ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
August 07, 2018
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10 – Q

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 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: 001-34292

ORRSTOWN FINANCIAL SERVICES, INC.
(Exact Name of Registrant as Specified in its Charter)

Pennsylvania	23-2530374
(State or Other Jurisdiction of Incorporation or Organization)	(I.R.S. Employer Identification No.)
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania	17257
(Address of Principal Executive Offices)	(Zip Code)

Registrant's Telephone Number, Including Area Code: (717) 532-6114

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x 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	x
Non-accelerated filer	¨ (Do not check if a smaller reporting company)	Smaller reporting company	¨
		Emerging growth company	o

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

Number of shares outstanding of the registrant's Common Stock as of July 31, 2018: 8,400,697.

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Glossary of Defined Terms

The following terms may be used throughout this Report, including the consolidated financial statements and related notes.

Term	Definition
ALL	Allowance for loan losses
AFS	Available for sale
AOCI	Accumulated other comprehensive income (loss)
ASC	Accounting Standards Codification
ASU	Accounting Standards Update
Bank	Orrstown Bank, the commercial banking subsidiary of Orrstown Financial Services, Inc.
CET1	Common Equity Tier 1
CMO	Collateralized mortgage obligation
Company	Orrstown Financial Services, Inc. and subsidiaries (interchangeable with "Orrstown" below)
EPS	Earnings per common share
ERM	Enterprise risk management
Exchange Act	Securities Exchange Act of 1934, as amended
FASB	Financial Accounting Standards Board
FDIC	Federal Deposit Insurance Corporation
FHLB	Federal Home Loan Bank
FRB	Board of Governors of the Federal Reserve System
GAAP	Accounting principles generally accepted in the United States of America
GSE	U.S. government-sponsored enterprise
IRC	Internal Revenue Code of 1986, as amended
LHFS	Loans held for sale
MBS	Mortgage-backed securities
MPF Program	Mortgage Partnership Finance Program
MSR	Mortgage servicing right
NIM	Net interest margin
OCI	Other comprehensive income (loss)
OREO	Other real estate owned (foreclosed real estate)
Orrstown	Orrstown Financial Services, Inc. and subsidiaries
OTTI	Other-than-temporary impairment
Parent Company	Orrstown Financial Services, Inc., the parent company of Orrstown Bank and Wheatland Advisors, Inc.
2011 Plan	2011 Orrstown Financial Services, Inc. Incentive Stock Plan
Repurchase Agreements	Securities sold under agreements to repurchase
SEC	Securities and Exchange Commission
Securities Act	Securities Act of 1933, as amended
TDR	Troubled debt restructuring
Wheatland	Wheatland Advisors, Inc., the Registered Investment Advisor subsidiary of Orrstown Financial Services, Inc.

Unless the context otherwise requires, the terms “Orrstown,” “we,” “us,” “our,” and “Company” refer to Orrstown Financial Services, Inc. and its subsidiaries.

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements
Consolidated Balance Sheets (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC.

(Dollars in thousands, except per share information)	June 30, 2018	December 31, 2017
Assets		
Cash and due from banks	$18,122	$21,734
Interest-bearing deposits with banks	4,460	8,073
Cash and cash equivalents	22,582	29,807
Restricted investments in bank stocks	12,697	9,997
Securities available for sale	449,419	415,308
Loans held for sale	5,495	6,089
Loans	1,063,883	1,010,012
Less: Allowance for loan losses	(13,437)	(12,796)
Net loans	1,050,446	997,216
Premises and equipment, net	34,558	34,809
Cash surrender value of life insurance	34,908	33,570
Accrued interest receivable	5,568	5,048
Other assets	28,445	27,005
Total assets	$1,644,118	$1,558,849
Liabilities		
Deposits:		
Noninterest-bearing	$178,704	$162,343
Interest-bearing	1,147,162	1,057,172
Total deposits	1,325,866	1,219,515
Short-term borrowings	63,838	93,576
Long-term debt	83,635	83,815
Accrued interest and other liabilities	25,642	17,178
Total liabilities	1,498,981	1,414,084
Shareholders' Equity		
Preferred stock, $1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding	0	0
Common stock, no par value—$0.05205 stated value per share 50,000,000 shares authorized; 8,423,479 and 8,347,856 shares issued; 8,400,697 and 8,347,039 shares outstanding	438	435
Additional paid - in capital	126,402	125,458
Retained earnings	21,584	16,042
Accumulated other comprehensive income (loss)	(2,693)	2,845
Treasury stock—common, 22,782 and 817 shares, at cost	(594)	(15)
Total shareholders' equity	145,137	144,765
Total liabilities and shareholders' equity	$1,644,118	$1,558,849

The Notes to Consolidated Financial Statements are an integral part of these statements.

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Consolidated Statements of Income (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC.

(Dollars in thousands, except per share information)	Three Months Ended June 30, 2018	Three Months Ended June 30, 2017	Six Months Ended June 30, 2018	Six Months Ended June 30, 2017
Interest and dividend income				
Interest and fees on loans	$11,731	$9,851	$22,787	$19,055
Interest and dividends on investment securities				
Taxable	2,539	1,766	4,832	3,593
Tax-exempt	1,008	805	1,879	1,586
Short-term investments	46	46	101	64
Total interest and dividend income	15,324	12,468	29,599	24,298
Interest expense				
Interest on deposits	2,161	1,484	3,985	2,810
Interest on short-term borrowings	402	189	765	361
Interest on long-term debt	408	77	812	172
Total interest expense	2,971	1,750	5,562	3,343
Net interest income	12,353	10,718	24,037	20,955
Provision for loan losses	200	100	400	100
Net interest income after provision for loan losses	12,153	10,618	23,637	20,855
Noninterest income				
Service charges on deposit accounts	1,463	1,429	2,881	2,787
Other service charges, commissions and fees	689	283	938	492
Trust and investment management income	1,701	1,623	3,369	3,069
Brokerage income	501	518	1,059	985
Mortgage banking activities	679	813	1,314	1,316
Earnings on life insurance	291	271	568	539
Other income	135	32	216	113
Investment securities gains	46	654	862	657
Total noninterest income	5,505	5,623	11,207	9,958
Noninterest expenses				
Salaries and employee benefits	7,855	7,422	15,877	14,822
Occupancy	679	705	1,477	1,462
Furniture and equipment	1,068	826	1,987	1,562
Data processing	595	664	1,214	1,175
Telephone and communication	165	193	361	315
Automated teller and interchange fees	190	194	361	372
Advertising and bank promotions	237	391	619	778
FDIC insurance	172	178	338	315
Legal fees	83	108	149	261
Other professional services	476	377	779	732
Directors' compensation	205	249	456	491
Collection and problem loan	21	3	78	78
Real estate owned	53	(12)	78	8
Taxes other than income	251	220	502	448
Merger related	154	0	154	0
Other operating expenses	1,068	899	1,911	1,744
Total noninterest expenses	13,272	12,417	26,341	24,563

Income before income tax expense	4,386	3,824	8,503	6,250
Income tax expense	374	516	866	940
Net income	$4,012	$3,308	$7,637	$5,310
Per share information:				
Basic earnings per share	$0.50	$0.41	$0.94	$0.66
Diluted earnings per share	0.48	0.40	0.92	0.65
Dividends per share	0.13	0.10	0.25	0.20

The Notes to Consolidated Financial Statements are an integral part of these statements.

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Consolidated Statements of Comprehensive Income (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC.

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Net income	$ 4,012	$ 3,308	$7,637	$5,310
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities available for sale arising during the period	(530)	5,130	(6,149)	6,750
Reclassification adjustment for gains realized in net income	(46)	(654)	(862)	(657)
Net unrealized gains (losses)	(576)	4,476	(7,011)	6,093
Tax effect	121	(1,521)	1,473	(2,071)
Total other comprehensive income (loss), net of tax and reclassification adjustments	(455)	2,955	(5,538)	4,022
Total comprehensive income	$ 3,557	$ 6,263	$2,099	$9,332

The Notes to Consolidated Financial Statements are an integral part of these statements.

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Consolidated Statements of Changes in Shareholders' Equity (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC.

Six Months Ended June 30, 2018 and 2017

(Dollars in thousands, except per share information)	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance, January 1, 2017	$437	$124,935	$11,669	$ (1,165)	$(1,017)	$ 134,859
Net income	0	0	5,310	0	0	5,310
Total other comprehensive income, net of taxes	0	0	0	4,022	0	4,022
Cash dividends ($0.20 per share)	0	0	(1,655)	0	0	(1,655)
Share-based compensation plans:						
Issuance of stock (4,808 net common shares and 53,367 treasury shares issued), including compensation expense of $666	(2)	(208)	0	0	937	727
Balance, June 30, 2017	$435	$124,727	$15,324	$ 2,857	$(80)	$ 143,263
Balance, January 1, 2018	$435	$125,458	$16,042	$ 2,845	$(15)	$ 144,765
Net income	0	0	7,637	0	0	7,637
Total other comprehensive loss, net of taxes	0	0	0	(5,538)	0	(5,538)
Cash dividends ($0.25 per share)	0	0	(2,095)	0	0	(2,095)
Share-based compensation plans:						
Issuance of stock (75,623 net common shares issued and 21,965 net treasury shares acquired), including compensation expense of $924	3	944	0	0	(579)	368
Balance, June 30, 2018	$438	$126,402	$21,584	$ (2,693)	$(594)	$ 145,137

The Notes to Consolidated Financial Statements are an integral part of these statements.

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Consolidated Statements of Cash Flows (Unaudited)
ORRSTOWN FINANCIAL SERVICES, INC.

(Dollars in thousands)	Six Months Ended June 30, 2018	June 30, 2017
Cash flows from operating activities		
Net income	$7,637	$5,310
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	947	2,477
Depreciation and amortization	1,721	1,539
Provision for loan losses	400	100
Share-based compensation	924	666
Gain on sales of loans originated for sale	(1,066)	(1,064)
Mortgage loans originated for sale	(45,050)	(44,710)
Proceeds from sales of loans originated for sale	46,485	43,011
Net gain on disposal of OREO	(106)	(10)
Writedown of OREO	13	4
Net gain on disposal of premises and equipment	(6)	(18)
Deferred income taxes	518	745
Investment securities gains	(862)	(657)
Earnings on cash surrender value of life insurance	(568)	(539)
(Increase) decrease in accrued interest receivable	(520)	205
Increase in accrued interest payable and other liabilities	5,218	589
Other, net	(1,739)	(95)
Net cash provided by operating activities	13,946	7,553
Cash flows from investing activities		
Proceeds from sales of available for sale securities	88,110	58,653
Maturities, repayments and calls of available for sale securities	7,059	13,824
Purchases of available for sale securities	(132,373)	(64,531)
Net (purchases) redemptions of restricted investments in bank stocks	(2,700)	898
Net increase in loans	(54,132)	(51,835)
Purchases of bank premises and equipment	(1,053)	(1,498)
Improvements to OREO	0	(9)
Proceeds from disposal of OREO	1,028	185
Proceeds from disposal of bank premises and equipment	7	83
Purchases of bank owned life insurance	(900)	0
Net cash used in investing activities	(94,954)	(44,230)
Cash flows from financing activities		
Net increase in deposits	106,351	43,484
Net increase (decrease) in borrowings with original maturities less than 90 days	10,263	(37,302)
Proceeds from other short-term borrowings	0	70,000
Payments on other short-term borrowings	(40,000)	(30,000)
Payments on long-term debt	(180)	(172)
Dividends paid	(2,095)	(1,655)
Treasury shares repurchased for employee taxes associated with restricted stock vesting	(651)	0
Proceeds from issuance of stock for option exercises and employee stock purchase plan	95	61
Net cash provided by financing activities	73,783	44,416
Net increase (decrease) in cash and cash equivalents	(7,225)	7,739
Cash and cash equivalents at beginning of period	29,807	30,273

Cash and cash equivalents at end of period	$22,582	$38,012
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		
Interest	$5,562	$3,332
Income taxes	60	150
Supplemental schedule of noncash investing activities:		
OREO acquired in settlement of loans	$408	$720
Security purchases not yet settled	4,002	5,423

The Notes to Consolidated Financial Statements are an integral part of these statements.

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Notes to Consolidated Financial Statements (Unaudited)
NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

See the Glossary of Defined Terms at the beginning of this Report for terms used throughout the consolidated financial statements and related notes of this Form 10-Q.

Nature of Operations – Orrstown Financial Services, Inc. and subsidiaries is a financial holding company that operates Orrstown Bank, a commercial bank with banking and financial advisory offices in Berks, Cumberland, Dauphin, Franklin, Lancaster, Perry and York Counties, Pennsylvania, and in Washington County, Maryland and Wheatland Advisors, Inc., a registered investment advisor non-bank subsidiary, headquartered in Lancaster, Pennsylvania. The Company operates in the community banking segment and engages in lending activities, including commercial, residential, commercial mortgages, construction, municipal, and various forms of consumer lending, and deposit services, including checking, savings, time, and money market deposits. The Company also provides fiduciary services, investment advisory, insurance and brokerage services. The Company and the Bank are subject to regulation by certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

Basis of Presentation – The accompanying condensed consolidated financial statements include the accounts of Orrstown Financial Services, Inc. and its wholly owned subsidiaries, the Bank and Wheatland. The Company has prepared these unaudited condensed consolidated financial statements in accordance with GAAP for interim financial information, SEC rules that permit reduced disclosure for interim periods, and Article 10 of Regulation S-X. In the opinion of management, all adjustments (all of which are of a normal recurring nature) that are necessary for a fair statement are reflected in the unaudited condensed consolidated financial statements. The December 31, 2017 consolidated balance sheet information contained in this Quarterly Report on Form 10-Q was derived from the 2017 audited consolidated financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included in the Company’s Annual Report on Form 10-K for the year ended December 31, 2017. Operating results for the three and six months ended June 30, 2018 are not necessarily indicative of the results that may be expected for the year ending December 31, 2018. All significant intercompany transactions and accounts have been eliminated. Certain reclassifications have been made to prior year amounts to conform with current year classifications.

The Company's management has evaluated all activity of the Company and concluded that subsequent events are properly reflected in the Company's consolidated financial statements and notes as required by GAAP.

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities as of the date of the financial statements and the reported amounts of revenues and expenses during the reporting periods. Actual results could differ from those estimates. Material estimates that are particularly susceptible to significant change include the determination of the ALL and income taxes.

Concentration of Credit Risk – The Company grants commercial, residential, construction, municipal, and various forms of consumer lending to customers primarily in its market area of Berks, Cumberland, Dauphin, Franklin, Lancaster, Perry, and York Counties, Pennsylvania, and in Washington County, Maryland. Therefore the Company's exposure to credit risk is significantly affected by changes in the economy in those areas. Although the Company maintains a diversified loan portfolio, a significant portion of its customers’ ability to honor their contracts is dependent upon economic sectors for commercial real estate, including office space, retail strip centers, sales finance, sub-dividers and developers, and multi-family, hospitality, and residential building operators. Management evaluates each customer’s creditworthiness on a case-by-case basis. The amount of collateral obtained, if collateral is deemed necessary by the Company upon the extension of credit, is based on management’s credit evaluation of the customer. Collateral held varies, but generally includes real estate and equipment.

The types of securities the Company invests in are included in Note 3, Securities Available for Sale, and the types of lending the Company engages in are included in Note 4, Loans and Allowance for Loan Losses.

Cash and Cash Equivalents – Cash and cash equivalents include cash, balances due from banks, federal funds sold and interest-bearing deposits due on demand, all of which have original maturities of 90 days or less. Net cash flows are

reported for customer loan and deposit transactions, loans held for sale, redemption (purchases) of restricted investments in bank stocks, and short-term borrowings.

Restricted Investments in Bank Stocks – Restricted investments in bank stocks consist of Federal Reserve Bank of Philadelphia stock, FHLB of Pittsburgh stock and Atlantic Community Bankers Bank stock. Federal law requires a member institution of the district Federal Reserve Bank and FHLB to hold stock according to predetermined formulas. Atlantic

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Community Bankers Bank requires its correspondent banking institutions to hold stock as a condition of membership. The restricted investment in bank stocks is carried at cost. Quarterly, management evaluates the bank stocks for impairment based on assessment of the ultimate recoverability of cost rather than by recognizing temporary declines in value. The determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as operating performance, liquidity, funding and capital positions, stock repurchase history, dividend history and impact of legislative and regulatory changes.

Securities – The Company typically classifies debt securities as available for sale on the date of purchase. At June 30, 2018 and December 31, 2017, the Company had no held to maturity or trading securities. AFS securities are reported at fair value. Interest income and dividends are recognized in interest income on an accrual basis. Purchase premiums and discounts on debt securities are amortized to interest income using the interest method over the terms of the securities and approximate the level yield method.

Changes in unrealized gains and losses, net of related deferred taxes, for AFS securities are recorded in AOCI. Realized gains and losses on securities are recorded on the trade date using the specific identification method and are included in noninterest income.

AFS securities include investments that management intends to use as part of its asset/liability management strategy. Securities may be sold in response to changes in interest rates, changes in prepayment rates and other factors. The Company does not have the intent to sell any of its AFS securities that are in an unrealized loss position and it is more likely than not that the Company will not be required to sell these securities before recovery of their amortized cost. Management evaluates securities for OTTI on at least a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. For securities in an unrealized loss position, management considers the extent and duration of the unrealized loss, and the financial condition and near-term prospects of the issuer. Management also assesses whether it intends to sell, or it is more likely than not that it will be required to sell, a security in an unrealized loss position before recovery of its amortized cost basis. If either of the criteria regarding intent or requirement to sell is met, the entire difference between amortized cost and fair value is recognized as impairment through earnings. For debt securities that do not meet the aforementioned criteria, the amount of impairment is split into two components: OTTI related to other factors, which is recognized in OCI, and the remaining OTTI, which is recognized in earnings. The credit loss is defined as the difference between the present value of the cash flows expected to be collected and the amortized cost basis.

The Company’s securities are exposed to various risks, such as interest rate risk, market risk, and credit risk. Due to the level of risk associated with certain investments and the level of uncertainty related to changes in the value of investments, it is at least reasonably possible that changes in risks in the near term would materially affect investment assets reported in the consolidated financial statements.

Loans Held for Sale – Loans originated and intended for sale in the secondary market are carried at the lower of aggregate cost or fair value. Gains and losses on loan sales (sales proceeds minus carrying value) are recorded in noninterest income.

Loans – The Company grants commercial loans; residential, commercial and construction mortgage loans; and various forms of consumer loans to its customers located principally in south central Pennsylvania and northern Maryland. The ability of the Company’s debtors to honor their contracts is dependent largely upon the real estate and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the ALL, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and amortized as a yield adjustment over the respective term of the loan. For purchased loans that are not deemed impaired at the acquisition date, premiums and discounts are amortized or accreted as adjustments to interest income using the effective yield method.

For all classes of loans, the accrual of interest income on loans, including impaired loans, ceases when principal or interest is past due 90 days or more or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, at the date of placement on

nonaccrual status, is reversed and charged against current interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending upon management's assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, the loan has performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contractual terms of the loan.

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Loans, the terms of which are modified, are classified as TDRs if a concession was granted in connection with the modification, for legal or economic reasons, related to the debtor's financial difficulties. Concessions granted under a TDR typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, a temporary reduction in interest rates, or granting of an interest rate below market rates given the risk of the transaction. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual TDRs may be restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. TDRs are evaluated individually for impairment on a quarterly basis including monitoring of performance according to their modified terms.

Allowance for Loan Losses – The ALL is evaluated on at least a quarterly basis, as losses are estimated to be probable and incurred, and, if deemed necessary, is increased through a provision for loan losses charged to earnings. Loan losses are charged against the ALL when management determines that all or a portion of the loan is uncollectible. Recoveries on previously charged-off loans are credited to the ALL when received. The ALL is allocated to loan portfolio classes on a quarterly basis, but the entire balance is available to cover losses from any of the portfolio classes when those losses are confirmed.

