerging growth company

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

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

Yes \_\_\_ No

The number of outstanding shares of the Registrant's Common Stock, as of October 31, 2018, was 3,509,143.

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Citizens Financial Services, Inc.  
Form 10-Q

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CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED BALANCE SHEET  
(UNAUDITED)

	September 30, 2018	December 31, 2017
(in thousands except share data)		
<b>ASSETS:</b>		
Cash and due from banks:		
Noninterest-bearing	\$15,496	\$16,347
Interest-bearing	1,004	2,170
Total cash and cash equivalents	16,500	18,517
Interest bearing time deposits with other banks	14,754	10,283
Equity Securities	291	-
Available-for-sale securities	240,426	254,782
Loans held for sale	960	1,439
Loans (net of allowance for loan losses: 2018, \$12,383 and 2017, \$11,190)	1,047,948	989,335
Premises and equipment	16,189	16,523
Accrued interest receivable	4,480	4,196
Goodwill	23,296	23,296
Bank owned life insurance	27,350	26,883
Other intangibles	1,703	1,953
Other assets	13,983	14,679
<b>TOTAL ASSETS</b>	<b>\$1,407,880</b>	<b>\$1,361,886</b>
<b>LIABILITIES:</b>		
Deposits:		
Noninterest-bearing	\$173,379	\$171,840
Interest-bearing	1,001,464	933,103
Total deposits	1,174,843	1,104,943
Borrowed funds	86,097	114,664
Accrued interest payable	979	897
Other liabilities	11,561	12,371
<b>TOTAL LIABILITIES</b>	<b>1,273,480</b>	<b>1,232,875</b>
<b>STOCKHOLDERS' EQUITY:</b>		
Preferred Stock		
\$1.00 par value; authorized 3,000,000 shares at September 30, 2018 and December 31, 2017; none issued in 2018 or 2017	-	-
Common stock		
\$1.00 par value; authorized 25,000,000 shares at September 30 2018 and 15,000,000 at December 31, 2017; issued 3,904,212 at September 30, 2018 and 3,869,939 at December 31, 2017	3,904	3,870
Additional paid-in capital	53,122	51,108
Retained earnings	96,754	89,982
Accumulated other comprehensive loss	(6,081 )	(3,398 )
Treasury stock, at cost: 395,070 shares at September 30, 2018 and 383,065 shares at December 31, 2017	(13,299 )	(12,551 )

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TOTAL STOCKHOLDERS' EQUITY	134,400	129,011
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	\$1,407,880	\$1,361,886

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

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CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF INCOME  
(UNAUDITED)

(in thousands, except share and per share data)	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
<b>INTEREST INCOME:</b>				
Interest and fees on loans	\$ 12,666	\$ 10,659	\$ 36,988	\$ 30,680
Interest-bearing deposits with banks	94	49	218	129
Investment securities:				
Taxable	967	762	2,683	2,341
Nontaxable	425	588	1,426	1,857
Dividends	107	62	355	191
<b>TOTAL INTEREST INCOME</b>	<b>14,259</b>	<b>12,120</b>	<b>41,670</b>	<b>35,198</b>
<b>INTEREST EXPENSE:</b>				
Deposits	1,794	1,210	4,695	3,398
Borrowed funds	695	293	2,034	782
<b>TOTAL INTEREST EXPENSE</b>	<b>2,489</b>	<b>1,503</b>	<b>6,729</b>	<b>4,180</b>
<b>NET INTEREST INCOME</b>	<b>11,770</b>	<b>10,617</b>	<b>34,941</b>	<b>31,018</b>
Provision for loan losses	475	500	1,300	1,740
<b>NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES</b>	<b>11,295</b>	<b>10,117</b>	<b>33,641</b>	<b>29,278</b>
<b>NON-INTEREST INCOME:</b>				
Service charges	1,181	1,145	3,455	3,323
Trust	147	187	548	596
Brokerage and insurance	222	154	571	459
Gains on loans sold	170	134	302	383
Equity security gains (losses), net	(4	) -	9	-
Available for sale security gains (losses), net	(8	) 9	(8	) 204
Earnings on bank owned life insurance	161	166	467	499
Other	141	126	414	380
<b>TOTAL NON-INTEREST INCOME</b>	<b>2,010</b>	<b>1,921</b>	<b>5,758</b>	<b>5,844</b>
<b>NON-INTEREST EXPENSES:</b>				
Salaries and employee benefits	4,679	4,287	14,251	13,030
Occupancy	500	475	1,606	1,479
Furniture and equipment	130	159	394	444
Professional fees	507	318	1,273	942
FDIC insurance	120	95	327	295
Pennsylvania shares tax	250	243	850	767
Amortization of intangibles	74	74	224	223
OREO expenses	6	139	92	255
Other	1,522	1,457	4,305	4,169
<b>TOTAL NON-INTEREST EXPENSES</b>	<b>7,788</b>	<b>7,247</b>	<b>23,322</b>	<b>21,604</b>
Income before provision for income taxes	5,517	4,791	16,077	13,518
Provision for income taxes	936	1,141	2,558	3,097
<b>NET INCOME</b>	<b>\$4,581</b>	<b>\$3,650</b>	<b>\$13,519</b>	<b>\$10,421</b>

PER COMMON SHARE DATA:

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Net Income - Basic	\$1.31	\$1.04	\$3.85	\$2.96
Net Income - Diluted	\$1.31	\$1.04	\$3.85	\$2.96
Cash Dividends Paid	\$0.440	\$0.426	\$1.302	\$1.228
Number of shares used in computation - basic	3,502,859	3,517,208	3,507,515	3,515,032
Number of shares used in computation - diluted	3,503,020	3,519,493	3,509,676	3,516,906

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



CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF  
COMPREHENSIVE INCOME  
(UNAUDITED)

	Three Months Ended September 30,		Nine Months Ended September 30,	
(in thousands)	2018	2017	2018	2017
Net income	\$4,581	\$3,650	\$13,519	\$10,421
Other comprehensive income (loss):				
Change in unrealized gains (losses) on available				
For sale securities	(971)	(288)	(3,544)	437
Income tax effect	205	98	744	(149)
Change in unrecognized pension cost	47	56	140	168
Income tax effect	(11 )	(19 )	(30 )	(57 )
Less: Reclassification adjustment for investment				
security (gains) losses included in net income	8	(9 )	8	(204)
Income tax effect	(2 )	3	(2 )	69
Other comprehensive income (loss), net of tax	(724 )	(159 )	(2,684 )	264
Comprehensive income	\$3,857	\$3,491	\$10,835	\$10,685

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

CITIZENS FINANCIAL SERVICES, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

	Nine Months Ended September 30,	
(in thousands)	2018	2017
<b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>		
Net income	\$13,519	\$10,421
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	1,300	1,740
Depreciation and amortization	301	321
Amortization and accretion of investment securities	813	1,089
Deferred income taxes	(260 )	(381 )
Investment securities (gains) losses, net	1	(204 )
Earnings on bank owned life insurance	(467 )	(499 )
Originations of loans held for sale	(14,709)	(17,144 )
Proceeds from sales of loans held for sale	15,374	17,789
Realized gains on loans sold	(302 )	(383 )
(Increase) decrease in accrued interest receivable	(284 )	303
Increase in accrued interest payable	82	11
Other, net	(435 )	(360 )
Net cash provided by operating activities	14,933	12,703
<b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>		
Available-for-sale securities:		
Proceeds from sales	25,168	30,393
Proceeds from maturity and principal repayments	41,027	47,677
Purchase of securities	(56,289)	(20,548 )
Purchase of equity securities	(191 )	-
Purchase of interest bearing time deposits with other banks	(5,713 )	(6,301 )
Proceeds from sale of interest bearing time deposits with other banks	1,239	2,741
Proceeds from matured interest bearing time deposits with other banks	-	496
Proceeds from redemption of regulatory stock	7,874	6,090
Purchase of regulatory stock	(6,751 )	(5,668 )
Net increase in loans	(59,646)	(107,864)
Purchase of premises and equipment	(228 )	(179 )
Proceeds from sale of foreclosed assets held for sale	899	312
Net cash used in investing activities	(52,611)	(52,851 )
<b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>		
Net increase in deposits	69,900	46,602
Proceeds from long-term borrowings	7	7
Repayments of long-term borrowings	(1,000 )	-
Net decrease in short-term borrowed funds	(27,574)	(6,041 )
Purchase of treasury and restricted stock	(1,098 )	(645 )
Dividends paid	(4,574 )	(3,714 )
Net cash provided by financing activities	35,661	36,209
Net decrease in cash and cash equivalents	(2,017 )	(3,939 )
<b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>	<b>18,517</b>	<b>17,754</b>
<b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>	<b>\$16,500</b>	<b>\$13,815</b>

Supplemental Disclosures of Cash Flow Information:

Interest paid	\$6,647	\$4,169
Income taxes paid	\$1,900	\$2,950
Loans transferred to foreclosed property	\$381	\$785

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

CITIZENS FINANCIAL SERVICES, INC.  
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
(Unaudited)

Note 1 - Basis of Presentation

Citizens Financial Services, Inc. (individually and collectively with its direct and indirect subsidiaries, the "Company") is a Pennsylvania corporation and the holding company of its wholly owned subsidiary, First Citizens Community Bank (the "Bank"), and of the Bank's wholly owned subsidiary, First Citizens Insurance Agency, Inc. ("First Citizens Insurance").

The accompanying consolidated financial statements have been prepared pursuant to rules and regulations of the Securities and Exchange Commission ("SEC") and in conformity with U.S. generally accepted accounting principles. Because this report is based on an interim period, certain information and footnote disclosures normally included in financial statements prepared in accordance with U.S. generally accepted accounting principles have been condensed or omitted. Certain of the prior year amounts have been reclassified to conform with the current year presentation. Such reclassifications had no effect on net income or stockholders' equity. All material inter company balances and transactions have been eliminated in consolidation.

In the opinion of management of the Company, the accompanying interim financial statements at September 30, 2018 and for the periods ended September 30, 2018 and 2017 include all adjustments, consisting of only normal recurring adjustments, necessary for a fair presentation of the financial condition and the results of operations at the dates and for the periods presented. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the balance sheet and revenues and expenses for the period covered by the Consolidated Income Statement. . The financial performance reported for the Company for the nine month period ended September 30, 2018 is not necessarily indicative of the results to be expected for the full year. This information should be read in conjunction with the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

In May 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-09, "Revenue from Contracts with Customers" ("ASU 2014-09"), which requires an entity to recognize the amount of revenue to which it expects to be entitled for the transfer of promised goods or services to customers. The ASU replaces most existing revenue recognition guidance in GAAP. The new standard was effective for the Company on January 1, 2018. Adoption of ASU 2014-09 did not have a material impact on the Company's consolidated financial statements other than additional disclosures in note 2 as the Company's primary sources of revenues are derived from interest and dividends earned on loans, investment securities, and other financial instruments that are not within the scope of ASU 2014-09.

In January 2016, the FASB finalized ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This accounting standard (a) requires separate presentation of equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) on the balance sheet and 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.

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The adoption resulted in the Company recognizing a one-time cumulative effect adjustment of \$1,000 between accumulated other comprehensive income and retained earnings on the consolidated balance sheet for the fair value of equity securities included in accumulated other comprehensive income as of the beginning of the period. The adjustment had no impact on net income on any prior periods presented.

The Company has adopted this standard during the reporting period. On a prospective basis, the Company implemented changes to the measurement of the fair value of financial instruments using an exit price notion for disclosure purposes included in Note 12 to the financial statements. The September 30, 2018 fair value of each class of financial instruments disclosure did utilize the exit price notion when measuring fair value and, therefore, may not be comparable to the December 31, 2017 disclosure.

In March 2017, the FASB issued ASU 2017-07, Compensation-Retirement Benefits (Topic 715). The amendments in this Update require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component. The Company adopted the standard on January 1, 2018, which resulted in a reclassification of \$(50) and (\$150) from Salaries and employee benefits into Other noninterest expenses on the Consolidated Statement of Income for the three and nine month periods ended September 30, 2017. See Note 9 for additional information on the presentation of these pension cost components.

#### Note 2 – Revenue Recognition

Effective January 1, 2018, the Company adopted Accounting Standards Update ASU 2014-09 Revenue from Contracts with Customers – Topic 606 and all subsequent ASUs that modified ASC 606. The Company has elected to apply the standard to all prior periods presented utilizing the full retrospective approach. The implementation of the new standard had no material impact to the measurement or recognition of revenue of prior periods. Management determined that the primary sources of revenue emanating from interest and dividend income on loans and investments along with noninterest revenue resulting from investment security gains, loan servicing, gains on loans sold and earnings on bank owned life insurances are not within the scope of ASC 606. As a result, no changes were made during the period related to these sources of revenue, which cumulatively comprise 90.0% and 89.8% of the total revenue of the Company for the three and nine months ended September 30, 2018, respectively. The main types of noninterest income within the scope of the standard are as follows:

Service charges on deposit accounts – The Company has contracts with its deposit customers where fees are charged if certain parameters are not met. These agreements can be cancelled at any time by either the Company or the deposit customer. Revenue from these transactions is recognized on a monthly basis as the Company has an unconditional right to the fee consideration. The Company also has transaction fees related to specific transactions or activities resulting from a customer request or activity that include overdraft fees, online banking fees, interchange fees, ATM fees and other transaction fees. All of these fees are attributable to specific performance obligations of the Company where the revenue is recognized at a defined point in time upon the completion of the requested service/transaction.

Trust fees – Typical contracts for trust services are based on a fixed percentage of the assets earned ratably over a defined period and billed on a monthly basis. Fees charged to customers' accounts are recognized as revenue over the period during which the Company fulfills its performance obligation under the contract (i.e., holding client asset in a managed fiduciary trust account). For these accounts, the performance obligation of the Company is typically satisfied by holding and managing the customer's assets over time. Other fees related to specific customer requests are attributable to specific performance obligations of the Company where the revenue is recognized at a defined point in time, upon completion of the requested service/transaction.

Gains (losses) on sale of other real estate owned – Gains and losses are recognized at the completion of the property sale when the buyer obtains control of the real estate and all of the performance obligations of the Company have been satisfied. Evidence of the buyer obtaining control of the asset include transfer of the property title, physical possession of the asset, and the buyer obtaining control of the risks and rewards related to the asset. In situations where the Company agrees to provide financing to facilitate the sale, additional analysis is performed to ensure that the contract for sale identifies the buyer and seller, the asset to be transferred, payment terms, and that the contract has a true commercial substance and that collection of amounts due from the buyer are reasonable. In situations where financing terms are not reflective of current market terms, the transaction price is discounted impacting the gain/loss and the carrying value of the asset.

Brokerage and insurance – Fees includes commissions from the sales of investments and insurance products recognized on a trade date basis as the performance obligation is satisfied at the point in time in which the trade is processed. Additional fees are based on a percentage of the market value of customer accounts and billed on a monthly or quarterly basis. The Company's performance obligation under the contracts with certain customers is generally satisfied through the passage of time as the Company monitors and manages the assets in the customer's portfolio and is not dependent on certain return or performance level of the customer's portfolio. Fees for these services are billed monthly and are recorded as revenue at the end of the month for which the wealth management service has been performed. Other performance obligations (such as the delivery of account statements to customers) are generally considered immaterial to the overall transaction price.

The following table depicts the disaggregation of revenue derived from contracts with customers to depict the nature, amount, timing, and uncertainty of revenue and cash flows for the three and nine months ended September 30, 2018 (in thousands). All revenue in the table below relates to goods and services transferred at a point in time.

Revenue stream	September 30, 2018	
	Three Months Ended	Nine Months Ended
Service charges on deposit accounts		
Overdraft fees	\$395	\$1,143
Statement fees	50	155
Interchange revenue	566	1,671
ATM income	104	301
Other service charges	66	185
Total Service Charges	1,181	3,455
Trust	147	548
Brokerage and insurance	222	571
Other	84	245
Total	\$1,634	\$4,819

#### Note 3 - Earnings per Share

The following table sets forth the computation of earnings per share. Earnings per share calculations give retroactive effect to stock dividends declared by the Company.



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	Three months ended		Nine months ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Net income applicable to common stock	\$4,581,000	\$3,650,000	\$13,519,000	\$10,421,000
Basic earnings per share computation				
Weighted average common shares outstanding	3,502,859	3,517,208	3,507,515	3,515,032
Earnings per share - basic	\$1.31	\$1.04	\$3.85	\$2.96
Diluted earnings per share computation				
Weighted average common shares outstanding for basic earnings per share	3,502,859	3,517,208	3,507,515	3,515,032
Add: Dilutive effects of restricted stock	161	2,285	2,161	1,874
Weighted average common shares outstanding for dilutive earnings per share	3,503,020	3,519,493	3,509,676	3,516,906
Earnings per share - diluted	\$1.31	\$1.04	\$3.85	\$2.96

For the three months ended September 30, 2018 and 2017, there were 4,696 and 1,107 shares, respectively, related to the restricted stock plan that were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had per share prices ranging from \$46.69-\$62.93 for the three month period ended September 30, 2018 and per share prices ranging from \$49.87-\$53.15 for the three month period ended September 30, 2017. For the nine months ended September 30, 2018 and 2017, 4,033 and 4,162 shares, respectively, related to the restricted stock plan were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had prices ranging from \$46.69-\$61.04 for the nine month period ended September 30, 2018 and prices ranging from \$46.69-\$53.15 for the nine month period ended September 30, 2017.

