

CITIZENS FINANCIAL SERVICES INC  
Form 10-Q  
August 09, 2018  
UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549  
FORM 10 Q

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

For the quarterly period ended 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 0 13222

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

PENNSYLVANIA  
(State or other jurisdiction of incorporation or organization)  
Employer Identification No.)

23 2265045  
(I.R.S.

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

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

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

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

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

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

|   |                                     |             |
|---|-------------------------------------|-------------|
| Large accelerated filer                       | <input type="checkbox"/>            | Accelerated |
| filer   | <input checked="" type="checkbox"/> |             |
| Non-accelerated filer                         | <input type="checkbox"/>            | Smaller     |
| reporting company                             | <input type="checkbox"/>            |             |
| (Do not check if a smaller reporting company) |                                     | Emerging    |
| growth company                                | <input type="checkbox"/>            |             |

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

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

The number of outstanding shares of the Registrant's Common Stock, as of August 2, 2018, was 3,512,653.

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Citizens Financial Services, Inc.  
Form 10-Q

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

| (in thousands except share data)  | June 30,<br>2018   | December<br>31,<br>2017 |
|---|--------------------|-------------------------|
| <b>ASSETS:</b>  |                    |                         |
| Cash and due from banks:  |                    |                         |
| Noninterest-bearing   | \$14,521           | \$16,347                |
| Interest-bearing  | 1,092              | 2,170                   |
| Total cash and cash equivalents   | 15,613             | 18,517                  |
| Interest bearing time deposits with other banks   | 13,762             | 10,283                  |
| Equity securities   | 195                | -                       |
| Available-for-sale securities   | 250,025            | 254,782                 |
| Loans held for sale   | 1,931              | 1,439                   |
| Loans (net of allowance for loan losses:<br>2018, \$11,941 and 2017, \$11,190)  | 1,028,259          | 989,335                 |
| Premises and equipment  | 16,289             | 16,523                  |
| Accrued interest receivable   | 4,285              | 4,196                   |
| Goodwill  | 23,296             | 23,296                  |
| Bank owned life insurance   | 27,189             | 26,883                  |
| Other intangibles   | 1,756              | 1,953                   |
| Other assets  | 14,994             | 14,679                  |
| <b>TOTAL ASSETS</b>   | <b>\$1,397,594</b> | <b>\$1,361,886</b>      |
| <b>LIABILITIES:</b>   |                    |                         |
| Deposits:   |                    |                         |
| Noninterest-bearing   | \$169,014          | \$171,840               |
| Interest-bearing  | 949,578            | 933,103                 |
| Total deposits  | 1,118,592          | 1,104,943               |
| Borrowed funds  | 133,652            | 114,664                 |
| Accrued interest payable  | 903                | 897                     |
| Other liabilities   | 12,166             | 12,371                  |
| <b>TOTAL LIABILITIES</b>  | <b>1,265,313</b>   | <b>1,232,875</b>        |
| <b>STOCKHOLDERS' EQUITY:</b>  |                    |                         |
| Preferred Stock   |                    |                         |
| \$1.00 par value; authorized 3,000,000 shares at June 30, 2018 and<br>December 31, 2017; none issued in 2018 or 2017  | -                  | -                       |
| Common stock  |                    |                         |
| \$1.00 par value; authorized 25,000,000 shares at June 30, 2018 and<br>15,000,000 at December 31, 2017; issued 3,904,212 at June 30, 2018 and<br>3,869,939 at December 31, 2017 | 3,904              | 3,870                   |
| Additional paid-in capital  | 53,098             | 51,108                  |
| Retained earnings   | 93,717             | 89,982                  |
| Accumulated other comprehensive loss  | (5,357 )           | (3,398 )                |
| Treasury stock, at cost: 391,559 shares at June 30, 2018<br>and 383,065 shares at December 31, 2017   | (13,081 )          | (12,551 )               |
| <b>TOTAL STOCKHOLDERS' EQUITY</b>   | <b>132,281</b>     | <b>129,011</b>          |
| <b>TOTAL LIABILITIES AND</b>  |                    |                         |

STOCKHOLDERS' EQUITY

\$1,397,594 \$1,361,886

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

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

|  | Three Months Ended |                 | Six Months Ended |                 |
|--|--------------------|-----------------|------------------|-----------------|
|  | June 30,           | June 30,        | June 30,         | June 30,        |
| (in thousands, except share and per share data)                | 2018               | 2017            | 2018             | 2017            |
| <b>INTEREST INCOME:</b>  |                    |                 |                  |                 |
| Interest and fees on loans                                     | \$ 12,461          | \$ 10,304       | \$ 24,322        | \$ 20,021       |
| Interest-bearing deposits with banks                           | 66                 | 45              | 124              | 80              |
| Investment securities:   |                    |                 |                  |                 |
| Taxable  | 916                | 775             | 1,716            | 1,579           |
| Nontaxable   | 474                | 601             | 1,001            | 1,269           |
| Dividends  | 111                | 53              | 248              | 129             |
| <b>TOTAL INTEREST INCOME</b>                                   | <b>14,028</b>      | <b>11,778</b>   | <b>27,411</b>    | <b>23,078</b>   |
| <b>INTEREST EXPENSE:</b>                                       |                    |                 |                  |                 |
| Deposits   | 1,585              | 1,143           | 2,901            | 2,188           |
| Borrowed funds   | 692                | 231             | 1,339            | 489             |
| <b>TOTAL INTEREST EXPENSE</b>                                  | <b>2,277</b>       | <b>1,374</b>    | <b>4,240</b>     | <b>2,677</b>    |
| <b>NET INTEREST INCOME</b>                                     | <b>11,751</b>      | <b>10,404</b>   | <b>23,171</b>    | <b>20,401</b>   |
| Provision for loan losses                                      | 325                | 625             | 825              | 1,240           |
| <b>NET INTEREST INCOME AFTER<br/>PROVISION FOR LOAN LOSSES</b> | <b>11,426</b>      | <b>9,779</b>    | <b>22,346</b>    | <b>19,161</b>   |
| <b>NON-INTEREST INCOME:</b>                                    |                    |                 |                  |                 |
| Service charges  | 1,170              | 1,120           | 2,274            | 2,178           |
| Trust  | 150                | 188             | 401              | 409             |
| Brokerage and insurance  | 168                | 114             | 349              | 305             |
| Gains on loans sold  | 60                 | 148             | 132              | 249             |
| Equity security gains, net                                     | 7                  | -               | 13               | -               |
| Available for sale security gains, net                         | -                  | 23              | -                | 195             |
| Earnings on bank owned life insurance                          | 154                | 167             | 306              | 333             |
| Other  | 133                | 128             | 273              | 254             |
| <b>TOTAL NON-INTEREST INCOME</b>                               | <b>1,842</b>       | <b>1,888</b>    | <b>3,748</b>     | <b>3,923</b>    |
| <b>NON-INTEREST EXPENSES:</b>                                  |                    |                 |                  |                 |
| Salaries and employee benefits                                 | 4,737              | 4,377           | 9,572            | 8,743           |
| Occupancy  | 514                | 477             | 1,106            | 1,004           |
| Furniture and equipment  | 122                | 146             | 264              | 285             |
| Professional fees  | 262                | 258             | 557              | 568             |
| FDIC insurance   | 107                | 95              | 207              | 200             |
| Pennsylvania shares tax  | 300                | 243             | 600              | 524             |
| Amortization of intangibles                                    | 74                 | 73              | 150              | 149             |
| Other real estate owned expenses                               | 157                | 82              | 295              | 172             |
| Other  | 1,429              | 1,415           | 2,783            | 2,712           |
| <b>TOTAL NON-INTEREST EXPENSES</b>                             | <b>7,702</b>       | <b>7,166</b>    | <b>15,534</b>    | <b>14,357</b>   |
| Income before provision for income taxes                       | 5,566              | 4,501           | 10,560           | 8,727           |
| Provision for income taxes                                     | 875                | 1,033           | 1,622            | 1,956           |
| <b>NET INCOME</b>  | <b>\$ 4,691</b>    | <b>\$ 3,468</b> | <b>\$ 8,938</b>  | <b>\$ 6,771</b> |
| <b>PER COMMON SHARE DATA:</b>                                  |                    |                 |                  |                 |
| Net Income - Basic   | \$ 1.34            | \$ 0.99         | \$ 2.55          | \$ 1.93         |
| Net Income - Diluted   | \$ 1.34            | \$ 0.99         | \$ 2.55          | \$ 1.93         |

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|  |           |           |           |           |
|--|-----------|-----------|-----------|-----------|
| Cash Dividends Paid                            | \$0.435   | \$0.401   | \$0.870   | \$0.802   |
| Number of shares used in computation - basic   | 3,507,242 | 3,514,394 | 3,509,882 | 3,513,925 |
| Number of shares used in computation - diluted | 3,508,709 | 3,515,582 | 3,510,513 | 3,514,535 |

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



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

|  | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |
|--|--------------------------------|---------|------------------------------|---------|
| (in thousands)   | 2018                           | 2017    | 2018                         | 2017    |
| Net income   | \$4,691                        | \$3,468 | \$8,938                      | \$6,771 |
| Other comprehensive income (loss):                             |                                |         |                              |         |
| Change in unrealized gains on available for<br>sale securities | (529)                          | 654     | (2,574)                      | 724     |
| Income tax effect  | 112                            | (222)   | 540                          | (246)   |
| Change in unrecognized pension cost                            | 47                             | 52      | 93                           | 112     |
| Income tax effect  | (10 )                          | (17 )   | (19 )                        | (38 )   |
| Less: Reclassification adjustment for<br>investment            |                                |         |                              |         |
| security gains included in net income                          | -                              | (23 )   | -                            | (195)   |
| Income tax effect  | -                              | 8       | -                            | 66      |
| Other comprehensive income (loss), net of tax                  | (380 )                         | 452     | (1,960)                      | 423     |
| Comprehensive income   | \$4,311                        | \$3,920 | \$6,978                      | \$7,194 |