Management uses internal policies and bank regulatory guidance in periodically evaluating loans for collectability and incorporates historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

See Note 4, Loans and Allowance for Loan Losses, for additional information.

Loan Commitments and Related Financial Instruments – Financial instruments include off-balance sheet credit commitments issued to meet customer financing needs, such as commitments to make loans and commercial letters of credit. These financial instruments are recorded when they are funded. The face amount represents the exposure to loss, before considering customer collateral or ability to repay. The Company maintains a reserve for probable losses on off-balance sheet commitments which is included in Other Liabilities.

Loans Serviced – The Bank administers secondary market mortgage programs available through the FHLB and the Federal National Mortgage Association and offers residential mortgage products and services to customers. The Bank originates single-family residential mortgage loans for immediate sale in the secondary market and retains the servicing of those loans. At June 30, 2018 and December 31, 2017, the balance of loans serviced for others totaled $336,428,000 and $334,802,000.

Transfers of Financial Assets – Transfers of financial assets are accounted for as sales when control over the assets has been surrendered. Control over transferred assets is deemed to be surrendered when (1) the assets have been isolated from the Company, (2) the transferee obtains the right (free of conditions that constrain it from taking advantage of that right) to pledge or exchange the transferred assets, and (3) the Company does not maintain effective control over the transferred assets through an agreement to repurchase them before their maturity.

Cash Surrender Value of Life Insurance – The Company has purchased life insurance policies on certain employees. Life insurance is recorded at the cash surrender value adjusted for other charges or other amounts due that are probable at settlement.

Premises and Equipment – Buildings, improvements, equipment, furniture and fixtures are carried at cost less accumulated depreciation and amortization. Land is carried at cost. Depreciation and amortization has been provided generally on the straight-line method and is computed over the estimated useful lives of the various assets as follows: buildings and improvements, including leasehold improvements – 10 to 40 years; and furniture and equipment – 3 to 15 years. Leasehold improvements are amortized over the shorter of the lease term or the indicated life. Repairs and maintenance are charged to operations as incurred, while major additions and improvements are capitalized. Gain or loss on retirement or disposal of individual assets is recorded as income or expense in the period of retirement or disposal.

Goodwill and Other Intangible Assets – Goodwill is calculated as the purchase premium, if any, after adjusting for the fair value of net assets acquired in purchase transactions. Goodwill is not amortized but is reviewed for potential

impairment on at least an annual basis, with testing between annual tests if an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit. Other intangible assets represent purchased assets that can be distinguished from goodwill because of contractual or other legal rights. The Company's other intangible assets have finite lives and are amortized on either the sum of the years digits or straight line bases over their estimated lives, generally 10 years for deposit premiums and 10 to 15 years for customer lists.

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Mortgage Servicing Rights – The estimated fair value of MSRs related to loans sold and serviced by the Company is recorded as an asset upon the sale of such loans. MSRs are amortized as a reduction to servicing income over the estimated lives of the underlying loans. MSRs are evaluated periodically for impairment by comparing the carrying amount to estimated fair value. Fair value is determined periodically through a discounted cash flows valuation performed by a third party. Significant inputs to the valuation include expected servicing income, net of expense, the discount rate and the expected life of the underlying loans. To the extent the amortized cost of the MSRs exceeds their estimated fair values, a valuation allowance is established for such impairment through a charge against servicing income on the consolidated statements of income. If the Company determines, based on subsequent valuations, that the impairment no longer exists or is reduced, the valuation allowance is reduced through a credit to earnings. MSRs totaled $2,917,000 and $2,897,000 at June 30, 2018 and December 31, 2017, and are included in Other Assets.

Foreclosed Real Estate – Real estate acquired through foreclosure or other means is initially recorded at the fair value of the related real estate collateral at the transfer date less estimated selling costs, and subsequently at the lower of its carrying value or fair value less estimated costs to sell. Fair value is usually determined based on an independent third party appraisal of the property or occasionally on a recent sales offer. Costs to maintain foreclosed real estate are expensed as incurred. Costs that significantly improve the value of the properties are capitalized. Foreclosed real estate totaled $395,000 and $961,000 at June 30, 2018 and December 31, 2017 and is included in Other Assets.

Investments in Real Estate Partnerships – The Company has a 99% limited partner interest in several real estate partnerships in central Pennsylvania. These investments are affordable housing projects, which entitle the Company to tax deductions and credits that expire through 2025. The Company accounts for its investments in affordable housing projects under the proportional amortization method when the criteria are met, which is limited to one investment entered into in 2015. Other investments are accounted for under the equity method of accounting. The investment in these real estate partnerships, included in Other Assets, totaled $4,140,000 and $4,416,000 at June 30, 2018 and December 31, 2017, of which $1,669,000 and $1,776,000 are accounted for under the proportional amortization method.

Equity method losses totaled $88,000 and $26,000 for the three months ended June 30, 2018 and 2017, and $169,000 and $115,000 for the six months ended June 30, 2018 and 2017, and are included in other noninterest income.

Proportional amortization method losses totaled $54,000 and $52,000 for the three months ended June 30, 2018 and 2017, and $107,000 and $105,000 for the six months ended June 30, 2018 and 2017 and are included in income tax expense. The Company recognized federal tax credits from these projects totaling $145,000 and $252,000 during the three months ended June 30, 2018 and 2017, and $289,000, and $505,000 during the six months ended June 30, 2018 and 2017, which are included in income tax expense.

Advertising – The Company expenses advertising as incurred. Advertising expense totaled totaled $61,000 and $214,000 for the three months ended June 30, 2018 and 2017, and $126,000 and $317,000 for the six months ended June 30, 2018 and 2017.

Repurchase Agreements – The Company enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities which are included in short-term borrowings. Under these agreements, the Company may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Company to repurchase the assets. As a result, these Repurchase Agreements are accounted for as collateralized financing arrangements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability in the Company's consolidated balance sheets, while the securities underlying the Repurchase Agreements remaining are reflected in AFS securities. The repurchase obligation and underlying securities are not offset or netted. The Company does not enter into reverse Repurchase Agreements, so there is no offsetting to be performed with Repurchase Agreements.

The right of setoff for a Repurchase Agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the Repurchase Agreement should the Company be in default (e.g., fail to make an interest payment to the counterparty). For the Repurchase Agreements, the collateral is held by the Company in a segregated custodial account under a third party agreement. Repurchase agreements are secured by GSE MBSs and mature overnight.

Share Compensation Plans – The Company has share compensation plans that cover employees and non-employee directors. Compensation expense relating to share-based payment transactions is measured based on the grant date fair value of the share award, including a Black-Scholes model for stock options. Compensation expense for all share awards is calculated and recognized over the employees' or non-employee directors' service period, generally defined as the vesting period.

Income Taxes – Income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of enacted tax law to taxable income or excess of deductions over revenues. The Company determines deferred income taxes using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the

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differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

Deferred income tax expense results from changes in deferred tax assets and liabilities between periods. Deferred tax assets are recognized if it is more likely than not, based on the technical merits, that the tax position will be realized or sustained upon examination. The term more likely than not means a likelihood of more than 50 percent; the terms examined and upon examination also include resolution of the related appeals or litigation processes, if any. A tax position that meets the more likely than not recognition threshold is initially and subsequently measured as the largest amount of tax benefit that has a greater than 50 percent likelihood of being realized upon settlement with a taxing authority that has full knowledge of all relevant information. The determination of whether or not a tax position has met the more likely than not recognition threshold considers the facts, circumstances, and information available at the reporting date and is subject to management's judgment. Deferred tax assets are reduced by a valuation allowance when, based on the weight of available evidence, it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company recognizes interest and penalties, if any, on income taxes as a component of income tax expense.

Loss Contingencies – Loss contingencies, including claims and legal actions arising in the ordinary course of business, are recorded as liabilities when the likelihood of loss is probable and an amount or range of loss can be reasonably estimated.

Treasury Stock – Common stock shares repurchased are recorded as treasury stock at cost.

Earnings Per Share – Basic earnings per share represents income available to common stockholders divided by the weighted average number of common shares outstanding during the period. Restricted stock awards are included in weighted average common shares outstanding as they are earned. Diluted earnings per share includes additional common shares that would have been outstanding if dilutive potential common shares had been issued. Potential common shares that may be issued by the Company relate solely to outstanding stock options and restricted stock awards and are determined using the treasury stock method.

Treasury shares are not deemed outstanding for earnings per share calculations.

Comprehensive Income – Comprehensive income consists of net income and OCI. OCI is limited to unrealized gains (losses) on securities available for sale for all years presented. Unrealized gains (losses) on securities available for sale, net of tax, was the sole component of AOCI at June 30, 2018 and December 31, 2017.

Fair Value – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 10, Fair Value. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

Segment Reporting – The Company operates in one significant segment – Community Banking. The Company's non-community banking activities, principally related to Wheatland, are insignificant to the consolidated financial statements.

Recent Accounting Pronouncements - ASU 2014-09, Revenue from Contracts with Customers (Topic 606). ASU 2014-09 implements a common revenue standard that clarifies the principles for recognizing revenue. The core principle of ASU 2014-09 is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. On January 1, 2018, the Company adopted ASU 2014-09 and all subsequent amendments (collectively "ASC 606"). The majority of the Company's revenue comes from interest income, including loans and securities, that are outside the scope of ASC 606. The Company's services that fall within the scope of ASC 606 are presented within noninterest income on the consolidated statements of income and are recognized as revenue as the Company satisfies its obligation to the customer. Services within the scope of ASC 606 include service charges on deposit accounts, income from fiduciary investment management and brokerage activities and interchange fees from service charges on ATM and debit card transactions. ASC 606 did not result in a change to the accounting for any in-scope revenue streams; as such, no cumulative effect adjustment was recorded.

ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions,

to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods 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, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to

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measure the liability at fair value in accordance with the fair value option for financial instruments, (vi) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements and (viii) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities. Our adoption of ASU 2016-01 on January 1, 2018, did not have a material effect on our consolidated financial condition or results of operations. In accordance with (iv) above, the Company measured fair value of its loan portfolio at June 30, 2018 using an exit price methodology as indicated in Note 10, Fair Value.

ASU 2016-02, Leases (Topic 842). ASU 2016-02 will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis, and a right-of-use asset, which is an asset that represents the lessee’s right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 will be effective for the Company on January 1, 2019 and will require transition using a modified retrospective approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. Notwithstanding the foregoing, in January 2018, the FASB issued a proposal to provide an additional transition method that would allow entities to not apply the guidance in ASU 2016-02 in the comparative periods presented in the financial statements and instead recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company anticipates that the impact on its consolidated balance sheet will result in an increase in assets and liabilities for its right of use assets and related lease liabilities for those leases that are outstanding at the date of adoption, however, it does not anticipate it will have a material impact on its results of operations. Management is evaluating other effects of this standard on our consolidated financial position and regulatory capital.

ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 requires the measurement of all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts and requires enhanced disclosures related to the significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of an organization’s portfolio. In addition, ASU 2016-13 amends the accounting for credit losses on available for sale debt securities and purchased financial assets with credit deterioration. ASU 2016-13 will be effective on January 1, 2020. The Company is currently evaluating the potential impact of ASU 2016-13 on our consolidated financial statements. In that regard, the Company has formed a cross-functional working group, under the direction of the Chief Financial Officer and the Chief Risk Officer. The working group is comprised of individuals from various functional areas including credit, risk management, finance and information technology. We are currently developing an implementation plan to include, but not limited to, an assessment of processes, portfolio segmentation, model development, system requirements and the identification of data and resource needs. We have selected a third-party vendor solution to assist us in the application of ASU 2016-13. While the Company is currently unable to reasonably estimate the impact of adopting ASU 2016-13, we expect that the impact of adoption will be significantly influenced by the composition, characteristics and quality of the Company's loan and securities portfolios, as well as the prevailing economic conditions and forecasts, at the adoption date.

ASU 2016-15, Statement of Cash Flows (Topic 230) - Restricted Cash. ASU 2016-18 requires that a statement of cash flows explain the change during the period in the total of cash, cash equivalents, and amounts generally described as restricted cash or restricted cash equivalents. Therefore, amounts generally described as restricted cash and restricted cash equivalents should be included with cash and cash equivalents when reconciling the beginning-of-period and end-of-period total amounts shown on the statement of cash flows. On January 1, 2018, the Company adopted ASU 2016-18 with no material impact on our consolidated financial condition or results of operations.

ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. ASU 2017-04 simplifies how all entities assess goodwill for impairment by eliminating Step 2 from the goodwill impairment test. As amended, the goodwill impairment test will consist of one step comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit’s fair value. ASU 2017-04 will be effective for the Company on

January 1, 2020, with earlier adoption permitted, and is not expected to have a material impact on the Company's consolidated financial statements.

ASU 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20). ASU 2017-08 shortens the amortization period of certain callable debt securities held at a premium to the earliest call date unless applicable guidance related to certain pools of securities is applied to consider estimated prepayments. Under prior guidance, entities were generally required to amortize premiums on individual, non-pooled callable debt securities as a yield adjustment over the contractual life of the security. ASU 2017-08 does not change the accounting for callable debt securities held at a discount. ASU 2017-08 will be effective for the Company on January 1, 2019, with early adoption permitted. Management does not anticipate ASU 2017-08 will have a material impact on the Company's consolidated financial statements.

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ASU 2017-09, Compensation - Stock Compensation (Topic 718). ASU 2017-09 clarifies when changes to the terms or conditions of a share-based payment award must be accounted for as modifications. Under ASU 2017-09, an entity will not apply modification accounting to a share-based payment award if all of the following are the same immediately before and after the change: (i) the award's fair value, (ii) the award's vesting conditions and (iii) the award's classification as an equity or liability instrument. On January 1, 2018, the Company adopted ASU 2017-09 with no material impact on our consolidated financial condition or results of operations.

NOTE 2. PENDING ACQUISITION

On May 31, 2018, the Company entered into an Agreement and Plan of Merger (the “Merger Agreement”) with Mercersburg Financial Corporation, a Pennsylvania corporation (“Mercersburg”) and the holding company for First Community Bank of Mercersburg, based in Mercersburg, Pennsylvania. At June 30, 2018, Mercersburg had approximately $183,000,000 in assets and 810,080 common shares outstanding. The Merger Agreement provides that, subject to the terms and conditions thereof, Mercersburg will merge with and into the Company, with the Company as the surviving corporation. The merger is expected to close during the fourth quarter of 2018, subject to receipt of regulatory approvals, the approval of Mercersburg’s shareholders, and the satisfaction of other customary closing conditions.

Pursuant to the Merger Agreement, for each share of Mercersburg common stock, the Company will issue $40.00 in cash, without interest, or 1.5291 shares of the Company’s common stock, no par value per share, subject to proration to ensure that in the aggregate 85% of Mercersburg common stock will be converted to Company common stock and the remaining 15% of Mercersburg common stock will be converted to cash, subject to adjustment pursuant to the terms of the Merger Agreement.

NOTE 3. SECURITIES AVAILABLE FOR SALE

The following table summarizes amortized cost and fair value of AFS securities at June 30, 2018 and December 31, 2017, and the corresponding amounts of gross unrealized gains and losses recognized in AOCI. At June 30, 2018 and December 31, 2017, all investment securities were classified as AFS.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2018				
States and political subdivisions	$ 169,209	$ 2,426	$ 1,717	$169,918
GSE residential CMOs	117,417	82	3,627	113,872
Private label residential CMOs	614	1	0	615
Private label commercial CMOs	18,694	0	290	18,404
Asset-backed and other	146,894	350	634	146,610
Totals	$ 452,828	$ 2,859	$ 6,268	$449,419
December 31, 2017				
States and political subdivisions	$ 153,803	$ 6,133	$ 478	$159,458
GSE residential MBSs	48,600	930	0	49,530
GSE residential CMOs	113,658	296	2,835	111,119
Private label residential CMOs	999	4	0	1,003
Private label commercial CMOs	7,809	0	156	7,653
Asset-backed and other	86,837	133	425	86,545
Totals	$ 411,706	$ 7,496	$ 3,894	$415,308

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The following table summarizes AFS securities with unrealized losses at June 30, 2018 and December 31, 2017, aggregated by major security type and length of time in a continuous unrealized loss position.

(Dollars in thousands)	Less Than 12 Months # of Securities	Fair Value	Unrealized Losses	12 Months or More # of Securities	Fair Value	Unrealized Losses	Total # of Securities	Fair Value	Unrealized Losses
June 30, 2018									
States and political subdivisions	32	$58,408	$ 1,576	1	$5,423	$ 141	33	$63,831	$ 1,717
GSE residential CMOs	4	55,583	1,078	6	35,971	2,549	10	91,554	3,627
Private label commercial CMOs	5	18,404	290	0	0	0	5	18,404	290
Asset-backed and other	7	88,913	504	1	4,187	130	8	93,100	634
Totals	48	$221,308	$ 3,448	8	$45,581	$ 2,820	56	$266,889	$ 6,268
December 31, 2017									
States and political subdivisions	7	$24,577	$ 473	1	$5,585	$ 5	8	$30,162	$ 478
GSE residential CMOs	4	25,155	914	5	37,459	1,921	9	62,614	2,835
Private label commercial CMOs	2	7,653	156	0	0	0	2	7,653	156
Asset-backed and other	6	60,006	425	0	0	0	6	60,006	425
Totals	19	$117,391	$ 1,968	6	$43,044	$ 1,926	25	$160,435	$ 3,894

States and Political Subdivisions. The unrealized losses presented in the table above have been caused by a widening of spreads and/or a rise in interest rates from the time these securities were purchased. Management considers the investment rating, the state of the issuer of the security and other credit support in determining whether the security is OTTI. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell them before recovery of their amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at June 30, 2018 or at December 31, 2017.

GSE Residential CMOs. The unrealized losses presented in the table above have been caused by a widening of spreads and/or a rise in interest rates from the time these securities were purchased. The contractual terms of these securities do not permit the issuer to settle the securities at a price less than its par value basis. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell them before recovery of their amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at June 30, 2018 or at December 31, 2017.

Private Label Commercial CMOs and Asset-backed and Other. The unrealized losses presented in the table above have been caused by the bid ask spread, widening of spreads and/or a rise in interest rates from the time the securities were purchased. Because the Company does not intend to sell these securities and it is not more likely than not that

the Company will be required to sell them before recovery of their amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at June 30, 2018 or at December 31, 2017.

The following table summarizes amortized cost and fair value of AFS securities at June 30, 2018 by contractual maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

	Available for Sale	
(Dollars in thousands)	Amortized Cost	Fair Value
Due after one year through five years	$9,834	$9,901
Due after five years through ten years	47,999	47,944
Due after ten years	111,376	112,073
CMOs	136,725	132,891
Asset-backed and other	146,894	146,610
	$452,828	$449,419

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The following table summarizes proceeds from sales of AFS securities and gross gains and gross losses for the three and six months ended June 30, 2018 and 2017.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Proceeds from sale of AFS securities	$25,533	$23,581	$88,110	$58,653
Gross gains	211	654	1,052	807
Gross losses	165	0	190	150

AFS securities with a fair value of $258,043,000 and $319,907,000 at June 30, 2018 and December 31, 2017 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES

The Company’s loan portfolio is grouped into classes to allow management to monitor the performance by the borrower and to monitor the yield on the portfolio. Consistent with ASU 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Loan Losses, the segments are further broken down into classes to allow for differing risk characteristics within a segment.

The risks associated with lending activities differ among the various loan classes and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact both the borrower’s ability to repay its loans and associated collateral.

The Company has various types of commercial real estate loans which have differing levels of credit risk. Owner occupied commercial real estate loans are generally dependent upon the successful operation of the borrower’s business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower’s ability to repay the loan could be in jeopardy. Non-owner occupied and multi-family commercial real estate loans and non-owner occupied residential loans present a different credit risk to the Company than owner occupied commercial real estate loans, as the repayment of the loan is dependent upon the borrower’s ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirements and operating expenses. Lower occupancy or lease rates may result in a reduction in cash flows, which hinders the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally recognizes that greater risk is inherent in these credit relationships as compared to owner occupied loans mentioned above.