Note 4 – Investments

The amortized cost, gross unrealized gains and losses, and fair value of investment securities at September 30, 2018 and December 31, 2017 were as follows (in thousands):

	Amortized	Gross	Gross	Fair
	Cost	Unrealized	Unrealized	Value
		Gains	Losses	
September 30, 2018				
Available-for-sale securities:				
U.S. agency securities	\$ 109,612	\$ -	\$ (1,343 )	\$108,269
U.S. treasury securities	33,798	-	(961 )	32,837
Obligations of state and political subdivisions	51,941	116	(459 )	51,598
Corporate obligations	3,000	-	-	3,000
Mortgage-backed securities in government sponsored entities	45,951	2	(1,231 )	44,722
Total available-for-sale securities	\$244,302	\$ 118	\$ (3,994 )	\$240,426
December 31, 2017				
Available-for-sale securities:				
U.S. agency securities	\$ 99,454	\$ 26	\$ (593 )	\$98,887
U.S. treasury securities	28,782	-	(178 )	28,604
Obligations of state and political subdivisions	78,409	820	(139 )	79,090
Corporate obligations	3,000	83	-	3,083

Mortgage-backed securities in					
government sponsored entities	45,385	19	(377	)	45,027
Equity securities in financial institutions	92	-	(1	)	91
Total available-for-sale securities	\$ 255,122	\$ 948	\$ (1,288	)	\$ 254,782

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, which individual securities have been in a continuous unrealized loss position, at September 30, 2018 and December 31, 2017 (in thousands). As of September 30, 2018, the Company owned 143 securities whose fair value was less than their cost basis.

September 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
U.S. agency securities	\$54,399	\$ (656 )	\$40,554	\$ (687 )	\$94,953	\$ (1,343 )
U.S. treasury securities	32,837	(961 )	-	-	32,837	(961 )
Obligations of state and political subdivisions	26,648	(249 )	8,381	(210 )	35,029	(459 )
Mortgage-backed securities in government sponsored entities	17,167	(299 )	24,056	(932 )	41,223	(1,231 )
Total securities	\$131,051	\$ (2,165 )	\$72,991	\$ (1,829 )	\$204,042	\$ (3,994 )
December 31, 2017						
U.S. agency securities	\$74,952	\$ (421 )	\$16,928	\$ (172 )	\$91,880	\$ (593 )
U.S. treasury securities	28,604	(178 )	-	-	28,604	(178 )
Obligations of states and political subdivisions	14,885	(85 )	5,958	(54 )	20,843	(139 )
Mortgage-backed securities in government sponsored entities	27,154	(190 )	13,822	(187 )	40,976	(377 )
Equity securities in financial institutions	91	(1 )	-	-	91	(1 )
Total securities	\$145,686	\$ (875 )	\$36,708	\$ (413 )	\$182,394	\$ (1,288 )

As of September 30, 2018 and December 31, 2017, the Company's investment securities portfolio contained unrealized losses on agency securities issued or backed by the full faith and credit of the United States government or are generally viewed as having the implied guarantee of the U.S. government, U.S treasury securities, obligations of states and political subdivisions and mortgage backed securities issued by government sponsored entities. For fixed maturity investments management considers whether the present value of cash flows expected to be collected are less than the security's amortized cost basis (the difference defined as the credit loss), the magnitude and duration of the decline, the reasons underlying the decline and the Company's intent to sell the security or whether it is more likely than not that the Company would be required to sell the security before its anticipated recovery in market value, to determine whether the loss in value is other than temporary. Once a decline in value is determined to be other than temporary, if the Company does not intend to sell the security, and it is more likely than not that it will not be required to sell the security before recovery of the security's amortized cost basis, the charge to earnings is limited to the amount of credit loss. Any remaining difference between fair value and amortized cost (the difference defined as the non-credit portion) is recognized in other comprehensive income, net of applicable taxes. Otherwise, the entire difference between fair value and amortized cost is charged to earnings. The Company has concluded that any impairment of its investment securities portfolio outlined in the above table is not other than temporary and is the result of interest rate changes, sector credit rating changes, or issuer-specific rating changes that are not expected to result in the non-collection of principal and interest during the period.

Proceeds from sales of securities available-for-sale for the nine months ended September 30, 2018 and 2017 were \$25,168,000 and \$30,393,000, respectively. Proceeds from sales of securities available-for-sale for the three months ended September 30, 2018 were \$25,168,000. There were no sales of available for sale securities during the three months ended September 30, 2017. The gross gains and losses were as follows (in thousands):

Three Months Ended Sept. 30,	Nine Months Ended Sept. 30,

	2018	2017	2018	2017
Gross gains on available for sale securities	\$161	\$ 9	\$161	\$211
Gross losses on available for sale securities	(169)	-	(169)	(7 )
Net gains	\$(8 )	\$ 9	\$(8 )	\$204

The following table presents the net gains on the Company's equity investments recognized in earnings during the three month and nine month periods ended September 30, 2018, and the portion of unrealized gains for the period that relates to equity investments held at September 30, 2018 (in thousands):

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	Three Months Ended September 30, 2018	Nine Months Ended September 30, 2018
Equity Securities		
Net gains (losses) recognized in equity securities during the period	\$ (4 )	\$ 9
Less: Net gains realized on the sale of equity securities during the period	-	-
Net unrealized gains (losses)	\$ (4 )	\$ 9

Investment securities with an approximate carrying value of \$237.0 million and \$243.4 million at September 30, 2018 and December 31, 2017, respectively, were pledged to secure public funds and certain other deposits.

Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties. The amortized cost and fair value of debt securities (excludes equity securities) at September 30, 2018, by contractual maturity, are shown below (in thousands):

	Amortized Cost	Fair Value
Available-for-sale debt securities:		
Due in one year or less	\$ 29,087	\$ 29,035
Due after one year through five years	105,536	103,350
Due after five years through ten years	59,609	58,574
Due after ten years	50,070	49,467
Total	\$ 244,302	\$ 240,426

#### Note 5 – Loans

The Company grants loans primarily to customers throughout north central, central and south central Pennsylvania and the southern tier of New York. Although the Company had a diversified loan portfolio at September 30, 2018 and December 31, 2017, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within these regions. The following table summarizes the primary segments of the loan portfolio and how those segments are analyzed within the allowance for loan losses as of September 30, 2018 and December 31, 2017 (in thousands):

September 30, 2018	Total Loans	Individually evaluated for impairment	Loans acquired with deteriorated credit quality	Collectively evaluated for impairment
Real estate loans:				
Residential	\$ 213,255	\$ 915	\$ 30	\$ 212,310
Commercial	312,982	14,148	1,345	297,489
Agricultural	280,569	5,038	683	274,848
Construction	30,262	-	-	30,262
Consumer	9,702	-	-	9,702
Other commercial loans	72,219	3,368	518	68,333
Other agricultural loans	39,917	1,448	-	38,469
State and political subdivision loans	101,425	-	-	101,425

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Total	1,060,331	24,917	2,576	1,032,838
Allowance for loan losses	12,383	654	-	11,729
Net loans	\$1,047,948	\$ 24,263	\$ 2,576	\$1,021,109

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December 31, 2017	Total Loans	Individually evaluated for impairment	Loans acquired with deteriorated credit quality	Collectively evaluated for impairment
Real estate loans:				
Residential	\$214,479	\$ 1,065	\$ 33	\$ 213,381
Commercial	308,084	13,864	1,460	292,760
Agricultural	239,957	3,901	702	235,354
Construction	13,502	-	-	13,502
Consumer	9,944	8	-	9,936
Other commercial loans	72,013	4,197	443	67,373
Other agricultural loans	37,809	1,363	-	36,446
State and political subdivision loans	104,737	-	-	104,737
Total	1,000,525	24,398	2,638	973,489
Allowance for loan losses	11,190	410	-	10,780
Net loans	\$989,335	\$ 23,988	\$ 2,638	\$ 962,709

Purchased loans are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses. Upon acquisition, the Company evaluates whether an acquired loan was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired ("PCI") loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. Based upon management's review, there were no material decreases in the expected cash flows of these loans between the acquisition date and September 30, 2018. The fair value of PCI loans, on the acquisition date, was determined, primarily based on the fair value of the loans' collateral. The carrying value of PCI loans was \$2,576,000 and \$2,638,000 at September 30, 2018 and December 31, 2017, respectively. The carrying value of the PCI loans was determined by projected discounted contractual cash flows and collateral valuations.

Changes in the accretable yield for PCI loans were as follows for the three and nine months ended September 30, 2018 and 2017, respectively (in thousands):

	Three months ended September 30, 2018		Nine months ended September 30, 2017	
Balance at beginning of period	\$59	\$167	\$106	\$389
Accretion	(24)	(90)	(71)	(312)
Reclassification of non-accretable discount	93	-	93	-
Balance at end of period	\$128	\$77	\$128	\$77

The following table presents additional information regarding loans acquired with specific evidence of deterioration in credit quality under ASC 310-30 (in thousands):

September 30, 2018	December 31, 2017
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Outstanding balance	\$ 5,340	\$ 5,295
Carrying amount	2,576	2,638

The segments of the Company's loan portfolio are disaggregated into classes to a level that allows management to monitor risk and performance. Residential real estate mortgages consist primarily of 15 to 30 year first mortgages on residential real estate, while residential real estate home equity loans are consumer purpose installment loans or lines of credit with terms of 15 years or less secured by a mortgage which is often a second lien on residential real estate. Commercial real estate loans are business purpose loans secured by a mortgage on commercial real estate. Agricultural real estate loans are loans secured by a mortgage on real estate used in agriculture production. Construction real estate loans are loans secured by residential, commercial or agricultural real estate used during the construction phase of residential, commercial or agricultural projects. Consumer loans are typically unsecured or primarily secured by assets other than real estate and overdraft lines of credit are typically secured by customer deposit accounts. Other commercial loans are loans for commercial purposes primarily secured by non-real estate collateral. Other agricultural loans are loans for agricultural purposes primarily secured by non-real estate collateral. State and political subdivision loans are loans to state and local municipalities for capital and operating expenses or tax free loans used to finance commercial development.



Management considers other commercial loans, other agricultural loans, state and political subdivision loans, commercial real estate loans and agricultural real estate loans which are 90 days or more past due to be impaired. Management will also consider a loan impaired based on other factors it becomes aware of, including the customer's results of operations and cash flows or if the loan is modified in a troubled debt restructuring. In addition, certain residential mortgages, home equity and consumer loans that are cross collateralized with commercial relationships that are determined to be impaired may also be classified as impaired. Impaired loans are analyzed to determine if it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allocation of the allowance for loan losses or a charge-off to the allowance for loan losses.

The following table includes the recorded investment and unpaid principal balances for impaired financing receivables by class, excluding PCI loans, with the associated allowance amount, if applicable (in thousands):

	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
September 30, 2018					
Real estate loans:					
Mortgages	\$ 939	\$ 360	\$ 466	\$ 826	\$ 12
Home Equity	108	12	77	89	15
Commercial	17,043	12,595	1,553	14,148	224
Agricultural	5,050	1,752	3,286	5,038	86
Construction	-	-	-	-	-
Consumer	-	-	-	-	-
Other commercial loans	3,956	2,990	378	3,368	152
Other agricultural loans	1,498	114	1,334	1,448	165
State and political subdivision loans	-	-	-	-	-
Total	\$ 28,594	\$ 17,823	\$ 7,094	\$ 24,917	\$ 654

	Unpaid Principal Balance	Recorded Investment With No Allowance	Recorded Investment With Allowance	Total Recorded Investment	Related Allowance
December 31, 2017					
Real estate loans:					
Mortgages	\$ 1,055	\$ 273	\$ 700	\$ 973	\$ 47
Home Equity	92	40	52	92	9
Commercial	16,363	13,154	710	13,864	94
Agricultural	5,231	3,283	618	3,901	3
Construction	-	-	-	-	-
Consumer	10	2	6	8	-
Other commercial loans	4,739	3,766	431	4,197	231
Other agricultural loans	1,397	1,238	125	1,363	26
State and political subdivision loans	-	-	-	-	-
Total	\$ 28,887	\$ 21,756	\$ 2,642	\$ 24,398	\$ 410

The following tables includes the average balance of impaired financing receivables by class and the income recognized on these receivables for the three and nine month periods ended September 30, 2018 and 2017(in thousands):



	For the Three Months Ended September 30, 2018			September 30, 2017		
	Average Recorded Investmen	Interest Recognized	Interest Income Recognized Cash Basis	Average Recorded Investmen	Interest Recognized	Interest Income Recognized Cash Basis
Real estate loans:						
Mortgages	\$896	\$ 3	\$ -	\$741	\$ 3	\$ -
Home Equity	92	2	-	70	1	-
Commercial	14,116	130	6	13,663	122	2
Agricultural	5,146	24	-	3,799	27	-
Construction	-	-	-	-	-	-
Consumer	-	-	-	4	-	-
Other commercial loans	3,495	21	-	4,337	54	25
Other agricultural loans	1,453	2	-	1,443	10	-
State and political subdivision loans	-	-	-	-	-	-
Total	\$25,198	\$ 182	\$ 6	\$24,057	\$ 217	\$ 27

	For the Nine Months ended September 30, 2018			September 30, 2017		
	Average Recorded Investmen	Interest Recognized	Interest Income Recognized Cash Basis	Average Recorded Investmen	Interest Recognized	Interest Income Recognized Cash Basis
Real estate loans:						
Mortgages	\$988	\$ 10	\$ -	\$874	\$ 9	\$ -
Home Equity	98	4	-	62	3	-
Commercial	13,915	372	14	10,812	280	5
Agricultural	4,472	124	-	3,609	90	-
Construction	-	-	-	-	-	-
Consumer	2	-	-	2	-	-
Other commercial loans	3,906	73	-	4,988	131	52
Other agricultural loans	1,388	21	-	1,528	55	-
State and political subdivision loans	-	-	-	-	-	-
Total	\$24,769	\$ 604	\$ 14	\$21,875	\$ 568	\$ 57

### Credit Quality Information

For commercial real estate, agricultural real estate, construction, other commercial, other agricultural and state and political subdivision loans, management uses a nine grade internal risk rating system to monitor and assess credit quality. The first five categories are considered not criticized and are aggregated as "Pass" rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The definitions of each rating are defined below:

Pass (Grades 1-5) – These loans are to customers with credit quality ranging from an acceptable to very high quality and are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.

Special Mention (Grade 6) – This loan grade is in accordance with regulatory guidance and includes loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard (Grade 7) – This loan grade is in accordance with regulatory guidance and includes loans that have a well-defined weakness based on objective evidence and be characterized by the distinct possibility that the Bank will

sustain some loss if the deficiencies are not corrected.

Doubtful (Grade 8) – This loan grade is in accordance with regulatory guidance and includes loans that have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

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Loss (Grade 9) – This loan grade is in accordance with regulatory guidance and includes loans that are considered uncollectible, or of such value that continuance as an asset is not warranted.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay the loan as agreed, the Company's loan rating process includes several layers of internal and external oversight. The Company's loan officers are responsible for the timely and accurate risk rating of the loans in each of their portfolios at origination and on an ongoing basis under the supervision of management. All commercial, agricultural and state and political loans are reviewed annually to ensure the appropriateness of the loan grade. In addition, the Company engages an external consultant on at least an annual basis to 1) review a minimum of 50% of the dollar volume of the commercial loan portfolio on an annual basis, 2) review new loans originated for over \$1.0 million in the last year, 3) review a majority of borrowers with commitments greater than or equal to \$1.0 million, 4) review selected loan relationships over \$750,000 which are over 30 days past due or classified Special Mention, Substandard, Doubtful, or Loss, and 5) such other loans which management or the consultant deems appropriate.

The following tables represent credit exposures by internally assigned grades as of September 30, 2018 and December 31, 2017 (in thousands):

September 30, 2018	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	\$289,909	\$12,540	\$10,415	\$118	\$-	\$312,982
Agricultural	260,554	14,619	5,396	-	-	280,569
Construction	30,262	-	-	-	-	30,262
Other commercial loans	68,449	732	2,918	120	-	72,219
Other agricultural loans	36,320	2,288	1,309	-	-	39,917
State and political subdivision loans	91,136	9,686	603	-	-	101,425
Total	\$776,630	\$39,865	\$20,641	\$238	\$-	\$837,374

December 31, 2017	Pass	Special Mention	Substandard	Doubtful	Loss	Ending Balance
Real estate loans:						
Commercial	\$281,742	\$15,029	\$11,271	\$42	\$-	\$308,084
Agricultural	222,198	11,538	6,221	-	-	239,957
Construction	13,364	-	138	-	-	13,502
Other commercial loans	67,706	615	3,567	125	-	72,013
Other agricultural loans	34,914	1,325	1,570	-	-	37,809
State and political subdivision loans	94,125	-	10,612	-	-	104,737
Total	\$714,049	\$28,507	\$33,379	\$167	\$-	\$776,102

For residential real estate mortgages, home equity and consumer loans, credit quality is monitored based on whether the loan is performing or non-performing, which is typically based on the aging status of the loan and payment activity, unless a specific action, such as bankruptcy, repossession, death or significant delay in payment occurs to raise awareness of a possible credit event. Non-performing loans include those loans that are considered nonaccrual, described in more detail below, and all loans past due 90 or more days and still accruing. The following table presents the recorded investment in those loan classes based on payment activity as of September 30, 2018 and December 31, 2017 (in thousands):

September 30, 2018	Performing	Non-performing	PCI	Total
Real estate loans:				

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Mortgages	\$ 153,328	\$ 1,264	\$30	\$154,621
Home Equity	58,547	86	-	58,634
Consumer	9,679	23	-	9,702
Total	\$ 221,554	\$ 1,373	\$30	\$222,957

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December 31, 2017	Performing	Non-performing	PCI	Total
Real estate loans:				
Mortgages	\$ 152,820	\$ 1,492	\$33	\$154,345
Home Equity	60,022	112	-	60,134
Consumer	9,895	49	-	9,944
Total	\$ 222,737	\$ 1,653	\$33	\$224,423

Aging Analysis of Past Due Financing Receivables

Management further monitors the performance and credit quality of the loan portfolio by analyzing the age of the portfolio as determined by the length of time a recorded payment is past due. The following table includes an aging analysis of the recorded investment of past due financing receivables as of September 30, 2018 and December 31, 2017 (in thousands):

	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	PCI	Total Financing Receivables	90 Days or Greater and Accruing
September 30, 2018								
Real estate loans:								
Mortgages	\$661	\$191	\$685	\$1,537	\$153,054	\$30	\$154,621	\$ 1
Home Equity	125	-	67	192	58,442	-	58,634	-
Commercial	1,576	1,109	4,597	7,282	304,355	1,345	312,982	300
Agricultural	-	6	3,253	3,259	276,627	683	280,569	-
Construction	-	-	-	-	30,262	-	30,262	-
Consumer	69	7	1	77	9,625	-	9,702	1
Other commercial loans	662	141	2,179	2,982	68,719	518	72,219	-
Other agricultural loans	81	195	909	1,185	38,732	-	39,917	-
State and political subdivision loans	-	-	-	-	101,425	-	101,425	-
Total	\$3,174	\$1,649	\$11,691	\$16,514	\$1,041,241	\$2,576	\$1,060,331	\$ 302
Loans considered non-accrual	\$326	\$1,370	\$11,389	\$13,085	\$1,445	\$-	\$14,530	
Loans still accruing	2,848	279	302	3,429	1,039,796	2,576	1,045,801	
Total	\$3,174	\$1,649	\$11,691	\$16,514	\$1,041,241	\$2,576	\$1,060,331	

	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	PCI	Total Financing Receivables	90 Days or Greater and Accruing
December 31, 2017								
Real estate loans:								
Mortgages	\$996	\$362	\$810	\$2,168	\$152,144	\$33	\$154,345	\$ 218
Home Equity	277	86	78	441	59,693	-	60,134	-
Commercial	1,353	1,010	3,865	6,228	300,396	1,460	308,084	162
Agricultural	242	-	205	447	238,808	702	239,957	30
Construction	-	-	133	133	13,369	-	13,502	-
Consumer	53	33	49	135	9,809	-	9,944	7

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Other commercial loans	132	-	2,372	2,504	69,066	443	72,013	32
Other agricultural loans	-	42	106	148	37,661	-	37,809	106
State and political subdivision loans	-	-	-	-	104,737	-	104,737	-
Total	\$3,053	\$1,533	\$7,618	\$12,204	\$985,683	\$2,638	\$1,000,525	\$ 555
Loans considered non-accrual	\$816	\$281	\$7,063	\$8,160	\$2,011	\$-	\$10,171	
Loans still accruing	2,237	1,252	555	4,044	983,672	2,638	990,354	
Total	\$3,053	\$1,533	\$7,618	\$12,204	\$985,683	\$2,638	\$1,000,525	



## Nonaccrual Loans

Loans are considered for non-accrual status upon reaching 90 days delinquency, although the Company may be receiving partial payments of interest and partial repayments of principal on such loans or if full payment of principal and interest is not expected. Additionally, if management is made aware of other information including bankruptcy, repossession, death, or legal proceedings, the loan may be placed on non-accrual status. If a loan is 90 days or more past due and is well secured and in the process of collection, it may still be considered accruing.