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

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

|   | Six Months Ended<br>June 30, |                 |
|---|------------------------------|-----------------|
| (in thousands)  | 2018                         | 2017            |
| <b>CASH FLOWS FROM OPERATING ACTIVITIES:</b>                                      |                              |                 |
| Net income  | \$8,938                      | \$6,771         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                              |                 |
| Provision for loan losses   | 825                          | 1,240           |
| Depreciation and amortization   | 182                          | 199             |
| Amortization and accretion of investment securities                               | 569                          | 735             |
| Deferred income taxes   | 42                           | (105 )          |
| Equity and available for sale securities gains, net                               | (13 )                        | (195 )          |
| Earnings on bank owned life insurance   | (306 )                       | (333 )          |
| Originations of loans held for sale   | (7,260 )                     | (10,247)        |
| Proceeds from sales of loans held for sale  | 6,849                        | 11,840          |
| Realized gains on loans sold  | (132 )                       | (249 )          |
| (Increase) decrease in accrued interest receivable                                | (89 )                        | 392             |
| Increase (decrease) in accrued interest payable                                   | 6                            | (92 )           |
| Other, net  | 23                           | (166 )          |
| Net cash provided by operating activities   | 9,634                        | 9,790           |
| <b>CASH FLOWS FROM INVESTING ACTIVITIES:</b>                                      |                              |                 |
| Available-for-sale securities:  |                              |                 |
| Proceeds from sales   | -                            | 25,407          |
| Proceeds from maturity and principal repayments                                   | 31,351                       | 36,510          |
| Purchase of securities  | (29,828)                     | (13,829)        |
| Purchase of equity securities   | (91 )                        | -               |
| Purchase of interest bearing time deposits with other banks                       | (4,721 )                     | (4,069 )        |
| Proceeds from sale of interest bearing time deposits with other banks             | 1,239                        | 1,745           |
| Proceeds from matured interest bearing time deposits with other banks             | -                            | 496             |
| Proceeds from redemption of regulatory stock                                      | 5,138                        | 4,303           |
| Purchase of regulatory stock  | (5,574 )                     | (3,487 )        |
| Net increase in loans   | (39,375)                     | (88,468)        |
| Purchase of premises and equipment  | (140 )                       | (131 )          |
| Proceeds from sale of foreclosed assets held for sale                             | 736                          | 237             |
| Net cash used in investing activities   | (41,265)                     | (41,286)        |
| <b>CASH FLOWS FROM FINANCING ACTIVITIES:</b>                                      |                              |                 |
| Net increase in deposits  | 13,649                       | 45,706          |
| Proceeds from long-term borrowings  | 4                            | 5               |
| Net short-term borrowed funds   | 18,984                       | (9,669 )        |
| Purchase of treasury and restricted stock   | (850 )                       | (509 )          |
| Dividends paid  | (3,060 )                     | (2,429 )        |
| Net cash provided by financing activities   | 28,727                       | 33,104          |
| Net (decrease) increase in cash and cash equivalents                              | (2,904 )                     | 1,608           |
| <b>CASH AND CASH EQUIVALENTS AT BEGINNING OF PERIOD</b>                           | <b>18,517</b>                | <b>17,754</b>   |
| <b>CASH AND CASH EQUIVALENTS AT END OF PERIOD</b>                                 | <b>\$15,613</b>              | <b>\$19,362</b> |

Supplemental Disclosures of Cash Flow Information:

|  |         |         |
|--|---------|---------|
| Interest paid                            | \$4,234 | \$2,769 |
| Income taxes paid                        | \$1,200 | \$2,075 |
| Loans transferred to foreclosed property | \$78    | \$335   |
| Investments purchased and not settled    | \$-     | \$1,541 |

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

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

Note 1 - Basis of Presentation

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

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

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

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

In January 2016, the FASB finalized ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This accounting standard (a) requires separate presentation of equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) on the balance sheet and measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in

combination with the entity's other deferred tax assets.

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

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

In March 2017, the FASB issued ASU 2017-07, Compensation-Retirement Benefits (Topic 71S). The amendments in this Update require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost are required to be presented in the income statement separately from the service cost component. The Company adopted the standard on January 1, 2018, which resulted in a reclassification of \$(53) and (\$100) from Salaries and employee benefits into Other noninterest expenses on the Consolidated Statement of Income for the three and six month periods ended June 30, 2017. See note 10 for additional information on the presentation of these pension cost components.

#### Note 2 – Revenue Recognition

Effective January 1, 2018, the Company adopted Accounting Standards Update ASU 2014-09 Revenue from Contracts with Customers – Topic 606 and all subsequent ASUs that modified ASC 606. The Company has elected to apply the standard to all prior periods presented utilizing the full retrospective approach. The implementation of the new standard had no material impact to the measurement or recognition of revenue of prior periods. Management determined that the primary sources of revenue emanating from interest and dividend income on loans and investments along with noninterest revenue resulting from investment security gains, loan servicing, gains on loans sold and earnings on bank owned life insurances are not within the scope of ASC 606. As a result, no changes were made during the period related to these sources of revenue, which cumulatively comprise 90.13% and 89.8% of the total revenue of the Company for the three and six months ended June 30, 2018, respectively. The main types of noninterest income within the scope of the standard are as follows:

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

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

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

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

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

| Revenue stream                      | June 30, 2018      |                  |
|-------------------------------------|--------------------|------------------|
|                                     | Three Months Ended | Six Months Ended |
| Service charges on deposit accounts |                    |                  |
| Overdraft fees                      | \$381              | \$748            |
| Statement fees                      | 51                 | 105              |
| Interchange revenue                 | 574                | 1,105            |
| ATM income                          | 101                | 197              |
| Other service charges               | 63                 | 119              |
| Total Service Charges               | 1,170              | 2,274            |
| Trust                               | 150                | 401              |
| Brokerage and insurance             | 168                | 349              |
| Other                               | 78                 | 163              |
| Total                               | \$1,566            | \$3,187          |

### Note 3 - Earnings per Share

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

|  | Three months ended |               | Six months ended |               |
|--|--------------------|---------------|------------------|---------------|
|  | June 30, 2018      | June 30, 2017 | June 30, 2018    | June 30, 2017 |
| Net income applicable to common stock                                      | \$4,691,000        | \$3,468,000   | \$8,938,000      | \$6,771,000   |
| Basic earnings per share computation                                       |                    |               |                  |               |
| Weighted average common shares outstanding                                 | 3,507,242          | 3,514,394     | 3,509,882        | 3,513,925     |
| Earnings per share - basic   | \$1.34             | \$0.99        | \$2.55           | \$1.93        |
| Diluted earnings per share computation                                     |                    |               |                  |               |
| Weighted average common shares outstanding for basic earnings per share    | 3,507,242          | 3,514,394     | 3,509,882        | 3,513,925     |
| Add: Dilutive effects of restricted stock                                  | 1,467              | 1,188         | 631              | 610           |
| Weighted average common shares outstanding for dilutive earnings per share | 3,508,709          | 3,515,582     | 3,510,513        | 3,514,535     |
| Earnings per share - diluted   | \$1.34             | \$0.99        | \$2.55           | \$1.93        |





For the three months ended June 30, 2018 and 2017, there were 465 and 1,562 shares, respectively, related to the restricted stock plan that were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had per share prices ranging from \$46.69-\$61.04 for the three month period ended June 30, 2018 and per share prices ranging from \$49.87-\$53.15 for the three month period ended June 30, 2017. For the six months ended June 30, 2018 and 2017, 3,349 and 4,921 shares, respectively, related to the restricted stock plan were excluded from the diluted earnings per share calculations since they were anti-dilutive. These anti-dilutive shares had prices ranging from \$46.69-\$61.04 for the six month period ended June 30, 2018 and prices ranging from \$47.81-\$53.15 for the six month period ended June 30, 2017.

#### Note 4 – Investments

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

|  | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
|--|-------------------|------------------------------|-------------------------------|---------------|
| June 30, 2018  |                   |                              |                               |               |
| Available-for-sale securities:                                 |                   |                              |                               |               |
| U.S. agency securities   | \$ 103,190        | \$ 30                        | \$ (1,232 )                   | \$ 101,988    |
| U.S. treasury securities                                       | 33,783            | -                            | (791 )                        | 32,992        |
| Obligations of state and<br>political subdivisions             | 67,763            | 456                          | (347 )                        | 67,872        |
| Corporate obligations  | 3,000             | 23                           | -                             | 3,023         |
| Mortgage-backed securities in<br>government sponsored entities | 45,202            | 3                            | (1,055 )                      | 44,150        |
| Total available-for-sale securities                            | \$ 252,938        | \$ 512                       | \$ (3,425 )                   | \$ 250,025    |
| December 31, 2017  |                   |                              |                               |               |
| Available-for-sale securities:                                 |                   |                              |                               |               |
| U.S. agency securities   | \$ 99,454         | \$ 26                        | \$ (593 )                     | \$ 98,887     |
| U.S. treasury securities                                       | 28,782            | -                            | (178 )                        | 28,604        |
| Obligations of state and<br>political subdivisions             | 78,409            | 820                          | (139 )                        | 79,090        |
| Corporate obligations  | 3,000             | 83                           | -                             | 3,083         |
| Mortgage-backed securities in<br>government sponsored entities | 45,385            | 19                           | (377 )                        | 45,027        |
| Equity securities in financial institutions                    | 92                | -                            | (1 )                          | 91            |
| Total available-for-sale securities                            | \$ 255,122        | \$ 948                       | \$ (1,288 )                   | \$ 254,782    |

The following table shows the Company's gross unrealized losses and fair value of the Company's investments with unrealized losses that are not deemed to be other-than-temporarily impaired, aggregated by investment category and length of time, which individual securities have been in a continuous unrealized loss position, at June 30, 2018 and December 31, 2017 (in thousands). As of June 30, 2018, the Company owned 201 securities whose fair value was less than their cost basis.

| June 30, 2018   | Less than Twelve Months |                         | Twelve Months or Greater |                         | Total      |                         |
|---|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
|   | Fair Value              | Gross Unrealized Losses | Fair Value               | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. agency securities                                      | \$76,159                | \$ (978 )               | \$ 19,842                | \$ (254 )               | \$96,001   | \$ (1,232 )             |
| U.S. treasury securities                                    | 32,992                  | (791 )                  | -                        | -                       | 32,992     | (791 )                  |
| Obligations of state and political subdivisions             | 22,564                  | (220 )                  | 6,007                    | (127 )                  | 28,571     | (347 )                  |
| Mortgage-backed securities in government sponsored entities | 25,918                  | (399 )                  | 17,677                   | (656 )                  | 43,595     | (1,055 )                |
| Total securities  | \$157,633               | \$ (2,388 )             | \$43,526                 | \$ (1,037 )             | \$201,159  | \$ (3,425 )             |
| December 31, 2017   |                         |                         |                          |                         |            |                         |
| U.S. agency securities                                      | \$74,952                | \$ (421 )               | \$ 16,928                | \$ (172 )               | \$91,880   | \$ (593 )               |
| U.S. treasury securities                                    | 28,604                  | (178 )                  | -                        | -                       | 28,604     | (178 )                  |
| Obligations of states and political subdivisions            | 14,885                  | (85 )                   | 5,958                    | (54 )                   | 20,843     | (139 )                  |
| Mortgage-backed securities in government sponsored entities | 27,154                  | (190 )                  | 13,822                   | (187 )                  | 40,976     | (377 )                  |
| Equity securities in financial institutions                 | 91                      | (1 )                    | -                        | -                       | 91         | (1 )                    |
| Total securities  | \$145,686               | \$ (875 )               | \$36,708                 | \$ (413 )               | \$182,394  | \$ (1,288 )             |