Acquisition and development loans consist of 1-4 family residential construction and commercial and land development loans. The risk of loss on these loans is largely dependent on the Company’s ability to assess the property’s value at the completion of the project, which should exceed the property’s construction costs. During the construction phase, a number of factors could potentially negatively impact the collateral value, including cost overruns, delays in completing the project, competition, and real estate market conditions which may change based on the supply of similar properties in the area. In the event the collateral value at the completion of the project is not sufficient to cover the outstanding loan balance, the Company must rely upon other repayment sources, including, if any, the guarantors of the project or other collateral securing the loan.

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest-rated borrowers, the majority of these loans are secured by the borrower’s accounts receivable, inventory and machinery and equipment. In a significant number of these loans, the collateral also includes the business real estate or the business owner’s personal real estate or assets. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through its underwriting standards, including evaluating the creditworthiness of the borrower and, to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and

meetings with the borrowers are typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

Municipal loans consist of extensions of credit to municipalities and school districts within the Company's market area. These loans generally present a lower risk than commercial and industrial loans, as they are generally secured by the

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municipality’s full taxing authority, by revenue obligations, or by its ability to raise assessments on its customers for a specific utility.

The Company originates loans to its retail customers, including fixed-rate and adjustable first lien mortgage loans with the underlying 1-4 family owner occupied residential property securing the loan. The Company’s risk exposure is minimized in these types of loans through the evaluation of the creditworthiness of the borrower, including credit scores and debt-to-income ratios, and underwriting standards which limit the loan-to-value ratio to generally no more than 80% upon loan origination, unless the borrower obtains private mortgage insurance.

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner occupied residential property, but can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The creditworthiness of the borrower is considered, including credit scores and debt-to-income ratios.

Installment and other loans’ credit risk are mitigated through prudent underwriting standards, including evaluation of the creditworthiness of the borrower through credit scores and debt-to-income ratios and, if secured, the collateral value of the assets. These loans can be unsecured or secured by assets the value of which may depreciate quickly or may fluctuate, and may present a greater risk to the Company than 1-4 family residential loans.

The following table presents the loan portfolio by segment and class, excluding residential LHFS, at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	June 30, 2018	December 31, 2017
Commercial real estate:		
Owner occupied	$119,507	$116,811
Non-owner occupied	244,058	244,491
Multi-family	58,575	53,634
Non-owner occupied residential	84,009	77,980
Acquisition and development:		
1-4 family residential construction	8,801	11,730
Commercial and land development	38,773	19,251
Commercial and industrial	130,280	115,663
Municipal	39,753	42,065
Residential mortgage:		
First lien	167,499	162,509
Home equity - term	11,313	11,784
Home equity - lines of credit	132,528	132,192
Installment and other loans	28,787	21,902
	$1,063,883	$1,010,012

In order to monitor ongoing risk associated with its loan portfolio and specific loans within the segments, management uses an internal grading system. The first several rating categories, representing the lowest risk to the Bank, are combined and given a “Pass” rating. Management generally follows regulatory definitions in assigning criticized ratings to loans, including "Special Mention," "Substandard," "Doubtful" or "Loss." The Special Mention category includes loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Bank's position at some future date. These assets pose elevated risk, but their weakness does not yet justify a more severe, or classified rating. Substandard loans are classified as they have a well-defined weakness, or weaknesses that jeopardize liquidation of the debt. These loans are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected. Substandard loans include loans that management has determined not to be impaired, as well as loans considered to be impaired. A Doubtful loan has a high probability of total or substantial loss, but because of specific pending events that may strengthen the asset, its classification as Loss is deferred. Loss loans are considered uncollectible, as the borrowers are often in bankruptcy, have suspended debt

repayments, or have ceased business operations. Once a loan is classified as Loss, there is little prospect of collecting the loan’s principal or interest and it is charged-off.

The Company has a loan review policy and program which is designed to identify and monitor risk in the lending function. The ERM Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Company's loan portfolio. This includes the monitoring of the lending activities of all Company personnel with respect to underwriting and processing new loans and the timely follow-up and

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corrective action for loans showing signs of deterioration in quality. A loan review program provides the Company with an independent review of the loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. In addition, all commercial relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed quarterly and corresponding risk ratings are reaffirmed by the Company's Problem Loan Committee, with subsequent reporting to the ERM Committee.

The following table summarizes the Company’s loan portfolio ratings based on its internal risk rating system at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
June 30, 2018						
Commercial real estate:						
Owner occupied	$115,202	$1,978	$ 1,139	$ 1,188	$ 0	$119,507
Non-owner occupied	239,622	0	4,436	0	0	244,058
Multi-family	52,263	5,429	735	148	0	58,575
Non-owner occupied residential	81,864	638	1,162	345	0	84,009
Acquisition and development:						
1-4 family residential construction	8,600	0	0	201	0	8,801
Commercial and land development	38,149	28	596	0	0	38,773
Commercial and industrial	128,011	1,946	0	323	0	130,280
Municipal	39,753	0	0	0	0	39,753
Residential mortgage:						
First lien	164,256	0	0	3,243	0	167,499
Home equity - term	11,294	0	0	19	0	11,313
Home equity - lines of credit	131,705	78	59	686	0	132,528
Installment and other loans	28,786	0	0	1	0	28,787
	$1,039,505	$10,097	$ 8,127	$ 6,154	$ 0	$1,063,883
December 31, 2017						
Commercial real estate:						
Owner occupied	$113,240	$413	$ 1,921	$ 1,237	$ 0	$116,811
Non-owner occupied	235,919	0	4,507	4,065	0	244,491
Multi-family	48,603	4,113	753	165	0	53,634
Non-owner occupied residential	76,373	142	1,084	381	0	77,980
Acquisition and development:						
1-4 family residential construction	11,238	0	0	492	0	11,730
Commercial and land development	18,635	5	611	0	0	19,251
Commercial and industrial	113,162	2,151	0	350	0	115,663
Municipal	42,065	0	0	0	0	42,065
Residential mortgage:						
First lien	158,673	0	0	3,836	0	162,509
Home equity - term	11,762	0	0	22	0	11,784
Home equity - lines of credit	131,585	80	60	467	0	132,192
Installment and other loans	21,891	0	0	11	0	21,902
	$983,146	$6,904	$ 8,936	$ 11,026	$ 0	$1,010,012

For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are deemed

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impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed to determine if the loan should be placed on nonaccrual status. Nonaccrual loans in the commercial and commercial real estate portfolios and any TDRs are, by definition, deemed to be impaired.

Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained, which may include updated appraisals. Updated fair values are incorporated into the impairment analysis in the next reporting period.

Loan charge-offs, which may include partial charge-offs, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value, the loan has been identified as uncollectible, and it is deemed to be a confirmed loss. Typically, impaired loans with a charge-off or partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and is adequately secured. The second, or non-performing note, would be charged-off. Generally, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant.

At June 30, 2018 and December 31, 2017, nearly all of the Company's impaired loans' extent of impairment were measured based on the estimated fair value of the collateral securing the loan, except for TDRs. By definition, TDRs are considered impaired. All restructured loans' impairment were determined based on discounted cash flows for those loans classified as TDRs and still accruing interest. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it could also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral.

Updated appraisals are generally required every 18 months for classified commercial loans in excess of $250,000. The "as is" value provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

Generally, impaired commercial loans secured by real estate, other than performing TDRs, are measured at fair value using certified real estate appraisals that had been completed within the last 18 months. Appraised values are discounted for estimated costs to sell the property and other selling considerations to arrive at the property's fair value. In those situations in which it is determined an updated appraisal is not required for loans individually evaluated for impairment, fair values are based on one or a combination of approaches. In those situations in which a combination of approaches is considered, the factor that carries the most consideration will be the one management believes is warranted. The approaches are:

- Original appraisal – if the original appraisal provides a strong loan-to-value ratio (generally 70% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the Credit Administration staff that there has not been a significant deterioration in the collateral value, the original certified appraised value may be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.
- Discounted cash flows – in limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

Collateral on certain impaired loans is not limited to real estate, and may consist of accounts receivable, inventory, equipment or other business assets. Estimated fair values are determined based on borrowers' financial statements, inventory ledgers, accounts receivable agings or appraisals from individuals with knowledge in the business. Stated balances are generally discounted for the age of the financial information or the quality of the assets. In determining fair value, liquidation discounts are applied to this collateral based on existing loan evaluation policies.

The Company distinguishes Substandard loans on both an impaired and nonimpaired basis, as it places less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms. A Substandard classification does not automatically meet the definition of impaired. Loss potential, while existing in the aggregate amount of Substandard loans, does not have to exist in individual extensions of credit classified Substandard. As a result, the Company's methodology includes an evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated Substandard to be collectively, as opposed to individually, evaluated for impairment. Although the Company believes these loans meet the definition of Substandard, they are generally performing and

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management has concluded that it is likely we will be able to collect the scheduled payments of principal and interest when due according to the contractual terms of the loan agreement.

Larger groups of smaller balance homogeneous loans are collectively evaluated for impairment. Generally, the Company does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a restructuring agreement due to financial difficulties of the borrower.

The following table summarizes impaired loans by segment and class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required at June 30, 2018 and December 31, 2017. The recorded investment in loans excludes accrued interest receivable due to insignificance. Related allowances established generally pertain to those loans in which loan forbearance agreements were in the process of being negotiated or updated appraisals were pending, and any partial charge-off will be recorded when final information is received.

	Impaired Loans with a Specific Allowance			Impaired Loans with No Specific Allowance	
(Dollars in thousands)	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)	Related Allowance	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)
June 30, 2018					
Commercial real estate:					
Owner occupied	$0	$ 0	$ 0	$ 1,188	$ 2,484
Multi-family	0	0	0	148	344
Non-owner occupied residential	0	0	0	345	650
Acquisition and development:					
1-4 family residential construction	0	0	0	201	201
Commercial and industrial	0	0	0	323	481
Residential mortgage:					
First lien	816	816	39	2,427	4,001
Home equity - term	0	0	0	19	24
Home equity - lines of credit	0	0	0	686	930
Installment and other loans	0	0	0	1	33
	$816	$ 816	$ 39	$ 5,338	$ 9,148
December 31, 2017					
Commercial real estate:					
Owner occupied	$0	$ 0	$ 0	$ 1,237	$ 2,479
Non-owner occupied	0	0	0	4,065	4,856
Multi-family	0	0	0	165	352
Non-owner occupied residential	0	0	0	381	669
Acquisition and development:					
1-4 family residential construction	0	0	0	492	492
Commercial and industrial	0	0	0	350	495
Residential mortgage:					
First lien	872	872	42	2,964	3,706
Home equity - term	0	0	0	22	27
Home equity - lines of credit	0	0	0	467	628
Installment and other loans	9	9	9	2	33
	$881	$ 881	$ 51	$ 10,145	$ 13,737

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

(Dollars in thousands)	2018 Average Impaired Balance	2018 Interest Income Recognized	2017 Average Impaired Balance	2017 Interest Income Recognized
Three Months Ended June 30,				
Commercial real estate:				
Owner-occupied	$1,233	$ 0	$979	$ 5
Non-owner occupied	2,960	0	0	0
Multi-family	153	0	186	0
Non-owner occupied residential	356	0	427	0
Acquisition and development:				
1-4 family residential construction	201	0	0	0
Commercial and industrial	330	0	404	0
Residential mortgage:				
First lien	3,310	14	4,192	21
Home equity – term	20	0	78	0
Home equity - lines of credit	667	1	503	1
Installment and other loans	5	0	6	0
	$9,235	$ 15	$6,775	$ 27
Six Months Ended June 30,				
Commercial real estate:				
Owner occupied	$1,233	$ 1	$1,036	$ 5
Non-owner occupied	3,421	0	276	0
Multi-family	157	0	191	0
Non-owner occupied residential	364	0	437	0
Acquisition and development:				
1-4 family residential construction	250	0	0	0
Commercial and industrial	336	0	458	0
Residential mortgage:				
First lien	3,538	29	4,272	29
Home equity - term	20	0	87	0
Home equity - lines of credit	589	1	513	1
Installment and other loans	8	0	6	0
	$9,916	$ 31	$7,276	$ 35

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The following table presents impaired loans that are TDRs, with the recorded investment at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	June 30, 2018		December 31, 2017	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Accruing:				
Commercial real estate:				
Owner occupied	1	$ 44	1	$ 52
Residential mortgage:				
First lien	11	1,086	11	1,102
Home equity - lines of credit	1	26	1	29
	13	1,156	13	1,183
Nonaccruing:				
Commercial real estate:				
Owner occupied	1	42	1	57
Residential mortgage:				
First lien	8	687	8	715
Installment and other loans	1	1	1	3
	10	730	10	775
	23	$ 1,886	23	$ 1,958

The following table presents the number of loans modified, and their pre-modification and post-modification investment balances.

(Dollars in thousands)	2018			2017		
	Number of Contracts	Pre-Modification Recorded Investment	Post Modification Recorded Investment	Number of Contracts	Pre-Modification Recorded Investment	Post Modification Recorded Investment
Three Months Ended June 30,						
Commercial real estate:						
Owner-occupied	0	$ 0	$ 0	1	$ 56	$ 56
Six Months Ended June 30,						
Commercial real estate:						
Owner occupied	0	$ 0	$ 0	2	$ 119	$ 119

There were no restructured loans for the three or six months ended June 30, 2018 and 2017 and that were modified as TDRs within the previous 12 months which were in payment default.

The loans presented in the table above were considered TDRs as a result of the Company agreeing to below market interest rates given the risk of the transaction; allowing the loan to remain on interest only status; or a reduction in interest rates, in order to give the borrowers an opportunity to improve their cash flows. For TDRs in default of their modified terms, impairment is generally determined on a collateral dependent approach, except for accruing residential mortgage TDRs, which are generally on the discounted cash flow approach. Certain loans modified during a period may no longer be outstanding at the end of the period if the loan was paid off.

No additional commitments have been made to borrowers whose loans are considered TDRs.

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Management further monitors the performance and credit quality of the loan portfolio by analyzing the length of time a portfolio is past due, by aggregating loans based on its delinquencies. The following table presents the classes of loan portfolio summarized by aging categories of performing loans and nonaccrual loans at June 30, 2018 and December 31, 2017.

		Days Past Due					
(Dollars in thousands)	Current	30-59	60-89	90+ (still accruing)	Total Past Due	Non-Accrual	Total Loans
June 30, 2018							
Commercial real estate:							
Owner occupied	$118,363	$0	$0	$ 0	$ 0	$ 1,144	$119,507
Non-owner occupied	244,058	0	0	0	0	0	244,058
Multi-family	58,427	0	0	0	0	148	58,575
Non-owner occupied residential	83,523	141	0	0	141	345	84,009
Acquisition and development:							
1-4 family residential construction	8,600	0	0	0	0	201	8,801
Commercial and land development	38,773	0	0	0	0	0	38,773
Commercial and industrial	129,957	0	0	0	0	323	130,280
Municipal	39,753	0	0	0	0	0	39,753
Residential mortgage:							
First lien	164,330	632	380	0	1,012	2,157	167,499
Home equity - term	11,264	30	0	0	30	19	11,313
Home equity - lines of credit	131,236	632	0	0	632	660	132,528
Installment and other loans	28,744	35	7	0	42	1	28,787
	$1,057,028	$1,470	$387	$ 0	$ 1,857	$ 4,998	$1,063,883
December 31, 2017							
Commercial real estate:							
Owner occupied	$115,605	$4	$17	$ 0	$ 21	$ 1,185	$116,811
Non-owner occupied	240,426	0	0	0	0	4,065	244,491
Multi-family	53,469	0	0	0	0	165	53,634
Non-owner occupied residential	77,454	145	0	0	145	381	77,980
Acquisition and development:							
1-4 family residential construction	11,238	0	0	0	0	492	11,730
Commercial and land development	19,226	25	0	0	25	0	19,251
Commercial and industrial	115,312	1	0	0	1	350	115,663
Municipal	42,065	0	0	0	0	0	42,065
Residential mortgage:							
First lien	155,387	3,333	1,055	0	4,388	2,734	162,509
Home equity - term	11,753	9	0	0	9	22	11,784
Home equity - lines of credit	131,208	474	72	0	546	438	132,192
Installment and other loans	21,749	141	1	0	142	11	21,902
	$994,892	$4,132	$1,145	$ 0	$ 5,277	$ 9,843	$1,010,012

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The Company maintains its ALL at a level management believes adequate for probable incurred credit losses. The ALL is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the ALL utilizing a defined methodology which considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes its approach properly addresses relevant accounting guidance for loans individually identified as impaired and for loans collectively evaluated for impairment, and other bank regulatory guidance.

In connection with its quarterly evaluation of the adequacy of the ALL, management reviews its methodology to determine if it properly addresses the current risk in the loan portfolio. For each loan class, general allowances based on quantitative factors, principally historical loss trends, are provided for loans that are collectively evaluated for impairment. An adjustment to historical loss factors may be incorporated for delinquency and other potential risk not elsewhere defined within the ALL methodology.

In addition to this quantitative analysis, adjustments to the ALL requirements are allocated on loans collectively evaluated for impairment based on additional qualitative factors, including:

Nature and Volume of Loans – including loan growth in the current and subsequent quarters based on the Company’s targeted growth and strategic plan, coupled with the types of loans booked based on risk management and credit culture; the number of exceptions to loan policy; and supervisory loan to value exceptions.

Concentrations of Credit and Changes within Credit Concentrations – including the composition of the Company’s overall portfolio makeup and management's evaluation related to concentration risk management and the inherent risk associated with the concentrations identified.

Underwriting Standards and Recovery Practices – including changes to underwriting standards and perceived impact on anticipated losses; trends in the number of exceptions to loan policy; supervisory loan to value exceptions; and administration of loan recovery practices.

Delinquency Trends – including delinquency percentages noted in the portfolio relative to economic conditions; severity of the delinquencies; and whether the ratios are trending upwards or downwards.

Classified Loans Trends – including internal loan ratings of the portfolio; severity of the ratings; whether the loan segment’s ratings show a more favorable or less favorable trend; and underlying market conditions and impact on the collateral values securing the loans.

Experience, Ability and Depth of Management/Lending staff – including the years’ experience of senior and middle management and the lending staff; turnover of the staff; and instances of repeat criticisms of ratings.

Quality of Loan Review – including the years of experience of the loan review staff; in-house versus outsourced provider of review; turnover of staff and the perceived quality of their work in relation to other external information.

National and Local Economic Conditions – including trends in the consumer price index, unemployment rates, the housing price index, housing statistics compared to the prior year, bankruptcy rates, regulatory and legal environment risks and competition.

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The following table presents the activity in the ALL for the three and six months ended June 30, 2018 and 2017.