The following table reflects the financing receivables, excluding PCI loans, on non-accrual status as of September 30, 2018 and December 31, 2017, respectively. The balances are presented by class of financing receivable (in thousands):

	September 30, 2018	December 31, 2017
Real estate loans:		
Mortgages	\$ 1,263	\$ 1,274
Home Equity	86	112
Commercial	6,445	5,192
Agricultural	3,259	175
Construction	-	133
Consumer	22	42
Other commercial loans	2,269	2,637
Other agricultural loans	1,186	606
State and political subdivision	-	-
	\$ 14,530	\$ 10,171

## Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a Troubled Debt Restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to structure more affordable terms before their loan reaches nonaccrual status. These restructured terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of interest or principal, or both, management measures any impairment on the restructuring by calculating the present value of the revised loan terms and comparing this balance to the Company's investment in the loan prior to the restructuring. As these loans are individually evaluated, they are excluded from pooled portfolios when calculating the allowance for loan and lease losses and a separate allocation within the allowance for loan and lease losses is provided. Management continually evaluates loans that are considered TDRs, including payment history under the modified loan terms, the borrower's ability to continue to repay the loan based on continued evaluation of their operating results and cash flows from operations. Based on this evaluation management would no longer consider a loan to be a TDR when the relevant facts support such a conclusion. As of September 30, 2018 and December 31, 2017, included within the allowance for loan losses are reserves of \$263,000 and \$41,000 respectively, that are associated with loans modified as TDRs.

Loan modifications that are considered TDRs completed during the three and nine months ended September 30, 2018 and 2017 were as follows (dollars in thousands):

For the Three Months Ended September 30, 2018		
Number of contracts	Pre-modification Outstanding	Post-Modification Outstanding

			Recorded Investment Interest	Term Modification	Recorded Investment Interest	Term Modification
Real estate loans:						
Commercial	-	1	\$ -	\$ 106	\$ -	\$ 106
Agricultural	-	2	-	1,302	-	1,302
Total	-	3	\$ -	\$ 1,408	\$ -	\$ 1,408

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For the Nine Months Ended September 30, 2018

			Pre-modification Outstanding Recorded Investment Interest Term Modification	Post-Modification Outstanding Recorded Investment Interest Term Modification
Real estate loans:				
Mortgages	-	1	\$ - \$ 7	\$ - \$ 7
Home Equity	-	1	- 1	- 1
Commercial	-	2	- 683	- 683
Agricultural	-	3	- 2,825	- 2,825
Other agricultural loans	-	4	- 176	- 176
Total	-	11	\$ - \$ 3,692	\$ - \$ 3,692

For the Three Months Ended September 30, 2017

			Pre-modification Outstanding Recorded Investment Interest Term Modification	Post-Modification Outstanding Recorded Investment Interest Term Modification
Real estate loans:				
Agricultural	-	2	\$ - \$ 150	\$ - \$ 150
Other agricultural loans	-	1	- 161	- 161
Total	-	3	\$ - \$ 311	\$ - \$ 311

For the Nine Months Ended September 30, 2017

			Pre-modification Outstanding Recorded Investment Interest Term Modification	Post-Modification Outstanding Recorded Investment Interest Term Modification
Real estate loans:				
Commercial	-	7	\$ - \$ 6,797	\$ - \$ 6,797
Agricultural	-	2	- 150	- 150
Other agricultural loans	-	1	- 161	- 161
Total	-	10	\$ - \$ 7,108	\$ - \$ 7,108

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism on modified loans occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. The following table presents the recorded investment in loans that were modified as TDRs during each 12-month period prior to the current reporting periods, which began January 1, 2018 and 2017 (9 month periods) and June 1, 2018 and 2017 (3 month periods), respectively, and that subsequently defaulted during these reporting periods (dollars in thousands):

For the Three Months Ended

For the Nine Months Ended

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	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
	Number of Recorded contracts	Number of Recorded contracts	Number of Recorded contracts	Number of Recorded contracts
	Investment	Investment	Investment	Investment
Real estate loans:				
Agricultural	2 \$ 1,302	- \$ -	2 \$ 1,302	- \$ -
Other agricultural loans	1 124	- -	1 124	- -
Total recidivism	3 \$ 1,426	- \$ -	3 \$ 1,426	- \$ -

Allowance for Loan Losses

The following table segregates the allowance for loan losses (ALLL) into the amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment as of September 30, 2018 and December 31, 2017, respectively (in thousands):

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	September 30, 2018			December 31, 2017		
	Individually evaluated for impairment	Collectively evaluated for impairment	Total	Individually evaluated for impairment	Collectively evaluated for impairment	Total
Real estate loans:						
Residential	\$27	\$ 1,025	\$1,052	\$56	\$ 993	\$1,049
Commercial	224	3,701	3,925	94	3,773	3,867
Agricultural	86	3,843	3,929	3	3,140	3,143
Construction	-	49	49	-	23	23
Consumer	-	123	123	-	124	124
Other commercial loans	152	1,067	1,219	231	1,041	1,272
Other agricultural loans	165	534	699	26	466	492
State and political subdivision loans	-	751	751	-	816	816
Unallocated	-	636	636	-	404	404
Total	\$654	\$ 11,729	\$12,383	\$410	\$ 10,780	\$11,190

The following tables roll forward the balance of the ALLL by portfolio segment for the three and nine months ended September 30, 2018 and 2017, respectively (in thousands):

	For the three months ended September 30, 2018				
	Balance at June 30, 2018	Charge-offs	Recoveries	Provision	Balance at September 30, 2018
Real estate loans:					
Residential	\$1,045	\$ (10 )	\$ 1	\$ 16	\$ 1,052
Commercial	3,794	(25 )	-	156	3,925
Agricultural	3,673	-	-	256	3,929
Construction	44	-	-	5	49
Consumer	115	(13 )	9	12	123
Other commercial loans	1,266	-	5	(52 )	1,219
Other agricultural loans	589	-	-	110	699
State and political subdivision loans	767	-	-	(16 )	751
Unallocated	648	-	-	(12 )	636
Total	\$11,941	\$ (48 )	\$ 15	\$ 475	\$ 12,383

	For the nine months ended September 30, 2018				
	Balance at December 31, 2017	Charge-offs	Recoveries	Provision	Balance at September 30, 2018
Real estate loans:					
Residential	\$1,049	\$ (27 )	\$ 70	\$ (40 )	\$ 1,052
Commercial	3,867	(25 )	3	80	3,925
Agricultural	3,143	-	-	786	3,929
Construction	23	-	-	26	49
Consumer	124	(32 )	26	5	123
Other commercial loans	1,272	(91 )	19	19	1,219

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Other agricultural loans	492	(50 )	-	257	699
State and political subdivision loans	816	-	-	(65 )	751
Unallocated	404	-	-	232	636
Total	\$11,190	\$ (225 )	\$ 118	\$ 1,300	\$ 12,383

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For the three months ended September 30, 2017

Balance

at

June

30,

2017

Charge-offs

Recoveries

Provision

Balance at

September

30, 2017

## Real estate loans:

Residential	\$1,104	\$ (11 )	\$ -	\$ (13 )	\$ 1,080
Commercial	3,541	-	5	36	3,582
Agricultural	2,452	-	-	242	2,694
Construction	45	-	-	(14 )	31
Consumer	125	(45 )	13	44	137
Other commercial loans	1,131	-	5	(24 )	1,112
Other agricultural loans	431	-	1	30	462
State and political subdivision loans	838	-	-	36	874
Unallocated	312	-	-	163	475
Total	\$9,979	\$ (56 )	\$ 24	\$ 500	\$ 10,447

For the nine months ended September 30, 2017

Balance

at

December

31,

2016

Charge-offs

Recoveries

Provision

Balance at

September

30, 2017

## Real estate loans:

Residential	\$1,064	\$ (104 )	\$ -	\$ 120	\$ 1,080
Commercial	3,589	(41 )	11	23	3,582
Agricultural	1,494	-	-	1,200	2,694
Construction	47	-	-	(16 )	31
Consumer	122	(90 )	35	70	137
Other commercial loans	1,327	-	14	(229 )	1,112
Other agricultural loans	312	(5 )	1	154	462
State and political subdivision loans	833	-	-	41	874
Unallocated	98	-	-	377	475
Total	\$8,886	\$ (240 )	\$ 61	\$ 1,740	\$ 10,447

The Company allocates the ALLL based on the factors described below, which conform to the Company's loan classification policy and credit quality measurements. In reviewing risk within the Company's loan portfolio, management has determined there to be several different risk categories within the loan portfolio. The ALLL consists of amounts applicable to: (i) residential real estate loans; (ii) residential real estate home equity loans; (iii) commercial real estate loans; (iv) agricultural real estate loans; (v) real estate construction loans; (vi) other commercial and agricultural loans; (vii) consumer loans; (viii) other agricultural loans and (ix) state and political subdivision loans. Factors considered in this process include general loan terms, collateral, and availability of historical data to support the analysis. Historical loss percentages are calculated and used as the basis for calculating allowance allocations. Certain qualitative factors are evaluated to determine additional inherent risks in the loan portfolio, which are not necessarily reflected in the historical loss percentages. These factors are then added to the historical allocation percentage to get the adjusted factor to be applied to non-classified loans. The following qualitative factors are analyzed:

- Level of and trends in delinquencies and impaired/classified loans
- § Change in volume and severity of past due loans
- § Volume of non-accrual loans
- § Volume and severity of classified, adversely or graded loans;
- Level of and trends in charge-offs and recoveries;
- Trends in volume, terms and nature of the loan portfolio;
- Effects of any changes in risk selection and underwriting standards and any other changes in lending and recovery policies, procedures and practices;
- Changes in the quality of the Company's loan review system;
- Experience, ability and depth of lending management and other relevant staff;
- National, state, regional and local economic trends and business conditions



§ General economic conditions

§ Unemployment rates

§ Inflation rate/ Consumer Price Index

§ Changes in values of underlying collateral for collateral-dependent loans;

· Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses;

· Existence and effect of any credit concentrations, and changes in the level of such concentrations; and

· Any change in the level of board oversight.

The Company analyzes its loan portfolio at least each quarter to determine the adequacy of its ALLL.

Loans determined to be TDRs are impaired and for purposes of estimating the ALLL must be individually evaluated for impairment. In calculating the impairment, the Company calculates the present value utilizing an analysis of discounted cash flows. If the present value calculated is below the recorded investment of the loan, impairment is recognized by a charge to the provision for loan and lease losses and a credit to the ALLL.

For the three months ended September 30, 2018, the allowance for commercial real estate was increased in general reserves due to an increase in the size of the portfolio as well as an increase in specific reserves. This was represented as an increase in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances, an increase in the amount of loans classified as non-accrual and an increase in specific reserves. The result of this was represented as an increase in the provision. The allowance for other agricultural loans was increased as a result of an increase in specific reserves, which offset the decrease due to the decrease in the portfolio size. The result of these changes was represented as an increase in the provision.

For the nine months ended September 30, 2018, the allowance for commercial real estate was decreased in general reserves due to a decrease in the qualitative factor associated with unemployment rates and an improvement in the number of loans classified as special mention. There was an increase in specific reserves for commercial real estate. The total change was represented as an increase in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances and an increase in the amount of loans classified as special mention and nonaccrual. Additionally, there was an increase in specific reserves. These resulted in an increase in the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances, loans past due and an increase in non-accrual loans. Additionally, specific reserves also increased. The result of these changes was represented as an increase in the provision.

For the three months ended September 30, 2017, the allowance for residential real estate increased in general reserves for pooled loans as a result of increased loss rates reflected in the charge-offs for the three month period, as well as higher loan balances. The increase was offset by a decrease in the specific reserve for individually evaluated residential loans. This was represented as a decrease to the provision. The allowance for commercial real estate was increased in general reserves due to growth in the commercial real estate loan portfolio, which was represented as an increase in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances. The result of this growth was represented as an increase in the provision. The allowance for other commercial loans was reduced as a result of a decrease in the historical loss factor in the portfolio segment and decrease in specific reserves. This was represented by a decrease to the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. It was also impacted by an increase in specific reserves during the quarter. The result of these changes was represented as an increase in the provision.

For the nine months ended September 30, 2017, the allowance for residential real estate increased in general reserves as a result of increased loss rates reflected in the charge-offs for the nine month period. This was represented as an increase to the provision. The allowance for agricultural real estate loans was increased in general reserves as a result

of higher loan balances as well as an increase in specific reserves. It was also impacted by the classified loan trend in the agricultural real estate portfolio. The result of these changes was represented as an increase in the provision. The allowance for other commercial loans was reduced as a result of lower loan balances, an improvement in the amount of classified loans and a reduction in the historical loss factor. This was represented by a decrease to the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. It was also impacted by the classified loan trend in the other agricultural loan portfolio. The result of these changes was represented as an increase in the provision.

## Foreclosed Assets Held For Sale

Foreclosed assets acquired in settlement of loans are carried at fair value, less estimated costs to sell, and are included in other assets on the Consolidated Balance Sheet. As of September 30, 2018 and December 31, 2017, included with other assets are \$628,000 and \$1,119,000, respectively, of foreclosed assets. As of September 30, 2018, included within the foreclosed assets are \$307,000 of consumer residential mortgages that were foreclosed on or received via a deed in lieu transaction prior to the period end. As of September 30, 2018, the Company has initiated formal foreclosure proceedings on \$2,168,000 of consumer residential mortgages, which have not yet been transferred into foreclosed assets.

## Note 6 – Goodwill and Other Intangible Assets

The following table provides the gross carrying value and accumulated amortization of intangible assets as of September 30, 2018 and December 31, 2017 (in thousands):

	September 30, 2018			December 31, 2017		
	Gross carrying value	Accumulated amortization	Net carrying value	Gross carrying value	Accumulated amortization	Net carrying value
Amortized intangible assets (1):						
MSRs	\$1,722	\$ (1,055)	) \$ 667	\$1,605	\$ (912)	) \$ 693
Core deposit intangibles	1,786	(786)	) 1,000	1,786	(586)	) 1,200
Covenant not to compete	125	(89)	) 36	125	(65)	) 60
Total amortized intangible assets	\$3,633	\$ (1,930)	) \$ 1,703	\$3,516	\$ (1,563)	) \$ 1,953
Unamortized intangible assets:						
Goodwill	\$23,296			\$23,296		

(1) Excludes fully amortized intangible assets

The following table provides the current year and estimated future amortization expense for amortized intangible assets for the next five years. We based our projections of amortization expense shown below on existing asset balances (in thousands) at September 30, 2018. Future amortization expense may vary from these projections:

	MSRs	Core deposit intangibles	Covenant not to compete	Total
Three months ended September 30, 2018 (actual)	\$ 46	\$ 66	\$ 8	\$ 120
Nine months ended September 30, 2018 (actual)	143	200	24	367
Three months ended September 30, 2017 (actual)	44	66	8	118
Nine months September 30, 2017 (actual)	134	200	23	357
Estimate for year ended December 31,				
Remaining 2018	43	64	7	114
2019	173	230	29	432
2020	137	197	-	334
2021	106	165	-	271
2022	78	133	-	211

## Note 7 – Repurchase Agreements

We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor collateral levels on a continuous basis. We may be required

to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agents.