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

There were no sales of available for sale securities during the six months ended June 30, 2018. Proceeds from sales of securities available-for-sale for the six months ended June 30, 2017 were \$25,407,000. There were no sales of available for sale securities during the three months ended June 30, 2018. Proceeds from sales of securities available-for-sale for the three months ended June 30, 2017 were \$6,641,000. The gross gains and losses were as follows (in thousands):

| Three Months | Six Months |
|--------------|------------|
|--------------|------------|

|   | Ended<br>June 30,<br>2018 | Ended<br>June 30,<br>2017 |
|---|---------------------------|---------------------------|
| Gross gains on available for sale securities  | \$- \$ 30                 | \$- \$202                 |
| Gross losses on available for sale securities | - ( 7 )                   | - ( 7 )                   |
| Net gains                                     | \$- \$ 23                 | \$- \$195                 |

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

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|   | Three Months<br>Ended June 30,<br>2018 | Six Months Ended<br>June 30, 2018 |
|---|--|-----------------------------------|
| Net gains recognized in equity securities during the period                 | \$ 7                                   | \$ 13                             |
| Less: Net gains realized on the sale of equity securities during the period | -                                      | -                                 |
| Unrealized gains recognized in equity securities held at reporting date     | \$ 7                                   | \$ 13                             |

Investment securities with an approximate carrying value of \$240.8 million and \$243.4 million at June 30, 2018 and December 31, 2017, respectively, were pledged to secure public funds and certain other deposits.

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

|  | Amortized  |            |
|--|------------|------------|
|  | Cost       | Fair Value |
| Available-for-sale debt securities:    |            |            |
| Due in one year or less                | \$ 47,012  | \$ 47,121  |
| Due after one year through five years  | 106,241    | 104,395    |
| Due after five years through ten years | 50,336     | 49,644     |
| Due after ten years                    | 49,349     | 48,865     |
| Total                                  | \$ 252,938 | \$ 250,025 |

#### Note 5 – Loans

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

|               | Total | Individually evaluated for impairment | Loans acquired with deteriorated credit quality | Collectively evaluated for impairment |
|---------------|-------|---------------------------------------|---|---------------------------------------|
| June 30, 2018 | Loans |                                       |   |                                       |

## Real estate loans:

|                                       |             |           |          |             |
|---------------------------------------|-------------|-----------|----------|-------------|
| Residential                           | \$213,242   | \$ 1,131  | \$ 30    | \$212,081   |
| Commercial                            | 309,571     | 13,791    | 1,388    | 294,392     |
| Agricultural                          | 262,691     | 5,204     | 683      | 256,804     |
| Construction                          | 27,901      | -         | -        | 27,901      |
| Consumer                              | 9,740       | -         | -        | 9,740       |
| Other commercial loans                | 75,002      | 3,934     | 425      | 70,643      |
| Other agricultural loans              | 42,131      | 1,471     | -        | 40,660      |
| State and political subdivision loans | 99,922      | -         | -        | 99,922      |
| Total                                 | 1,040,200   | 25,531    | 2,526    | 1,012,143   |
| Allowance for loan losses             | 11,941      | 405       | -        | 11,536      |
| Net loans                             | \$1,028,259 | \$ 25,126 | \$ 2,526 | \$1,000,607 |

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

Purchased loans were recorded at fair value on their purchase date without a carryover of the related allowance for loan losses. Upon acquisition, the Company evaluated whether an acquired loan was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired ("PCI") loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. Based upon management's review, there were no material increases or decreases in the expected cash flows of these loans between the acquisition date and June 30, 2018. The fair value of PCI loans, on the acquisition date, was determined, primarily based on the fair value of the loans' collateral. The carrying value of PCI loans was \$2,526,000 and \$2,638,000 at June 30, 2018 and December 31, 2017, respectively. The carrying value of the PCI loans was determined by projected discounted contractual cash flows and collateral valuations.

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

|                                | Three<br>months<br>ended<br>June 30,<br>2018 |       | Six months<br>ended<br>June 30,<br>2017 |       |
|--------------------------------|--|-------|---|-------|
| Balance at beginning of period | \$82   | \$275 | \$106                                   | \$389 |
| Accretion                      | (23)   | (108) | (47)                                    | (222) |
| Balance at end of period       | \$59   | \$167 | \$59                                    | \$167 |

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

|                     | June<br>30,<br>2018 | December<br>31, 2017 |
|---------------------|---------------------|----------------------|
| Outstanding balance | \$5,262             | \$ 5,295             |

|                 |       |       |
|-----------------|-------|-------|
| Carrying amount | 2,526 | 2,638 |
|-----------------|-------|-------|

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



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

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

|                                       | Unpaid<br>Principal<br>Balance | Recorded<br>Investment<br>With No<br>Allowance | Recorded<br>Investment<br>With<br>Allowance | Total<br>Recorded<br>Investment | Related<br>Allowance |
|---------------------------------------|--------------------------------|--|---|---------------------------------|----------------------|
| June 30, 2018                         |                                |  |   |                                 |                      |
| Real estate loans:                    |                                |  |   |                                 |                      |
| Mortgages                             | \$ 1,138                       | \$ 261   | \$ 776                                      | \$ 1,037                        | \$ 15                |
| Home Equity                           | 111                            | 14   | 80  | 94                              | 15                   |
| Commercial                            | 16,576                         | 12,442   | 1,349                                       | 13,791                          | 159                  |
| Agricultural                          | 5,210                          | 3,648  | 1,556                                       | 5,204                           | 25                   |
| Construction                          | -                              | -  | -   | -                               | -                    |
| Consumer                              | -                              | -  | -   | -                               | -                    |
| Other commercial loans                | 4,489                          | 3,552  | 382   | 3,934                           | 151                  |
| Other agricultural loans              | 1,514                          | 1,295  | 176   | 1,471                           | 40                   |
| State and political subdivision loans | -                              | -  | -   | -                               | -                    |
| Total                                 | \$ 29,038                      | \$ 21,212                                      | \$ 4,319                                    | \$ 25,531                       | \$ 405               |

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

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

|                                       | For the Three Months Ended |            |            | June 30, 2017 |            |            |
|---------------------------------------|----------------------------|------------|------------|---------------|------------|------------|
|                                       | June 30, 2018              |            |            | June 30, 2017 |            |            |
|                                       | Average                    | Interest   | Interest   | Average       | Interest   | Interest   |
|                                       | Recorded                   | Income     | Income     | Recorded      | Income     | Income     |
|                                       | Investmen                  | Recognized | Cash Basis | Investmen     | Recognized | Cash Basis |
|                                       | Recorded                   | Recognized | Cash Basis | Recorded      | Recognized | Cash Basis |
| Real estate loans:                    |                            |            |            |               |            |            |
| Mortgages                             | \$1,045                    | \$ 3       | \$ -       | \$986         | \$ 3       | \$ -       |
| Home Equity                           | 95                         | 1          | -          | 60            | 1          | -          |
| Commercial                            | 13,833                     | 120        | 3          | 12,980        | 134        | -          |
| Agricultural                          | 4,185                      | 49         | -          | 3,641         | 32         | -          |
| Construction                          | -                          | -          | -          | -             | -          | -          |
| Consumer                              | -                          | -          | -          | 3             | -          | -          |
| Other commercial loans                | 4,067                      | 26         | -          | 5,029         | 37         | 17         |
| Other agricultural loans              | 1,342                      | 9          | -          | 1,515         | 22         | -          |
| State and political subdivision loans | -                          | -          | -          | -             | -          | -          |
| Total                                 | \$24,567                   | \$ 208     | \$ 3       | \$24,214      | \$ 229     | \$ 17      |

|                                       | For the Six Months ended |            |            | June 30, 2017 |            |            |
|---------------------------------------|--------------------------|------------|------------|---------------|------------|------------|
|                                       | June 30, 2018            |            |            | June 30, 2017 |            |            |
|                                       | Average                  | Interest   | Interest   | Average       | Interest   | Interest   |
|                                       | Recorded                 | Income     | Income     | Recorded      | Income     | Income     |
|                                       | Investmen                | Recognized | Cash Basis | Investmen     | Recognized | Cash Basis |
|                                       | Recorded                 | Recognized | Cash Basis | Recorded      | Recognized | Cash Basis |
| Real estate loans:                    |                          |            |            |               |            |            |
| Mortgages                             | \$1,034                  | \$ 7       | \$ -       | \$940         | \$ 6       | \$ -       |
| Home Equity                           | 101                      | 2          | -          | 58            | 2          | -          |
| Commercial                            | 13,814                   | 242        | 8          | 9,387         | 158        | 3          |
| Agricultural                          | 4,135                    | 100        | -          | 3,513         | 63         | -          |
| Construction                          | -                        | -          | -          | -             | -          | -          |
| Consumer                              | 2                        | -          | -          | 2             | -          | -          |
| Other commercial loans                | 4,112                    | 52         | -          | 5,313         | 77         | 27         |
| Other agricultural loans              | 1,356                    | 19         | -          | 1,571         | 45         | -          |
| State and political subdivision loans | -                        | -          | -          | -             | -          | -          |
| Total                                 | \$24,554                 | \$ 422     | \$ 8       | \$20,784      | \$ 351     | \$ 30      |

### Credit Quality Information

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

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

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

Substandard (Grade 7) – This loan grade is in accordance with regulatory guidance and includes loans that have a well-defined weakness based on objective evidence and be characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

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

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

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

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

| June 30, 2018                            | Pass      | Special<br>Mention | Substandard | Doubtful | Loss | Ending<br>Balance |
|--|-----------|--------------------|-------------|----------|------|-------------------|
| Real estate loans:                       |           |                    |             |          |      |                   |
| Commercial                               | \$284,415 | \$13,347           | \$11,690    | \$119    | \$-  | \$309,571         |
| Agricultural                             | 244,605   | 12,427             | 5,659       | -        | -    | 262,691           |
| Construction                             | 27,901    | -                  | -           | -        | -    | 27,901            |
| Other commercial loans                   | 71,036    | 870                | 2,975       | 121      | -    | 75,002            |
| Other agricultural loans                 | 39,753    | 1,048              | 1,330       | -        | -    | 42,131            |
| State and political<br>subdivision loans | 89,602    | -                  | 10,320      | -        | -    | 99,922            |
| Total                                    | \$757,312 | \$27,692           | \$31,974    | \$240    | \$-  | \$817,218         |