(Dollars in thousands)	Commercial					Consumer				
	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
Three Months Ended June 30, 2018										
Balance, beginning of period	$6,770	$ 510	$ 1,590	$ 83	$8,953	$3,382	$ 204	$3,586	$ 461	$13,000
Provision for loan losses	(418)	208	8	(3)	(205)	237	44	281	124	200
Charge-offs	0	0	0	0	0	(86)	(47)	(133)	0	(133)
Recoveries	328	2	0	0	330	11	29	40	0	370
Balance, end of period	$6,680	$ 720	$ 1,598	$ 80	$9,078	$3,544	$ 230	$3,774	$ 585	$13,437
June 30, 2017										
Balance, beginning of period	$6,963	$ 513	$ 1,218	$ 106	$8,800	$3,229	$ 127	$3,356	$ 512	$12,668
Provision for loan losses	(214)	65	69	11	(69)	198	13	211	(42)	100
Charge-offs	0	0	0	0	0	(51)	(27)	(78)	0	(78)
Recoveries	28	1	4	0	33	10	18	28	0	61
Balance, end of period	$6,777	$ 579	$ 1,291	$ 117	$8,764	$3,386	$ 131	$3,517	$ 470	$12,751
Six Months Ended June 30, 2018										
Balance, beginning of period	$6,763	$ 417	$ 1,446	$ 84	$8,710	$3,400	$ 211	$3,611	$ 475	$12,796
Provision for loan losses	(411)	300	152	(4)	37	202	51	253	110	400
Charge-offs	0	0	0	0	0	(86)	(118)	(204)	0	(204)
Recoveries	328	3	0	0	331	28	86	114	0	445
Balance, end of period	$6,680	$ 720	$ 1,598	$ 80	$9,078	$3,544	$ 230	$3,774	$ 585	$13,437
June 30, 2017										
Balance, beginning of period	$7,530	$ 580	$ 1,074	$ 54	$9,238	$2,979	$ 144	$3,123	$ 414	$12,775
Provision for loan losses	(738)	(3)	267	63	(411)	441	14	455	56	100
Charge-offs	(45)	0	(55)	0	(100)	(51)	(56)	(107)	0	(207)
Recoveries	30	2	5	0	37	17	29	46	0	83
Balance, end of period	$6,777	$ 579	$ 1,291	$ 117	$8,764	$3,386	$ 131	$3,517	$ 470	$12,751

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The following table summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related ALL loss allocation for each at June 30, 2018 and December 31, 2017:

	Commercial					Consumer				
(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
June 30, 2018										
Loans allocated by:										
Individually evaluated for impairment	$1,681	$201	$323	$0	$2,205	$3,948	$1	$3,949	$0	$6,154
Collectively evaluated for impairment	504,468	47,373	129,957	39,753	721,551	307,392	28,786	336,178	0	1,057,729
	$506,149	$47,574	$130,280	$39,753	$723,756	$311,340	$28,787	$340,127	$0	$1,063,883
ALL allocated by:										
Individually evaluated for impairment	$0	$0	$0	$0	$0	$39	$0	$39	$0	$39
Collectively evaluated for impairment	6,680	720	1,598	80	9,078	3,505	230	3,735	585	13,398
	$6,680	$720	$1,598	$80	$9,078	$3,544	$230	$3,774	$585	$13,437
December 31, 2017										
Loans allocated by:										
Individually evaluated for impairment	$5,848	$492	$350	$0	$6,690	$4,325	$11	$4,336	$0	$11,026
Collectively evaluated for impairment	487,068	30,489	115,313	42,065	674,935	302,160	21,891	324,051	0	998,986
	$492,916	$30,981	$115,663	$42,065	$681,625	$306,485	$21,902	$328,387	$0	$1,010,012
ALL allocated by:										
Individually evaluated for impairment	$0	$0	$0	$0	$0	$42	$9	$51	$0	$51
Collectively evaluated for impairment	6,763	417	1,446	84	8,710	3,358	202	3,560	475	12,745
	$6,763	$417	$1,446	$84	$8,710	$3,400	$211	$3,611	$475	$12,796

NOTE 5. INCOME TAXES

The Company files income tax returns in the U.S. federal jurisdiction, the Commonwealth of Pennsylvania and the State of Maryland. The Company is no longer subject to tax examination by tax authorities for years before 2014.

The following table summarizes income tax expense for the three and six months ended June 30, 2018 and 2017.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Current expense	$125	$136	$348	$195
Deferred expense	249	380	518	745
Income tax expense	$374	$516	$866	$940

Income tax expense includes $10,000 and $222,000 related to net securities gains for the three months ended June 30, 2018 and 2017, and $181,000 and $223,000 related to net security gains for the six months ended June 30, 2018 and 2017.

The base federal statutory rate used in determining the estimated annual effective tax rate for periods ending in 2018 is 21% and for periods ending in 2017 was 34%. The 21% base federal statutory rate became effective for the Company on January 1, 2018, as a result of federal tax reform legislation enacted in December 2017. SEC Staff Accounting Bulletin No. 118, issued in December 2017, provided for a measurement period that should not extend beyond one year from the tax reform legislation's enactment date for companies to complete the accounting under ASC 740, Income Taxes. In measuring the impact of the tax reform legislation on our net deferred tax asset in 2017, we estimated the income in 2017 for our limited partnership investments in affordable housing real estate partnerships and interest income on nonperforming loans. Any adjustment

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between our estimates and the actual amounts determined during the measurement period are not expected to have a material impact to our consolidated financial statements.

The following table summarizes deferred tax assets and liabilities at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	June 30, 2018	December 31, 2017
Deferred tax assets:		
Allowance for loan losses	$ 3,056	$ 2,919
Deferred compensation	353	355
Retirement plans and salary continuation	1,360	1,301
Share-based compensation	629	597
Off-balance sheet reserves	189	207
Nonaccrual loan interest	296	258
Net unrealized losses on securities available for sale	716	0
Goodwill	30	39
Bonus accrual	241	25
Low-income housing credit carryforward	1,402	2,313
Other	300	390
Total deferred tax assets	8,572	8,404
Deferred tax liabilities:		
Depreciation	410	488
Net unrealized gains on securities available for sale	0	757
Mortgage servicing rights	565	536
Purchase accounting adjustments	243	251
Other	149	122
Total deferred tax liabilities	1,367	2,154
Net deferred tax asset, included in Other Assets	$ 7,205	$ 6,250

The provision for income taxes differs from that computed by applying statutory rates to income before income taxes primarily due to the effects of tax-exempt income, non-deductible expenses and tax credits.

At June 30, 2018, the Company had low-income housing credit carryforwards that expire through 2037.

NOTE 6. SHARE-BASED COMPENSATION PLANS

The Company maintains share-based compensation plans under the shareholder-approved 2011 Plan. The purpose of the share-based compensation plans is to provide officers, employees, and non-employee members of the Board of Directors of the Company with additional incentive to further the success of the Company. At the 2018 Annual Meeting of Shareholders on May 1, 2018, the Company's shareholders approved an increase in the number of shares available for issuance to 881,920 shares and extended the term of the 2011 Plan to May 31, 2028, subject to any future extensions. At June 30, 2018, 881,920 shares of the common stock of the Company were reserved to be issued and 507,793 shares were available to be issued.

The 2011 Plan incentive awards may consist of grants of incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, deferred stock units and performance shares. All employees of the Company and its present or future subsidiaries, and members of the Board of Directors of the Company or any subsidiary of the Company, are eligible to participate in the 2011 Plan. The 2011 Plan allows for the Compensation Committee of the Board of Directors to determine the type of incentive to be awarded, its term, manner of exercise, vesting of awards and restrictions on shares. Generally, awards are nonqualified under the IRC, unless the awards are deemed to be incentive awards to employees at the Compensation Committee’s discretion.

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The following table presents a summary of nonvested restricted shares activity for the six months ended June 30, 2018.

	Shares	Weighted Average Grant Date Fair Value
Nonvested shares, beginning of year	268,411	$ 18.18
Granted	75,017	25.61
Forfeited	(533)	21.55
Vested	(40,424)	18.67
Nonvested shares, at period end	302,471	$ 19.96

The following table presents restricted shares compensation expense, with tax benefit information, and fair value of shares vested, for the three and six months ended June 30, 2018 and 2017.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Restricted share award expense	$444	$363	$920	$659
Restricted share award tax benefit	93	123	193	224
Fair value of shares vested	659	263	1,056	263

The unrecognized compensation expense related to the share awards totaled $2,848,000 at June 30, 2018 and $2,035,000 at December 31, 2017. The unrecognized compensation expense at June 30, 2018 is expected to be recognized over a weighted-average period of 2.0 years.

The following table presents a summary of outstanding stock options activity for the six months ended June 30, 2018.

	Shares	Weighted Average Exercise Price
Outstanding, beginning of year	59,583	$ 25.89
Forfeited	(2,235)	28.02
Expired	(3,444)	30.44
Exercised	(1,150)	21.14
Options outstanding and exercisable, at period end	52,754	$ 25.60

The exercise price of each option equals the market price of the Company’s stock on the grant date. An option’s maximum term is ten years. All options are fully vested upon issuance. The following table presents information pertaining to options outstanding and exercisable at June 30, 2018.

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
$21.14 - $24.99	31,519	1.90	$ 21.51
$25.00 - $29.99	2,792	1.76	25.76
$30.00 - $34.99	11,770	0.04	30.01
$35.00 - $37.59	6,673	1.06	37.10
$21.14 - $37.59	52,754	1.37	$ 25.60

Outstanding and exercisable options had an intrinsic value of $142,000 at June 30, 2018 and $127,000 at December 31, 2017.

The Company maintains an employee stock purchase plan to provide employees of the Company an opportunity to purchase Company common stock. Eligible employees may purchase shares in an amount that does not exceed 10% of their annual salary, at the lower of 95% of the fair market value of the shares on the semi-annual offering date or related purchase date. The Company reserved 350,000 shares of its common stock to be issued under the employee stock purchase plan. At June 30, 2018, 176,416 shares were available to be issued.

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The following table presents information for the employee stock purchase plan for the three and six months ended June 30, 2018 and 2017.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands except share information)	2018	2017	2018	2017
Shares purchased	0	0	2,956	3,114
Weighted average price of shares purchased	$0.00	$0.00	$23.47	$19.71
Compensation expense recognized	0	0	4	7
Tax benefits	0	0	1	2

The Company issues new shares or treasury shares, depending on market conditions, in its share-based compensation plans.

NOTE 7. SHAREHOLDERS’ EQUITY AND REGULATORY CAPITAL

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. Under the Basel Committee on Banking Supervision's capital guidelines for U.S. Banks ("Basel III rules"), the Company must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The required capital conservation buffer for the Company was 1.25% for 2017, is 1.875% for 2018 and will be 2.50% for 2019 under phase-in rules. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes the Company and the Bank met all applicable capital adequacy requirements at June 30, 2018.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion, and capital restoration plans are required. At June 30, 2018, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

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The following table presents capital amounts and ratios at June 30, 2018 and December 31, 2017.

	Actual		For Capital Adequacy Purposes (includes applicable capital conservation buffer)		To Be Well Capitalized Under Prompt Corrective Action Provisions	
(Dollars in thousands)	Amount	Ratio	Amount	Ratio	Amount	Ratio
June 30, 2018						
Total Capital to risk weighted assets						
Consolidated	$159,961	13.4%	$118,315	9.875%	n/a	n/a
Bank	157,054	13.1%	118,197	9.875%	$ 119,694	10.0 %
Tier 1 Capital to risk weighted assets						
Consolidated	145,559	12.1%	94,352	7.875%	n/a	n/a
Bank	142,652	11.9%	94,259	7.875%	95,755	8.0 %
Common Tier 1 (CET1) to risk weighted assets						
Consolidated	145,559	12.1%	76,380	6.375%	n/a	n/a
Bank	142,652	11.9%	76,305	6.375%	77,801	6.5 %
Tier 1 Capital to average assets						
Consolidated	145,559	8.9 %	65,662	4.0 %	n/a	n/a
Bank	142,652	8.7 %	65,703	4.0 %	82,128	5.0 %
December 31, 2017						
Total Capital to risk weighted assets						
Consolidated	$152,386	13.3%	$106,040	9.250%	n/a	n/a
Bank	148,997	13.0%	105,747	9.250%	$ 114,321	10.0 %
Tier 1 Capital to risk weighted assets						
Consolidated	138,774	12.1%	83,112	7.250%	n/a	n/a
Bank	135,385	11.8%	82,883	7.250%	91,457	8.0 %
Common Tier 1 (CET1) to risk weighted assets						
Consolidated	138,774	12.1%	65,917	5.750%	n/a	n/a
Bank	135,385	11.8%	65,734	5.750%	74,308	6.5 %
Tier 1 Capital to average assets						
Consolidated	138,774	8.9 %	62,042	4.0 %	n/a	n/a
Bank	135,385	8.7 %	62,066	4.0 %	77,582	5.0 %

In September 2015, the Board of Directors of the Company authorized a share repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act of 1934, as amended. When and if appropriate, repurchases may be made in open market or privately negotiated transactions, depending on market conditions, regulatory requirements and other corporate considerations, as determined by management. Share repurchases may not occur and may be discontinued at any time. At June 30, 2018, 82,725 shares had been repurchased under the program at a total cost of $1,438,000, or $17.38 per share.

On July 18, 2018, the Board declared a cash dividend of $0.13 per common share, which was paid on August 3, 2018 to shareholders of record at July 28, 2018.

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NOTE 8. EARNINGS PER SHARE

The following table presents earnings per share for the three and six months ended June 30, 2018 and 2017.

	Three Months Ended June 30,		Six Months Ended June 30,	
(In thousands, except per share data)	2018	2017	2018	2017
Net income	$4,012	$3,308	$7,637	$5,310
Weighted average shares outstanding - basic	8,094	8,069	8,088	8,064
Dilutive effect of share-based compensation	189	139	187	139
Weighted average shares outstanding - diluted	8,283	8,208	8,275	8,203
Per share information:				
Basic earnings per share	$0.50	$0.41	$0.94	$0.66
Diluted earnings per share	0.48	0.40	0.92	0.65

Average outstanding stock options of 22,000 and 46,000 for the three months ended June 30, 2018 and 2017, and of 24,000 and 48,000 for the six months ended June 30, 2018 and 2017, were not included in the computation of earnings per share because the effect was antidilutive, due to the exercise price exceeding the average market price. The dilutive effect of share-based compensation in each period above relates principally to restricted stock awards.

NOTE 9. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the consolidated balance sheets. The contract amounts of those instruments reflect the extent of involvement the Company has in particular classes of financial instruments.

The Company’s exposure to credit loss in the event of nonperformance by the other party to the financial instrument for commitments to extend credit and standby letters of credit and financial guarantees written is represented by the contractual amount of those instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The following table presents these contract, or notional, amounts.

	Contract or Notional Amount	
(Dollars in thousands)	June 30, 2018	December 31, 2017
Commitments to fund:		
Home equity lines of credit	$ 153,985	$ 139,281
1-4 family residential construction loans	16,931	11,420
Commercial real estate, construction and land development loans	51,848	44,592
Commercial, industrial and other loans	139,299	145,394
Standby letters of credit	14,231	12,273

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Company evaluates each customer’s credit-worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company upon extension of credit, is based on management’s credit evaluation of the customer. Collateral varies but may include accounts receivable, inventory, equipment, residential real estate, and income-producing commercial properties.

Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that

involved in extending loans to customers. The Company holds collateral supporting those commitments when deemed necessary by management. The liability, at June 30, 2018 and December 31, 2017, for guarantees under standby letters of credit issued was not material.

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The Company currently maintains a reserve, based on historical loss experience of the related loan class, for off-balance sheet credit exposures that currently are not funded, in other liabilities. This reserve totaled $965,000 and $816,000 at June 30, 2018 and December 31, 2017. The following table presents the net amount expensed for the off-balance sheet credit exposures reserve for the three and six months ended June 30, 2018 and 2017.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
Off-balance sheet credit exposures expense	$133	$140	$149	$ 45

The Company sells loans to the FHLB of Chicago as part of its MPF Program. Under the terms of the MPF Program, there is limited recourse back to the Company for loans that do not perform in accordance with the terms of the loan agreement. Each loan that is sold under the program is “credit enhanced” such that the individual loan’s rating is raised to a minimum “BBB,” as determined by the FHLB of Chicago. Outstanding loans sold under the MPF Program totaled $30,342,000 and $31,977,000 at June 30, 2018 and December 31, 2017, with limited recourse back to the Company on these loans of $1,135,000 at each period end. Many of the loans sold under the MPF Program have primary mortgage insurance, which reduces the Company’s overall exposure. The net amount expensed or recovered for the Company's estimate of losses under its recourse exposure for loans foreclosed, or in the process of foreclosure, is recorded in other expenses. The following table presents the net amounts recovered for the three and six months ended June 30, 2018 and 2017.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands)	2018	2017	2018	2017
MPF program recourse loss recoveries	$(76)	$(35)	$(155)	$(26)

NOTE 10. FAIR VALUE

Fair value is the exchange price that would be received for an asset or paid to transfer a liability (exit price) in the principal or most advantageous market for the asset or liability in an orderly transaction between market participants on the measurement date. Certain financial instruments and all non-financial instruments are excluded from disclosure requirements. Accordingly, the aggregate fair value amounts presented do not represent the underlying value of the Company.

The fair value hierarchy distinguishes between (1) market participant assumptions developed based on market data obtained from independent sources (observable inputs) and (2) an entity's own assumptions about market participant assumptions based on the best information available in the circumstances (unobservable inputs). The fair value hierarchy consists of three broad levels, which gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1) and the lowest priority to unobservable inputs (Level 3). The three levels of the fair value hierarchy are:

Level 1 – quoted prices (unadjusted) for identical assets or liabilities in active markets that the entity has the ability to access at the measurement date.

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

Level 3 – at least one significant unobservable input that reflects a company's own assumptions about the assumptions that market participants would use in pricing an asset or liability.

In instances in which multiple levels of inputs are used to measure fair value, hierarchy classification is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

The Company used the following methods and significant assumptions to estimate fair value for instruments measured on a recurring basis:

Securities

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, securities are classified within Level 2 and fair values are estimated by using pricing models, quoted

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prices of securities with similar characteristics or discounted cash flow. Level 2 securities include U.S. agency securities, mortgage-backed securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. All of the Company's securities are classified as available for sale.

The Company had no fair value liabilities measured on a recurring basis at June 30, 2018 and December 31, 2017.

The following table summarizes assets measured at fair value on a recurring basis at June 30, 2018 and December 31, 2017.

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
June 30, 2018				
AFS Securities:				
States and political subdivisions	$ 0	$169,918	$ 0	$ 169,918
GSE residential CMOs	0	113,872	0	113,872
Private label residential CMOs	0	615	0	615
Private label commercial CMOs	0	18,404	0	18,404
Asset-backed and other	0	146,610	0	146,610
Totals	$ 0	$449,419	$ 0	$ 449,419
December 31, 2017				
AFS Securities:				
States and political subdivisions	$ 0	$159,458	$ 0	$ 159,458
GSE residential MBSs	0	49,530	0	49,530
GSE residential CMOs	0	111,119	0	111,119
Private label residential CMOs	0	1,003	0	1,003
Private label commercial CMOs	0	7,653	0	7,653
Asset-backed and other	0	86,545	0	86,545
Totals	$ 0	$415,308	$ 0	$ 415,308

Certain financial assets are measured at fair value on a nonrecurring basis. Adjustments to the fair value of these assets usually result from the application of lower-of-cost-or-market accounting or write-downs of individual assets. The Company used the following methods and significant assumptions to estimate fair value for these financial assets.

Impaired Loans

Loans are designated as impaired when, in the judgment of management and based on current information and events, it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected. The measurement of loss associated with impaired loans for all loan classes can be based on either the observable market price of the loan, the fair value of the collateral, or discounted cash flows based on a market rate of interest for performing TDRs. For collateral-dependent loans, fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, or if management adjusts the appraisal value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with an allocation to the ALL are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of income. Specific allocations to the ALL or partial charge-offs totaled $1,514,000 and $2,266,000 at June 30, 2018 and

December 31, 2017.

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The following table presents changes in the fair value for impaired loans still held at June 30, considered in the determination of the provision for loan losses, for the three and six months ended June 30, 2018 and 2017.

(Dollars in thousands)	Three months ended June 30, 2018	2017	Six months ended June 30, 2018	2017
Changes in fair value of impaired loans still held	$79	$ 4	$84	$ 2

Foreclosed Real Estate

OREO property acquired through foreclosure is initially recorded at the fair value of the property at the transfer date less estimated selling cost. Subsequently, OREO is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. Specific charges to value OREO at the lower of cost or fair value on properties held at June 30, 2018 and December 31, 2017 totaled $13,000 and $0. The following table summarizes changes in the fair value of OREO for properties still held at June 30, charged to real estate expenses, for the three and six months ended June 30, 2018 and 2017.