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The value of the collateral segmented by the remaining contractual maturity of the repurchase agreements in the Consolidated Balance Sheets as of September 30, 2018 and December 31, 2017 is presented in the following tables (in thousands):

	Remaining Contractual Maturity of the Agreements				Total
	Overnight and	Up to 30 - 30 Days	30 - 90 Days	Greater than 90 days	
September 30, 2018					
Repurchase Agreements:					
U.S. agency securities	\$16,946	\$ -	\$ -	\$1,989	\$18,935
Total carrying value of collateral pledged	\$16,946	\$ -	\$ -	\$1,989	\$18,935
Total liability recognized for repurchase agreements					\$15,441
December 31, 2017					
Repurchase Agreements:					
U.S. agency securities	\$16,027	\$ -	\$ -	\$2,035	\$18,062
Total carrying value of collateral pledged	\$16,027	\$ -	\$ -	\$2,035	\$18,062
Total liability recognized for repurchase agreements					\$14,989

Note 8 - Employee Benefit Plans

For additional detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 11 of the Company's Consolidated Financial Statements included in the 2017 Annual Report on Form 10-K.

Noncontributory Defined Benefit Pension Plan

The Bank sponsors a trustee noncontributory defined benefit pension plan ("Pension Plan") covering substantially all employees and officers hired prior to January 1, 2007. Additionally, the Bank assumed the noncontributory defined benefit pension plan of FNB when it was acquired. The FNB plan was frozen prior to the acquisition and therefore, no additional benefits will accrue for employees covered under that plan. The Bank has begun proceedings to close the FNB plan, which is expected to occur in 2019. These two plans are collectively referred to herein as "the Plans." The Bank's funding policy is to make annual contributions, if needed, based upon the funding formula developed by the plans' actuary. Any employee with a hire date of January 1, 2007 or later is not eligible to participate in the Pension Plan.

In lieu of the Pension Plan, employees with a hire date of January 1, 2007 or later are eligible to receive, after meeting certain length of service requirements, an annual discretionary 401(k) plan contribution from the Bank equal to a percentage of an employee's base compensation. The contribution amount, if any, is placed in a separate account within the 401(k) plan and is subject to a vesting requirement.

For employees who are eligible to participate in the Pension Plan, the Pension Plan requires benefits to be paid to eligible employees based primarily upon age and compensation rates during employment. Upon retirement or other termination of employment, employees can elect either an annuity benefit or a lump sum distribution of vested benefits in the Pension Plan.

The following sets forth the components of net periodic benefit costs of the Pension Plan and the line item on the Consolidated Statement of Income where such amounts are included, for the three and nine months ended September

30, 2018 and 2017, respectively (in thousands):

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	Three Months		Nine Months		Affected line item on the Consolidated Statement of income
	Ended	Ended	Ended	Ended	
	September 30,	September 30,	September 30,	September 30,	
	2018	2017	2018	2017	
Service cost	\$90	\$87	\$269	\$262	Salary and Employee Benefits
Interest cost	164	168	489	503	Other Expenses
Expected return on plan assets	(230)	(274)	(919)	(821)	Other Expenses
Net amortization and deferral	47	56	140	168	Other Expenses
Net periodic benefit cost	\$71	\$37	\$(21)	\$112	

The Bank does not expect to make any contributions to the Pension Plans during 2018.

#### Restricted Stock Plan

The Company maintains a Restricted Stock Plan (the "Plan") whereby employees and non-employee corporate directors are eligible to receive awards of restricted stock based upon performance related requirements. Awards granted under the Plan are in the form of the Company's common stock and are subject to certain vesting requirements including continuous employment or service with the Company. In April of 2016, the Company's shareholders authorized a total of 150,000 shares of the Company's common stock to be made available under the Plan. As of September 30, 2018, 136,539 shares remain available to be issued under the Plan. The Plan assists the Company in attracting, retaining and motivating employees to make substantial contributions to the success of the Company and to increase the emphasis on the use of equity as a key component of compensation.

The following table details the vesting, awarding and forfeiting of restricted shares during the three and nine months ended September 30, 2018:

	Three months		Nine months	
	Unvested	Weighted Average Market Price	Unvested	Weighted Average Market Price
	Shares	Price	Shares	Price
Outstanding, beginning of period	9,934	\$ 57.18	8,783	\$ 51.20
Granted	-	-	4,869	62.91
Vested	(401)	(57.23)	(4,119)	(51.22)
Outstanding, end of period	9,533	\$ 57.17	9,533	\$ 57.17

Compensation expense related to restricted stock is recognized, based on the market price of the stock at the grant date, over the vesting period. Compensation expense related to restricted stock was \$187,000 and \$158,000 for the nine months ended September 30, 2018 and 2017, respectively. For the three months ended September 30, 2018 and 2017, compensation expense totaled \$68,000 and \$54,000, respectively. At September 30, 2018, the total compensation cost related to nonvested awards that has not yet been recognized was \$545,000, which is expected to be recognized over the next three years.

#### Note 9 – Accumulated Comprehensive Loss

The following tables present the changes in accumulated other comprehensive loss by component net of tax for the three and nine months ended September 30, 2018 and 2017 (in thousands):

	Nine months ended September 30, 2018		
	Unrealized gain (loss)		
	on	Defined	
	available	Benefit	
	for sale	Pension	
	securities	Items	
	(a)	(a)	Total
Balance as of December 31, 2017	\$(269 )	\$(3,129 )	\$(3,398)
Change in Accounting policy for equity securities	1	-	1
Other comprehensive income (loss) before reclassifications (net of tax)	(2,800)	-	(2,800)
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	6	110	116
Net current period other comprehensive income (loss)	(2,794)	110	(2,684)
Balance as of September 30, 2018	\$(3,062)	\$(3,019 )	\$(6,081)



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	Nine months ended September 30, 2017 Unrealized gain (loss) on Defined available Benefit for sale Pension securities Items (a) (a) Total		
Balance as of December 31, 2016	\$1,306	\$(2,698 )	\$(1,392)
Other comprehensive income (loss) before reclassifications (net of tax)	288	-	288
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	(135 )	111	(24 )
Net current period other comprehensive income	153	111	264
Balance as of September 30, 2017	\$1,459	\$(2,587 )	\$(1,128)

	Three months ended September 30, 2018 Unrealized gain (loss) on Defined available Benefit for sale Pension securities Items (a) (a) Total		
Balance as of June 30, 2018	\$(2,302)	\$(3,055 )	\$(5,357)
Other comprehensive income (loss) before reclassifications (net of tax)	(766 )	-	(766 )
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	6	36	42
Net current period other comprehensive income (loss)	(760 )	36	(724 )
Balance as of September 30, 2018	\$(3,062)	\$(3,019 )	\$(6,081)

	Three months ended September 30, 2017 Unrealized gain (loss) on Defined available Benefit for sale Pension securities Items (a) (a) Total		
Balance as of June 30, 2017	\$1,655	\$(2,624 )	\$(969 )
Other comprehensive income (loss) before reclassifications (net of tax)	(190 )	-	(190 )
Amounts reclassified from accumulated other comprehensive income (loss) (net of tax)	(6 )	37	31
Net current period other comprehensive income (loss)	(196 )	37	(159 )
Balance as of September 30, 2017	\$1,459	\$(2,587 )	\$(1,128)

(a) Amounts in parentheses indicate debits on the Consolidated Balance Sheet.

The following table presents the significant amounts reclassified out of each component of accumulated other comprehensive income for the three and nine months ended September 30, 2018 and 2017 (in thousands):

Details about accumulated other comprehensive income (loss)	Amount reclassified from accumulated comprehensive income (loss) (a)	Affected line item in the Consolidated Statement of Income
	Three Months Ended	
	September 30,	
	2018    2017	
Unrealized gains and losses on available for sale securities	\$ (8 ) \$ 9	Available for sale securities gains, net
	2        (3 )	Provision for income taxes
	\$ (6 ) \$ 6	Net of tax
Defined benefit pension items	\$ (47 ) \$ (56 )	Other expenses
	11        19	Provision for income taxes
	\$ (36 ) \$ (37 )	Net of tax
Total reclassifications	\$ (42 ) \$ (31 )	

Details about accumulated other comprehensive income (loss)	Amount reclassified from accumulated comprehensive income (loss) (a)	Affected line item in the Consolidated Statement of Income
	Nine Months Ended September 30	
	2018	2017
Unrealized gains and losses on available for sale securities	\$(8 )	\$204
	2	(69 )
	\$(6 )	\$135
		Available for sale securities gains, net
		Provision for income taxes
		Net of tax
Defined benefit pension items	\$(140 )	\$(168 )
	30	57
	\$(110 )	\$(111 )
		Other expenses
		Provision for income taxes
		Net of tax
Total reclassifications	\$(116 )	\$24

(a) Amounts in parentheses indicate expenses and other amounts indicate income on the Consolidated Statement of Income

#### Note 10 – Fair Value Measurements

The Company has established a hierarchal disclosure framework associated with the level of pricing observability utilized in measuring assets and liabilities at fair value. The three broad levels defined by this hierarchy are as follows:

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.

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth below.

In general, fair value is based upon quoted market prices, where available. If such quoted market prices are not available, fair value is based upon internally developed models that primarily use, as inputs, observable market-based parameters. Valuation adjustments may be made to ensure that financial instruments are recorded at fair value. These

adjustments may include amounts to reflect counterparty credit quality, the Company's creditworthiness, among other things, as well as unobservable parameters. Any such valuation adjustments are applied consistently over time. Our valuation methodologies may produce a fair value calculation that may not be indicative of net realizable value or reflective of future fair values. While management believes the Company's valuation methodologies are appropriate and consistent with other market participants, the use of different methodologies or assumptions to determine the fair value of certain financial instruments could result in a different estimate of fair value at the reporting date. Transfers between levels of the fair value hierarchy are recognized on the actual date of the event or circumstances that caused the transfer, which generally coincides with the Company's monthly and/or quarterly valuation process.

Assets and Liabilities Required to be Measured at Fair Value on a Recurring Basis

The fair values of equity securities and securities available for sale are determined by quoted prices in active markets, when available, and classified as Level I. If quoted market prices are not available, the fair value is determined by a matrix pricing, which is a mathematical technique, widely used in the industry to value debt securities without relying exclusively on quoted prices for the specific securities but rather by relying on the securities' relationship to other benchmark quoted securities and classified as Level II. The fair values consider observable data that may include dealer quotes, market spreads, cash flows, the U.S. Treasury yield curve, live trading levels, trade execution data, market consensus prepayment speeds, credit information and the bond's terms and conditions, among other things. The following tables present the assets and liabilities reported on the Consolidated Balance Sheet at their fair value on a recurring basis as of September 30, 2018 and December 31, 2017 by level within the fair value hierarchy (in thousands). Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

September 30, 2018	Level			Total
	Level I	Level II	III	
Fair value measurements on a recurring basis:				
Equity securities in financial institutions	\$291	\$-	\$ -	\$291
Available for sale securities:				
U.S. Agency securities	-	108,269	-	108,269
U.S. Treasury securities	32,837	-	-	32,837
Obligations of state and political subdivisions	-	51,598	-	51,598
Corporate obligations	-	3,000	-	3,000
Mortgage-backed securities in government sponsored entities	-	44,722	-	44,722

December 31, 2017	Level			Total
	Level I	Level II	III	
Fair value measurements on a recurring basis:				
Available for sale securities:				
U.S. Agency securities	\$-	\$98,887	\$ -	\$98,887
U.S. Treasuries securities	28,604	-	-	28,604
Obligations of state and political subdivisions	-	79,090	-	79,090
Corporate obligations	-	3,083	-	3,083
Mortgage-backed securities in government sponsored entities	-	45,027	-	45,027
Equity securities in financial institutions	91	-	-	91

Assets and Liabilities Required to be Measured and Reported at Fair Value on a Nonrecurring Basis

Assets measured at fair value on a nonrecurring basis as of September 30, 2018 and December 31, 2017 are included in the table below (in thousands):

September 30, 2018	Level I	Level II	Level III	Total
	Impaired Loans	\$ -	\$ -	
Other real estate owned	-	-	520	520
December 31, 2017				
Impaired Loans	\$ -	\$ -	\$1,569	\$1,569

Other real estate owned	-	-	1,024	1,024
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Impaired Loans - The Company has measured impairment on impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral dependent loan is less than the carrying amount of the loan a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the table above as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is not included in the table above as it is not currently being carried at its fair value. The fair values above excluded estimated selling costs of \$604,000 and \$163,000 at September 30, 2018 and December 31, 2017, respectively.

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Other Real Estate Owned (OREO) – OREO is carried at the lower of cost or fair value, less estimated costs to sell, which is measured at the date of foreclosure. If the fair value of the collateral exceeds the carrying amount of the loan, no charge-off or adjustment is necessary, the loan is not considered to be carried at fair value, and is therefore not included in the table above. If the fair value of the collateral is less than the carrying amount of the loan, management will charge the loan down to its estimated realizable value. The fair value of OREO is based on the appraised value of the property, which is generally unadjusted by management and is based on comparable sales for similar properties in the same geographic region as the subject property, and is included in the above table as a Level II measurement. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. In these cases, the loans are categorized in the above table as a Level III measurement since these adjustments are considered to be unobservable inputs. Income and expenses from operations and further declines in the fair value of the collateral subsequent to foreclosure are included in net expenses from OREO.

The following table provides a listing of the significant unobservable inputs used in the fair value measurement process for items valued utilizing Level III techniques (dollars in thousands).

September 30, 2018	Fair Value	Valuation Technique(s)	Unobservable input	Range	Weighted average	
Impaired Loans	\$6,281	Appraised Collateral Values	Discount for time since appraisal	0-100 %	20.06	%
			Selling costs	5%-11 %	8.73	%
			Holding period	0 - 12 months	11.71 months	
Other real estate owned	520	Appraised Collateral Values	Discount for time since appraisal	25-35 %	26.34	%
December 31, 2017	Fair Value	Valuation Technique(s)	Unobservable input	Range	Weighted average	
Impaired Loans	1,569	Appraised Collateral Values	Discount for time since appraisal	0-100 %	30.83	%
			Selling costs	5%-9 %	8.35	%
			Holding period	6 - 12 months	11.12 months	
Other real estate owned	1,024	Appraised Collateral Values	Discount for time since appraisal	15-65 %	26.26	%

Financial Instruments Not Required to be Measured or Reported at Fair Value

The carrying amount and fair value of the Company's financial instruments that are not required to be measured or reported at fair value on a recurring basis are as follows (in thousands):

September 30, 2018	Carrying		Level I	Level II	Level III
	Amount	Fair Value			
Financial assets:					
Cash and due from banks	\$16,500	\$16,500	\$16,500	\$-	\$-
Interest bearing time deposits with other banks	14,754	14,773	-	-	14,773
Equity securities	291	291	291	-	-
Available-for-sale securities	240,426	240,426	32,837	207,589	-
Loans held for sale	960	960	960	-	-





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Net loans	1,047,948	1,037,065	-	-	1,037,065
Bank owned life insurance	27,350	27,350	27,350	-	-
Regulatory stock	5,661	5,661	5,661	-	-
Accrued interest receivable	4,480	4,480	4,480	-	-

Financial liabilities:

Deposits	\$1,174,843	\$1,168,834	\$882,539	\$-	\$286,295
Borrowed funds	86,097	84,686	49,631	-	35,055
Accrued interest payable	979	979	979	-	-

December 31, 2017	Carrying			Level	
	Amount	Fair Value	Level I	II	Level III
Financial assets:					
Cash and due from banks	\$18,517	\$18,517	\$18,517	\$ -	\$-
Interest bearing time deposits with other banks	10,283	10,287	-	-	10,287
Loans held for sale	1,439	1,439	1,439	-	-
Net loans	989,335	981,238	-	-	981,238
Bank owned life insurance	26,883	26,883	26,883	-	-
Regulatory stock	6,784	6,784	6,784	-	-
Accrued interest receivable	4,196	4,196	4,196	-	-
Financial liabilities:					
Deposits	\$1,104,943	\$1,101,583	\$838,490	\$ -	\$263,093
Borrowed funds	114,664	113,452	77,650	-	35,802
Accrued interest payable	897	897	897	-	-

Note 11 Legal and Regulatory Proceedings

In the ordinary course of business, the Company is subject to legal proceedings, including claims, litigation, investigations and administrative proceedings, all of which are considered incidental to the normal conduct of business. Litigation may relate to lending, deposit and other customer relationships, vendor and contractual issues, employee matters, intellectual property matters, personal injuries and torts, regulatory and legal compliance, and other matters. The Company believes it has substantial defenses to the claims asserted against it in its currently outstanding legal proceedings and, with respect to such legal proceedings, intends to defend itself vigorously. Set forth below are descriptions of certain of the Company's legal proceedings.

The Bank was named as a defendant in a lawsuit filed in the United States Bankruptcy Court for Western District of New York District, Arnold v. First Citizens National Bank, wherein the plaintiff is seeking avoid and recover various payments to First Citizens by Cornerstone Homes, Inc. and avoid or subordinate liens made in favor of First Citizens on property of Cornerstone on multiple grounds, including that the transfers constituted fraudulent conveyances under applicable law.

The Company assesses its liabilities and contingencies in connection with outstanding legal proceedings utilizing the latest information available. Where it is probable that the Company will incur a loss and the amount of the loss can be reasonably estimated, the Company records a liability in its consolidated financial statements. These legal reserves may be increased or decreased to reflect any relevant developments. Where a loss is not probable or the amount of a probable loss is not reasonably estimable, the Company does not accrue legal reserves. Additionally, for those matters where a loss is reasonably possible and the amount of loss is reasonably estimable, the Company estimates the amount of losses that it could incur beyond the accrued legal reserves. Under U.S. GAAP, an event is "reasonably possible" if

"the chance of the future event or events occurring is more than remote but less than likely" and an event is "remote" if "the chance of the future event or events occurring is slight."

While the outcome of legal proceedings and the timing of the ultimate resolution are inherently difficult to predict, based on information currently available, advice of counsel and available insurance coverage, the Company believes that it has established adequate legal reserves. Further, based upon available information, the Company is of the opinion that these legal proceedings, individually or in the aggregate, will not have a material adverse effect on the Company's financial condition or results of operations. However, in the event of unexpected future developments, it is reasonably possible that an adverse outcome in any of the matters discussed above could be material to the Company's business, consolidated financial position, results of operations or cash flows for any particular reporting period of occurrence.