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

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

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

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|             |            |          |      |            |
|-------------|------------|----------|------|------------|
| Mortgages   | \$ 153,342 | \$ 1,375 | \$30 | \$154,747  |
| Home Equity | 58,377     | 118      | -    | 58,495     |
| Consumer    | 9,683      | 57       | -    | 9,740      |
| Total       | \$ 221,402 | \$ 1,550 | \$30 | \$ 222,982 |

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

Aging Analysis of Past Due Financing Receivables

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

|  | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | 90 Days<br>Or<br>Greater | Total<br>Past<br>Due | Current     | PCI     | Total<br>Financing<br>Receivables | 90 Days<br>or<br>Greater<br>and<br>Accruing |
|--|------------------------------|------------------------------|--------------------------|----------------------|-------------|---------|-----------------------------------|---|
| June 30, 2018                            |                              |                              |                          |                      |             |         |                                   |   |
| Real estate loans:                       |                              |                              |                          |                      |             |         |                                   |   |
| Mortgages                                | \$476                        | \$202                        | \$796                    | \$1,474              | \$153,243   | \$30    | \$154,747                         | \$ -  |
| Home Equity                              | 220                          | 8                            | 94                       | 322                  | 58,173      | -       | 58,495                            | -   |
| Commercial                               | 1,649                        | 2,019                        | 4,201                    | 7,869                | 300,314     | 1,388   | 309,571                           | 38  |
| Agricultural                             | 8                            | 1,105                        | 702                      | 1,815                | 260,193     | 683     | 262,691                           | 543   |
| Construction                             | -                            | -                            | -                        | -                    | 27,901      | -       | 27,901                            | -   |
| Consumer                                 | 31                           | 26                           | 32                       | 89                   | 9,651       | -       | 9,740                             | 32  |
| Other commercial loans                   | 47                           | 8                            | 2,324                    | 2,379                | 72,198      | 425     | 75,002                            | -   |
| Other agricultural loans                 | 182                          | 569                          | 433                      | 1,184                | 40,947      | -       | 42,131                            | 433   |
| State and political<br>subdivision loans | -                            | -                            | -                        | -                    | 99,922      | -       | 99,922                            | -   |
| Total                                    | \$2,613                      | \$3,937                      | \$8,582                  | \$15,132             | \$1,022,542 | \$2,526 | \$1,040,200                       | \$1,046                                     |
| Loans considered non-accrual             | \$617                        | \$790                        | \$7,536                  | \$8,943              | \$1,988     | \$-     | \$10,931                          |   |
| Loans still accruing                     | 1,996                        | 3,147                        | 1,046                    | 6,189                | 1,020,554   | 2,526   | 1,029,269                         |   |
| Total                                    | \$2,613                      | \$3,937                      | \$8,582                  | \$15,132             | \$1,022,542 | \$2,526 | \$1,040,200                       |   |

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

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|  |         |         |         |          |           |         |             |        |
|--|---------|---------|---------|----------|-----------|---------|-------------|--------|
| Construction                             | -       | -       | 133     | 133      | 13,369    | -       | 13,502      | -      |
| Consumer                                 | 53      | 33      | 49      | 135      | 9,809     | -       | 9,944       | 7      |
| Other commercial loans                   | 132     | -       | 2,372   | 2,504    | 69,066    | 443     | 72,013      | 32     |
| Other agricultural loans                 | -       | 42      | 106     | 148      | 37,661    | -       | 37,809      | 106    |
| State and political<br>subdivision loans | -       | -       | -       | -        | 104,737   | -       | 104,737     | -      |
| Total                                    | \$3,053 | \$1,533 | \$7,618 | \$12,204 | \$985,683 | \$2,638 | \$1,000,525 | \$ 555 |
| Loans considered non-accrual             | \$816   | \$281   | \$7,063 | \$8,160  | \$2,011   | \$-     | \$10,171    |        |
| Loans still accruing                     | 2,237   | 1,252   | 555     | 4,044    | 983,672   | 2,638   | 990,354     |        |
| Total                                    | \$3,053 | \$1,533 | \$7,618 | \$12,204 | \$985,683 | \$2,638 | \$1,000,525 |        |

Nonaccrual Loans

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

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

|                                 | June 30,<br>2018 | December<br>31, 2017 |
|---------------------------------|------------------|----------------------|
| Real estate loans:              |                  |                      |
| Mortgages                       | \$ 1,375         | \$ 1,274             |
| Home Equity                     | 118              | 112                  |
| Commercial                      | 6,262            | 5,192                |
| Agricultural                    | 167              | 175                  |
| Construction                    | -                | 133                  |
| Consumer                        | 25               | 42                   |
| Other commercial loans          | 2,415            | 2,637                |
| Other agricultural loans        | 569              | 606                  |
| State and political subdivision | -                | -                    |
|                                 | \$ 10,931        | \$ 10,171            |

Troubled Debt Restructurings

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a Troubled Debt Restructuring (TDR). Management strives to identify borrowers in financial difficulty early and work with them to structure more affordable terms before their loan reaches nonaccrual status. These restructured terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of interest or principal, or both, management measures any impairment on the restructuring by calculating the present value of the revised loan terms and comparing this balance to the Company's investment in the loan prior to the restructuring. As these loans are individually evaluated, they are excluded from pooled portfolios when calculating the allowance for loan and lease losses and a separate allocation within the allowance for loan and lease losses is provided. Management continually evaluates loans that are considered TDRs, including payment history under the modified loan terms, the borrower's ability to continue to repay the loan based on continued evaluation of their operating results and cash flows from operations. Based on this evaluation management would no longer consider a loan to be a TDR when the relevant facts support such a conclusion. As of June 30, 2018 and December 31, 2017, included within the allowance for loan losses are reserves of \$87,000 and \$41,000 respectively, that are associated with loans modified as TDRs.

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

|                          | For the Three Months Ended June 30, 2018 |              |                   |              |              |              |
|--------------------------|--|--------------|-------------------|--------------|--------------|--------------|
|                          | Pre-modification                         |              | Post-Modification |              |              |              |
| Number of contracts      | Outstanding                              |              | Outstanding       |              |              |              |
|                          | Recorded                                 |              | Recorded          |              |              |              |
| Interest Term            | Investment                               |              | Investment        |              |              |              |
|                          | Interest Term                            |              | Interest Term     |              |              |              |
| Modification             | Modification                             | Modification | Modification      | Modification | Modification | Modification |
| Real estate loans:       |  |              |                   |              |              |              |
| Home Equity              | -  | 1            | \$ -              | \$ 1         | \$ -         | \$ 1         |
| Commercial               | -  | 1            | -                 | 577          | -            | 577          |
| Agricultural             | -  | 1            | -                 | 1,523        | -            | 1,523        |
| Other agricultural loans | -  | 4            | -                 | 176          | -            | 176          |



Total                    -        7                \$ -    \$ 2,277                \$ -    \$ 2,277

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## For the Six Months Ended June 30, 2018

|                          | Number of contracts |              | Pre-modification Outstanding Recorded Investment Interest Term |              | Post-Modification Outstanding Recorded Investment Interest Term |              |
|--------------------------|---------------------|--------------|--|--------------|---|--------------|
|                          | Modification        | Modification | Modification   | Modification | Modification  | Modification |
| Real estate loans:       |                     |              |  |              |   |              |
| Mortgages                | -                   | 1            | \$ -   | \$ 7         | \$  | \$ 7         |
| Home Equity              | -                   | 1            | -  | 1            | -   | 1            |
| Commercial               | -                   | 1            | -  | 577          | -   | 577          |
| Agricultural             | -                   | 1            | -  | 1,523        |   | 1,523        |
| Other agricultural loans | -                   | 4            | -  | 176          |   | 176          |
| Total                    | -                   | 8            | \$ -   | \$ 2,284     | \$ -  | \$ 2,284     |

## For the Three Months Ended June 30, 2017

|                    | Number of contracts |              | Pre-modification Outstanding Recorded Investment Interest Term |              | Post-Modification Outstanding Recorded Investment Interest Term |              |
|--------------------|---------------------|--------------|--|--------------|---|--------------|
|                    | Modification        | Modification | Modification   | Modification | Modification  | Modification |
| Real estate loans: |                     |              |  |              |   |              |
| Commercial         | -                   | 5            | \$ -   | \$ 6,093     | \$ -  | \$ 6,093     |
| Total              | -                   | 5            | \$ -   | \$ 6,093     | \$ -  | \$ 6,093     |

## For the Six Months Ended June 30, 2017

|                    | Number of contracts |              | Pre-modification Outstanding Recorded Investment Interest Term |              | Post-Modification Outstanding Recorded Investment Interest Term |              |
|--------------------|---------------------|--------------|--|--------------|---|--------------|
|                    | Modification        | Modification | Modification   | Modification | Modification  | Modification |
| Real estate loans: |                     |              |  |              |   |              |
| Commercial         | -                   | 7            | \$ -   | \$ 6,797     | \$ -  | \$ 6,797     |
| Total              | -                   | 7            | \$ -   | \$ 6,797     | \$ -  | \$ 6,797     |

Recidivism, or the borrower defaulting on its obligation pursuant to a modified loan, results in the loan once again becoming a non-accrual loan. Recidivism on modified loans occurs at a notably higher rate than do defaults on new origination loans, so modified loans present a higher risk of loss than do new origination loans. There were no loans that were modified as TDRs during each 12-month period prior to the current reporting periods, which began January 1, 2018 and 2017 (6 month periods) and April 1, 2018 and 2017 (3 month periods), respectively, that subsequently defaulted during these reporting periods.