(Dollars in thousands)	Three months ended June 30, 2018	2017	Six months ended June 30, 2018	2017
Changes in fair value of OREO still held	$13	$ 0	$13	$ 0

The following table summarizes assets measured at fair value on a nonrecurring basis at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
June 30, 2018				
Impaired Loans				
Commercial real estate:				
Owner occupied	$ 0	$ 0	$334	$ 334
Multi-family	0	0	148	148
Non-owner occupied residential	0	0	311	311
Commercial and industrial	0	0	44	44
Residential mortgage:				
First lien	0	0	1,720	1,720
Home equity - lines of credit	0	0	294	294
Installment and other loans	0	0	1	1
Total impaired loans	$ 0	$ 0	$2,852	$ 2,852
December 31, 2017				
Impaired Loans				
Commercial real estate:				
Owner occupied	$ 0	$ 0	$430	$ 430
Non-owner occupied	0	0	4,066	4,066
Multi-family	0	0	165	165
Non-owner occupied residential	0	0	344	344
Commercial and industrial	0	0	53	53
Residential mortgage:				
First lien	0	0	1,951	1,951

Home equity - lines of credit	0	0	161	161
Installment and other loans	0	0	3	3
Total impaired loans	$ 0	$ 0	$7,173	$ 7,173

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The following table presents additional qualitative information about assets measured on a nonrecurring basis and for which the Company has utilized Level 3 inputs to determine fair value.

(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range
June 30, 2018				
Impaired loans	$ 2,852	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	10% - 75% discount
			- Management adjustments for liquidation expenses	6% - 20% discount
December 31, 2017				
Impaired loans	$ 7,173	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity	7% - 75% discount
			- Management adjustments for liquidation expenses	0% - 20% discount

Fair values of financial instruments

The following table presents carrying amounts and estimated fair values of the Company's financial instruments at June 30, 2018 and December 31, 2017:

(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
June 30, 2018					
Financial Assets					
Cash and due from banks	$ 18,122	$ 18,122	$ 18,122	$ 0	$ 0
Interest-bearing deposits with banks	4,460	4,460	4,460	0	0
Restricted investments in bank stocks	12,697	n/a	n/a	n/a	n/a
Securities available for sale	449,419	449,419	0	449,419	0
Loans held for sale	5,495	5,538	0	5,538	0
Loans, net of allowance for loan losses	1,050,446	1,042,855	0	0	1,042,855
Accrued interest receivable	5,568	5,568	0	2,906	2,662
Financial Liabilities					
Deposits	1,325,866	1,324,138	0	1,324,138	0
Short-term borrowings	63,838	63,838	0	63,838	0
Long-term debt	83,635	82,928	0	82,928	0
Accrued interest payable	495	495	0	495	0
Off-balance sheet instruments	0	0	0	0	0
December 31, 2017					
Financial Assets					
Cash and due from banks	$ 21,734	$ 21,734	$ 21,734	$ 0	$ 0
Interest-bearing deposits with banks	8,073	8,073	8,073	0	0
Restricted investments in bank stocks	9,997	n/a	n/a	n/a	n/a
Securities available for sale	415,308	415,308	0	415,308	0
Loans held for sale	6,089	6,272	0	6,272	0
Loans, net of allowance for loan losses	997,216	994,617	0	0	994,617
Accrued interest receivable	5,048	5,048	0	2,580	2,468
Financial Liabilities					
Deposits	1,219,515	1,213,288	0	1,213,288	0
Short-term borrowings	93,576	93,576	0	93,576	0
Long-term debt	83,815	83,949	0	83,949	0
Accrued interest payable	495	495	0	495	0

Off-balance sheet instruments	0	0	0	0	0

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The methods utilized to estimate the fair value of financial instruments at December 31, 2017 did not necessarily represent an exit price. In accordance with our adoption of ASU 2016-01 in 2018, the methods utilized to measure the fair value of financial instruments at June 30, 2018 represent an approximation of exit price; however, an actual exit price may differ.

NOTE 11. REVENUE FROM CONTRACTS WITH CUSTOMERS

All of the Company's revenue from contracts with customers within the scope of ASC 606 is recognized within noninterest income on the consolidated statements of income. Consistent with ASC 606, noninterest income covered by this guidance is recognized as services are transferred to our customers in an amount that reflects the consideration we expect to be entitled to in exchange for those services.

Service Charges on Deposit Accounts - The Company earns fees from its deposit customers for transaction-based, account maintenance, and overdraft services. Transaction-based fees, which include services such as ATM use fees, stop payment charges, statement rendering, and ACH fees, are recognized at the time the transaction is executed as that is the point in time the Company fulfills the customer's request. Account maintenance fees, which relate primarily to monthly maintenance, are earned over the course of a month, representing the period over which the Company satisfies the performance obligation. Overdraft fees are recognized at the point in time that the overdraft occurs. Service charges on deposits are withdrawn from the customer's account balance.

Interchange Income - The Company earns interchange fees from debit/credit cardholder transactions conducted through the MasterCard payment network. Interchange fees from cardholder transactions represent a percentage of the underlying transaction value and are recognized daily, concurrently with the transaction processing services provided to the cardholder. Interchange income is presented net of cardholder rewards.

Wealth Management and Investment Advisory Income (Gross) - The Company earns wealth management and investment brokerage fees from its contracts with trust and wealth management customers to manage assets for investment, and/or to transact on their accounts. These fees are primarily earned over time as the Company provides the contracted services and are generally assessed based on a tiered scale of the market value of assets under management. Fees that are transaction based, including trade execution services, are recognized at the point in time that the transaction is executed, i.e., the trade date. Other related services provided included financial planning services and the fees the Company earns, which are based on a fixed fee schedule, are recognized when the services are rendered. Services are generally billed in arrears and a receivable is recorded until fees are paid.

Investment Brokerage Income (Net) - The Company earns fees from investment management and brokerage services provided to its customers through a third-party service provider. The Company receives commissions from the third-party service provider and recognizes income on a weekly basis based upon customer activity. Because the Company acts as an agent in arranging the relationship between the customer and the third-party service provider and does not control the services rendered to the customers, investment brokerage income is presented net of related costs.

Gains/Losses on Sales of OREO - The Company records a gain or loss on the sale of OREO when control of the property transfers to the buyer, which generally occurs at the time of an executed deed. If the Company finances the sale of OREO to the buyer, the Company assesses whether the buyer is committed to perform their obligations under the contract and whether collectability of the transaction price is probable. Once these criteria are met, the OREO asset is derecognized and the gain or loss on sale is recorded upon the transfer of control of the property to the buyer. In determining the gain or loss on the sale, the Company adjusts the transaction price and related gain (loss) on sale if a significant financing component is present.

At June 30, 2018 and December 31, 2017, the Company had receivables from customers totaling $654,000 and $682,000.

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The following table presents our noninterest income disaggregated by revenue source for the three and six months ended June 30, 2018 and 2017.

(Dollars in thousands, except per share data)	Three Months Ended		Six Months Ended	
	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Noninterest income				
Service charges on deposits	$835	$851	$1,673	$1,655
Trust and investment management income	1,701	1,623	3,369	3,069
Brokerage income	501	518	1,059	985
Merchant and bankcard fees (interchange income)	711	667	1,366	1,303
Revenue from contracts with customers	3,748	3,659	7,467	7,012
Other service charges	606	194	780	321
Mortgage banking activities	679	813	1,314	1,316
Earnings on life insurance	291	271	568	539
Other income	135	32	216	113
Investment securities gains	46	654	862	657
Total noninterest income	$5,505	$5,623	$11,207	$9,958

NOTE 12. CONTINGENCIES

The nature of the Company's business generates a certain amount of litigation involving matters arising out of the ordinary course of business. Except as described below, in the opinion of management, there are no legal proceedings that might have a material effect on the results of operations, liquidity, or the financial position of the Company at this time.

On May 25, 2012, SEPTA filed a putative class action complaint in the U.S. District Court for the Middle District of Pennsylvania against the Company, the Bank and certain current and former directors and executive officers (collectively, the "Defendants"). The complaint alleges, among other things, that (i) in connection with the Company's Registration Statement on Form S-3 dated February 23, 2010 and its Prospectus Supplement dated March 23, 2010, and (ii) during the purported class period of March 24, 2010 through October 27, 2011, the Company issued materially false and misleading statements regarding the Company's lending practices and financial results, including misleading statements concerning the stringent nature of the Bank's credit practices and underwriting standards, the quality of its loan portfolio, and the intended use of the proceeds from the Company's March 2010 public offering of common stock. The complaint asserts claims under Sections 11, 12(a) and 15 of the Securities Act of 1933, Sections 10(b) and 20(a) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks class certification, unspecified money damages, interest, costs, fees and equitable or injunctive relief. Under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), motions for appointment of Lead Plaintiff in this case were due by July 24, 2012. SEPTA was the sole movant and the Court appointed SEPTA Lead Plaintiff on August 20, 2012. Pursuant to the PSLRA and the Court's September 27, 2012 Order, SEPTA was given until October 26, 2012 to file an amended complaint and the Defendants until December 7, 2012 to file a motion to dismiss the amended complaint. SEPTA's opposition to the Defendant's motion to dismiss was originally due January 11, 2013. Under the PSLRA, discovery and all other proceedings in the case were stayed pending the Court's ruling on the motion to dismiss. The September 27, 2012 Order specified that if the motion to dismiss were denied, the Court would schedule a conference to address discovery and the filing of a motion for class certification. On October 26, 2012, SEPTA filed an unopposed motion for enlargement of time to file its amended complaint in order to permit the parties and new defendants to be named in the amended complaint time to discuss plaintiff's claims and defendants' defenses. On October 26, 2012, the Court granted SEPTA's motion, mooting its September 27, 2012 scheduling Order, and requiring SEPTA to file its amended complaint on or before January 16, 2013 or otherwise advise the Court of circumstances that require a further enlargement of time. On January 14, 2013, the Court granted SEPTA's second

unopposed motion for enlargement of time to file an amended complaint on or before March 22, 2013.
On March 4, 2013, SEPTA filed an amended complaint. The amended complaint expands the list of defendants in the action to include the Company's independent registered public accounting firm and the underwriters of the Company's March 2010 public offering of common stock. In addition, among other things, the amended complaint extends the purported 1934 Exchange Act class period from March 15, 2010 through April 5, 2012. Pursuant to the Court's March 28, 2013 Second Scheduling Order, on May 28, 2013 all defendants filed their motions to dismiss the amended complaint, and on July 22, 2013 SEPTA filed its "omnibus" opposition to all of the defendants' motions to dismiss. On August 23, 2013, all defendants filed

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reply briefs in further support of their motions to dismiss. On December 5, 2013, the Court ordered oral argument on the Orrstown Defendants' motion to dismiss the amended complaint to be heard on February 7, 2014. Oral argument on the pending motions to dismiss SEPTA's amended complaint was held on April 29, 2014.

The Second Scheduling Order stayed all discovery in the case pending the outcome of the motions to dismiss, and informed the parties that, if required, a telephonic conference to address discovery and the filing of SEPTA's motion for class certification would be scheduled after the Court's ruling on the motions to dismiss.

On April 10, 2015, pursuant to Court order, all parties filed supplemental briefs addressing the impact of the U.S. Supreme Court's March 24, 2015 decision in Omnicare, Inc. v. Laborers District Council Construction Industry Pension Fund on defendants' motions to dismiss the amended complaint.

On June 22, 2015, in a 96-page Memorandum, the Court dismissed without prejudice SEPTA's amended complaint against all defendants, finding that SEPTA failed to state a claim under either the Securities Act of 1933, as amended, or the Securities Exchange Act of 1934, as amended. The Court ordered that, within 30 days, SEPTA either seek leave to amend its amended complaint, accompanied by the proposed amendment, or file a notice of its intention to stand on the amended complaint.

On July 22, 2015, SEPTA filed a motion for leave to amend under Local Rule 15.1, and attached a copy of its proposed second amended complaint to its motion. Many of the allegations of the proposed second amended complaint are essentially the same or similar to the allegations of the dismissed amended complaint. The proposed second amended complaint also alleges that the Orrstown Defendants did not publicly disclose certain alleged failures of internal controls over loan underwriting, risk management, and financial reporting during the period 2009 to 2012, in violation of the federal securities laws. On February 8, 2016, the Court granted SEPTA's motion for leave to amend and SEPTA filed its second amended complaint that same day.

On February 25, 2016, the Court issued a scheduling Order directing: all defendants to file any motions to dismiss by March 18, 2016; SEPTA to file an omnibus opposition to defendants' motions to dismiss by April 8, 2016; and all defendants to file reply briefs in support of their motions to dismiss by April 22, 2016. Defendants timely filed their motions to dismiss the second amended complaint and the parties filed their briefs in accordance with the Court-ordered schedule, above. The February 25, 2016 Order stays all discovery and other deadlines in the case (including the filing of SEPTA's motion for class certification) pending the outcome of the motions to dismiss.

The allegations of SEPTA's proposed second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the SEC. As disclosed in the Company's Form 8-K filed on September 27, 2016, on that date the Company entered into a settlement agreement with the SEC resolving the investigation of accounting and related matters at the Company for the periods ended June 30, 2010, to December 31, 2011. As part of the settlement of the SEC's administrative proceedings and pursuant to the cease-and-desist order, without admitting or denying the SEC's findings, the Company, its Chief Executive Officer, its former Chief Financial Officer, its former Executive Vice President and Chief Credit Officer, and its Chief Accounting Officer, agreed to pay civil money penalties to the SEC. The Company agreed to pay a civil money penalty of $1,000,000. The Company had previously established a reserve for that amount which was expensed in the second fiscal quarter of 2016. In the settlement agreement with the SEC, the Company also agreed to cease and desist from committing or causing any violations and any future violations of Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder.

On September 27, 2016, the Orrstown Defendants filed with the Court a Notice of Subsequent Event in Further Support of their Motion to Dismiss the Second Amended Complaint, regarding the settlement with the SEC. The Notice attached a copy of the SEC's cease-and-desist order and briefly described what the Company believed were the most salient terms of the neither-admit-nor-deny settlement. On September 29, 2016, SEPTA filed a Response to the Notice, in which SEPTA argued that the settlement with the SEC did not support dismissal of the second amended complaint.

On December 7, 2016, the Court issued an Order and Memorandum granting in part and denying in part defendants' motions to dismiss SEPTA's second amended complaint. The Court granted the motions to dismiss the Securities Act claims against all defendants, and granted the motions to dismiss the Exchange Act Section 10(b) and Rule 10b-5 claims against all defendants except Orrstown Financial Services, Inc., Orrstown Bank, Thomas R. Quinn, Jr., Bradley

S. Everly, and Jeffrey W. Embly. The Court also denied the motions to dismiss the Exchange Act Section 20(a) claims against Quinn, Everly, and Embly.

On January 31, 2017, the Court entered a Case Management Order establishing the schedule for the litigation and, on August 15, 2017, it entered a revised Order that, among other things, set the following deadlines: all fact discovery closes on March 1, 2018, and SEPTA's motion for class certification is due the same day; expert merits discovery closes May 30, 2018;

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summary judgment motions are due by June 26, 2018; the mandatory pretrial and settlement conference is set for December 11, 2018; and trial is scheduled to begin on January 7, 2019.

Document discovery has begun in the case and is ongoing. To date, one deposition, of a non-party, has been concluded.

On December 15, 2017, the Orrstown Defendants and SEPTA exchanged expert reports in opposition to and in support of class certification, respectively. On January 15, 2018, the parties exchanged expert rebuttal reports. SEPTA's motion for class certification was due March 1, 2018, with the Orrstown Defendants' opposition due April 2, 2018, and SEPTA's reply due April 23, 2018.

On February 9, 2018, SEPTA filed a Status Report and Request for a Telephonic Status Conference asking the Court to convene a conference to discuss the status of discovery in the case and possible revisions to the case schedule. On February 12, 2018, the Orrstown Defendants filed their status report to provide the Court with a summary of document discovery in the case to date. On February 27, 2018, SEPTA filed an unopposed motion for a continuance of the existing case deadlines pending a status conference with the Court or the issuance of a revised case schedule. On February 28, 2018, the Court issued an Order continuing all case management deadlines until further order of the Court.

On March 27, 2018, the Court held a telephonic status conference with the parties to discuss outstanding discovery issues and case deadlines. On May 2, 2018, the parties filed a joint status report. On May 10, 2018 the Court held a follow-up telephonic status conference at which the parties reported on the progress of discovery to date. Document discovery in the case continues and no further depositions have been scheduled.

The Company believes that the allegations of SEPTA's second amended complaint are without merit and intends to vigorously defend itself against those claims. It is not possible at this time to estimate reasonably possible losses, or even a range of reasonably possible losses, in connection with the litigation.

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See the Glossary of Defined Terms at the beginning of this Report for terms used throughout this Form 10-Q.

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

Overview

The Company, headquartered in Shippensburg, Pennsylvania, is a one-bank holding company that has elected status as a financial holding company. The consolidated financial information presented herein reflects the Company and its wholly-owned subsidiaries, the Bank and Wheatland. At June 30, 2018, the Company had total assets of $1,644,118,000, total liabilities of $1,498,981,000 and total shareholders' equity of $145,137,000.

Caution About Forward-Looking Statements

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, we may make other written and oral communications, from time to time, that contain such statements. Such forward-looking statements refer to a future period or periods, reflecting our current beliefs as to likely future developments, and use words like "may," "will," "expect," "estimate," "anticipate" or similar terms. Forward-looking statements are statements that include projections, predictions, expectations, or beliefs about events or results or otherwise are not statements of historical facts, including, but not limited to, statements related to new business development, new loan opportunities, growth in the balance sheet and fee based revenue lines of business, merger and acquisition activity, reducing risk assets, and mitigating losses in the future. Actual results and trends could differ materially from those set forth in such statements and there can be no assurances that we will achieve the desired level of new business development and new loans, growth in the balance sheet and fee based revenue lines of business, successful merger and acquisition activity, continue to reduce risk assets or mitigate losses in the future. Factors that could cause actual results to differ from those expressed or implied by the forward-looking statements include, but are not limited to, the following: ineffectiveness of the Company's business strategy due to changes in current or future market conditions; the effects of competition, including industry consolidation and development of competing financial products and services; the integration of the Company's strategic acquisitions; the inability to fully achieve expected savings, efficiencies or synergies from mergers and acquisitions, or taking longer than estimated for such savings, efficiencies and synergies to be realized; changes in laws and regulations; interest rate movements; changes in credit quality; inability to raise capital, if necessary, under favorable conditions; volatilities in the securities markets; deteriorating economic conditions; expenses associated with pending litigation and legal proceedings; and other risks and uncertainties, including those detailed in our Annual Report on Form 10-K for the year ended December 31, 2017, and our Quarterly Reports on Form 10-Q under the sections titled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in other filings made with the SEC. The statements are valid only as of the date hereof and we disclaim any obligation to update this information.

The following is a discussion of our consolidated financial condition at June 30, 2018 and results of operations for the three and six months ended June 30, 2018 and 2017. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated. The discussion and analysis should be read in conjunction with our consolidated financial statements and accompanying notes presented elsewhere in this report. Certain prior period amounts, presented in this discussion and analysis, have been reclassified to conform to current period classifications.

Critical Accounting Policies

The Company's accounting and reporting policies are in accordance with GAAP and follow accounting and reporting guidelines prescribed by bank regulatory authorities and general practices within the financial services industry in which it operates. Our financial position and results of operations are affected by management's application of accounting policies, including estimates, and assumptions and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the balance sheet date and through the date the financial statements are filed with the SEC. Different assumptions in the application of these policies could result in material changes in the consolidated financial position and/or consolidated results of operations and related disclosures. The more critical accounting and reporting policies include accounting for the ALL and income taxes. Accordingly, the critical accounting policies are discussed

in detail in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2017. Significant accounting policies and changes in accounting principles and effects of new accounting pronouncements are discussed in detail in Note 1, Summary of Significant Accounting Policies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements and Supplementary Data," in our Annual Report on Form 10-K for the year ended December 31, 2017. Additional disclosures regarding the effects of new accounting pronouncements are included in Note 1, Summary of Significant

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Accounting Policies, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information." There have been no other changes to the significant accounting policies during 2018.