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## Note 12 – 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 Company's consolidated 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 Company's consolidated financial statements.

In July 2018, the FASB issued ASU 2018-11, Leases (Topic 842): Targeted Improvements. This Update provides another transition method which allows entities to initially apply ASC 842 at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Entities that elect this approach should report comparative periods in accordance with ASC 840, Leases. In addition, this Update provides a practical expedient under which lessors may elect, by class of underlying assets, to not separate nonlease components from the associated lease component, similar to the expedient provided for lessees. However, the lessor practical expedient is limited to circumstances in which the nonlease component or components otherwise would be accounted for under the new revenue guidance and both (a) the timing and pattern of transfer are the same for the nonlease component(s) and associated lease component and (b) the lease component, if accounted for separately, would be classified as an operating lease. If the nonlease component or components associated with the lease component are the predominant component of the combined component, an entity should account for the combined component in accordance with ASC 606, Revenue from Contracts with Customers. Otherwise, the entity should account for the combined component as an operating lease in accordance with ASC 842. If a lessor elects the practical expedient, certain disclosures are required. This Update is effective for public business entities for fiscal years

beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. 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. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial statement disclosures.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement (Topic 820): Disclosure Framework – Changes the Disclosure Requirements for Fair Value Measurements. The Update removes the requirement to disclose the amount of and reasons for transfers between Level I and Level II of the fair value hierarchy; the policy for timing of transfers between levels; and the valuation processes for Level III fair value measurements. The Update requires disclosure of changes in unrealized gains and losses for the period included in other comprehensive income (loss) for recurring Level III fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level III fair value measurements. This Update is effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. The Company is currently evaluating the impact the adoption of the standard will have on the Company's consolidated financial position or results of operations.

In August 2018, the FASB issued ASU 2018-14, Compensation – Retirement Benefits (Topic 715-20). This Update amends ASC 715 to add, remove and clarify disclosure requirements related to defined benefit pension and other postretirement plans. The Update eliminates the requirement to disclose the amounts in accumulated other comprehensive income expected to be recognized as part of net periodic benefit cost over the next year. The Update also removes the disclosure requirements for the effects of a one-percentage-point change on the assumed health care costs and the effect of this change in rates on service cost, interest cost and the benefit obligation for postretirement health care benefits. This Update is effective for public business entities for fiscal years ending after December 15, 2020, and must be applied on a retrospective basis. For all other entities, this Update is effective for fiscal years ending after December 15, 2021. This Update is not expected to have a significant impact on the Company's consolidated financial statements.

ITEM 2. Management's Discussion and Analysis of Financial Condition and Results of Operations

Forward-Looking Statements

We have made forward-looking statements in this document, and in documents that we incorporate by reference, that are subject to risks and uncertainties. Forward-looking statements include information concerning possible or expected future results of operations of Citizens Financial Services, Inc., First Citizens Community Bank, First Citizens Insurance Agency, Inc. or the combined Company. When we use words such as "believes," "expects," "anticipates," or similar expressions, we are making forward-looking statements. For a variety of reasons, actual results could differ materially from those contained in or implied by forward-looking statements. The Company cautions readers that the following important factors, among others, 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:

- Interest rates could change more rapidly or more significantly than we expect.  
The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.
- The financial markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.  
It could take us longer than we anticipate to implement strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.
- We may not be able to successfully integrate businesses we acquire or be able to fully realize the expected financial and other benefits from acquisitions.
- Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.  
We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition or operating results.
- We may become subject to new and unanticipated accounting, tax, or regulatory practices or requirements.  
We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition.
- We could experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.
- We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.
- The agricultural economy is subject to extreme swings in both the costs of resources and the prices received from the sale of products, which could negatively impact some of our customers.  
Agricultural customers could be affected by factors outside of their control including adverse weather conditions, loss of crops or livestock due to diseases or other factors and government policies and regulations.
- Loan concentrations in certain industries could negatively impact financial results, if financial results or economic conditions deteriorate.
- A budget impasse in the Commonwealth of Pennsylvania could impact our asset values, liquidity and profitability as a result of either delayed or reduced funding to school districts and municipalities who are customers of the Bank.  
Companies providing support services related to the exploration and drilling of the natural gas reserves in our market area may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection, which could negatively impact our customers and, as a result, negatively impact our loan and deposit volume and loan quality. Additionally, the activities the companies providing support services related to the exploration and drilling of the natural gas reserves may be dependent on the market price of natural gas. As a result, decreases in the market price of natural gas could also negatively impact these companies, our customers.

Additional factors that may affect our results are discussed under "Part II – Item 1A – Risk Factors" in this report and in the Company's 2017 Annual Report on Form 10-K under "Item 1.A/ Risk Factors." Except as required by applicable law and regulation, we assume no obligation to update or revise any forward-looking statements after the date on which they are made.

### Introduction

The following is management's discussion and analysis of the financial condition and results of operations at the dates and for the periods presented in the accompanying consolidated financial statements for the Company. Our consolidated financial condition and results of operations consist almost entirely of the Bank's financial condition and results of operations. Management's discussion and analysis should be read in conjunction with the preceding financial statements presented under Part I. The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the results you may expect for the full year.

The Company currently engages in the general business of banking throughout our service area of Potter, Tioga, Clinton, Bradford and Centre counties in north central Pennsylvania, Lebanon, Berks, Schuylkill and Lancaster counties in south central Pennsylvania and Allegany County in southern New York. We also have a limited branch office in Union county, Pennsylvania, which primarily serves agricultural customers in the central Pennsylvania market. We maintain our central office in Mansfield, Pennsylvania. Presently we operate 29 banking facilities, 28 of which operate as bank branches. In Pennsylvania, the Company has full service offices located in Mansfield, Blossburg, Ulysses, Genesee, Wellsboro, Troy, Sayre, Canton, Gillett, Millerton, LeRaysville, Towanda, Rome, the Mansfield Wal-Mart Super Center, Mill Hall, Schuylkill Haven, Friedensburg, Mt. Aetna, Fredericksburg, Mount Joy, State College and three branches near the city of Lebanon, Pennsylvania. We also have limited branch offices in Winfield and Narvon, Pennsylvania. In New York, our office is in Wellsville. We have received regulatory approval to open a full service branch in Denver, Pennsylvania, which is expected to occur in the fourth quarter. We have also received regulatory approval to close the Narvon limited branch office, which will occur in the fourth quarter.

On December 8, 2017, we closed the transaction with S&T Bank to acquire its State College, Pennsylvania office.

### Risk Management

Risk identification and management are essential elements for the successful management of the Company. In the normal course of business, the Company is subject to various types of risk, including interest rate, credit, liquidity, reputational and regulatory risk.

Interest rate risk is the sensitivity of net interest income and the market value of financial instruments to the direction and frequency of changes in market interest rates. Interest rate risk results from various re-pricing frequencies and the maturity structure of the financial instruments owned by the Company. The Company uses its asset/liability and funds management policy to control and manage interest rate risk.

Credit risk represents the possibility that a customer may not perform in accordance with contractual terms. Credit risk results from loans with customers and the purchasing of securities. The Company's primary credit risk is in the loan portfolio. The Company manages credit risk by adhering to an established credit policy and through a disciplined evaluation of the adequacy of the allowance for loan losses. Also, the investment policy limits the amount of credit risk that may be taken in the investment portfolio.

Liquidity risk represents the inability to generate or otherwise obtain funds at reasonable rates to satisfy commitments to borrowers and obligations to depositors. The Company has established guidelines within its asset/liability and funds management policy to manage liquidity risk. These guidelines include, among other things, contingent funding alternatives.



Reputational risk, or the risk to our business, earnings, liquidity, and capital from negative public opinion, could result from our actual or alleged conduct in a variety of areas, including legal and regulatory compliance, lending practices, corporate governance, litigation, ethical issues, or inadequate protection of customer information, including fraudulent activity outside the Company's control. We expend significant resources to comply with regulatory requirements. Failure to comply could result in reputational harm or significant legal or remedial costs. Damage to our reputation could adversely affect our ability to retain and attract new customers, and adversely impact our earnings and liquidity.

Regulatory and compliance risk represents the possibility that a change in law, regulations or regulatory policy may have a material effect on the business of the Company. We cannot predict what legislation might be enacted or what regulations might be adopted, or if adopted, the effect thereof on our operations.

### Competition

The banking industry in the Bank's service areas continue to be extremely competitive, both among commercial banks and with other financial service providers such as consumer finance companies, thrifts, investment firms, mutual funds, insurance companies, credit unions, agricultural cooperatives and internet entities. Competition in our north central Pennsylvania market has increased as a result of other financial institutions looking to expand into new markets. With larger population centers in our central and south central markets, we experience more competition to gather deposits and to make loans. Mortgage banking firms, financial companies, financial affiliates of industrial companies, brokerage firms, retirement fund management firms and even government agencies provide additional competition for loans and other financial services. The Bank is generally competitive with all competing financial institutions in its service areas with respect to interest rates paid on time and savings deposits, service charges on deposit accounts and interest rates charged on loans.

### Trust and Investment Services; Oil and Gas Services

Our Investment and Trust Services Division offers professional trust administration, investment management services, estate planning and administration, and custody of securities. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the Consolidated Balance Sheets since such items are not assets of the Company. Revenues and fees of the Trust Department are reflected in trust income in the Consolidated Statement of Income. As of September 30, 2018 and December 31, 2017, the Trust Department had \$127.2 million and \$122.7 million of assets under management, respectively.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc. The assets associated with these products are not included in the Consolidated Balance Sheets since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from \$156.0 million at December 31, 2017 to \$182.7 million at September 30, 2018. Fee income from the sale of these products is reflected in brokerage and insurance income in the Consolidated Statement of Income. Management believes that there are opportunities to increase non-interest income through these products and services, especially in our central and south central Pennsylvania markets.

In addition to traditional trust and investment services offered, we assist our customers through various oil and gas specific leasing matters from lease negotiations to establishing a successful approach to personal wealth management. As of September 30, 2018, customers owning 7,012 acres have signed agreements with the Bank that provide for the Bank to manage oil and gas matters related to the customers land, which may include negotiating lease payments and royalty percentages, resolving leasing issues, accounting for and ensuring the accuracy of royalty checks, distributing revenue to satisfy investment objectives and providing customized reports outlining payment and distribution information.





## Results of Operations

### Overview of the Income Statement

The Company had net income of \$13,519,000 for the first nine months of 2018 compared to \$10,421,000 for last year's comparable period, an increase of \$3,098,000, or 29.7%. Basic earnings per share for the first nine months of 2018 were \$3.85, compared to \$2.96 last year, representing a 30.1% increase. Annualized return on assets and return on equity for the nine months of 2018 were 1.30% and 13.13%, respectively, compared with 1.12% and 10.81% for last year's comparable period.

Net income for the three months ended September 30, 2018 was \$4,581,000 compared to \$3,650,000 in the comparable 2017 period, an increase of \$931,000 or 25.5%. Basic earnings per share for the three months ended September 30, 2018 were \$1.31, compared to \$1.04 last year, representing a 26.0% increase. Annualized return on assets and return on equity for the quarter ended September 30, 2018 was 1.30% and 13.08%, respectively, compared with 1.15% and 11.16% for the same 2017 period.

### Net Interest Income

Net interest income, the most significant component of the Company's earnings, is the amount by which interest income generated from interest-earning assets exceeds interest expense paid on interest-bearing liabilities.

Net interest income for the first nine months of 2018 was \$34,941,000, an increase of \$3,923,000, or 12.7%, compared to the same period in 2017. For the first nine months of 2018, the provision for loan losses totaled \$1,300,000, a decrease of \$440,000 over the comparable period in 2017. Consequently, net interest income after the provision for loan losses was \$33,641,000 compared to \$29,278,000 during the first nine months of 2017.

For the three months ended September 30, 2018, net interest income was \$11,770,000 compared to \$10,617,000, an increase of \$1,153,000, or 10.9% over the comparable period in 2017. The provision for loan losses this quarter was \$475,000 compared to \$500,000 for last year's third quarter. Consequently, net interest income after the provision for loan losses was \$11,295,000 for the quarter ended September 30, 2018 compared to \$10,117,000 in 2017.

The following table sets forth the average balances of, and the interest earned or incurred on, for each principal category of assets, liabilities and stockholders' equity, the related rates, net interest income and interest rate spread created for the nine and three months ended September 30, 2018 and 2017 on a tax equivalent basis (dollars in thousands):

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Analysis of Average Balances and Interest Rates (1)						
Nine Months Ended						
September 30, 2018			September 30, 2017			
	Average Balance (1)	Interest \$	Average Rate %	Average Balance (1)	Interest \$	Average Rate %
(dollars in thousands)	\$	\$	%	\$	\$	%
<b>ASSETS</b>						
Short-term investments:						
Interest-bearing deposits at banks	8,806	14	0.21	8,919	12	0.18
Total short-term investments	8,806	14	0.21	8,919	12	0.18
Interest bearing time deposits at banks	11,972	204	2.28	7,740	117	2.03
Investment securities:						
Taxable	189,220	3,038	2.14	197,814	2,532	1.71
Tax-exempt (3)	68,975	1,805	3.49	86,033	2,813	4.36
Total investment securities	258,195	4,843	2.50	283,847	5,345	2.51
Loans (2)(3)(4):						
Residential mortgage loans	214,134	8,347	5.21	205,860	7,967	5.17
Construction	23,441	829	4.73	26,804	851	4.25
Commercial Loans	387,482	15,273	5.27	323,801	12,688	5.24
Agricultural Loans	298,875	9,812	4.39	200,287	6,467	4.32
Loans to state & political subdivisions	101,189	2,693	3.56	97,139	3,055	4.21
Other loans	9,540	553	7.75	10,403	621	7.98
Loans, net of discount	1,034,661	37,507	4.85	864,294	31,649	4.90
Total interest-earning assets	1,313,634	42,568	4.33	1,164,800	37,123	4.26
Cash and due from banks	6,826			6,650		
Bank premises and equipment	16,367			16,871		
Other assets	54,849			55,874		
Total non-interest earning assets	78,042			79,395		
Total assets	1,391,676			1,244,195		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest-bearing liabilities:						
NOW accounts	325,667	1,127	0.46	322,084	829	0.34
Savings accounts	189,635	185	0.13	178,806	141	0.11
Money market accounts	162,816	1,091	0.90	126,874	469	0.49
Certificates of deposit	268,737	2,292	1.14	262,321	1,959	1.00
Total interest-bearing deposits	946,855	4,695	0.66	890,085	3,398	0.51
Other borrowed funds	126,158	2,034	2.16	58,651	782	1.78
Total interest-bearing liabilities	1,073,013	6,729	0.84	948,736	4,180	0.59
Demand deposits	168,951			152,188		
Other liabilities	12,392			14,686		
Total non-interest-bearing liabilities	181,343			166,874		
Stockholders' equity	137,320			128,585		
Total liabilities & stockholders' equity	1,391,676			1,244,195		
Net interest income		35,839			32,943	
Net interest spread (5)			3.49 %			3.67 %
Net interest income as a percentage of average interest-earning assets			3.65 %			3.78 %
Ratio of interest-earning assets to interest-bearing liabilities			122 %			123 %

- (1) Averages are based on daily averages.
- (2) Includes loan origination and commitment fees.
- (3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 21% for 2018 and 34% for 2017.
- (4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.
- (5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Analysis of Average Balances and Interest Rates (1)						
Three Months Ended						
September 30, 2018			September 30, 2017			
	Average Balance (1)	Interest	Average Rate	Average Balance (1)	Interest	Average Rate
(dollars in thousands)	\$	\$	%	\$	\$	%
<b>ASSETS</b>						
Short-term investments:						
Interest-bearing deposits at banks	9,195	5	0.22	8,552	3	0.16
Total short-term investments	9,195	5	0.22	8,552	3	0.16
Interest bearing time deposits at banks	14,369	89	2.47	8,953	47	2.07
Investment securities:						
Taxable	177,937	1,074	2.41	180,004	824	1.83
Tax-exempt (3)	63,467	538	3.49	83,164	891	4.29
Total investment securities	241,404	1,612	2.67	263,168	1,715	2.61
Loans (2)(3)(4):						
Residential mortgage loans	212,891	2,808	5.23	205,548	2,677	5.17
Construction	29,184	355	4.82	26,028	278	4.23
Commercial Loans	382,417	5,098	5.29	327,345	4,296	5.21
Agricultural Loans	314,307	3,489	4.40	230,048	2,501	4.31
Loans to state & political subdivisions	99,807	906	3.60	97,771	1,029	4.18
Other loans	9,618	185	7.65	10,420	205	7.83
Loans, net of discount	1,048,224	12,841	4.86	897,160	10,986	4.86
Total interest-earning assets	1,313,192	14,547	4.39	1,177,833	12,751	4.30
Cash and due from banks	7,039			6,739		
Bank premises and equipment	16,266			16,722		
Other assets	69,708			64,851		
Total non-interest earning assets	93,013			88,312		
Total assets	1,406,205			1,266,145		
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>						
Interest-bearing liabilities:						
NOW accounts	320,574	394	0.49	327,391	295	0.36
Savings accounts	194,110	84	0.17	180,891	49	0.11
Money market accounts	181,449	480	1.05	134,610	178	0.53
Certificates of deposit	271,355	836	1.22	263,065	688	1.04
Total interest-bearing deposits	967,488	1,794	0.74	905,957	1,210	0.53
Other borrowed funds	114,314	695	2.41	61,215	293	1.90
Total interest-bearing liabilities	1,081,802	2,489	0.91	967,172	1,503	0.62
Demand deposits	172,288			153,747		
Other liabilities	12,022			14,388		
Total non-interest-bearing liabilities	184,310			168,135		
Stockholders' equity	140,093			130,838		
Total liabilities & stockholders' equity	1,406,205			1,266,145		
Net interest income		12,058			11,248	
Net interest spread (5)			3.48 %			3.68 %
Net interest income as a percentage of average interest-earning assets			3.64 %			3.79 %
Ratio of interest-earning assets						

to interest-bearing liabilities	121	%	122	%
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- (1) Averages are based on daily averages.
- (2) Includes loan origination and commitment fees.
- (3) Tax exempt interest revenue is shown on a tax equivalent basis for proper comparison using a statutory federal income tax rate of 21% for 2018 and 34% for 2017.
- (4) Income on non-accrual loans is accounted for on a cash basis, and the loan balances are included in interest-earning assets.
- (5) Interest rate spread represents the difference between the average rate earned on interest-earning assets and the average rate paid on interest-bearing liabilities.