## Allowance for Loan Losses

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



|  | June 30, 2018                                  |  |          | December 31, 2017                              |  |          |
|--|--|--|----------|--|--|----------|
|  | Individually<br>evaluated<br>for<br>impairment | Collectively<br>evaluated<br>for<br>impairment | Total    | Individually<br>evaluated<br>for<br>impairment | Collectively<br>evaluated<br>for<br>impairment | Total    |
| Real estate loans:                       |  |  |          |  |  |          |
| Residential                              | \$30   | \$ 1,015                                       | \$1,045  | \$56   | \$ 993   | \$1,049  |
| Commercial                               | 159  | 3,635  | 3,794    | 94   | 3,773  | 3,867    |
| Agricultural                             | 25   | 3,648  | 3,673    | 3  | 3,140  | 3,143    |
| Construction                             | -  | 44   | 44       | -  | 23   | 23       |
| Consumer                                 | -  | 115  | 115      | -  | 124  | 124      |
| Other commercial loans                   | 151  | 1,115  | 1,266    | 231  | 1,041  | 1,272    |
| Other agricultural loans                 | 40   | 549  | 589      | 26   | 466  | 492      |
| State and political<br>subdivision loans | -  | 767  | 767      | -  | 816  | 816      |
| Unallocated                              | -  | 648  | 648      | -  | 404  | 404      |
| Total                                    | \$405  | \$ 11,536                                      | \$11,941 | \$410  | \$ 10,780                                      | \$11,190 |

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

|  | For the three months ended June 30, 2018 |             |            |           | Balance<br>at<br>June 30,<br>2018 |
|--|--|-------------|------------|-----------|-----------------------------------|
|  | Balance<br>at<br>March<br>31,<br>2018    | Charge-offs | Recoveries | Provision |                                   |
| Real estate loans:                       |  |             |            |           |                                   |
| Residential                              | \$1,077                                  | \$ (2 )     | \$ 69      | \$ (99 )  | \$1,045                           |
| Commercial                               | 4,006                                    | -           | 3          | (215 )    | 3,794                             |
| Agricultural                             | 3,340                                    | -           | -          | 333       | 3,673                             |
| Construction                             | 39                                       | -           | -          | 5         | 44                                |
| Consumer                                 | 123                                      | (6 )        | 7          | (9 )      | 115                               |
| Other commercial loans                   | 1,273                                    | (46 )       | 11         | 28        | 1,266                             |
| Other agricultural loans                 | 532                                      | (7 )        | -          | 64        | 589                               |
| State and political<br>subdivision loans | 789                                      | -           | -          | (22 )     | 767                               |
| Unallocated                              | 408                                      | -           | -          | 240       | 648                               |
| Total                                    | \$11,587                                 | \$ (61 )    | \$ 90      | \$ 325    | \$11,941                          |

|                    | For the six months ended June 30, 2018   |             |            |           | Balance<br>at<br>June 30,<br>2018 |
|--------------------|--|-------------|------------|-----------|-----------------------------------|
|                    | Balance<br>at<br>December<br>31,<br>2017 | Charge-offs | Recoveries | Provision |                                   |
| Real estate loans: |  |             |            |           |                                   |
| Residential        | \$1,049                                  | \$ (17 )    | \$ 69      | \$ (56 )  | \$1,045                           |
| Commercial         | 3,867                                    | -           | 3          | (76 )     | 3,794                             |
| Agricultural       | 3,143                                    | -           | -          | 530       | 3,673                             |

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|  |          |         |   |        |                 |
|--|----------|---------|---|--------|-----------------|
| Construction                             | 23       | -       | - | 21     | 44              |
| Consumer                                 | 124      | (19     | ) | 17     | (7 ) 115        |
| Other commercial loans                   | 1,272    | (91     | ) | 14     | 71 1,266        |
| Other agricultural loans                 | 492      | (50     | ) | -      | 147 589         |
| State and political<br>subdivision loans | 816      | -       | - | (49    | ) 767           |
| Unallocated                              | 404      | -       | - | 244    | 648             |
| Total                                    | \$11,190 | \$ (177 | ) | \$ 103 | \$ 825 \$11,941 |

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|  | For the three months ended June 30, 2017 |             |            |           |          |
|--|--|-------------|------------|-----------|----------|
|  | Balance                                  |             |            |           | Balance  |
|  | at                                       |             |            |           | at       |
|  | March                                    |             |            |           | June     |
|  | 31,                                      |             |            |           | 30,      |
|  | 2017                                     | Charge-offs | Recoveries | Provision | 2017     |
| Real estate loans:                       |  |             |            |           |          |
| Residential                              | \$1,042                                  | \$ (48 )    | \$ -       | \$ 110    | \$ 1,104 |
| Commercial                               | 3,665                                    | -           | 2          | (126 )    | 3,541    |
| Agricultural                             | 1,952                                    | -           | -          | 500       | 2,452    |
| Construction                             | 46                                       | -           | -          | (1 )      | 45       |
| Consumer                                 | 123                                      | (17 )       | 12         | 7         | 125      |
| Other commercial loans                   | 1,215                                    | -           | -          | (84 )     | 1,131    |
| Other agricultural loans                 | 306                                      | -           | -          | 125       | 431      |
| State and political<br>subdivision loans | 824                                      | -           | -          | 14        | 838      |
| Unallocated                              | 232                                      | -           | -          | 80        | 312      |
| Total                                    | \$9,405                                  | \$ (65 )    | \$ 14      | \$ 625    | \$9,979  |

|  | For the six months ended June 30, 2017 |             |            |           |          |
|--|--|-------------|------------|-----------|----------|
|  | Balance                                |             |            |           | Balance  |
|  | at                                     |             |            |           | at       |
|  | December                               |             |            |           | June     |
|  | 31,                                    |             |            |           | 30,      |
|  | 2016                                   | Charge-offs | Recoveries | Provision | 2017     |
| Real estate loans:                       |  |             |            |           |          |
| Residential                              | \$1,064                                | \$ (93 )    | \$ -       | \$ 133    | \$ 1,104 |
| Commercial                               | 3,589                                  | (41 )       | 6          | (13 )     | 3,541    |
| Agricultural                             | 1,494                                  | -           | -          | 958       | 2,452    |
| Construction                             | 47                                     | -           | -          | (2 )      | 45       |
| Consumer                                 | 122                                    | (45 )       | 22         | 26        | 125      |
| Other commercial loans                   | 1,327                                  | -           | 9          | (205 )    | 1,131    |
| Other agricultural loans                 | 312                                    | (5 )        | -          | 124       | 431      |
| State and political<br>subdivision loans | 833                                    | -           | -          | 5         | 838      |
| Unallocated                              | 98                                     | -           | -          | 214       | 312      |
| Total                                    | \$8,886                                | \$ (184 )   | \$ 37      | \$ 1,240  | \$9,979  |

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

analyzed:

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

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- National, state, regional and local economic trends and business conditions
- § General economic conditions
- § Unemployment rates
- § Inflation rate/ Consumer Price Index
- § Changes in values of underlying collateral for collateral-dependent loans;
- Industry conditions including the effects of external factors such as competition, legal, and regulatory requirements on the level of estimated credit losses;
- Existence and effect of any credit concentrations, and changes in the level of such concentrations; and
- Any change in the level of board oversight.

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

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

For the three months ended June 30, 2018, the allowance for residential real estate decreased in general reserves for pooled loans as a result of a decrease in the qualitative factor associated with unemployment rates. In addition, there was a decrease in total residential loans. This was represented as a decrease to the provision. The allowance for commercial real estate was decreased in general reserves due to a decrease in the qualitative factor associated with unemployment rates and an improvement in the number of loans classified as special mention. This was represented as a decrease in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances and an increase in the amount of loans classified as special mention and substandard. The result of this was represented as an increase in the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. The result of these changes was represented as an increase in the provision.

For the six months ended June 30, 2018, the allowance for residential real estate decreased in general reserves for pooled loans as a result of a decrease in the qualitative factor associated with unemployment rates. In addition, there was a decrease in total residential loans. This was represented as a decrease to the provision. The allowance for commercial real estate was decreased in general reserves due to a decrease in the qualitative factor associated with unemployment rates and an improvement in the number of loans classified as special mention. This was represented as a decrease in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances and an increase in the amount of loans classified as special mention. The result of this was represented as an increase in the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. The result of these changes was represented as an increase in the provision.

For the three months ended June 30, 2017, the allowance for residential real estate increased in general reserves for pooled loans as a result of increased loss rates reflected in the charge-offs for the three month period, as well as higher loan balances, and an increase in the specific reserve for individually evaluated loans. This was represented as an increase to the provision. The allowance for commercial real estate was decreased in general reserves due to the improvement in classified loans, which was represented as a decrease in the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances. It was also impacted by the classified loan trend in the agricultural real estate portfolio. The result of these changes was represented as an increase in the provision. The allowance for other commercial loans was reduced as a result of lower loan balances, an improvement in the amount of classified loans and a reduction in the specific reserves. This was represented by a decrease to the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. It was also impacted by the classified loan trend in the other agricultural loan portfolio. The result of these changes was represented as an increase in the provision.





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For the six months ended June 30, 2017, the allowance for residential real estate increased in general reserves as a result of increased loss rates reflected in the charge-offs for the six month period and an increase in the specific reserve. This was represented as an increase to the provision. The allowance for agricultural real estate loans was increased in general reserves as a result of higher loan balances as well as an increase in specific reserves. It was also impacted by the classified loan trend in the agricultural real estate portfolio. The result of these changes was represented as an increase in the provision. The allowance for other commercial loans was reduced as a result of lower loan balances, an improvement in the amount of classified loans and a reduction in the specific reserves. This was represented by a decrease to the provision. The allowance for other agricultural loans was increased in general reserves as a result of higher loan balances. It was also impacted by the classified loan trend in the other agricultural loan portfolio. The result of these changes was represented as an increase in the provision.

Foreclosed Assets Held For Sale

Foreclosed assets acquired in settlement of loans are carried at fair value, less estimated costs to sell, and are included in other assets on the Consolidated Balance Sheet. As of June 30, 2018 and December 31, 2017, included with other assets are \$471,000 and \$1,119,000, respectively, of foreclosed assets. As of June 30, 2018, included within the foreclosed assets are \$175,000 of consumer residential mortgages that were foreclosed on or received via a deed in lieu transaction prior to the period end. As of June 30 2018, the Company has initiated formal foreclosure proceedings on \$2,023,000 of consumer residential mortgages, which have not yet been transferred into foreclosed assets.