RESULTS OF OPERATIONS

Quarter ended June 30, 2018 compared with quarter ended June 30, 2017

Summary

The Company recorded net income of $4,012,000 for the three months ended June 30, 2018 compared with net income of $3,308,000 for the same period in 2017. Diluted EPS for the three months ended June 30, 2018 totaled $0.48, compared with $0.40 for the three months ended June 30, 2017. Net interest income positively influenced results of operations, and totaled $12,353,000 for the three months ended June 30, 2018, a 15.3% increase compared with 2017. Noninterest income, excluding investment securities gains, increased moderately between the periods, with increases in service charges, commissions and fee income and trust and investment management income partially offset by a decrease in mortgage banking activities. Investment securities gains totaled $46,000 in the three months ended June 30, 2018, compared with $654,000 for the same period in 2017. Noninterest expenses totaled $13,272,000 and $12,417,000 for the three months ended June 30, 2018 and 2017. Noninterest expenses in 2018 included increased expenses associated with the Company's ongoing growth strategy in comparison with 2017.

Net Interest Income

Net interest income increased $1,635,000, from $10,718,000 for the three months ended June 30, 2017 to $12,353,000 for the three months ended June 30, 2018. Interest income on loans increased $1,880,000 from $9,851,000 to $11,731,000 and securities interest income increased $976,000 from $2,571,000 to $3,547,000 in comparing the three months ended June 30, 2017 with the same period in 2018.

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The following table presents net interest income, net interest spread and net interest margin for the three months ended June 30, 2018 and 2017 on a taxable-equivalent basis:

	Three Months Ended June 30, 2018			Three Months Ended June 30, 2017		
(Dollars in thousands)	Average Balance	Taxable-Equivalent Interest	Taxable-Equivalent Rate	Average Balance	Taxable-Equivalent Interest	Taxable-Equivalent Rate
Assets						
Federal funds sold & interest-bearing bank balances	$9,189	$46	2.01 %	$12,380	$46	1.49 %
Securities	470,993	3,815	3.25	416,823	2,986	2.87
Loans	1,055,562	11,825	4.49	928,739	10,065	4.35
Total interest-earning assets	1,535,744	15,686	4.10	1,357,942	13,097	3.87
Other assets	108,087			109,793		
Total	$1,643,831			$1,467,735		
Liabilities and Shareholders' Equity						
Interest-bearing demand deposits	$741,161	1,006	0.54	$641,111	474	0.30
Savings deposits	99,407	39	0.16	96,261	38	0.16
Time deposits	300,576	1,116	1.49	303,473	972	1.28
Short-term borrowings	87,463	402	1.84	99,983	189	0.76
Long-term debt	83,686	408	1.96	10,634	77	2.90
Total interest-bearing liabilities	1,312,293	2,971	0.91	1,151,462	1,750	0.61
Noninterest-bearing demand deposits	172,813			161,236		
Other	16,408			15,205		
Total Liabilities	1,501,514			1,327,903		
Shareholders' Equity	142,317			139,832		
Total	$1,643,831			$1,467,735		
Taxable-equivalent net interest income /net interest spread		12,715	3.19 %		11,347	3.26 %
Taxable-equivalent net interest margin			3.32 %			3.35 %
Taxable-equivalent adjustment		(362)			(629)	
Net interest income		$12,353			$10,718	

Notes: (1) Yields and interest income on tax-exempt assets have been computed on a taxable-equivalent basis assuming a 21% tax rate in 2018 and a 34% tax rate in 2017.

(2) For yield calculation purposes, nonaccruing loans are included in the average loan balance.

For the three months ended June 30, 2018, taxable-equivalent basis net interest income increased $1,368,000 from the corresponding period in 2017. The increase reflected increased average loan and securities balances at increased market interest rates, partially offset by a higher average balance of interest-bearing liabilities at higher interest rates. While yields on interest-earning assets and costs of interest-bearing liabilities both increased year-over-year, the taxable-equivalent adjustment in 2018 was reduced by the change in our statutory tax rate effective January 1, 2018. The lower tax rate in effect for 2018 was the principal factor in the overall decrease in net interest margin on a taxable-equivalent basis between periods.

Taxable-equivalent interest income earned on loans increased $1,760,000 year-over-year. The $126,823,000 increase in average loan balance year-over-year reflects the Company's loan growth in legacy and newer markets through its expanded sales force. The 14 basis point increase in the yield on loans year-over-year reflects four prime lending rate increases of 25 basis points between June 30, 2017 and June 30, 2018, offset by the impact of the change in the statutory rate used in the taxable-equivalent adjustment.

Taxable-equivalent securities interest income increased $829,000 year-over-year, with the average balance of securities increasing $54,170,000 from June 30, 2017 to June 30, 2018. The increase in taxable-equivalent interest

income on securities reflected the increased interest rate environment and certain repositioning within the portfolio under the Company's asset/liability management strategies. Similar to the yield on loans, the 38 basis point increase in the yield on securities year-over-year was offset by the change in the statutory rate used in the taxable-equivalent adjustment.

Interest expense on deposits and borrowings increased $1,221,000 year-over-year. The Company continues to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings as it increases its

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commercial relationships. The increase in interest expense principally reflects the noted increased interest rate environment on the increased deposit and borrowings base. The tax rate change did not impact interest expense.

Provision for Loan Losses

The Company recorded a $200,000 provision for loan losses for the three months ended June 30, 2018 compared with a $100,000 provision recorded for the same period in 2017. The Company has experienced loan portfolio growth, as well as the benefit of favorable historical charge-off statistics and generally stable economic and market conditions for the last several years. These key factors were included in the quantitative and qualitative considerations used by management in the determination of the provision expense required to maintain an adequate allowance for loan losses at June 30, 2018.

Additional information is included in the "Credit Risk Management" section herein.

Noninterest Income

The following table compares noninterest income for the three months ended June 30, 2018 and 2017.

(Dollars in thousands)	Three Months Ended June 30,		$ Change	% Change
	2018	2017	2018-2017	2018-2017
Service charges on deposit accounts	$1,463	$1,429	$ 34	2.4 %
Other service charges, commissions and fees	689	283	406	143.5 %
Trust and investment management income	1,701	1,623	78	4.8 %
Brokerage income	501	518	(17)	(3.3)%
Mortgage banking activities	679	813	(134)	(16.5)%
Earnings on life insurance	291	271	20	7.4 %
Other income	135	32	103	321.9 %
Subtotal before securities gains	5,459	4,969	490	9.9 %
Investment securities gains	46	654	(608)	(93.0)%
Total noninterest income	$5,505	$5,623	$ (118)	(2.1)%

The following factors contributed to the more significant changes in noninterest income between the three months ended June 30, 2018 and 2017.

- Other service charges, commissions and fees in 2018 reflects an increase in loan transaction fees from 2017.
- Mortgage banking income decreased in response to decreased refinancing activity as mortgage rates have been rising, as well as a shortage in available housing inventory.
- Other income in 2018 includes an increase of $103,000 in gain on sales of OREO properties.
- Other line items within noninterest income showed fluctuations between 2018 and 2017 attributable to normal business operations.

The Company recognized investment securities gains in 2018 and 2017 as opportunities became available to reposition part of the investment portfolio under asset/liability management strategies or to improve responsiveness of the portfolio to interest rate conditions, while also considering funding requirements of anticipated lending activity.

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Noninterest Expenses

The following table compares noninterest expenses for the three months ended June 30, 2018 and 2017.

	Three Months Ended June 30,		$ Change	% Change
(Dollars in thousands)	2018	2017	2018-2017	2018-2017
Salaries and employee benefits	$7,855	$7,422	$ 433	5.8 %
Occupancy expense	679	705	(26)	(3.7)%
Furniture and equipment	1,068	826	242	29.3 %
Data processing	595	664	(69)	(10.4)%
Telephone and communication	165	193	(28)	(14.5)%
Automated teller machine and interchange fees	190	194	(4)	(2.1)%
Advertising and bank promotions	237	391	(154)	(39.4)%
FDIC insurance	172	178	(6)	(3.4)%
Legal fees	83	108	(25)	(23.1)%
Other professional services	476	377	99	26.3 %
Directors compensation	205	249	(44)	(17.7)%
Collection and problem loan	21	3	18	nm*
Real estate owned	53	(12)	65	nm*
Taxes other than income	251	220	31	14.1 %
Merger related	154	0	154	0.0 %
Other operating expenses	1,068	899	169	18.8 %
Total noninterest expenses	$13,272	$12,417	$ 855	6.9 %

nm*: not meaningful

The following factors contributed to the more significant changes in noninterest expenses between the three months ended June 30, 2018 and 2017.

- Expanded operations with the addition of branch banking locations opened in Lancaster County, Pennsylvania, in the second and third quarters of 2017; the addition of lenders in York County, Pennsylvania, in the third quarter of 2017; and additional support personnel all contributed to increases in salaries and employee benefits and furniture and equipment costs in 2018. New branch location openings in Lancaster County in the second half of 2018 as part of the Company's continuing expansion are expected to increase costs in each of these expense categories, as well as in advertising and bank promotions expense.
- The salaries and employee benefits increase in 2018 over 2017 also includes the impact of annual merit increases awarded in 2017, incentive compensation increases and additional share-based awards granted in 2018. Costs associated with the Company's self-insured group health plan decreased year-over-year due to improving claims experience.
- Advertising and bank promotions expense decreased from 2017 to 2018, reflecting the increased activity in 2017 in connection with branch openings.
- The Company incurred merger related expenses, principally legal and professional fees, in 2018 in connection with the Company's pending acquisition of Mercersburg Financial Corporation ("Mercersburg"). The merger is expected to be completed in the fourth quarter of 2018, subject to receipt of regulatory approvals, the approval of Mercersburg’s shareholders, and the satisfaction of other customary closing conditions.
- Other line items within noninterest expenses showed fluctuations between 2018 and 2017 attributable to normal business operations.

The Company’s efficiency ratio improved to 72.1% for the three months ended June 30, 2018, compared with 76.0% for the same period in 2017. The lower, or more favorable, ratio between the two periods was primarily the result of the growth in net interest and noninterest income outpacing the increase in noninterest expenses. The efficiency ratio expresses noninterest expense as a percentage of taxable-equivalent net interest income and noninterest income, excluding securities gains, merger related expenses, intangible asset amortization, and other real estate income and

expenses.

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Income Tax Expense

Income tax expense totaled $374,000, an effective tax rate of 8.5%, for the three months ended June 30, 2018, compared with $516,000, an effective tax rate of 13.5%, for the three months ended June 30, 2017. The Company's effective tax rate is significantly less than the federal statutory rate, which is 21.0% in 2018 and was 34.0% in 2017, principally due to tax-free income, including interest earned on tax-free loans and securities and earnings on the cash surrender value of life insurance policies; federal income tax credits; and non-tax deductible expenses, including estimated merger expenses. The lower effective tax rate for the three months ended June 30, 2018, compared with the same period in 2017, results principally from the reduced statutory tax rate which became effective for the Company on January 1, 2018 as a result of federal tax reform enacted in 2017.

Six months ended June 30, 2018 compared with six months ended June 30, 2017

Summary

The Company recorded net income of $7,637,000 for the six months ended June 30, 2018 compared with net income of $5,310,000 for the same period in 2017. Diluted EPS for the six months ended June 30, 2018 totaled $0.92, compared with $0.65 for the six months ended June 30, 2017. Net interest income positively influenced results of operations, and totaled $24,037,000 for the six months ended June 30, 2018, a 14.7% increase compared with 2017. Noninterest income, excluding investment securities gains, increased moderately between the periods, with increases in other service charges, commissions and fees income and trust and investment management income. Investment securities gains totaled $862,000 in the six months ended June 30, 2018, compared with $657,000 for the same period in 2017. Noninterest expenses totaled $26,341,000 and $24,563,000 for the six months ended June 30, 2018 and 2017. The principal driver of the increase was salaries and employee benefits associated with the Company's ongoing growth strategy.

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Net Interest Income

Net interest income increased $3,082,000, from $20,955,000 to $24,037,000, for the six months ended June 30, 2018 compared with the same period in 2017. Interest and fees income on loans increased $3,732,000, from $19,055,000 to $22,787,000 and securities interest income increased $1,532,000, from $5,179,000 to $6,711,000, in comparing the six months ended June 30, 2018 with the same period in 2017.

The following table presents net interest income, net interest spread and net interest margin for the six months ended June 30, 2018 and 2017 on a taxable-equivalent basis.

	Six Months Ended June 30, 2018			Six Months Ended June 30, 2017		
(Dollars in thousands)	Average Balance	Taxable-Equivalent Interest	Taxable-Equivalent Rate	Average Balance	Taxable-Equivalent Interest	Taxable-Equivalent Rate
Assets						
Federal funds sold & interest-bearing bank balances	$11,717	$101	1.74 %	$8,981	$64	1.44 %
Securities	459,892	7,210	3.16	416,087	5,996	2.91
Loans	1,043,258	22,967	4.44	912,127	19,487	4.31
Total interest-earning assets	1,514,867	30,278	4.03	1,337,195	25,547	3.85
Other assets	105,964			108,696		
Total	$1,620,831			$1,445,891		
Liabilities and Shareholders' Equity						
Interest-bearing demand deposits	$729,362	1,814	0.50	$625,170	837	0.27
Savings deposits	98,400	77	0.16	94,795	74	0.16
Time deposits	291,257	2,094	1.45	300,117	1,899	1.28
Short-term borrowings	93,584	765	1.65	102,303	361	0.71
Long-term debt	83,731	812	1.96	16,017	172	2.17
Total interest-bearing liabilities	1,296,334	5,562	0.87	1,138,402	3,343	0.59
Noninterest-bearing demand deposits	166,440			154,904		
Other	16,053			14,900		
Total Liabilities	1,478,827			1,308,206		
Shareholders' Equity	142,004			137,685		
Total	$1,620,831			$1,445,891		
Taxable-equivalent net interest income /net interest spread		24,716	3.16 %		22,204	3.26 %
Taxable-equivalent net interest margin			3.29 %			3.35 %
Taxable-equivalent adjustment		(679)			(1,249)	
Net interest income		$24,037			$20,955	

Notes: (1) Yields and interest income on tax-exempt assets have been computed on a taxable-equivalent basis assuming a 21% tax rate in 2018 and a 34% tax rate in 2017.

(2) For yield calculation purposes, nonaccruing loans are included in the average loan balance.

For the six months ended June 30, 2018, taxable-equivalent basis net interest income increased $2,512,000 from the corresponding period in 2017. The increase reflected increased average loan and securities balances at increased market interest rates, partially offset by a higher average balance of interest-bearing liabilities at higher interest rates. While yields on interest-earning assets and costs of interest-bearing liabilities both increased year-over-year, the taxable-equivalent adjustment in 2018 was reduced by the change in our statutory tax rate effective January 1, 2018. The lower tax rate in effect for 2018 was the principal factor in the overall decrease in net interest margin on a taxable-equivalent basis between periods.

Taxable-equivalent interest income earned on loans increased $3,480,000 year-over-year. The $131,131,000 increase in average loan balance year-over-year reflects the Company's loan growth in legacy and newer markets through its expanded sales force. The 13 basis point increase in the yield on loans year-over-year reflects four prime lending rate increases of 25 basis points between June 30, 2017 and June 30, 2018, offset by the impact of the change in the statutory rate used in the taxable-equivalent adjustment.

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Taxable-equivalent securities interest income increased $1,214,000 year-over-year, with the average balance of securities increasing $43,805,000 from June 30, 2017 to June 30, 2018. The increase in taxable-equivalent interest income on securities reflected the increased interest rate environment and certain repositioning within the portfolio under the Company's asset/liability management strategies. Similar to the yield on loans, the 25 basis point increase in the yield on securities year-over-year was offset by the change in the statutory rate used in the taxable-equivalent adjustment.

Interest expense on deposits and borrowings increased $2,219,000 year-over-year. The Company continues to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings as it increases its commercial relationships. The increase in interest expense principally reflects the noted increased interest rate environment on the increased deposit and borrowings base. The tax rate change did not impact interest expense.

Provision for Loan Losses

The Company recorded a $400,000 provision for loan losses for the six months ended June 30, 2018 compared with a $100,000 provision recorded for the same period in 2017. The Company has experienced loan portfolio growth, as well as the benefit of favorable historical charge-off statistics and generally stable economic and market conditions for the last several years. These key factors were included in the quantitative and qualitative considerations used by management in the determination of the provision expense required to maintain an adequate allowance for loan losses at June 30, 2018.

Additional information is included in the "Credit Risk Management" section herein.

Noninterest Income

The following table compares noninterest income for the six months ended June 30, 2018 and 2017.

(Dollars in thousands)	Six Months Ended June 30,		$ Change	% Change
	2018	2017	2018-2017	2018-2017
Service charges on deposit accounts	$2,881	$2,787	$ 94	3.4 %
Other service charges, commissions and fees	938	492	446	90.7 %
Trust and investment management income	3,369	3,069	300	9.8 %
Brokerage income	1,059	985	74	7.5 %
Mortgage banking activities	1,314	1,316	(2)	(0.2)%
Earnings on life insurance	568	539	29	5.4 %
Other income	216	113	103	91.2 %
Subtotal before securities gains	10,345	9,301	1,044	11.2 %
Investment securities gains	862	657	205	31.2 %
Total noninterest income	$11,207	$9,958	$ 1,249	12.5 %

The following factors contributed to the more significant changes in noninterest income between the six months ended June 30, 2018 and 2017.

- Other service charges, commissions and fees in 2018 reflects an increase in loan transaction fees from 2017.
- Overall, fees have increased in trust and investment management income and brokerage income as additional revenues have been generated from volatility in the marketplace, which led to higher fees generated from increased volumes. In addition, the six month comparison reflects increased estate fees recognized in the first quarter of 2018 compared with 2017.
- Mortgage banking income is consistent in the year-over-year comparison, with increases noted in the first quarter of 2018 offset by decreases in the second quarter due to decreased refinancing activity as mortgage rates have been rising, as well as a shortage in available housing inventory.
- Other income in 2018 includes an increase of $96,000 in gain on sales of OREO properties.
- Other line items within noninterest income showed fluctuations between 2018 and 2017 attributable to normal business operations.

The Company recognized investment securities gains in 2018 and 2017 as opportunities became available to reposition part of the investment portfolio under asset/liability management strategies or to improve responsiveness of the portfolio to interest rate conditions, while also considering funding requirements of anticipated lending activity.

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Noninterest Expenses

The following table compares noninterest expenses for the six months ended June 30, 2018 and 2017.

	Six Months Ended June 30,		$ Change	% Change
(Dollars in thousands)	2018	2017	2018-2017	2018-2017
Salaries and employee benefits	$15,877	$14,822	$ 1,055	7.1 %
Occupancy	1,477	1,462	15	1.0 %
Furniture and equipment	1,987	1,562	425	27.2 %
Data processing	1,214	1,175	39	3.3 %
Telephone and communication	361	315	46	14.6 %
Automated teller machine and interchange fees	361	372	(11)	(3.0)%
Advertising and bank promotions	619	778	(159)	(20.4)%
FDIC insurance	338	315	23	7.3 %
Legal	149	261	(112)	(42.9)%
Other professional services	779	732	47	6.4 %
Directors' compensation	456	491	(35)	(7.1)%
Collection and problem loan	78	78	0	0.0 %
Real estate owned	78	8	70	nm*
Taxes other than income	502	448	54	12.1 %
Merger related	154	0	154	0.0 %
Other operating expenses	1,911	1,744	167	9.6 %
Total noninterest expenses	$26,341	$24,563	$ 1,778	7.2 %

nm*: not meaningful

The following factors contributed to the more significant changes in noninterest expenses between the six months ended June 30, 2018 and 2017.