Tax exempt revenue is shown on a tax-equivalent basis for proper comparison using a federal statutory income tax rate of 21% for the nine and three months ended September 30, 2018 and 34% for the nine and three months ended September 30, 2017. For purposes of the comparison, as well as the discussion that follows, this presentation facilitates performance comparisons between taxable and tax-free assets by increasing the tax-free income by an amount equivalent to the Federal income taxes that would have been paid if this income were taxable at the Company's Federal statutory rate during the corresponding period. The following table represents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the periods ended September 30, 2018 and 2017 (in thousands):

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	For the Three Months Ended September 30, 2018		For the Nine Months Ended September 30, 2017	
Interest and dividend income from investment securities and interest bearing deposits at banks (non-tax adjusted)	\$1,593	\$1,461	\$4,682	\$4,518
Tax equivalent adjustment	113	304	379	956
Interest and dividend income from investment securities and interest bearing deposits at banks (tax equivalent basis)	\$1,706	\$1,765	\$5,061	\$5,474
Interest and fees on loans (non-tax adjusted)	\$12,666	\$10,659	\$36,988	\$30,680
Tax equivalent adjustment	175	327	519	969
Interest and fees on loans (tax equivalent basis)	\$12,841	\$10,986	\$37,507	\$31,649
Total interest income	\$14,259	\$12,120	\$41,670	\$35,198
Total interest expense	2,489	1,503	6,729	4,180
Net interest income	11,770	10,617	34,941	31,018
Total tax equivalent adjustment	288	631	898	1,925
Net interest income (tax equivalent basis)	\$12,058	\$11,248	\$35,839	\$32,943

The following table shows the tax-equivalent effect of changes in volume and rate on interest income and expense (in thousands):

	Three months ended September 30, 2018 vs 2017 (1) Change in Volume    Change in Rate    Total Change			Nine months ended September 30, 2018 vs. 2017 (1) Change in Volume    Change in Rate    Total Change		
Interest Income:						
Short-term investments:						
Interest-bearing deposits at banks	\$1	\$ 1	\$2	\$-	\$2	\$2
Interest bearing time deposits at banks	32	10	42	71	16	87
Investment securities:						
Taxable	(9 )	259	250	(105 )	611	506
Tax-exempt	(188 )	(165 )	(353 )	(502 )	(506 )	(1,008)
Total investments	(197 )	94	(103 )	(607 )	105	(502 )
Loans:						
Residential mortgage loans	96	35	131	322	58	380
Construction	36	41	77	(229 )	207	(22 )
Commercial Loans	733	69	802	2,510	75	2,585
Agricultural Loans	934	54	988	3,235	110	3,345
Loans to state & political subdivisions	22	(145 )	(123 )	134	(496 )	(362 )
Other loans	(15 )	(5 )	(20 )	(50 )	(18 )	(68 )
Total loans, net of discount	1,806	49	1,855	5,922	(64 )	5,858
Total Interest Income	1,642	154	1,796	5,386	59	5,445
Interest Expense:						
Interest-bearing deposits:						

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NOW accounts	(6 )	105	99	9	289	298
Savings accounts	4	31	35	9	35	44
Money Market accounts	78	224	302	161	461	622
Certificates of deposit	22	126	148	49	284	333
Total interest-bearing deposits	98	486	584	228	1,069	1,297
Other borrowed funds	307	95	402	1,059	193	1,252
Total interest expense	405	581	986	1,287	1,262	2,549
Net interest income	\$1,237	\$(427 )	\$810	\$4,099	\$(1,203)	\$2,896

(1) The portion of the total change attributable to both volume and rate changes, which can not be separated, has been allocated proportionally to the change due to volume and the change due to rate prior to allocation.

Tax equivalent net interest income increased from \$32,943,000 for the nine month period ended September 30, 2017 to \$35,839,000 for the nine month period ended September 30, 2018, an increase of \$2,896,000. The tax equivalent net interest margin decreased from 3.78% for the first nine months of 2017 to 3.65% for the comparable period in 2017. A significant portion of the decrease is attributable to a change in the federal corporate tax rate from 34% to 21%, which resulted in the tax equivalent yield on our tax-exempt investments and loans to decrease.

Total tax equivalent interest income for the 2018 nine month period increased \$5,445,000 as compared to the 2017 nine month period. This increase was primarily a result of an increase of \$5,386,000 due to a change in volume as average interest-bearing assets increased \$148.8 million. Additionally, due to an increase in rates on taxable securities, there was an increase due to rate of \$59,000. As a result of converting investment assets to loans, the yield on average interest earning assets increased 7 basis points from 4.26% to 4.33%.



Tax equivalent investment income for the nine months ended September 30, 2018 decreased \$502,000 over the same period last year. The primary cause of the decrease was a decrease in the average outstanding balance of investments.

The average balance of taxable securities decreased by \$8.6 million, which resulted in a decrease in investment income of \$105,000. The decrease in the average balance of taxable securities was due to the Bank's strategy of funding loan growth through the cashflows of the investment portfolio. The yield on taxable securities increased 43 basis points from 1.71% to 2.14% as a result of the recent rise in rates and the calls and maturities of lower yielding investments. This resulted in an increase in investment income of \$611,000.

The average balance of tax-exempt securities decreased by \$17.1 million, which resulted in a decrease in investment income of \$502,000. The decrease was utilized to fund loan growth. The yield on tax-exempt securities decreased 87 basis points from 4.36% to 3.49%, which corresponds to a decrease in interest income of \$506,000. The yield decrease was partially attributable to the decrease in the federal statutory income tax rate as well as higher yielding securities being called and maturing and replaced by lower yielding securities. For a discussion of the Company's current investment strategy, see the "Financial Condition – Investments".

Total loan interest income increased \$5,858,000 for the nine months ended September 30, 2018 compared to the same period last year, primarily as a result of loan growth achieved in 2017 and the first nine months of 2018 that was primarily due to the hiring of experienced lending teams in our central and south central Pennsylvania markets. It was also positively impacted by the acquisition of the State College branch in December of 2017.

The average balance of commercial loans increased \$63.7 million from a year ago. The growth was attributable to the State College branch acquisition and organic growth in our central and south central Pennsylvania markets. This had a positive impact of \$2,510,000 on total interest income due to volume.

Interest income on agricultural loans increased \$3,345,000 from 2017 to 2018. The increase in the average balance of agricultural loans of \$98.6 million is primarily attributable to the additional agricultural lenders hired in 2016 to serve the central and south central markets. The increase in the average balance of these loans resulted in an increase in interest income due to volume of \$3,235,000.

The average balance of construction loans decreased \$3.4 million from a year ago. This resulted in a decrease of \$229,000 on total interest income due to volume. Offsetting this decrease, there was a \$207,000 increase due to rate, as the yield earned increased from 4.25% to 4.73%.

The average balance of state and political subdivision loans increased \$4.1 million from a year ago. This resulted in an increase of \$134,000 on total interest income due to volume. The tax effected yield decreased 65 basis points to 3.56%, which decreased loan interest income \$496,000. The decrease in the tax effected yield on this portfolio was due to the decrease in the Federal statutory income tax rate from 2017 to 2018, which lowered the tax effected increase to income for tax free loans.

Interest income on residential mortgage loans increased \$380,000. The average balance of residential loans increased \$8.3 million from a year ago, primarily due to the State College acquisition, which resulted in an increase in loan interest income of \$322,000.

Total interest expense increased \$2,549,000 for the nine months ended September 30, 2018 compared with the comparative period last year primarily as a result of an increase in borrowings to fund loan growth in 2017 and 2018 and higher rates paid on deposits and overnight borrowings. Interest expense increased \$1,287,000 as a result of volume as the average balance of interest bearing liabilities increased \$124.3 million. In addition, there was an increase of \$1,262,000 due to rate as a result of an increase in the average rate paid on interest bearing liabilities from 0.59% to 0.84%.

The average balance of interest bearing deposits increased \$56.8 million from September 30, 2017 to September 30, 2018. Increases were experienced in NOW accounts of \$3.6 million, savings accounts of \$10.8 million, money market accounts of \$35.9 million and certificates of deposit of \$6.4 million. The cumulative effect of these volume changes was an increase in interest expense of \$228,000. (see also "Financial Condition – Deposits"). The rate paid on interest bearing deposits was 0.66% for the first nine months of 2018 and 0.51% for the comparable period in 2017. This resulted in an increase in interest expense of \$1,069,000.

The average balance of other borrowed funds increased \$67.5 million from a year ago. This resulted in an increase in interest expense of \$1,059,000. There was also an increase in the average rate on other borrowed funds from 1.78% to 2.16% due to an increase in the overnight borrowing rate as a result of the Federal Reserve interest rate increases in 2017 and 2018 resulting in an increase in interest expense of \$193,000.

Tax equivalent net interest income for the three months ended September 30, 2018 was \$12,058,000 which compares to \$11,248,000 for the same period last year. This represents an increase of \$810,000 or 7.2%. The tax equivalent net interest margin decreased from 3.79% for the three months ended September 30, 2017 to 3.64% for the comparable period in 2018 with the majority of the decrease attributable to the decrease in the federal statutory income tax rate from 34% in 2017 to 21% in 2018.

Total tax equivalent interest income was \$14,547,000 for the three month period ended September 30, 2018, compared to \$12,751,000 for the comparable period last year, an increase of \$1,796,000. The primary driver of this increase was an increase of \$1,642,000 due to a change in volume as interest-earning assets increased \$135.4 million that was primarily due to the hiring of experienced lending teams in our central and south central Pennsylvania markets. It was also positively impacted by the acquisition of the State College branch in December of 2017. In addition, the average yield on interest-earning assets increased 9 basis points from 4.30% to 4.39% for the comparable periods, resulting in an increase in tax equivalent interest income of \$154,000.

Total investment income decreased by \$103,000 compared to same period last year. The primary cause of the decrease was a decrease of \$21.8 million in the average outstanding balance of investment securities, which equates to a decrease of \$197,000. Offsetting this increase, there was a 6 point increase in rate on investments securities from 2.61% to 2.67%, which equates to a \$94,000 increase in income.

Total loan interest income increased \$1,855,000 compared to the same period last year. This was primarily due to an increase in volume of \$151.1 million, which corresponds to a \$1,806,000 increase in interest income.

Total interest expense increased \$986,000 for the three months ended September 30, 2018 compared with last year as a result of the increase in the average balance of interest-bearing liabilities of \$114.6 million, accounting for a \$405,000 increase in interest expense. The average rate on interest-bearing liabilities increased 29 basis points from 0.62% to 0.91%, which increased interest expense \$581,000.

The average balance of interest bearing deposits increased \$61.5 million for the nine month period ended September 30, 2017 to the comparable period ended September 30, 2018. The cumulative effect of these volume changes was an increase in interest expense of \$98,000. The rate paid on interest bearing deposits was 0.74% for the first nine months of 2018 and 0.53% for the comparable period in 2017. This results in an increase in interest expense of \$486,000.

The average balance of other borrowed funds increased \$53.1 million from a year ago. This resulted in an increase in interest expense of \$307,000. There was also an increase in the average rate on other borrowed fund from 1.90% to 2.41% due to an increase in the overnight borrowing rate as a result of the Federal Reserve interest rate moves in 2017 and 2018 resulting in an increase in interest expense of \$95,000.

## Provision for Loan Losses

For the nine month period ended September 30, 2018, we recorded a provision for loan losses of \$1,300,000, which represents a decrease of \$440,000 from the \$1,740,000 provision recorded in the corresponding nine months of last year. The provision was lower in 2018 than 2017 primarily due to the loan growth that occurred in 2017 compared to the loan growth in 2018. (see "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

For the three months ended September 30, 2018, we recorded a provision of \$475,000 compared to \$500,000 in 2017 with the decrease for the three month period being due to the lower level of loan growth in 2018 compared to the same period in 2017.

## Non-interest Income

The following table shows the breakdown of non-interest income for the three and nine months ended September 30, 2018 and 2017 (dollars in thousands):

	Nine months ended		Change	
	September 30, 2018	September 30, 2017	Amount	%
Service charges	\$3,455	\$3,323	\$132	4.0
Trust	548	596	(48 )	(8.1 )
Brokerage and insurance	571	459	112	24.4
Gains on loans sold	302	383	(81 )	(21.1 )
Equity security gains, net	9	-	9	NA
Available for sale security gains, net	(8 )	204	(212 )	(103.9 )
Earnings on bank owned life insurance	467	499	(32 )	(6.4 )
Other	414	380	34	8.9
Total	\$5,758	\$5,844	\$(86 )	(1.5 )
	Three months ended		Change	
	September 30, 2018	September 30, 2017	Amount	%
Service charges	\$1,181	\$1,145	\$36	3.1
Trust	147	187	(40 )	(21.4 )
Brokerage and insurance	222	154	68	44.2
Gains on loans sold	170	134	36	26.9
Equity security gains, net	(4 )	-	(4 )	NA
Available for sale security gains, net	(8 )	9	(17 )	(188.9 )
Earnings on bank owned life insurance	161	166	(5 )	(3.0 )
Other	141	126	15	11.9
Total	\$2,010	\$1,921	\$89	4.6

Non-interest income for the nine months ended September 30, 2018 totaled \$5,758,000, a decrease of \$86,000 when compared to the same period in 2017. During the first nine months of 2018, there were \$8,000 of losses from the sale of available for sale securities in 2018 compared to a \$204,000 gain in 2017. We sold \$11.4 million of US agency securities for a loss of \$169,000 and \$13.8 million of state and political securities for a gain of \$161,000. In 2017, we sold nine agency securities for gains totaling \$15,000, two of our equity positions for a gain of \$158,000 and a mortgage backed security for a gain of \$20,000. We recognized a \$9,000 increase in the market value of our equity portfolio in 2018.

For the first nine months of 2018, account service charges totaled \$3,455,000, an increase of \$132,000 or 4.0%, when compared to the same period in 2017. The increase was associated with an \$113,000 increase in interchange revenue and a \$40,000 increase in ATM income. The increase in brokerage revenues is attributable to the hiring of a broker in the south central market in the second quarter of 2017. The decrease in gains on loans sold is due to a decrease in the amount of loans sold in 2018 compared to 2017. The decrease in Trust revenues is due to estate settlement fees being lower.

For the three month period ended September 30, 2018, the changes experienced from the prior year related to service charges, trust and brokerage and insurance correspond to the changes experienced for the nine month period. The increase in gains on loans sold in the third quarter was attributable to an increase of \$2.6 million in proceeds from loan sales when comparing sales in the third quarter of 2018 to the same period in 2017. Proceeds totaled \$8.5 million for the third quarter of 2018.

## Non-interest Expense

The following tables reflect the breakdown of non-interest expense for the three and nine months ended September 30, 2018 and 2017 (dollars in thousands):

	Nine months ended		Change	
	September 30, 2018	2017	Amount	%
Salaries and employee benefits	\$14,251	\$13,030	\$1,221	9.4
Occupancy	1,606	1,479	127	8.6
Furniture and equipment	394	444	(50)	(11.3)
Professional fees	1,273	942	331	35.1
FDIC insurance	327	295	32	10.8
Pennsylvania shares tax	850	767	83	10.8
Amortization of intangibles	224	223	1	NA
OREO expenses	92	255	(163)	(63.9)
Other	4,305	4,169	136	3.3
Total	\$23,322	\$21,604	\$1,718	8.0

	Three months ended		Change	
	September 30, 2018	2017	Amount	%
Salaries and employee benefits	\$4,679	\$4,287	\$392	9.1
Occupancy	500	475	25	5.3
Furniture and equipment	130	159	(29)	(18.2)
Professional fees	507	318	189	59.4
FDIC insurance	120	95	25	26.3
Pennsylvania shares tax	250	243	7	2.9
Amortization of intangibles	74	74	-	-
OREO expenses (recovery)	6	139	(133)	(95.7)
Other	1,522	1,457	65	4.5
Total	\$7,788	\$7,247	\$541	7.5

Non-interest expenses increased \$1,718,000 for the nine months ended September 30, 2018 compared to the same period in 2017. Salaries and employee benefits increased \$1,221,000 or 9.4%. The increase was due to merit increases effective at the beginning of 2018, an increase in the number of full-time equivalent employees of 9.0 as a result of staffing for additional branch locations, specifically State College, and an increase in profit sharing and retirement expenses as a result of additional headcount and improved financial results.

The primary cause of the increase in occupancy expenses is due to the acquisition of the State College branch and the openings of the limited branch office in Narvon, Pennsylvania. The increase in professional fees is the result of legal fees associated with a customer that is in bankruptcy. The decrease in OREO expenses is due to having fewer properties, which results in lower taxes and maintenance costs.

For the three months ended, September 30, 2018, non-interest expenses increased \$541,000 when compared to the same period in 2017. The changes in salaries and employee benefits, occupancy expenses, professional fees and OREO expenses for the quarter are consistent with the changes for the nine month period.

## Provision for Income Taxes

The provision for income taxes was \$2,558,000 for the nine month period ended September 30, 2018 compared to \$3,097,000 for the same period in 2017. The decrease is attributable to the decrease in the Federal statutory income tax rate from 35% in 2017 to 21% in 2018. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 15.9% and 22.9% for the first nine months of 2018 and 2017, respectively, compared to the statutory rate of 21% for 2018 and 34% for 2017.

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For the three months ended September 30, 2018, the provision for income taxes was \$936,000 compared to \$1,141,000 for the same period in 2017. The decrease is attributable to the decrease in the Federal statutory income tax rate. Our effective tax rate was 17.0% and 23.8% for the three months ended September 30, 2018 and 2017, respectively.