Note 6 – Goodwill and Other Intangible Assets

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

|                                   | June 30, 2018        |                          |                    | December 31, 2017    |                          |                    |
|-----------------------------------|----------------------|--------------------------|--------------------|----------------------|--------------------------|--------------------|
|                                   | Gross carrying value | Accumulated amortization | Net carrying value | Gross carrying value | Accumulated amortization | Net carrying value |
| Amortized intangible assets (1):  |                      |                          |                    |                      |                          |                    |
| MSRs                              | \$ 1,656             | \$ (1,009)               | ) \$ 647           | \$ 1,605             | \$ (912)                 | ) \$ 693           |
| Core deposit intangibles          | 1,786                | (721)                    | ) 1,065            | 1,786                | (586)                    | ) 1,200            |
| Covenant not to compete           | 125                  | (81)                     | ) 44               | 125                  | (65)                     | ) 60               |
| Total amortized intangible assets | \$ 3,567             | \$ (1,811)               | ) \$ 1,756         | \$ 3,516             | \$ (1,563)               | ) \$ 1,953         |
| Unamortized intangible assets:    |                      |                          |                    |                      |                          |                    |
| Goodwill                          | \$ 23,296            |                          |                    | \$ 23,296            |                          |                    |

(1) Excludes fully amortized intangible assets

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

|   | MSRs  | Core deposit intangibles | Covenant not to compete | Total  |
|---|-------|--------------------------|-------------------------|--------|
| Three months ended June 30, 2018 (actual)           | \$ 48 | \$ 66                    | \$ 8                    | \$ 122 |
| Six months ended June 30, 2018 (actual)             | 97    | 134                      | 16                      | 247    |
| Three months ended June 30, 2017 (actual)           | 45    | 66                       | 7                       | 118    |
| Six months June 30, 2017 (actual)                   | 91    | 134                      | 15                      | 240    |
| Estimate for year ended December 31, Remaining 2018 | 88    | 130                      | 15                      | 233    |
| 2019  | 157   | 230                      | 29                      | 416    |

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|      |     |     |   |     |
|------|-----|-----|---|-----|
| 2020 | 123 | 197 | - | 320 |
| 2021 | 94  | 165 | - | 259 |
| 2022 | 69  | 133 | - | 202 |

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## Note 7 – Federal Home Loan Bank Stock

As a member of the FHLB of Pittsburgh, the Bank is required to maintain a minimum investment in stock of the FHLB that varies with the level of advances outstanding with the FHLB. As of June 30, 2018 and December 31, 2017, the Bank's investment in FHLB stock was \$6,456,000 and \$6,021,000, respectively. The stock does not have a readily determinable fair value and, as such, is classified as restricted stock, carried at cost and evaluated by management for impairment. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) a significant decline in net assets of the FHLB as compared to the capital stock amount and the length of time this situation has persisted (b) commitments by the FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance (c) the impact of legislative and regulatory changes on the customer base of the FHLB and (d) the liquidity position of the FHLB. Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB's regulatory capital ratios are sufficient, liquidity appears adequate, new shares of FHLB stock continue to exchange hands at the \$100 par value and the FHLB has repurchased shares of excess capital stock from its members and has paid a quarterly cash dividend.

## Note 8 – Repurchase Agreements

We utilize securities sold under agreements to repurchase to facilitate the needs of our customers and to facilitate secured short-term funding needs. Securities sold under agreements to repurchase are stated at the amount of cash received in connection with the transaction. We monitor collateral levels on a continuous basis. We may be required to provide additional collateral based on the fair value of the underlying securities. Securities pledged as collateral under repurchase agreements are maintained with our safekeeping agents.

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

|  | Remaining Contractual Maturity of the Agreements |               |              |                      | Total    |
|--|--|---------------|--------------|----------------------|----------|
|  | Overnight and Continuous                         | Up to 30 Days | 30 - 90 Days | Greater than 90 days |          |
| June 30, 2018  |  |               |              |                      |          |
| Repurchase Agreements:                               |  |               |              |                      |          |
| U.S. agency securities                               | \$18,909   | \$ -          | \$ -         | \$1,998              | \$20,907 |
| Total carrying value of collateral pledged           | \$18,909   | \$ -          | \$ -         | \$1,998              | \$20,907 |
| Total liability recognized for repurchase agreements |  |               |              |                      | \$15,061 |
| December 31, 2017                                    |  |               |              |                      |          |
| Repurchase Agreements:                               |  |               |              |                      |          |
| U.S. agency securities                               | \$16,027   | \$ -          | \$ -         | \$2,035              | \$18,062 |
| Total carrying value of collateral pledged           | \$16,027   | \$ -          | \$ -         | \$2,035              | \$18,062 |
| Total liability recognized for repurchase agreements |  |               |              |                      | \$14,989 |

## Note 9 - Employee Benefit Plans

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

#### Noncontributory Defined Benefit Pension Plan

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

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

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

The following sets forth the components of net periodic benefit costs of the Pension Plan and the line item on the Consolidated Statement of Income where such amounts are included, for the three months ended June 30, 2018 and 2017, respectively (in thousands):

|                                | Three Months Ended |               | Six Months Ended |               | Affected line item on the Consolidated Statement of income |
|--------------------------------|--------------------|---------------|------------------|---------------|--|
|                                | June 30, 2018      | June 30, 2017 | June 30, 2018    | June 30, 2017 |  |
| Service cost                   | \$90               | \$84          | \$179            | \$175         | Salaries and Employee Benefits                             |
| Interest cost                  | 162                | 168           | 325              | 335           | Other Expenses   |
| Expected return on plan assets | (345)              | (273)         | (689)            | (547)         | Other Expenses   |
| Net amortization and deferral  | 47                 | 52            | 93               | 112           | Other Expenses   |
| Net periodic (benefit) cost    | \$(46 )            | \$31          | \$(92 )          | \$75          |  |

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

#### Restricted Stock Plan

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

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

|                                  | Three months |                               | Six months |                               |
|----------------------------------|--------------|-------------------------------|------------|-------------------------------|
|                                  | Unvested     | Weighted Average Market Price | Unvested   | Weighted Average Market Price |
| Outstanding, beginning of period | 8,691        | \$ 51.19                      | 8,783      | \$ 51.20                      |
| Granted                          | 4,869        | 62.91                         | 4,869      | 62.91                         |
| Forfeited                        | -            | -                             | -          | -                             |
| Vested                           | (3,626)      | (50.54 )                      | (3,718)    | (50.58 )                      |
| Outstanding, end of period       | 9,934        | \$ 57.18                      | 9,934      | \$ 57.18                      |

Compensation cost related to restricted stock is recognized, based on the market price of the stock at the grant date, over the vesting period. Compensation expense related to restricted stock was \$119,000 and \$104,000 for the six months ended June 30, 2018 and 2017, respectively. For the three months ended June 30, 2018 and 2017, compensation expense totaled \$63,000 and \$54,000, respectively. At June 30, 2018, the total compensation cost related to nonvested awards that has not yet been recognized was \$568,000, which is expected to be recognized over the next three years.

## Note 10 – Accumulated Comprehensive Loss

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

|   | Six months ended June 30,<br>2018   |            |           |
|---|---|------------|-----------|
|   | Unrealized<br>gain<br>(loss)<br>on Defined<br>available Benefit<br>for sale Pension<br>securities Items |            |           |
|   | (a)   | (a)        | Total     |
| Balance as of December 31, 2017   | \$(269 )  | \$(3,129 ) | \$(3,398) |
| Change in Accounting policy for equity securities                                       | 1   | -          | 1         |
| Other comprehensive loss before reclassifications (net of tax)                          | (2,034)   | -          | (2,034)   |
| Amounts reclassified from accumulated other<br>comprehensive income (loss) (net of tax) | -   | 74         | 74        |
| Net current period other comprehensive loss   | (2,034)   | 74         | (1,960)   |
| Balance as of June 30, 2018   | \$(2,302)   | \$(3,055 ) | \$(5,357) |

|  | Six months ended June 30,<br>2017   |            |           |
|--|---|------------|-----------|
|  | Unrealized<br>gain<br>(loss)<br>on Defined<br>available Benefit<br>for sale Pension<br>securities Items |            |           |
|  | (a)   | (a)        | Total     |
| Balance as of December 31, 2016  | \$1,306   | \$(2,698 ) | \$(1,392) |
| Other comprehensive income before reclassifications (net of tax)               | 478   | -          | 478       |
| Amounts reclassified from accumulated other<br>comprehensive loss (net of tax) | (129 )  | 74         | (55 )     |
| Net current period other comprehensive income                                  | 349   | 74         | 423       |
| Balance as of June 30, 2017  | \$1,655   | \$(2,624 ) | \$(969 )  |

|                              | Three months ended June<br>30, 2018   |            |           |
|------------------------------|---|------------|-----------|
|                              | Unrealized<br>gain<br>(loss)<br>on Defined<br>available Benefit<br>for sale Pension<br>securities Items |            |           |
|                              | (a)   | (a)        | Total     |
| Balance as of March 31, 2018 | \$(1,885)   | \$(3,092 ) | \$(4,977) |



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|   |           |            |           |
|---|-----------|------------|-----------|
| Other comprehensive loss before reclassifications (net of tax)              | (417 )    | -          | (417 )    |
| Amounts reclassified from accumulated other comprehensive loss (net of tax) | -         | 37         | 37        |
| Net current period other comprehensive income (loss)                        | (417 )    | 37         | (380 )    |
| Balance as of June 30, 2018   | \$(2,302) | \$(3,055 ) | \$(5,357) |

|  | Three months ended June 30, 2017  |            |           |
|--|---|------------|-----------|
|  | Unrealized gain (loss) on Defined available for sale securities Pension Items |            |           |
|  | (a)   | (a)        | Total     |
| Balance as of March 31, 2017   | \$1,238   | \$(2,659 ) | \$(1,421) |
| Other comprehensive income before reclassifications (net of tax)                     | 432   | -          | 432       |
| Amounts reclassified from accumulated other comprehensive income (loss) (net of tax) | (15 )   | 35         | 20        |
| Net current period other comprehensive income (loss)                                 | 417   | 35         | 452       |
| Balance as of June 30, 2017  | \$1,655   | \$(2,624 ) | \$(969 )  |

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

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

| Details about accumulated other comprehensive income (loss)  | Amount reclassified from accumulated comprehensive income (loss) (a) | Affected line item in the Consolidated Statement of Income                           |
|--|--|--|
|  | Three Months Ended June 30, 2018                                     | 2017   |
| Unrealized gains and losses on available for sale securities | \$-<br>-<br>\$-  | \$23<br>(8)<br>\$15  |
|  |  | Available for sale securities gains, net<br>Provision for income taxes<br>Net of tax |
| Defined benefit pension items                                | \$(47)<br>10<br>\$(37)   | \$(52)<br>17<br>\$(35)   |
|  |  | Salaries and employee benefits<br>Provision for income taxes<br>Net of tax           |
| Total reclassifications                                      | \$(37)   | \$(20)   |
|  | Six Months Ended June 30   | 2018   |
|  | 2017   |  |
| Unrealized gains and losses on available for sale securities | \$-<br>-<br>\$-  | \$195<br>(66)<br>\$129   |
|  |  | Available for sale securities gains, net<br>Provision for income taxes<br>Net of tax |
| Defined benefit pension items                                | \$(93)<br>19<br>\$(74)   | \$(112)<br>38<br>\$(74)  |
|  |  | Salaries and employee benefits<br>Provision for income taxes<br>Net of tax           |
| Total reclassifications                                      | \$(74)   | \$55   |

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

#### Note 11 – Fair Value Measurements

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

Level I: Quoted prices are available in active markets for identical assets or liabilities as of the reported date.