- Expanded operations with the addition of branch banking locations opened in Lancaster County, Pennsylvania, in the second and third quarters of 2017; the addition of lenders in York County, Pennsylvania, in the third quarter of 2017; and additional support personnel all contributed to increases in salaries and employee benefits and furniture and equipment costs in 2018. New branch location openings in Lancaster County in the second half of 2018 as part of the Company's continuing expansion are expected to increase costs in each of these expense categories, as well as in advertising and bank promotions expense.
- The salaries and employee benefits increase in 2018 over 2017 also includes the impact of annual merit increases awarded in 2017, incentive compensation increases and additional share-based awards granted in 2018. Costs associated with the Company's self-insured group health plan decreased year-over-year due to improving claims experience.
- Advertising and bank promotions expense decreased from 2017 to 2018, reflecting the increased activity in 2017 in connection with branch openings.
- The Company incurred merger related expenses, principally legal and professional fees, in 2018 in connection with the Company's pending acquisition of Mercersburg. The merger is expected to be completed in the fourth quarter of 2018, subject to receipt of regulatory approvals, the approval of Mercersburg’s shareholders, and the satisfaction of other customary closing conditions.
- Other line items within noninterest expenses showed fluctuations between 2018 and 2017 attributable to normal business operations.

The Company’s efficiency ratio improved to 74.6% for the six months ended June 30, 2018, compared with 77.8% for the same period in 2017. The lower, or more favorable, ratio between the two periods was primarily the result of the growth in net interest and noninterest income outpacing the increase in noninterest expenses. The efficiency ratio expresses noninterest expense as a percentage of taxable-equivalent net interest income and noninterest income, excluding securities gains, merger related expenses, intangible asset amortization, and other real estate income and expenses.

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Income Tax Expense

Income tax expense totaled $866,000, an effective tax rate of 10.2%, for the six months ended June 30, 2018, compared with $940,000, an effective tax rate of 15.0%, for the six months ended June 30, 2017. The Company's effective tax rate is significantly less than the federal statutory rate, which is 21.0% in 2018 and was 34.0% in 2017, principally due to tax-free income, including interest earned on tax-free loans and securities and earnings on the cash surrender value of life insurance policies; federal income tax credits; and non-tax deductible expenses, including estimated merger expenses. The lower effective tax rate for the six months ended June 30, 2018, compared with the same period in 2017, results principally from the reduced statutory tax rate which became effective for the Company on January 1, 2018 as a result of federal tax reform enacted in 2017.

FINANCIAL CONDITION

A substantial amount of time is devoted by management to overseeing the investment of funds in loans and securities and the formulation of policies directed toward maximizing profitability and minimizing risk associated with such investments.

Securities Available for Sale

The Company utilizes securities available for sale to manage interest rate risk, to enhance income through interest and dividend income, to provide liquidity and to provide collateral for certain deposits and borrowings. At June 30, 2018, securities available for sale totaled $449,419,000, an increase of $34,111,000, from the December 31, 2017 balance of $415,308,000.

In the six months ended June 30, 2018, the Company realized gains totaling $862,000 from sales of investments, as it repositioned parts of its portfolio in response to market and interest rate opportunities under its asset/liability management strategies. Sales of investments in GSE residential MBSs were the principal driver of the realized gains. Sale proceeds totaling $88,110,000 were principally redeployed in investments in asset-backed securities and states and political subdivisions securities.

Loan Portfolio

The Company offers a variety of products to meet the credit needs of our borrowers, principally commercial real estate loans, commercial and industrial loans, and retail loans consisting of loans secured by residential properties, and to a lesser extent, installment loans. No loans are extended to non-domestic borrowers or governments.

The risks associated with lending activities differ among loan classes and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans and general economic conditions. Any of these factors may adversely impact a borrower's ability to repay loans, and also impact the associated collateral. See Note 4, Loans Receivable and Allowance for Loan Losses, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information," for a description of the Company's loan classes and differing levels of associated credit risk.

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The following table presents the loan portfolio, excluding residential LHFS, by segment and class at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	June 30, 2018	December 31, 2017
Commercial real estate:		
Owner occupied	$119,507	$ 116,811
Non-owner occupied	244,058	244,491
Multi-family	58,575	53,634
Non-owner occupied residential	84,009	77,980
Acquisition and development:		
1-4 family residential construction	8,801	11,730
Commercial and land development	38,773	19,251
Commercial and industrial	130,280	115,663
Municipal	39,753	42,065
Residential mortgage:		
First lien	167,499	162,509
Home equity - term	11,313	11,784
Home equity - lines of credit	132,528	132,192
Installment and other loans	28,787	21,902
	$1,063,883	$ 1,010,012

The loan portfolio at June 30, 2018 increased $53,871,000, or 5.3% (10.8% annualized), from December 31, 2017. The Company continues to grow in both its legacy and newer markets through its expanded sales force. Loan portfolio growth was experienced in nearly all loan segments from December 31, 2017 to June 30, 2018, with the largest dollar increases in the acquisition and development, commercial and industrial and commercial real estate segments. Acquisition and development loans grew $16.6 million, or 53.6%, as the need for new construction financing has increased in the market. Commercial and industrial loans grew $14.6 million, or 12.6%, and reflected the Company's additional emphasis on growing this segment to increase diversification of its loan portfolio. The commercial real estate segment also grew $13.2 million, or 2.7%, during this period. Partially offsetting 2018 growth in commercial real estate loans was the payoff of loans in connection with a business ownership transition and payoff of a nonaccrual loan.

Competition for new business opportunities remains strong, which may impact loan growth in future quarters.

Asset Quality

Risk Elements

The Company’s loan portfolio is subject to varying degrees of credit risk. Credit risk is mitigated through our underwriting standards, on-going credit reviews, and monitoring of asset quality measures. Additionally, loan portfolio diversification, which limits exposure to a single industry or borrower, and collateral requirements also mitigate our risk of credit loss.

The loan portfolio consists principally of loans to borrowers in south central Pennsylvania and Washington County, Maryland. As the majority of loans are concentrated in this geographic region, a substantial portion of the borrowers' ability to honor their obligations may be affected by the level of economic activity in the market area.

Nonperforming assets include nonaccrual loans and foreclosed real estate. In addition, restructured loans still accruing and loans past due 90 days or more and still accruing are also deemed to be risk assets. For all loan classes, generally the accrual of interest income ceases when principal or interest is past due 90 days or more and collateral is inadequate to cover principal and interest or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is generally reversed and charged against interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending on management’s assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan

classes, when all the principal and interest amounts contractually due are brought current, the loans have performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on contract terms of the loan.

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Loans, the terms of which are modified, are classified as TDRs if a concession was granted for legal or economic reasons related to a borrower's financial difficulties. Concessions granted under a TDR typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual TDRs are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. TDRs are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms.
The following table presents the Company's risk elements, including the aggregate balances of nonaccrual loans, restructured loans still accruing, loans past due 90 days or more, and OREO as of June 30, 2018, December 31, 2017 and June 30, 2017. Relevant asset quality ratios are also presented.

(Dollars in thousands)	June 30, 2018	December 31, 2017	June 30, 2017
Nonaccrual loans (cash basis)	$4,998	$ 9,843	$5,160
OREO	395	961	1,012
Total nonperforming assets	5,393	10,804	6,172
Restructured loans still accruing	1,156	1,183	1,204
Loans past due 90 days or more and still accruing	0	0	0
Total nonperforming and other risk assets	$6,549	$ 11,987	$7,376
Loans 30-89 days past due	$1,857	$ 5,277	$1,069
Asset quality ratios:			
Total nonperforming loans to total loans	0.47 %	0.97 %	0.55 %
Total nonperforming assets to total assets	0.33 %	0.69 %	0.42 %
Total nonperforming assets to total loans and OREO	0.51 %	1.07 %	0.66 %
Total risk assets to total loans and OREO	0.62 %	1.19 %	0.79 %
Total risk assets to total assets	0.40 %	0.77 %	0.50 %
ALL to total loans	1.26 %	1.27 %	1.36 %
ALL to nonperforming loans	268.85 %	130.00 %	247.11 %
ALL to nonperforming loans and restructured loans still accruing	218.35 %	116.05 %	200.36 %

Total nonperforming and other risk assets decreased $5,438,000, or 45.4%, from December 31, 2017 to June 30, 2018 and by $827,000, or 11.2% from June 30, 2017. One commercial real estate loan, downgraded to nonaccrual status in the fourth quarter of 2017 and paid off in the second quarter of 2018, was the principal driver of the nonperforming and risk asset changes between periods in the above table and in the impaired loans tables below.

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The following table presents detail of impaired loans at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	June 30, 2018			December 31, 2017		
	Nonaccrual Loans	Restructured Loans Still Accruing	Total	Nonaccrual Loans	Restructured Loans Still Accruing	Total
Commercial real estate:						
Owner occupied	$1,144	$ 44	$1,188	$1,185	$ 52	$1,237
Non-owner occupied	0	0	0	4,065	0	4,065
Multi-family	148	0	148	165	0	165
Non-owner occupied residential	345	0	345	381	0	381
Acquisition and development:						
1-4 family residential construction	201	0	201	492	0	492
Commercial and industrial	323	0	323	350	0	350
Residential mortgage:						
First lien	2,157	1,086	3,243	2,734	1,102	3,836
Home equity - term	19	0	19	22	0	22
Home equity - lines of credit	660	26	686	438	29	467
Installment and other loans	1	0	1	11	0	11
	$4,998	$ 1,156	$6,154	$9,843	$ 1,183	$11,026

The following table presents our exposure to borrowers with impaired loans, partial charge-offs taken to date and specific reserves established on the borrowing relationships at June 30, 2018 and December 31, 2017. Of the relationships deemed to be impaired at June 30, 2018, none had a recorded balance in excess of $1,000,000 and 64 had recorded balances of less than $250,000, or 76.2%, of total impaired loans.

(Dollars in thousands)	# of Relationships	Recorded Investment	Partial Charge-offs to Date	Specific Reserves
June 30, 2018				
Relationships greater than $1,000,000	0	$ 0	$ 0	$ 0
Relationships greater than $500,000 but less than $1,000,000	1	506	145	0
Relationships greater than $250,000 but less than $500,000	3	959	120	0
Relationships less than $250,000	64	4,689	1,210	39
	68	$ 6,154	$ 1,475	$ 39
December 31, 2017				
Relationships greater than $1,000,000	1	$ 4,065	$ 791	$ 0
Relationships greater than $500,000 but less than $1,000,000	1	518	145	0
Relationships greater than $250,000 but less than $500,000	4	1,501	120	0
Relationships less than $250,000	62	4,942	1,160	51
	68	$ 11,026	$ 2,216	$ 51

The Company takes partial charge-offs on collateral-dependent loans when carrying value exceeds estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions, less costs to dispose. Impairment reserves remain in place if updated appraisals are pending, and represent management’s estimate of potential loss, or on restructured loans that are still accruing, and the impairment is based on discounted cash flows. Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of $500,000, which includes confirmation of risk rating by an independent credit officer. Credit Administration also reviews loans in excess of $1,000,000. In addition, all relationships greater than $250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Bank's Problem Loan Committee, with subsequent reporting to the ERM Committee.

In its individual loan impairment analysis, the Company determines the extent of any full or partial charge-offs that may be required, or any reserves that may be needed. The determination of the Company’s charge-offs or impairment

reserve include an evaluation of the outstanding loan balance and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships at June 30, 2018. However, over time, additional information may result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

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The Company’s OREO totaled $395,000 at June 30, 2018 and consisted of two residential properties. The decrease in OREO from $961,000 at December 31, 2017 was principally the result of the sale of two commercial properties at modest gains in the second quarter of 2018 and the addition of the two residential properties in the first quarter of 2018, which migrated to OREO from nonaccrual status. All properties are carried at the lower of cost or fair value, less costs to dispose.

At June 30, 2018, the Company believes the value of OREO represents the properties' fair values, but if the real estate market changes, additional charges may be needed.

Credit Risk Management

Allowance for Loan Losses

The Company maintains the ALL at a level deemed adequate by management for probable incurred credit losses. The ALL is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the ALL utilizing a defined methodology which considers specific credit evaluation of impaired loans, past loan loss historical experience and qualitative factors. Management addresses the requirements for loans individually identified as impaired, loans collectively evaluated for impairment, and other bank regulatory guidance in its assessment.

The ALL is evaluated based on review of the collectability of loans in light of historical experience; the nature and volume of the loan portfolio; adverse situations that may affect a borrower’s ability to repay; estimated value of any underlying collateral; and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve is included in Note 4, Loans Receivable and Allowance for Loan Losses, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information."

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The following table summarizes the Company's internal risk ratings at June 30, 2018 and December 31, 2017:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
June 30, 2018						
Commercial real estate:						
Owner occupied	$115,202	$1,978	$ 1,139	$ 1,188	$ 0	$119,507
Non-owner occupied	239,622	0	4,436	0	0	244,058
Multi-family	52,263	5,429	735	148	0	58,575
Non-owner occupied residential	81,864	638	1,162	345	0	84,009
Acquisition and development:						
1-4 family residential construction	8,600	0	0	201	0	8,801
Commercial and land development	38,149	28	596	0	0	38,773
Commercial and industrial	128,011	1,946	0	323	0	130,280
Municipal	39,753	0	0	0	0	39,753
Residential mortgage:						
First lien	164,256	0	0	3,243	0	167,499
Home equity - term	11,294	0	0	19	0	11,313
Home equity - lines of credit	131,705	78	59	686	0	132,528
Installment and other loans	28,786	0	0	1	0	28,787
	$1,039,505	$10,097	$ 8,127	$ 6,154	$ 0	$1,063,883
December 31, 2017						
Commercial real estate:						
Owner occupied	$113,240	$413	$ 1,921	$ 1,237	$ 0	$116,811
Non-owner occupied	235,919	0	4,507	4,065	0	244,491
Multi-family	48,603	4,113	753	165	0	53,634
Non-owner occupied residential	76,373	142	1,084	381	0	77,980
Acquisition and development:						
1-4 family residential construction	11,238	0	0	492	0	11,730
Commercial and land development	18,635	5	611	0	0	19,251
Commercial and industrial	113,162	2,151	0	350	0	115,663
Municipal	42,065	0	0	0	0	42,065
Residential mortgage:						
First lien	158,673	0	0	3,836	0	162,509
Home equity - term	11,762	0	0	22	0	11,784
Home equity - lines of credit	131,585	80	60	467	0	132,192
Installment and other loans	21,891	0	0	11	0	21,902
	$983,146	$6,904	$ 8,936	$ 11,026	$ 0	$1,010,012

Potential problem loans are defined as performing loans which have characteristics that cause management concern over the ability of the borrower to perform under present loan repayment terms and which may result in the reporting of these loans as nonperforming loans in the future. Generally, management feels that Substandard loans that are currently performing and not considered impaired result in some doubt as to the borrower's ability to continue to perform under the terms of the loan, and represent potential problem loans. Additionally, the Special Mention classification is intended to be a temporary classification reflective of loans that have potential weaknesses that may, if not monitored or corrected, weaken the asset or inadequately protect the Company's position at some future date. Special Mention loans represent an elevated risk, but their weakness does not yet justify a classified (Substandard, Doubtful, or Loss) rating. These loans require inquiry by lenders on the cause of the potential weakness and, once analyzed, the loan classification may be downgraded to Substandard or, alternatively, could be upgraded to Pass.

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The following table summarizes activity in the ALL for the three and six months ended June 30, 2018 and 2017.

(Dollars in thousands)	Commercial					Consumer				
	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
Three Months Ended June 30, 2018										
Balance, beginning of period	$6,770	$ 510	$ 1,590	$ 83	$8,953	$3,382	$ 204	$3,586	$ 461	$13,000
Provision for loan losses	(418)	208	8	(3)	(205)	237	44	281	124	200
Charge-offs	0	0	0	0	0	(86)	(47)	(133)	0	(133)
Recoveries	328	2	0	0	330	11	29	40	0	370
Balance, end of period	$6,680	$ 720	$ 1,598	$ 80	$9,078	$3,544	$ 230	$3,774	$ 585	$13,437
June 30, 2017										
Balance, beginning of period	$6,963	$ 513	$ 1,218	$ 106	$8,800	$3,229	$ 127	$3,356	$ 512	$12,668
Provision for loan losses	(214)	65	69	11	(69)	198	13	211	(42)	100
Charge-offs	0	0	0	0	0	(51)	(27)	(78)	0	(78)
Recoveries	28	1	4	0	33	10	18	28	0	61
Balance, end of period	$6,777	$ 579	$ 1,291	$ 117	$8,764	$3,386	$ 131	$3,517	$ 470	$12,751
Six Months Ended June 30, 2018										
Balance, beginning of period	$6,763	$ 417	$ 1,446	$ 84	$8,710	$3,400	$ 211	$3,611	$ 475	$12,796
Provision for loan losses	(411)	300	152	(4)	37	202	51	253	110	400
Charge-offs	0	0	0	0	0	(86)	(118)	(204)	0	(204)
Recoveries	328	3	0	0	331	28	86	114	0	445
Balance, end of period	$6,680	$ 720	$ 1,598	$ 80	$9,078	$3,544	$ 230	$3,774	$ 585	$13,437
June 30, 2017										
Balance, beginning of period	$7,530	$ 580	$ 1,074	$ 54	$9,238	$2,979	$ 144	$3,123	$ 414	$12,775
Provision for loan losses	(738)	(3)	267	63	(411)	441	14	455	56	100
Charge-offs	(45)	0	(55)	0	(100)	(51)	(56)	(107)	0	(207)
Recoveries	30	2	5	0	37	17	29	46	0	83
Balance, end of period	$6,777	$ 579	$ 1,291	$ 117	$8,764	$3,386	$ 131	$3,517	$ 470	$12,751

The ALL at June 30, 2018, increased $641,000 from December 31, 2017, reflecting the $400,000 provision for loan losses and net recoveries during the period. Net recoveries totaled $237,000 and $241,000 for the three and six months ended June 30, 2018 compared with net charge-offs of $17,000 and $124,000 for the same periods in 2017, principally due to recoveries in 2018 on the commercial real estate loan previously noted. The ratio of annualized net charge-offs (recoveries) to average loans outstanding was (0.09)% and (0.05)% for the three and six months ended June 30, 2018

compared with 0.01% and 0.03% for the same periods in 2017. Classified loans totaled $14,281,000 at June 30, 2018, or 1.3% of total loans outstanding, and decreased from $19,962,000 at December 31, 2017, or 2.0% of loans outstanding. The asset quality ratios previously noted are indicative of the continued benefit the Company has received from favorable historical charge-off statistics and generally stable economic and market conditions for the last few years, even while the loan portfolio has been growing. Recent loan growth trends contributed to management's determination that a provision for loan losses in the first two quarters of 2018 was required to maintain an adequate ALL, with an ALL to total loans ratio of 1.26%, at June 30, 2018, compared with 1.27% at December 31, 2017.

Despite generally favorable historical charge-off data and stable and economic and market conditions, the growth the Company has experienced in its loan portfolio may result in the need for additional provisions for loan losses in future quarters.

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The following table summarizes the ending loan balances individually or collectively evaluated for impairment based on loan type, as well as the ALL allocation for each, at June 30, 2018 and December 31, 2017.