We are invested in four limited partnership agreements that have established low-income housing projects in our market areas. We anticipate recognizing an aggregate of \$599,000 of tax credits over the next 4.5 years, with an additional \$35,000 anticipated to be recognized during 2018.

Financial Condition

Total assets were \$1.41 billion at September 30, 2018, an increase of \$46.0 million from \$1.36 billion at December 31, 2017. Cash and cash equivalents decreased \$2.0 million to \$16.5 million. Investment securities decreased \$14.4 million and net loans increased \$58.6 million to \$1.05 billion at September 30, 2018. Total deposits increased \$69.9 million to \$1.17 billion since year-end 2017, while borrowed funds decreased \$28.6 million to \$86.1 million.

Cash and Cash Equivalents

Cash and cash equivalents totaled \$16.5 million at September 30, 2018 compared to \$18.5 million at December 31, 2017, a decrease of \$2.9 million. Management actively measures and evaluates its liquidity position through our Asset-Liability Committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources including the Bank's core deposits, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

Investments

The following table shows the composition of the investment portfolio (including debt and equity securities as of September 30, 2018 and December 31, 2017 (dollars in thousands):

	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Debt securities:				
U. S. Agency securities	\$108,269	45.0	\$98,887	38.8
U. S. Treasury notes	32,837	13.6	28,604	11.2
Obligations of state & political subdivisions	51,598	21.4	79,090	31.0
Corporate obligations	3,000	1.2	3,083	1.2
Mortgage-backed securities in government sponsored entities	44,722	18.6	45,027	17.7
Equity securities (a)	291	0.2	91	0.1
Total	\$240,717	100.0	\$254,782	100.0

	September 30, 2018/ December 31, 2017	
	Change Amount	%
Debt securities:		
U. S. Agency securities	\$9,382	9.5
U. S. Treasury notes	4,233	14.8

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Obligations of state & political subdivisions	(27,492 )	(34.8 )
Corporate obligations	(83 )	(2.7 )
Mortgage-backed securities in government sponsored entities	(305 )	(0.7 )
Equity securities in financial institutions	200	219.8
Total	\$(14,065 )	(5.5 )

a. As of January 1, 2018, the Company adopted ASU 2016-01 resulting in the reclassification of equity securities from available for sale securities to equity securities in the Consolidated Balance Sheet.



Our investment portfolio decreased by \$14.1 million, or 5.5%, from December 31, 2017 to September 30, 2018. During 2018, we purchased \$5.0 million of treasury securities, \$44.3 million of U.S. agency obligations, \$7.1 million of mortgage-backed securities in government sponsored entities and \$191,000 of equity securities, which helped offset the \$6.4 million of principal repayments and \$34.7 million of calls and maturities that occurred during the nine month period. Additionally, as part of restructuring our investment portfolio, we sold \$11.4 million of U.S. agency securities at a loss of \$169,000 and \$13.8 million of pre-refunded state and political securities at a gain of \$161,000. This restructuring was performed to lock in the gains on the pre-refunded securities, which would have been called in the near future and to increase the overall yield of the investment portfolio. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio for the nine month period ended September 30, 2018 yielded 2.50%, compared to 2.51% in the comparable period in 2017 on a tax equivalent basis.

The investment strategy for 2018 has been to utilize cashflows from the investment portfolio to purchase agency and treasury securities to pledge against our public deposits. Investment purchases have been focused on securities with short fixed maturities for agency and treasury securities. We continually monitor interest rate trading ranges and try to focus purchases to times when rates are in the top third of the trading range. The Bank believes its investment strategy has appropriately mitigated its interest rate risk exposure if rates continue to rise, while providing sufficient cashflows to meet liquidity needs.

Management continues to monitor the earnings performance and the liquidity of the investment portfolio on a regular basis. Through active balance sheet management and analysis of the securities portfolio, the Company believes it maintains sufficient liquidity to satisfy depositor requirements and various credit needs of its customers.

#### Loans

The following table shows the composition of the loan portfolio as of September 30, 2018 and December 31, 2017 (dollars in thousands):

	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Real estate:				
Residential	\$213,255	20.1	\$214,479	21.4
Commercial	312,982	29.5	308,084	30.8
Agricultural	280,569	26.5	239,957	24.0
Construction	30,262	2.9	13,502	1.3
Consumer	9,702	0.9	9,944	1.0
Other commercial loans	72,219	6.8	72,013	7.2
Other agricultural loans	39,917	3.8	37,809	3.8
State & political subdivision loans	101,425	9.5	104,737	10.5
Total loans	1,060,331	100.0	1,000,525	100.0
Less allowance for loan losses	12,383		11,190	
Net loans	\$1,047,948		\$989,335	

	September 30, 2018/	December 31, 2017	Change Amount %
Real estate:			
Residential	\$(1,224 )	(0.6 )	
Commercial	4,898	1.6	
Agricultural	40,612	16.9	
Construction	16,760	124.1	
Consumer	(242 )	(2.4 )	
Other commercial loans	206	0.3	
Other agricultural loans	2,108	5.6	
State & political subdivision loans	(3,312 )	(3.2 )	
Total loans	\$59,806	6.0	

The Bank's lending efforts have historically focused on north central Pennsylvania and southern New York. The acquisition of FNB in 2015 expanded the focus into Lebanon, Lancaster, Schuylkill and Berks County markets in south central Pennsylvania. The opening of the Winfield office in 2016 and the acquisition of the State College branch in 2017 has increased our presence in the central Pennsylvania market. We originate loans primarily through direct loans to our existing customer base, with new customers generated through the strong relationships our new lending teams have with their customers, as well as by referrals from real estate brokers, building contractors, attorneys, accountants, corporate and advisory board members, existing customers and the Bank's website. The Bank offers a variety of loans although historically most of our lending has focused on real estate loans including residential, commercial, agricultural, and construction loans. All lending is governed by a lending policy that is developed and administered by management and approved by the Board of Directors. As of September 30, 2018, the Company had one industry specific loan concentration, within the dairy industry, totaling \$153.5 million or 14.5% of total loans. During the first nine months of 2018, the primary driver of growth in the loan portfolio continued to be commercial and agricultural real estate loans, some of which is in the construction phase, in both the central and south central Pennsylvania markets. We experienced some significant pay-offs of purchased participation loans in the second quarter, which while limiting our overall growth, provided funding for our organic loan growth that was focused on customer relationships. Commercial and agricultural loan demand is subject to significant competitive pressures, the yield curve, and the strengthening of the overall national, regional and local economies.

While the Bank lends to companies that service the exploration for natural gas in our market area, the Bank has not originated any loans to companies performing the actual drilling and exploration activities. Loans made by the Company are to service industry customers which include trucking companies, stone quarries and other support businesses. We also have originated loans to businesses and individuals for restaurants, hotels and apartment rentals that have been developed and expanded to meet the housing and living needs of the gas industry workers. Due to our understanding of the industry and its cyclical nature, the loans made for natural gas-related activities have been originated in accordance with specific policies and procedures for lending to these entities, which include more stringent loan to value thresholds, shortened amortization periods, and expansion of our monitoring of loan concentrations associated with this activity.

Residential real estate loans decreased slightly during the first nine months of 2018. Loan demand for conforming mortgages, which the Company typically sells on the secondary market has decreased in 2018 when compared to 2017. For loans sold on the secondary market, the Company recognizes fee income for servicing these sold loans, which is included in non-interest income.

#### Allowance for Loan Losses

The allowance for loan losses is maintained at a level which in management's judgment is adequate to absorb probable future loan losses inherent in the loan portfolio at the balance sheet date. The provision for loan losses is charged against current income. Loans deemed not collectable are charged-off against the allowance while subsequent recoveries increase the allowance. The following table presents an analysis of the allowance for loan losses and non-performing loans and assets as of and for the nine months ended September 30, 2018 and for the years ended December 31, 2017, 2016, 2015 and 2014 (dollars in thousands):

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	September 30, 2018	December 31, 2017	2016	2015	2014
Balance					
at beginning of period	\$11,190	\$8,886	\$7,106	\$6,815	\$7,098
Charge-offs:					
Real estate:					
Residential	27	107	85	66	97
Commercial	25	41	100	84	516
Agricultural	-	30	-	-	-
Consumer	32	130	100	47	47
Other commercial loans	91	-	55	41	250
Other agricultural loans	50	5	-	-	-
Total loans charged-off	225	313	340	238	910
Recoveries:					
Real estate:					
Residential	70	-	-	-	-
Commercial	3	11	479	14	15
Agricultural	-	-	-	-	-
Consumer	26	49	88	33	27
Other commercial loans	19	16	33	2	-
Other agricultural loans	-	1	-	-	-
Total loans recovered	118	77	600	49	42
Net loans (recovered) charged-off	107	236	(260 )	189	868
Provision charged to expense	1,300	2,540	1,520	480	585
Balance at end of year	\$12,383	\$11,190	\$8,886	\$7,106	\$6,815
Loans outstanding at end of period	\$1,060,331	\$1,000,525	\$799,611	\$695,031	\$554,105
Average loans outstanding, net	\$1,034,661	\$883,355	\$725,881	\$577,992	\$540,541
Non-performing assets:					
Non-accruing loans	\$14,530	\$10,171	\$11,454	\$6,531	\$6,599
Accrual loans - 90 days or more past due	302	555	405	623	836
Total non-performing loans	\$14,832	\$10,726	\$11,859	\$7,154	\$7,435
Foreclosed assets held for sale	628	1,119	1,036	1,354	1,792
Total non-performing assets	\$15,460	\$11,845	\$12,895	\$8,508	\$9,227
Annualized net charge-offs to average loans	0.01	% 0.03	% -0.04	% 0.03	% 0.16
Allowance to total loans	1.17	% 1.12	% 1.11	% 1.02	% 1.23
Allowance to total non-performing loans	83.49	% 104.33	% 74.93	% 99.33	% 91.66
Non-performing loans as a percent of loans net of unearned income	1.40	% 1.07	% 1.48	% 1.03	% 1.34
Non-performing assets as a percent of loans net of unearned income	1.46	% 1.18	% 1.61	% 1.22	% 1.67

Management believes it uses the best information available when establishing the allowance for loan losses and that the allowance for loan losses is adequate as of September 30, 2018. However, future adjustments could be required if circumstances differ substantially from assumptions and estimates used in making the initial determination. A prolonged downturn in the economy, high unemployment rates, significant changes in the value of collateral and delays in receiving financial information from borrowers could result in increased levels of non-performing assets,

charge-offs, loan loss provisions and reduction in income. Additionally, bank regulatory agencies periodically examine the Bank's allowance for loan losses. The banking agencies could require the recognition of additions to the allowance for loan losses based upon their judgment of information available to them at the time of their examination.

On a monthly basis, problem loans are identified and updated primarily using internally prepared past due reports. Based on data surrounding the collection process of each identified loan, the loan may be added or deleted from the monthly watch list. The watch list includes loans graded special mention, substandard, doubtful, and loss, as well as additional loans that management may choose to include. Watch list loans are continually monitored going forward until satisfactory conditions exist that allow management to upgrade and remove the loan. In certain cases, loans may be placed on non-accrual status or charged-off based upon management's evaluation of the borrower's ability to pay. All commercial loans, which include commercial real estate, agricultural real estate, state and political subdivision loans and other commercial and agricultural loans, on non-accrual are evaluated quarterly for impairment.

The allowance for loan losses was \$12,383,000 or 1.17% of total loans as of September 30, 2018 as compared to \$11,190,000 or 1.12% of loans as of December 31, 2017. The \$1,193,000 increase in the allowance during the first nine months of 2018 is the result of a \$1,300,000 provision and net charge-offs of \$107,000. The following table shows the distribution of the allowance for loan losses and the percentage of loans compared to total loans by loan category as of September 30, 2018 and December 31, 2017, 2016, 2015 and 2014 (dollars in thousands):

	September 30, 2018		December 31 2017		2016		2015		2014	
	Amount	%	Amount	%	Amount	%	Amount	%	Amount	%
Real estate loans:										
Residential	\$1,052	20.1	\$1,049	21.4	\$1,064	25.9	\$905	29.3	\$878	33.5
Commercial	3,925	29.5	3,867	30.8	3,589	31.6	3,376	34.2	3,419	34.5
Agricultural	3,929	26.5	3,143	24.0	1,494	15.5	409	8.3	451	4.4
Construction	49	2.9	23	1.3	47	3.2	24	2.2	26	1.1
Consumer	123	0.9	124	1.0	122	1.4	102	1.7	84	1.5
Other commercial loans	1,219	6.8	1,272	7.2	1,327	7.3	1,183	8.2	1,007	8.6
Other agricultural loans	699	3.8	492	3.8	312	2.9	122	2.0	217	2.0
State & political subdivision loans	751	9.5	816	10.5	833	12.2	593	14.1	545	14.4
Unallocated	636	N/A	404	N/A	98	N/A	392	N/A	188	N/A
Total allowance for loan losses	\$12,383	100.0	\$11,190	100.0	\$8,886	100.0	\$7,106	100.0	\$6,815	100.0

As a result of previous loss experiences and other risk factors utilized in determining the allowance, the Bank's allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 56.0% of the loan portfolio, 63.6% of the allowance is assigned to this segment of the loan portfolio as these loans have more inherent credit risk than residential real estate or loans to state and political subdivisions.

The following table identifies amounts of loans contractually past due 30 to 89 days and non-performing loans by loan category, as well as the change from December 31, 2017 to September 30, 2018 in non-performing loans (dollars in thousands). Non-performing loans include accruing loans that are contractually past due 90 days or more and non-accrual loans. Interest does not accrue on non-accrual loans. Subsequent cash payments received are applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of its ultimate ability to collect principal and interest.

	September 30, 2018				December 31, 2017			
	Non-Performing Loans				Non-Performing Loans			
	30 - 89				30 - 89			
	Days				Days			
	90				90			
	Past	Days			Past	Days		
	Due	Past	Non-	Total Non-	Due	Past	Non-	Total Non-
		Due	accruing	Performing		Due	accruing	Performing
(in thousands)	Accruing	Accruing	accruing	Performing	Accruing	Accruing	accruing	Performing
Real estate:								
Residential	\$739	\$1	\$1,349	\$ 1,350	\$1,550	\$218	\$1,386	\$ 1,604
Commercial	1,536	300	6,445	6,745	1,519	162	5,192	5,354
Agricultural	-	-	3,259	3,259	242	30	175	205
Construction	-	-	-	-	-	-	133	133
Consumer	54	1	22	23	86	7	42	49
Other commercial loans	682	-	2,269	2,269	50	32	2,637	2,669
Other agricultural loans	116	-	1,186	1,186	42	106	606	712
Total nonperforming loans	\$3,127	\$302	\$14,530	\$ 14,832	\$3,489	\$555	\$10,171	\$ 10,726

	Change in	
	Non-Performing	
	Loans	
	September 30,	
	2018 /December	
	31, 2017	
(in thousands)	Amount	%
Real estate:		
Residential	\$(254 )	(15.8 )
Commercial	1,391	26.0
Agricultural	3,054	1,489.8
Construction	(133 )	(100.0 )
Consumer	(26 )	(53.1 )
Other commercial loans	(400 )	(15.0 )
Other agricultural loans	474	66.6
Total nonperforming loans	\$4,106	38.3

For the nine months ended September 30, 2018, we recorded a provision for loan losses of \$1,300,000, which compares to \$1,740,000 for the same period in 2017. The decrease was primarily attributable to the loan growth experienced during 2018 being lower than the growth experienced during the comparable period of 2017.

Non-performing loans increased \$4.1 million or 38.3%, from December 31, 2017 to September 30, 2018, primarily due to two customer relationships. Approximately 67.2% of the Bank's non-performing loans at September 30, 2018 are associated with the following four customer relationships:

- A commercial customer with a total loan relationship of \$3.1 million, secured by undeveloped land, stone quarries and equipment, was on non-accrual status as of September 30, 2018. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer, who provides excavation services and stone for pad construction related to these activities. During 2017, the Company had the underlying collateral appraised. The appraisals indicated a decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. Management determined that no specific

reserve was required as of September 30, 2018.

A commercial customer with a total loan relationship of \$2.4 million, secured by residential rental properties, was on non-accrual status as of September 30, 2018. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. In July of 2013, the customer filed for bankruptcy under Chapter 11 and a Trustee was appointed in January of 2014. In 2015, the Trustee decreased the loan payments below what was agreed to in the forbearance agreement. As a result of the decrease, the relationship has become more than 90 days past due. During 2016, the Company appraised the underlying collateral. The appraisals indicated a slight decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. We continue to monitor the bankruptcy proceedings to identify potential changes in the customer's operations and the impact these would have on the loan payments for our loans to the customer and the underlying collateral that supports these loans. As of September 30, 2018, there was no specific reserve for this relationship.



An agricultural customer with a total loan relationship of \$2.8 million, secured by real estate, equipment and cattle, was on non-accrual status as of September 30, 2018. Included within these loans to this customer are \$1,151,000 of loans which are subject to Farm Service Agency guarantees. Depressed milk prices have created cash flow difficulties for this customer. Absent a sizable and sustained increase in milk prices, which is not assured, we will need to rely upon the collateral for repayment of interest and principal. As of September 30, 2018, there was a specific reserve of \$238,000 for this relationship.

An agricultural customer with a total loan relationship of \$1.6 million, secured by real estate, equipment and cattle, was on non-accrual status as of September 30, 2018. Included within these loans to this customer are \$181,000 of loans which are subject to Farm Service Agency guarantees. Depressed milk prices have created cash flow difficulties for this customer. Absent a sizable and sustained increase in milk prices, which is not assured, we expect we will need to rely upon the collateral for repayment of interest and principal. As of September 30, 2018, there was a specific reserve of \$13,000 for this relationship.

Management of the Bank believes that the allowance for loan losses as of September 30, 2018 is adequate, which is based on the following factors:

Four loan relationships comprise 67.2% of the non-performing loan balance, which has approximately \$250,000 of specific reserves as of September 30, 2018.