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

Level III: Assets and liabilities that have little to no pricing observability as of the reported date. These items do not have two-way markets and are measured using management's best estimate of fair value, where the inputs into the determination of fair value require significant management judgment or estimation.

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

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

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

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

| June 30, 2018   | Level I | Level II | Level III | Total   |
|---|---------|----------|-----------|---------|
| Fair value measurements on a recurring basis:               |         |          |           |         |
| Assets  |         |          |           |         |
| Equity securities in financial institutions                 | \$195   | \$-      | \$ -      | \$195   |
| Available for sale securities:                              |         |          |           |         |
| U.S. Agency securities                                      | -       | 101,988  | -         | 101,988 |
| U.S. Treasury securities                                    | 32,992  | -        | -         | 32,992  |
| Obligations of state and political subdivisions             | -       | 67,872   | -         | 67,872  |
| Corporate obligations                                       | -       | 3,023    | -         | 3,023   |
| Mortgage-backed securities in government sponsored entities | -       | 44,150   | -         | 44,150  |

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

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

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

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|                         | Level<br>I | Level<br>II | Level<br>III | Total   |
|-------------------------|------------|-------------|--------------|---------|
| June 30, 2018           |            |             |              |         |
| Impaired Loans          | \$ -       | \$ -        | \$3,470      | \$3,470 |
| Other real estate owned | -          | -           | 326          | 326     |
| December 31, 2017       |            |             |              |         |
| Impaired Loans          | \$ -       | \$ -        | \$1,569      | \$1,569 |
| Other real estate owned | -          | -           | 1,024        | 1,024   |

Impaired Loans - The Company has measured impairment on impaired loans generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties. In some cases, management may adjust the appraised value due to the age of the appraisal, changes in market conditions, or observable deterioration of the property since the appraisal was completed. Additionally, management makes estimates about expected costs to sell the property which are also included in the net realizable value. If the fair value of the collateral dependent loan is less than the carrying amount of the loan a specific reserve for the loan is made in the allowance for loan losses or a charge-off is taken to reduce the loan to the fair value of the collateral (less estimated selling costs) and the loan is included in the table above as a Level III measurement. If the fair value of the collateral exceeds the carrying amount of the loan, then the loan is not included in the table above as it is not currently being carried at its fair value. The fair values above excluded estimated selling costs of \$304,000 and \$163,000 at June 30, 2018 and December 31, 2017, respectively.

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

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

|                         | Fair<br>Value | Valuation Technique(s)      | Unobservable input                | Range            | Weighted<br>average |        |
|-------------------------|---------------|-----------------------------|-----------------------------------|------------------|---------------------|--------|
| June 30, 2018           |               |                             |                                   |                  |                     |        |
| Impaired Loans          | \$3,470       | Appraised Collateral Values | Discount for time since appraisal | 0-100%           | 27.32               | %      |
|                         |               |                             | Selling costs                     | 5%-11%           | 7.88                | %      |
|                         |               |                             | Holding period                    | 0 - 12<br>months | 11.4                | months |
| Other real estate owned | 326           | Appraised Collateral Values | Discount for time since appraisal | 25-35%           | 27.45               | %      |
| December 31, 2017       |               |                             |                                   |                  |                     |        |
| Impaired Loans          | 1,569         | Appraised Collateral Values | Discount for time since appraisal | 0-100%           | 30.83               | %      |
|                         |               |                             | Selling costs                     | 5%-9%            | 8.35                | %      |
|                         |               |                             | Holding period                    | 6 - 12<br>months | 11                  | months |

Other real estate owned 1,024 Appraised Collateral ValuesDiscount for time since appraisal 15-65% 26.26 %

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

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

| June 30, 2018                                   | Carrying    |             | Level     |      |           |
|---|-------------|-------------|-----------|------|-----------|
|   | Amount      | Fair Value  | Level I   | II   | Level III |
| Financial assets:                               |             |             |           |      |           |
| Cash and due from banks                         | \$15,613    | \$15,613    | \$15,613  | \$ - | \$-       |
| Interest bearing time deposits with other banks | 13,762      | 13,766      | -         | -    | 13,766    |
| Loans held for sale                             | 1,931       | 1,931       | 1,931     | -    | -         |
| Net loans                                       | 1,028,259   | 1,021,166   | -         | -    | 1,021,166 |
| Bank owned life insurance                       | 27,189      | 27,189      | 27,189    | -    | -         |
| Regulatory stock                                | 7,220       | 7,220       | 7,220     | -    | -         |
| Accrued interest receivable                     | 4,285       | 4,285       | 4,285     | -    | -         |
| Financial liabilities:                          |             |             |           |      |           |
| Deposits  | \$1,118,592 | \$1,113,001 | \$847,151 | \$ - | \$265,850 |
| Borrowed funds                                  | 133,652     | 132,322     | 96,566    | -    | 35,756    |
| Accrued interest payable                        | 903         | 903         | 903       | -    | -         |

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

## Note 13 – Recent Accounting Pronouncements

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a



modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

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

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

Forward-Looking Statements

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

· Interest rates could change more rapidly or more significantly than we expect.

The economy could change significantly in an unexpected way, which would cause the demand for new loans and the ability of borrowers to repay outstanding loans to change in ways that our models do not anticipate.

The financial markets could suffer a significant disruption, which may have a negative effect on our financial condition and that of our borrowers, and on our ability to raise money by issuing new securities.

It could take us longer than we anticipate to implement strategic initiatives designed to increase revenues or manage expenses, or we may be unable to implement those initiatives at all.

We may not be able to successfully integrate businesses we acquire or be able to fully realize the expected financial and other benefits from acquisitions.

· Acquisitions and dispositions of assets could affect us in ways that management has not anticipated.

We may become subject to new legal obligations or the resolution of litigation may have a negative effect on our financial condition or operating results.

· We may become subject to new and unanticipated accounting, tax, or regulatory practices or requirements.

We could experience greater loan delinquencies than anticipated, adversely affecting our earnings and financial condition.

We could experience greater losses than expected due to the ever increasing volume of information theft and fraudulent scams impacting our customers and the banking industry.

We could lose the services of some or all of our key personnel, which would negatively impact our business because of their business development skills, financial expertise, lending experience, technical expertise and market area knowledge.

The agricultural economy is subject to extreme swings in both the costs of resources and the prices received from the sale of products, which could negatively impact our customers.

Loan concentrations in certain industries could negatively impact financial results, if financial results or economic conditions deteriorate.

A budget impasse in the Commonwealth of Pennsylvania could impact our asset values, liquidity and profitability as a result of either delayed or reduced funding to school districts and municipalities who are customers of the Bank. Companies providing support services related to the exploration and drilling of the natural gas reserves in our market area may be affected by federal, state and local laws and regulations such as restrictions on production, permitting, changes in taxes and environmental protection, which could negatively impact our customers and, as a result, negatively impact our loan and deposit volume and loan quality. Additionally, the activities the companies providing support services related to the exploration and drilling of the natural gas reserves may be dependent on the market price of natural gas. As a result, decreases in the market price of natural gas could also negatively impact these companies, our customers.

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

### Introduction

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

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

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

### Risk Management

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

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

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

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

Reputational risk, or the risk to our business, earnings, liquidity, and capital from negative public opinion, could result from our actual or alleged conduct in a variety of areas, including legal and regulatory compliance, lending practices,

corporate governance, litigation, ethical issues, or inadequate protection of customer information, including fraudulent activity outside the Company's control. We expend significant resources to comply with regulatory requirements. Failure to comply could result in reputational harm or significant legal or remedial costs. Damage to our reputation could adversely affect our ability to retain and attract new customers, and adversely impact our earnings and liquidity.

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

### Competition

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

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

Our Investment and Trust Services Division offers professional trust administration, investment management services, estate planning and administration, and custody of securities. Assets held by the Company in a fiduciary or agency capacity for its customers are not included in the Consolidated Balance Sheets since such items are not assets of the Company. Revenues and fees of the Trust Department are reflected in trust income in the Consolidated Statement of Income. As of June 30, 2018 and December 31, 2017, the Trust Department had \$122.2 million and \$122.7 million of assets under management, respectively.

Our Investment Representatives offer full service brokerage services and financial planning throughout the Bank's market area. Products such as mutual funds, annuities, health and life insurance are made available through our insurance subsidiary, First Citizens Insurance Agency, Inc. The assets associated with these products are not included in the Consolidated Balance Sheets since such items are not assets of the Company. Assets owned and invested by customers of the Bank through the Bank's Investment Representatives increased from \$156.0 million at December 31, 2017 to \$165.7 million at June 30, 2018. Fee income from the sale of these products is reflected in brokerage and insurance income in the Consolidated Statement of Income. Management believes that there are opportunities to increase non-interest income through these products and services, especially in our central and south central Pennsylvania markets.

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

### Results of Operations

#### Overview of the Income Statement

The Company had net income of \$8,938,000 for the first six months of 2018 compared to \$6,771,000 for last year's comparable period, an increase of \$2,167,000, or 32.0%. Basic earnings per share for the first six months of 2018 were \$2.55, compared to \$1.93 last year, representing a 32.1% increase. Annualized return on assets and return on

equity for the six months of 2018 were 1.29% and 13.15%, respectively, compared with 1.10% and 10.63% for last year's comparable period.

Net income for the three months ended June 30, 2018 was \$4,691,000 compared to \$3,468,000 in the comparable 2017 period, an increase of \$1,223,000 or 35.3%. Basic earnings per share for the three months ended June 30, 2018 were \$1.34, compared to \$0.99 last year, representing a 35.4% increase. Annualized return on assets and return on equity for the quarter ended June 30, 2018 was 1.34% and 13.68%, respectively, compared with 1.12% and 10.80% for the same 2017 period.

#### Net Interest Income

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

Net interest income for the first six months of 2018 was \$23,171,000, an increase of \$2,770,000, or 13.6%, compared to the same period in 2017. For the first six months of 2018, the provision for loan losses totaled \$825,000, a decrease of \$415,000 over the comparable period in 2017. Consequently, net interest income after the provision for loan losses was \$22,346,000 compared to \$19,161,000 during the first six months of 2017.

For the three months ended June 30, 2018, net interest income was \$11,751,000 compared to \$10,404,000, an increase of \$1,347,000, or 13.0% over the comparable period in 2017. The provision for loan losses this quarter was \$325,000 compared to \$625,000 for last year's second quarter. Consequently, net interest income after the provision for loan losses was \$11,426,000 for the quarter ended June 30, 2018 compared to \$9,779,000 in 2017.