(Dollars in thousands)	Commercial					Consumer				
	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Residential Mortgage	Installment and Other	Total	Unallocated	Total
June 30, 2018										
Loans allocated by:										
Individually evaluated for impairment	$1,681	$201	$323	$0	$2,205	$3,948	$1	$3,949	$0	$6,154
Collectively evaluated for impairment	504,468	47,373	129,957	39,753	721,551	307,392	28,786	336,178	0	1,057,729
	$506,149	$47,574	$130,280	$39,753	$723,756	$311,340	$28,787	$340,127	$0	$1,063,883
ALL allocated by:										
Individually evaluated for impairment	$0	$0	$0	$0	$0	$39	$0	$39	$0	$39
Collectively evaluated for impairment	6,680	720	1,598	80	9,078	3,505	230	3,735	585	13,398
	$6,680	$720	$1,598	$80	$9,078	$3,544	$230	$3,774	$585	$13,437
December 31, 2017										
Loans allocated by:										
Individually evaluated for impairment	$5,848	$492	$350	$0	$6,690	$4,325	$11	$4,336	$0	$11,026
Collectively evaluated for impairment	487,068	30,489	115,313	42,065	674,935	302,160	21,891	324,051	0	998,986
	$492,916	$30,981	$115,663	$42,065	$681,625	$306,485	$21,902	$328,387	$0	$1,010,012
ALL allocated by:										
Individually evaluated for impairment	$0	$0	$0	$0	$0	$42	$9	$51	$0	$51
Collectively evaluated for impairment	6,763	417	1,446	84	8,710	3,358	202	3,560	475	12,745
	$6,763	$417	$1,446	$84	$8,710	$3,400	$211	$3,611	$475	$12,796

In addition to the specific reserve allocations on impaired loans noted previously, 18 loans, with aggregate outstanding principal balances of $2,075,000, have had cumulative partial charge-offs to the ALL totaling $1,475,000 at June 30, 2018. As updated appraisals were received on collateral-dependent loans, partial charge-offs were taken to the extent the loans' principal balance exceeded their fair value.

Management believes the allocation of the ALL between the various loan segments adequately reflects the probable incurred credit losses in each portfolio. Management re-evaluates and makes certain enhancements to its methodology used to establish a reserve to better reflect the risks inherent in the different segments of the portfolio, particularly in light of changes in levels of charge-offs with noticeable differences between the different loan segments. Management believes these enhancements to the ALL methodology improve the accuracy of quantifying losses presently incurred in the portfolio. Management charges actual loan losses to the reserve and bases the provision for loan losses on the overall analysis taking the methodology into account.

The unallocated portion of the ALL reflects estimated probable incurred losses within the portfolio that have not been identified to specific loans or portfolio segments due to risk of error in the specific and general reserve allocation; other potential exposure in the loan portfolio; variances in management’s assessment of national and local economic conditions; and other factors management believes appropriate at the time. The unallocated portion of the ALL totaled $585,000, or 4.4% of the ALL balance, at June 30, 2018 compared with $475,000 at December 31, 2017, or 3.7% of the ALL balance at December 31, 2017.

While management believes the Company’s ALL is adequate based on information currently available, future adjustments to the reserve and enhancements to the methodology may be necessary due to changes in economic conditions, regulatory guidance, or management’s assumptions as to future delinquencies or loss rates.

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Deposits

Deposits totaled $1,325,866,000 at June 30, 2018, an increase of $106,351,000, or 8.7%, from $1,219,515,000 at December 31, 2017.

Noninterest-bearing deposits increased $16,361,000, or 10.1%, from December 31, 2017 to June 30, 2018 and totaled $178,704,000 at June 30, 2018. Interest-bearing deposits totaled $1,147,162,000 at June 30, 2018, an increase of $89,990,000, or 8.5% from the $1,057,172,000 balance at December 31, 2017. Approximately $40,000,000 of the growth in interest-bearing deposits occurred as certain larger depository relationships, previously enrolled in the Company's repurchase agreement program included in short-term borrowings, transitioned to interest-bearing deposits in a program provided through a third party which provides full FDIC insurance on deposit amounts by exchanging or reciprocating larger depository relationships with other member banks.

The Company has continued to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings delivered by its expanded sales force as it increases its commercial relationships. Deposit growth in the first half of 2018 was used to fund growth in the loan and investment portfolios.

Shareholders' Equity, Capital Adequacy and Regulatory Matters

The management of capital in a regulated financial services company must properly balance return on equity to its shareholders while maintaining sufficient levels of capital and related risk-based regulatory capital ratios to satisfy statutory regulatory requirements. The Company’s capital management strategies have historically been developed to provide attractive rates of returns to its shareholders, while maintaining a “well capitalized” position as defined by our regulators.

Shareholders’ equity totaled $145,137,000 at June 30, 2018, and increased $372,000 or 0.3%, from $144,765,000 at December 31, 2017. Significant factors in this change were net income totaling $7,637,000 for the six months ended June 30, 2018, offset by a decrease in net unrealized gains/losses in AOCI, net of taxes, totaling $5,538,000 and by dividends declared on common stock of $2,095,000.

Capital Adequacy. The Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Management believes, at June 30, 2018 and December 31, 2017, that the Company and the Bank met all capital adequacy requirements to which they are subject. At June 30, 2018 and December 31, 2017, the Bank was considered well capitalized under applicable banking regulations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. Although applicable to the Bank, prompt corrective action provisions are not applicable to bank holding companies, including financial holding companies.

Note 7, Shareholders' Equity and Regulatory Capital, to the Notes to Consolidated Financial Statements under Part I, Item 1, "Financial Information," includes a table presenting capital amounts and ratios for the Company and the Bank at June 30, 2018 and December 31, 2017.

The Company routinely evaluates its capital levels in light of its risk profile to assess its capital needs. In addition to the minimum capital ratio requirement and minimum capital ratio to be well capitalized presented in the referenced table in Note 7, the Company and the Bank must maintain a capital conservation buffer as more fully described in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, Item 1 - Business, under the topic Basel III Capital Rules. At June 30, 2018, the Company's and the Bank's capital conservation buffer, based on the most restrictive Total Capital to risk weighted assets capital ratio, was 5.4% and 5.1%, respectively, which is above the phase in requirements of 1.875% for December 31, 2018.

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Liquidity

The primary functions of asset/liability management are to ensure adequate liquidity and manage the Company's sensitivity to changing interest rates. Liquidity management involves our ability to meet the cash flow requirements of customers who may be either depositors wanting to withdraw funds or borrowers needing assurance that sufficient funds will be available to meet their credit needs. Our primary sources of funds are deposit inflows, loan repayments, maturities and sales of investment securities, the sale of mortgage loans and borrowings from the FHLB of Pittsburgh. While maturities and scheduled amortization of loans and securities are predictable sources of funds, deposit flows and mortgage prepayments are greatly influenced by general interest rates, economic conditions and competition. We regularly adjust our investments in liquid assets based upon our assessment of expected loan demand, expected deposit flows, yields available on interest-earning deposits and securities and the objectives of our asset/liability management policy.

Pending Acquisition

See Note 2, Pending Acquisition, to the Consolidated Financial Statements under Part I, Item 1, "Financial Statements" in this Form 10-Q.

Item 3. Quantitative and Qualitative Disclosures about Market Risk

Market risk comprises exposure to interest rate risk, foreign currency exchange rate risk, commodity price risk, and other relevant market rate or price risks. For domestic banks, including the Company, the majority of market risk is related to interest rate risk. Interest rate sensitivity management requires the maintenance of an appropriate balance between reward, in the form of net interest margin, and risk as measured by the amount of earnings and value at risk.

Interest Rate Risk

Interest rate risk is the exposure to fluctuations in the Company's future earnings (earnings at risk) and value (value at risk) resulting from changes in interest rates. This exposure results from differences between the amounts of interest-earning assets and interest-bearing liabilities that reprice within a specified time period as a result of scheduled maturities, scheduled and unscheduled repayments, the propensity of borrowers and depositors to react to changes in their economic interests, and security and contractual interest rate changes.

Management attempts to manage the level of repricing and maturity mismatch through its asset/liability management process so that fluctuations in net interest income are maintained within policy limits across a range of market conditions while satisfying liquidity and capital requirements. Management recognizes that a certain amount of interest rate risk is inherent, appropriate and necessary to ensure the Company's profitability. Thus, the goal of interest rate risk management is to evaluate the amount of reward for taking risk and adjusting both the size and composition of the balance sheet relative to the level of reward available for taking risk.

Management endeavors to control the exposure to changes in interest rates by understanding, reviewing and making decisions based on its risk position. The Company primarily uses its securities portfolio, FHLB advances and brokered deposits to manage its interest rate risk position. Additionally, pricing, promotion and product development activities are directed in an effort to emphasize the loan and deposit term or repricing characteristics that best meet current interest rate risk objectives. We do not currently use hedging instruments for risk management, but we do evaluate them and may use them in the future.

The asset/liability committee operates under management policies, approved by the Board of Directors, which define guidelines and limits on the level of risk.

The Company uses simulation analysis to assess earnings at risk and net present value analysis to assess value at risk. These methods allow management to regularly monitor both the direction and magnitude of the Company's interest rate risk exposure. These modeling techniques involve assumptions and estimates that inherently cannot be measured with complete precision. Key assumptions in the analyses include maturity and repricing characteristics of assets and liabilities, prepayments on amortizing assets, non-maturity deposit sensitivity, and loan and deposit pricing. These assumptions are inherently uncertain due to the timing, magnitude and frequency of rate changes and changes in market conditions and management strategies, among other factors. However, the analyses are useful in quantifying risk and providing a relative gauge of the Company's interest rate risk position over time.

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Earnings at Risk

Simulation analysis evaluates the effect of upward and downward changes in market interest rates on future net interest income. The analysis involves changing the interest rates used in determining net interest income over the next twelve months. The resulting percentage change in net interest income in various rate scenarios is an indication of the Company's short-term interest rate risk. The analysis assumes recent trends in new loan and deposit volumes will continue while the amount of investment securities remains constant. Additional assumptions are applied to modify volumes and pricing under the various rate scenarios. These include prepayment assumptions on mortgage assets, sensitivity of non-maturity deposit rates, and other factors deemed significant.

The simulation analysis results are presented in the Earnings at Risk table below. At June 30, 2018, similar to at December 31, 2017, these results indicate the Company would be better positioned in a moderately rising interest rate environment than it would be if interest rates increased more substantially or decreased.

Value at Risk

Net present value analysis provides information on the risk inherent in the balance sheet that might not be taken into account in the simulation analysis due to the short time horizon used in that analysis. The net present value of the balance sheet is defined as the discounted present value of expected asset cash flows minus the discounted present value of the expected liability cash flows. The analysis involves changing the interest rates used in determining the expected cash flows and in discounting the cash flows. The resulting percentage change in net present value in various rate scenarios is an indication of the longer term repricing risk and options embedded in the balance sheet.

The net present value analysis results are presented in the Value at Risk table below. At June 30, 2018, similar to at December 31, 2017, these results indicate the Company would be better positioned in a moderately rising interest rate environment than it would be if interest rates increased more substantially or decreased.

Earnings at Risk			Value at Risk		
	% Change in Net Interest Income			% Change in Market Value	
Change in Market Interest Rates (basis points)	June 30, 2018	December 31, 2017	Change in Market Interest Rates (basis points)	June 30, 2018	December 31, 2017
(100)	(6.5%)	(6.5 %)	(100)	(7.2%)	(7.2 %)
100	(2.9%)	(1.3 %)	100	(1.9%)	(1.8 %)
200	(6.4%)	(4.9 %)	200	(5.7%)	(5.4 %)

Item 4. Controls and Procedures

Based on the evaluation required by Securities Exchange Act Rules 13a-15(b) and 15d-15(b), the Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures, as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e), at June 30, 2018. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective at June 30, 2018. There have been no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting during the second quarter of 2018.

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PART II – OTHER INFORMATION

Item 1 – Legal Proceedings

Information regarding legal proceedings is included in Note 12, Contingencies, to the Consolidated Financial Statements under Part I, Item 1, "Financial Statements" and incorporated herein by reference.

Item 1A – Risk Factors

In addition to the risk factors disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2017, investors should consider the following:

There is no assurance when or even if our merger acquisition of Mercersburg Financial Corporation will be completed.

The merger agreement between the Company and Mercersburg is subject to a number of conditions which must be fulfilled in order to complete the merger. Those conditions include:

- approval of the merger agreement and the merger by Mercersburg shareholders;
- the receipt of required regulatory approvals;
- absence of orders prohibiting the completion of the merger;
- effectiveness of the registration statement filed by the Company to register the shares of our common stock to be issued to Mercersburg shareholders in the merger;
- the continued accuracy of the representations and warranties by both parties and the performance by both parties of their covenants and agreements; and
- the receipt by both parties of legal opinions from their respective tax counsels.

There can be no assurance that the parties will be able to satisfy the closing conditions or that closing conditions beyond their control will be satisfied or waived.

The merger agreement may be terminated in accordance with its terms and the merger may not be completed.

The parties can agree at any time to terminate the merger agreement even after Mercersburg's shareholders have provided their approval. The parties can also terminate the merger agreement under other specified circumstances. In addition, Mercersburg may choose to terminate the merger agreement if the volume weighted average stock price of our common stock as reported on NASDAQ during the 15 trading day period ending on the determination date is less than $20.928 per share and our common stock underperforms the NASDAQ Bank Index by more than 20% between May 29, 2018 and the determination date. Any such termination would be subject to the right of the Company to increase the amount of our common stock to be provided to Mercersburg shareholders pursuant to the formula prescribed in the merger agreement.

Regulatory approvals may not be received or may take longer than expected in order to be obtained.

We are required to obtain the approvals of the Board of Governors of the Federal Reserve System and the Pennsylvania Department of Banking and Securities prior to completing the merger. Obtaining the approval of these regulatory agencies may delay the date of completion of the merger. In addition, you should be aware that, as in any transaction, it is possible that, among other things, restrictions on the combined operations of the two companies may be sought by governmental agencies as a condition to obtaining the required regulatory approvals. This may diminish the benefits of the merger to us or have an adverse effect on us following the merger and prevent us from achieving the expected benefits of the merger. We have the right to terminate the merger agreement if the approval of any governmental authority required for consummation of the merger and the other transactions provided for in the merger agreement, imposes any term, condition or restriction upon us or any of our subsidiaries that we reasonably determine would (a) prohibit or materially limit the ownership or operation by us of any material portion of Mercersburg's business or assets, (b) compel us to dispose or hold separate any material portion of Mercersburg's assets or (c) compel us to take any action, or commit to take any action, or agree to any condition or request, if the prohibition, limitation, condition or other requirement described in clauses (a)-(c) of this sentence would have a material adverse effect on the future operation by us of our business, taken as a whole.

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If the merger is not completed, we will have incurred substantial expenses without realizing the expected benefits.
We have incurred, and will continue to incur, substantial expenses in connection with the pending merger acquisition of Mercersburg. If the merger is not completed, these expenses may have a material adverse impact on our operating results.

Goodwill incurred in the merger may negatively affect our financial condition.
To the extent that the merger consideration, consisting of the cash and the number of shares of our common stock issued or to be issued in the merger, exceeds the fair value of the net assets, including identifiable intangibles, of Mercersburg, that amount will be reported as goodwill by us. In accordance with current accounting guidance, goodwill will not be amortized but will be evaluated for impairment annually or more frequently if events or circumstances warrant. A failure to realize expected benefits of the merger could adversely impact the carrying value of the goodwill recognized in the merger and, in turn, negatively affect our financial results.

We may be unable to successfully integrate Mercersburg's operations.
The merger involves the integration of two companies that previously operated independently. The difficulties of combining the companies' operations include:

- integrating personnel with diverse business backgrounds;
- integrating departments, systems, operating procedures and information technologies;
- combining different corporate cultures;
- retaining existing customers and attracting new customers; and
- retaining key employees.

The process of integrating operations could cause an interruption of, or loss of momentum in, the activities of one or more of the combined company's businesses and the loss of key personnel. The diversion of management's attention and any delays or difficulties encountered in connection with the merger and the integration of the two companies' operations could have a material adverse effect on the business and results of operations of the combined company.
The success of the merger will depend, in part, on our ability to realize the anticipated benefits and cost savings from combining the business of the Company with Mercersburg. If we are unable to successfully integrate Mercersburg, the anticipated benefits and cost savings of the merger may not be realized fully or may take longer to realize than expected. For example, we may fail to realize the anticipated increase in earnings and cost savings anticipated to be derived from the acquisition. In addition, as with regard to any merger, a significant change in interest rates or economic conditions or decline in asset valuations may also cause us not to realize expected benefits and result in the merger not being as accretive as expected.

Unanticipated costs relating to the merger could reduce our future earnings per share.
We believe that we have reasonably estimated the likely costs of integrating the operations of the Company and Mercersburg, and the incremental costs of operating as a combined company. However, it is possible that we could incur unexpected transaction costs such as taxes, fees or professional expenses or unexpected future operating expenses such as increased personnel costs or increased taxes, which could result in the merger not being as accretive as expected or having a dilutive effect on the combined company's earnings per share.

The market price of our common stock after the merger may be affected by factors different from those affecting our shares currently.
The businesses of the Company and Mercersburg differ and, accordingly, the results of operations of the combined company and the market price of the combined company's shares of common stock may be affected by factors different from those currently affecting the independent results of operations and market prices of common stock of each of us and Mercersburg. The market value of our common stock fluctuates based upon various factors, including changes in our business, operations or prospects, market assessments of the merger, regulatory considerations, market and economic considerations, and other factors. Further, the market price of our common stock after the merger may be affected by factors different from those currently affecting our common stock.

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

Period	(a) Total Number of Shares (or units) purchased	(b) Average price paid per share (or unit)	(c) Total number of shares (or units) purchased as part of publicly announced plans or programs	(d) Maximum number (or approximate dollar value) of shares (or units) that may yet be purchased under the plans or programs
April 1, 2018 to April 30, 2018	0	$ 0.00	0	333,275
May 1, 2018 to May 31, 2018	3,136	26.10	0	333,275
June 1, 2018 to June 30, 2018	10,031	26.10	0	333,275
Total	13,167	$ 26.10	0	

(1) The 13,167 shares purchased in May and June 2018 were in connection with the vesting of restricted stock granted to employees under the 2011 Orrstown Financial Services, Inc. Stock Incentive Plan.

In September 2015, the Board of Directors of the Company authorized a share repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. At June 30, 2018, there are 333,275 authorized shares remaining in the program. When and if appropriate, repurchases may be made in open market or privately negotiated transactions, depending on market conditions, regulatory requirements and other corporate considerations, as determined by management. Share repurchases may not occur and may be discontinued at any time.

Item 3 – Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosures

Not applicable.

Item 5 – Other Information

None.

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Item 6 – Exhibits

2.1	Agreement and Plan of Merger, incorporated by reference to Exhibit 2.1 to the Registrant's Report on Form 8-K filed June 1, 2018.
3.1	Articles of Incorporation as amended, incorporated by reference to Exhibit 3.1 of the Registrant's Report on Form 8-K filed on January 29, 2010.
3.2	By-laws as amended, incorporated by reference to Exhibit 3.2 to the Registrant's Report on Form 8-K filed January 30, 2018.
4.1	Specimen Common Stock Certificate, incorporated by reference to the Registrant's Registration Statement on Form S-3 filed February 8, 2010 (File No. 333-164780).
31.1	Rule 13a – 14(a)/15d-14(a) Certification (Principal Executive Officer)
31.2	Rule 13a – 14(a)/15d-14(a) Certifications (Principal Financial Officer)
32.1	Section 1350 Certifications (Principal Executive Officer)
32.2	Section 1350 Certifications (Principal Financial Officer)
101.LAB	XBRL Taxonomy Extension Label Linkbase
101.PRE	XBRL Taxonomy Extension Presentation Linkbase
101.INS	XBRL Instance Document
101.SCH	XBRL Taxonomy Extension Schema
101.CAL	XBRL Taxonomy Extension Calculation Linkbase
101.DEF	XBRL Taxonomy Extension Definition Linkbase

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

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SIGNATURES

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

/s/ Thomas R. Quinn, Jr.
Thomas R. Quinn, Jr.
President and Chief Executive Officer
(Principal Executive Officer)

/s/ David P. Boyle
David P. Boyle
Executive Vice President and Chief Financial Officer
(Principal Financial Officer)

Date: August 7, 2018