The Company has a history of low charge-offs, which continued in 2018 as the net charge-offs were .01% of average loans and only \$107,000, which on an annualized basis is less than 2017's charge-offs of \$236,000. In 2016, a net recovery was experienced as the result of recovering a loan that was partially charged off in 2014.

#### Bank Owned Life Insurance

The Company holds bank owned life insurance policies to offset future employee benefit costs. These policies provide the Bank with an asset that generates earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits. As of September 30, 2018 and December 31, 2017, the cash surrender value of the life insurance was \$27.3 million and \$26.9 million, respectively. The change in cash surrender value, net of purchases and amounts acquired through acquisitions, is recognized in the results of operations. The amounts recorded as non-interest income totaled \$161,000 and \$166,000 for the three month periods ended September 30, 2018 and 2017, respectively. For the nine months ended September 30, 2018 and 2017, \$467,000 and \$499,000, respectively, was recorded in non-interest income. The Company evaluates annually the risks associated with the life insurance policies, including limits on the amount of coverage and an evaluation of the various carriers' credit ratings.

The Company agreements that were purchased directly from insurance companies are structured so that any death benefits received from a policy while the insured person is an active employee of the Bank will be split with the beneficiary of the policy. Under these agreements, the employee's beneficiary will be entitled to receive 50% of the net amount at risk from the proceeds. The net amount at risk is the total death benefit payable less the cash surrender value of the policy as of the date of death. The policies acquired as part of the acquisition of FNB provide a fixed split-dollar benefit for the beneficiaries estate, which is dependent on several factors including whether the covered individual was a Director of FNB or an employee of FNB and their salary level. As of September 30, 2018 and December 31, 2017, included in other liabilities on the Consolidated Balance Sheet was a liability of \$631,000 and \$576,000, respectively, for the obligation under the split-dollar benefit agreements.

#### Premises and Equipment

Premises and equipment decreased \$334,000 to \$16.2 million as of September 30, 2018 from December 31, 2017. This occurred primarily as a result of normal depreciation expense recorded in the first nine months of 2018.



## Deposits

The following table shows the composition of deposits as of September 30, 2018 and December 31, 2017 (dollars in thousands):

	September 30, 2018		December 31, 2017	
	Amount	%	Amount	%
Non-interest-bearing deposits	\$ 173,379	14.8	\$ 171,840	15.6
NOW accounts	327,808	27.9	337,307	30.5
Savings deposits	200,338	17.1	184,057	16.7
Money market deposit accounts	181,014	15.4	145,287	13.1
Certificates of deposit	292,304	24.8	266,452	24.1
Total	\$ 1,174,843	100.0	\$ 1,104,943	100.0

	September 30, 2018/ December 31, 2017	
	Amount	%
Non-interest-bearing deposits	\$ 1,539	0.9
NOW accounts	(9,499 )	(2.8 )
Savings deposits	16,281	8.8
Money market deposit accounts	35,727	24.6
Certificates of deposit	25,852	9.7
Total	\$ 69,900	6.3

Deposits increased \$69.9 million since December 31, 2017. The increase in money market deposit accounts is attributable to municipal deposits, which increased approximately \$33.7 million since year end. The increases are attributable to several new customers, as well as timing of local real estate tax collections. The increase in savings account balances is due to growth in our central and south central markets. The decrease in NOW accounts is primarily due to municipal customers moving money into money market deposit accounts. As a result of strategic initiatives, we have increased our focus and have enhanced our cash management services.

Certificates of deposits increased \$25.9 million in 2018. This increase was due to issuing \$20.0 million of brokered certificates of deposits in the third quarter of 2018. In addition, a municipality opened a \$4.5 million certificate of deposit in the third quarter. The rates paid on certificates of deposits have increased in the first part of 2018 making them more attractive to customers who typically utilize certificate of deposits as a means of generating income or as a longer term investment option. The rates paid on certificates of deposit by the Company remain competitive with rates paid by our competition. As of September 30, 2018, the Bank had \$20.0 million of brokered certificates of deposit outstanding.

## Borrowed Funds

Borrowed funds decreased \$28.6 million during the first nine months of 2018. The decrease was the result of repaying \$28.0 million of overnight advances from the FHLB and \$1.0 million of long-term advances from the FHLB as a result of the deposit growth, which included the \$20.0 million of brokered certificates of deposit, experienced in the third quarter of 2018. The Bank's current strategy for borrowings is to consider terms and structures to manage interest rate risk and liquidity in a potential rising interest rate environment. The Company's daily cash requirements

or short-term investments are primarily met by using the financial instruments available through the Federal Home Loan Bank of Pittsburgh.

#### Stockholders' Equity

We evaluate stockholders' equity in relation to total assets and the risks associated with those assets. The greater the capital resource, the more likely a corporation will meet its cash obligations and absorb unforeseen losses. For these reasons, capital adequacy has been, and will continue to be, of paramount importance to the Company. As such, the Company has implemented policies and procedures to ensure that it has adequate capital levels. As part of this process, we routinely stress test our capital levels and identify potential risk and alternative sources of additional capital should the need arise.

Total stockholders' equity was \$134.4 million at September 30, 2018 compared to \$129.0 million at December 31, 2017, an increase of \$5,389,000, or 4.2%. Excluding accumulated other comprehensive loss, stockholders' equity increased \$8.1 million, or 6.1%. The Company purchased 12,710 shares of treasury stock at a weighted average cost of \$62.26 per share. The Company reissued 217 shares to certain employees as a reward for years of services at a weighted average cost of \$62.47 per share. The Company awarded employees 4,869 shares of restricted stock at a weighted average cost of \$62.91 per share during the first nine months of 2018. For the first nine months of 2018, the Company had net income of \$13.5 million and declared cash dividends of \$4.6 million, or \$1.30 per share, representing a cash dividend payout ratio of 34.1%.

All of the Company's debt investment securities are classified as available-for-sale, making this portion of the Company's balance sheet more sensitive to the changing market value of investments. As a result of changes in the interest rate environment and the defined benefit plan obligations, accumulated other comprehensive loss decreased approximately \$2.7 million from December 31, 2017.

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

Quantitative measures established by regulatory capital standards to ensure capital adequacy require the Company and Bank to maintain minimum amounts and ratios of total and Tier 1 capital (as defined) to risk-weighted assets (as defined), common equity Tier 1 capital (as defined) to total risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of September 30, 2018 and December 31, 2017, that the Company and Bank meet all capital adequacy requirements to which they were subject at such dates.

As of September 30, 2018 and December 31, 2017, the Company and Bank were categorized as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Company must maintain minimum total risk-based capital, Tier 1 risk-based capital, common equity Tier 1 risk-based capital, and Tier 1 leverage ratios as set forth in the table. There are no conditions or events since that notification that management believes have changed the institution's category.

The Company and Bank's computed risk based capital ratios are as follows (dollars in thousands):

September 30, 2018	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighted Assets):						
Company	\$ 137,977	13.40 %	\$ 82,386	8.00 %	\$ 102,983	10.00 %
Bank	\$ 131,830	12.81 %	\$ 82,343	8.00 %	\$ 102,929	10.00 %
Tier 1 Capital (to Risk Weighted Assets):						
Company	\$ 125,429	12.18 %	\$ 61,790	6.00 %	\$ 82,386	8.00 %
Bank	\$ 119,282	11.59 %	\$ 61,757	6.00 %	\$ 82,343	8.00 %
Common Equity Tier 1 Capital (to Risk Weighted Assets):						
Company	\$ 117,929	11.45 %	\$ 46,342	4.50 %	\$ 66,939	6.50 %
Bank	\$ 119,282	11.59 %	\$ 46,318	4.50 %	\$ 66,904	6.50 %
Tier 1 Capital (to Average Assets):						
Company	\$ 125,429	9.09 %	\$ 55,215	4.00 %	\$ 69,019	5.00 %
Bank	\$ 119,282	8.64 %	\$ 55,195	4.00 %	\$ 68,993	5.00 %

December 31, 2017	Actual		For Capital Adequacy Purposes		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
Total Capital (to Risk Weighted Assets):						
Company	\$ 128,578	13.20 %	\$ 77,906	8.00 %	\$ 97,383	10.00 %
Bank	\$ 122,469	12.58 %	\$ 77,852	8.00 %	\$ 97,315	10.00 %
Tier 1 Capital (to Risk Weighted Assets):						
Company	\$ 117,224	12.04 %	\$ 58,430	6.00 %	\$ 77,906	8.00 %
Bank	\$ 111,114	11.42 %	\$ 58,389	6.00 %	\$ 77,852	8.00 %
Common Equity Tier 1 Capital (to Risk Weighted Assets):						
Company	\$ 109,724	11.27 %	\$ 43,822	4.50 %	\$ 63,299	6.50 %
Bank	\$ 111,114	11.42 %	\$ 43,792	4.50 %	\$ 63,255	6.50 %
Tier 1 Capital (to Average Assets):						
Company	\$ 117,224	9.18 %	\$ 51,085	4.00 %	\$ 63,857	5.00 %
Bank	\$ 111,114	8.71 %	\$ 51,023	4.00 %	\$ 63,778	5.00 %

#### Off-Balance Sheet Activities

Some financial instruments, such as loan commitments, credit lines, and letters of credit, are issued to meet customer financing needs. The contractual amount of financial instruments with off-balance sheet risk was as follows at September 30, 2018 and December 31, 2017 (in thousands):

	September 30, 2018	December 31, 2017
Commitments to extend credit	\$ 197,057	\$ 188,482
Standby letters of credit	16,012	15,244

\$ 213,069   \$ 203,726

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing. Overdraft charges as a result of ATM withdrawals and one time point of sale (non-recurring) transactions require prior approval of the customer. The non-contractual amount of financial instruments with off-balance sheet risk at September 30, 2018 and December 31, 2017 was \$9,451,000 and \$9,335,000, respectively. The Company reserves the right to discontinue this service without prior notice.

#### Liquidity

Liquidity is a measure of the Company's ability to efficiently meet normal cash flow requirements of both borrowers and depositors. To maintain proper liquidity, we use funds management policies, which include liquidity target ratios, along with our investment policies to assure we can meet our financial obligations to depositors, credit customers and stockholders. Liquidity is needed to meet depositors' withdrawal demands, extend credit to meet borrowers' needs, provide funds for normal operating expenses and cash dividends, and to fund other capital expenditures.

Cash generated by operating activities, investing activities and financing activities influences liquidity management. Our Company's historical activity in this area can be seen in the Consolidated Statement of Cash Flows. The most important source of funds is core deposits. Repayment of principal on outstanding loans and cash flows created from the investment portfolio are also factors in liquidity management. Other sources of funding include brokered certificates of deposit and the sale of loans or investments, if needed.

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures (including software purchases), during the first nine months of 2018 were \$228,000 compared to \$179,000 during the same time period in 2017.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$503.1 million, of which \$101.3 million was outstanding via loans and letters of credits at September 30, 2018. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon. We also have a borrower in custody line with the Federal Reserve Bank of approximately \$4.0 million, which also is not drawn upon as of September 30, 2018. The Company continues to evaluate its liquidity needs and as necessary finds additional sources.

Citizens Financial Services, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial Services, Inc. is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial Services, Inc.'s primary source of income is dividends received from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. In particular, the Bank may not, as a state-chartered bank which is a member of the Federal Reserve System, declare a dividend without approval of the Federal Reserve, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends, because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At September 30, 2018, Citizens Financial Services, Inc. (on an unconsolidated basis) had liquid assets of \$5.9 million.

#### Interest Rate and Market Risk Management

The objective of interest rate sensitivity management is to maintain an appropriate balance between the stable growth of income and the risks associated with maximizing income through interest sensitivity imbalances and the market value risk of assets and liabilities.

Because of the nature of our operations, we are not subject to foreign currency exchange or commodity price risk and, because we have no trading portfolio, we are not subject to trading risk. Currently, the Company has equity securities that represent only 0.08% of its total assets and, therefore, equity risk is not significant.

The primary components of interest-sensitive assets include adjustable-rate loans and investments, loan repayments, investment maturities and money market investments. The primary components of interest-sensitive liabilities include maturing certificates of deposit, IRA certificates of deposit and short-term borrowings. Savings deposits, NOW accounts and money market investor accounts are considered core deposits and are not short-term interest sensitive (except for the top-tier money market investor accounts, typically held by local governments, which are paid current market interest rates).



Gap analysis, one of the methods used by us to analyze interest rate risk, does not necessarily show the precise impact of specific interest rate movements on our Company's net interest income because the re-pricing of certain assets and liabilities is discretionary and is subject to competitive and other pressures. In addition, assets and liabilities within the same period may, in fact, be repaid at different times and at different rate levels. We have not experienced the kind of earnings volatility that might be indicated from gap analysis.

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The Company currently uses a computer simulation model to better measure the impact of interest rate changes on net interest income. We use the model as part of our risk management and asset liability management processes that we believe will effectively identify, measure, and monitor the Company's risk exposure. In this analysis, the Company examines the results of movements in interest rates with additional assumptions made concerning prepayment speeds on mortgage loans and mortgage securities. Shock scenarios, which assume a parallel shift in interest rates and is instantaneous, typically have the greatest impact on net interest income. The following is a rate shock analysis and the impact on net interest income as of September 30, 2018 (dollars in thousands):

Changes in Rates	Prospective One-Year Net Interest Income	% Change Change In In	
		Prospective Net Interest Income	Prospective Net Interest Income
-200 Shock	\$ 46,191	\$ (1,973 )	(4.10 )
-100 Shock	46,809	(1,355 )	(2.81 )
Base	48,164	-	-
+100 Shock	46,822	(1,342 )	(2.79 )
+200 Shock	45,218	(2,946 )	(6.12 )
+300 Shock	43,622	(4,542 )	(9.43 )
+400 Shock	42,058	(6,106 )	(12.68 )

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage backed securities, call activity of other investment securities, and deposit selection, re-pricing and maturity structure. Because of these assumptions, actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change on net interest income. Additionally, the changes 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. It should be noted that the changes in net interest income noted above are in line with Company policy for interest rate risk.

### Item 3-Quantitative and Qualitative Disclosure about Market Risk

In the normal course of conducting business activities, the Company is exposed to market risk, principally interest rate risk, through the operations of its banking subsidiary. Interest rate risk arises from market driven fluctuations in interest rates that affect cash flows, income, expense and values of financial instruments and was discussed previously in this Form 10-Q. Management and a committee of the Board of Directors manage interest rate risk (see also "Interest Rate and Market Risk Management").

### Item 4-Control and Procedures

#### (a) Disclosure Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of

ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the SEC (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

## (b) Changes to Internal Control over Financial Reporting

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

## PART II OTHER INFORMATION

## Item 1 Legal Proceedings

Management is not aware of any pending or threatened litigation that would have a material adverse effect on the consolidated financial position of the Company. Other than as disclosed in Note 11 of the accompanying consolidated financial statements, any other pending proceedings are ordinary, routine litigation incidental to the business of the Company and its subsidiary. In addition, no material proceedings are pending or are known to be threatened or contemplated against the Company and its subsidiary by government authorities.

## Item 1A – Risk Factors

In addition to the other information set forth in this report, you should carefully consider the factors discussed in Part I, "Item 1.A. Risk Factors" in our Annual Report on Form 10-K for the year ended December 31, 2017, which could materially affect our business, financial condition or future results. At September 30, 2018, the risk factors of the Company have not changed materially from those reported in our Annual Report on Form 10-K. However, the risks described in our Annual Report on Form 10-K are not the only risks that we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

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

## ISSUER PURCHASES OF EQUITY SECURITIES

Period	Total Number of Shares (or units Purchased)	Average Price Paid per Share (or Unit)	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 (1)
7/1/18 to 7/31/18	4	\$ 61.50	4	80,757
8/1/18 to 8/31/18	-	\$ 0.00	-	80,757
9/1/18 to 9/30/18	3,995	\$ 62.20	3,995	76,762
Total	3,999	\$ 62.20	3,999	76,762

On October 20, 2015, the Company announced that the Board of Directors authorized the Company to repurchase up to an additional 150,000 shares. The repurchases will be conducted through open-market purchases or privately (1) negotiated transactions and will be made from time to time depending on market conditions and other factors. No time limit was placed on the duration of the share repurchase program. Any repurchased shares will be held as treasury stock and will be available for general corporate purposes.

Item 3 Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosure

Not applicable.

Item 5 Other Information

None

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Item 6 Exhibits

(a) The following documents are filed as a part of this report:

3.1 Articles of Incorporation of Citizens Financial Services, Inc., as amended <sup>(1)</sup>

3.2 Bylaws of Citizens Financial Services, Inc. <sup>(2)</sup>

4.1 Form of Common Stock Certificate. <sup>(3)</sup>

31.1 Rule 13a-14(a)/15d-14(a) Certification of Chief Executive Officer

31.2 Rule 13a-14(a)/15d-14(a) Certification of Chief Financial Officer

32.1 Section 1350 Certification of Chief Executive Officer and Chief Financial Officer

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\*\* The following materials from the Company's Quarterly Report on Form 10-Q for the period ended September 30, 2018, formatted in XBRL (Extensible Business Reporting Language): (i) The Consolidated Balance Sheet (unaudited), (ii) the Consolidated Statement of Income (unaudited), (iii) the Consolidated Statement of Comprehensive Income (unaudited), (iv) the Consolidated Statement of Cash Flows (unaudited) and (v) related notes (unaudited).

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(1) Incorporated by reference to Exhibit 3.1 to the Company's Quarterly Report on Form 10-Q for the quarter ended June 30, 2018, as filed with the Commission on August 9, 2018.

(2) Incorporated by reference to Exhibit 3.2 to the Company's Current Report on Form 8-K, as filed with the Commission on December 24, 2009.

(3) Incorporated by reference to Exhibit 4 to the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2005, as filed with the Commission on March 14, 2006.

\*\* Furnished, not filed.

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.

**Citizens Financial Services, Inc.**

November 8, 2018 By: /s/ Randall E. Black  
Randall E. Black  
President and Chief Executive Officer  
(Principal Executive Officer)

November 8, 2018 By: /s/ Mickey L. Jones  
Mickey L. Jones  
Chief Financial Officer  
(Principal Financial and Accounting Officer)