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

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| Analysis of Average Balances and Interest Rates (1)                       |             |          |               |             |          |         |
|---|-------------|----------|---------------|-------------|----------|---------|
| Six Months Ended  |             |          |               |             |          |         |
| June 30, 2018   |             |          | June 30, 2017 |             |          |         |
|   | Average     | Average  | Average       | Average     | Average  | Average |
| (dollars in thousands)  | Balance (1) | Interest | Rate          | Balance (1) | Interest | Rate    |
|   | \$          |          | \$ %          | \$          |          | \$ %    |
| <b>ASSETS</b>   |             |          |               |             |          |         |
| Short-term investments:   |             |          |               |             |          |         |
| Interest-bearing deposits at banks  | 8,609       | 9        | 0.21          | 9,106       | 9        | 0.20    |
| Total short-term investments  | 8,609       | 9        | 0.21          | 9,106       | 9        | 0.20    |
| Interest bearing time deposits at banks                                   | 10,753      | 115      | 2.16          | 7,123       | 71       | 2.01    |
| Investment securities:  |             |          |               |             |          |         |
| Taxable   | 187,650     | 1,965    | 2.09          | 202,316     | 1,708    | 1.69    |
| Tax-exempt (3)  | 71,775      | 1,267    | 3.53          | 87,491      | 1,922    | 4.39    |
| Total investment securities   | 259,425     | 3,232    | 2.49          | 289,807     | 3,630    | 2.51    |
| Loans:  |             |          |               |             |          |         |
| Residential mortgage loans  | 214,766     | 5,538    | 5.20          | 206,018     | 5,291    | 5.18    |
| Construction  | 20,523      | 474      | 4.66          | 27,198      | 574      | 4.25    |
| Commercial Loans  | 390,068     | 10,175   | 5.26          | 322,012     | 8,392    | 5.26    |
| Agricultural Loans  | 291,030     | 6,324    | 4.38          | 185,160     | 3,966    | 4.32    |
| Loans to state & political subdivisions                                   | 101,891     | 1,788    | 3.54          | 96,818      | 2,026    | 4.22    |
| Other loans   | 9,500       | 368      | 7.81          | 10,394      | 415      | 8.04    |
| Loans, net of discount (2)(3)(4)  | 1,027,778   | 24,667   | 4.84          | 847,600     | 20,664   | 4.92    |
| Total interest-earning assets   | 1,306,565   | 28,023   | 4.33          | 1,153,636   | 24,374   | 4.26    |
| Cash and due from banks   | 6,717       |          |               | 6,604       |          |         |
| Bank premises and equipment   | 16,418      |          |               | 16,947      |          |         |
| Other assets  | 54,590      |          |               | 55,850      |          |         |
| Total non-interest earning assets   | 77,725      |          |               | 79,401      |          |         |
| Total assets  | 1,384,290   |          |               | 1,233,037   |          |         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                               |             |          |               |             |          |         |
| Interest-bearing liabilities:   |             |          |               |             |          |         |
| NOW accounts  | 328,256     | 733      | 0.45          | 319,387     | 534      | 0.34    |
| Savings accounts  | 187,361     | 101      | 0.11          | 177,746     | 92       | 0.10    |
| Money market accounts   | 153,345     | 610      | 0.80          | 122,943     | 290      | 0.48    |
| Certificates of deposit   | 267,407     | 1,457    | 1.10          | 261,942     | 1,272    | 0.98    |
| Total interest-bearing deposits   | 936,369     | 2,901    | 0.62          | 882,018     | 2,188    | 0.50    |
| Other borrowed funds  | 132,179     | 1,339    | 2.04          | 57,348      | 489      | 1.72    |
| Total interest-bearing liabilities  | 1,068,548   | 4,240    | 0.80          | 939,366     | 2,677    | 0.57    |
| Demand deposits   | 167,255     |          |               | 151,396     |          |         |
| Other liabilities   | 12,577      |          |               | 14,846      |          |         |
| Total non-interest-bearing liabilities                                    | 179,832     |          |               | 166,242     |          |         |
| Stockholders' equity  | 135,910     |          |               | 127,429     |          |         |
| Total liabilities & stockholders' equity                                  | 1,384,290   |          |               | 1,233,037   |          |         |
| Net interest income   |             | 23,783   |               |             | 21,697   |         |
| Net interest spread (5)   |             |          | 3.53 %        |             |          | 3.69 %  |
| Net interest income as a percentage<br>of average interest-earning assets |             |          | 3.67 %        |             |          | 3.79 %  |
| Ratio of interest-earning assets<br>to interest-bearing liabilities       |             |          | 122 %         |             |          | 123 %   |

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

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|  | Analysis of Average Balances and Interest Rates (1) |          |         |               |          |         |
|--|---|----------|---------|---------------|----------|---------|
|  | Three Months Ended                                  |          |         |               |          |         |
|  | June 30, 2018                                       |          |         | June 30, 2017 |          |         |
|  | Average   | Average  | Average | Average       | Average  | Average |
| (dollars in thousands)   | Balance (1)   | Interest | Rate    | Balance (1)   | Interest | Rate    |
|  | \$  |          | \$ %    | \$            |          | \$ %    |
| <b>ASSETS</b>  |   |          |         |               |          |         |
| Short-term investments:  |   |          |         |               |          |         |
| Interest-bearing deposits at banks                                     | 9,112   | 4        | 0.18    | 10,552        | 7        | 0.23    |
| Total short-term investments   | 9,112   | 4        | 0.18    | 10,552        | 7        | 0.23    |
| Interest bearing time deposits at banks                                | 11,191  | 62       | 2.19    | 7,374         | 38       | 2.03    |
| Investment securities:   |   |          |         |               |          |         |
| Taxable  | 180,905   | 1,028    | 2.27    | 186,983       | 828      | 1.77    |
| Tax-exempt (3)   | 68,301  | 600      | 3.51    | 84,235        | 909      | 4.32    |
| Total investment securities  | 249,206   | 1,628    | 2.61    | 271,218       | 1,737    | 2.56    |
| Loans:   |   |          |         |               |          |         |
| Residential mortgage loans   | 214,932   | 2,814    | 5.25    | 206,057       | 2,657    | 5.17    |
| Construction   | 23,349  | 273      | 4.69    | 26,258        | 269      | 4.12    |
| Commercial Loans   | 391,935   | 5,197    | 5.32    | 327,924       | 4,326    | 5.29    |
| Agricultural Loans   | 298,266   | 3,286    | 4.42    | 200,865       | 2,153    | 4.30    |
| Loans to state & political subdivisions                                | 99,301  | 873      | 3.53    | 96,461        | 1,014    | 4.22    |
| Other loans  | 9,494   | 184      | 7.82    | 10,294        | 206      | 8.03    |
| Loans, net of discount (2)(3)(4)                                       | 1,037,277   | 12,627   | 4.88    | 867,859       | 10,625   | 4.91    |
| Total interest-earning assets  | 1,306,786   | 14,321   | 4.40    | 1,157,003     | 12,407   | 4.30    |
| Cash and due from banks  | 6,529   |          |         | 6,538         |          |         |
| Bank premises and equipment  | 16,356  |          |         | 16,888        |          |         |
| Other assets   | 65,473  |          |         | 62,907        |          |         |
| Total non-interest earning assets                                      | 88,358  |          |         | 86,333        |          |         |
| Total assets   | 1,395,144   |          |         | 1,243,336     |          |         |
| <b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>                            |   |          |         |               |          |         |
| Interest-bearing liabilities:  |   |          |         |               |          |         |
| NOW accounts   | 330,550   | 404      | 0.49    | 328,055       | 294      | 0.36    |
| Savings accounts   | 189,457   | 51       | 0.11    | 180,042       | 47       | 0.10    |
| Money market accounts  | 160,719   | 365      | 0.91    | 128,931       | 160      | 0.50    |
| Certificates of deposit  | 268,526   | 765      | 1.14    | 261,368       | 642      | 0.98    |
| Total interest-bearing deposits  | 949,252   | 1,585    | 0.67    | 898,396       | 1,143    | 0.51    |
| Other borrowed funds   | 125,815   | 692      | 2.21    | 45,969        | 231      | 2.02    |
| Total interest-bearing liabilities                                     | 1,075,067   | 2,277    | 0.85    | 944,365       | 1,374    | 0.58    |
| Demand deposits  | 170,287   |          |         | 155,724       |          |         |
| Other liabilities  | 12,617  |          |         | 14,820        |          |         |
| Total non-interest-bearing liabilities                                 | 182,904   |          |         | 170,544       |          |         |
| Stockholders' equity   | 137,173   |          |         | 128,427       |          |         |
| Total liabilities & stockholders' equity                               | 1,395,144   |          |         | 1,243,336     |          |         |
| Net interest income  |   | 12,044   |         |               | 11,033   |         |
| Net interest spread (5)  |   |          | 3.55 %  |               |          | 3.72 %  |
| Net interest income as a percentage of average interest-earning assets |   |          | 3.70 %  |               |          | 3.82 %  |
| Ratio of interest-earning assets to interest-bearing liabilities       |   |          | 122 %   |               |          | 123 %   |

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

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

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|  | For the Three<br>Months<br>Ended June 30,<br>2018 |          | For the Six<br>Months<br>Ended June 30,<br>2017 |          |
|--|---|----------|---|----------|
| Interest and dividend income from investment securities<br>and interest bearing deposits at banks (non-tax adjusted)     | \$1,567   | \$1,474  | \$3,089   | \$3,057  |
| Tax equivalent adjustment  | 127   | 308      | 267   | 653      |
| Interest and dividend income from investment securities<br>and interest bearing deposits at banks (tax equivalent basis) | \$1,694   | \$1,782  | \$3,356   | \$3,710  |
| Interest and fees on loans (non-tax adjusted)  | \$12,461  | \$10,304 | \$24,322  | \$20,021 |
| Tax equivalent adjustment  | 166   | 321      | 345   | 643      |
| Interest and fees on loans (tax equivalent basis)  | \$12,627  | \$10,625 | \$24,667  | \$20,664 |
| Total interest income  | \$14,028  | \$11,778 | \$27,411  | \$23,078 |
| Total interest expense   | 2,277   | 1,374    | 4,240   | 2,677    |
| Net interest income  | 11,751  | 10,404   | 23,171  | 20,401   |
| Total tax equivalent adjustment  | 293   | 629      | 612   | 1,296    |
| Net interest income (tax equivalent basis)   | \$12,044  | \$11,033 | \$23,783  | \$21,697 |

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

|   | Three months ended June<br>30, 2018 vs 2017 (1)<br>Change<br>in Volume    Change in Rate    Total Change |        |        | Six months ended June 30,<br>2018 vs. 2017 (1)<br>Change<br>in Volume    Change in Rate    Total Change |        |        |
|---|--|--------|--------|---|--------|--------|
| Interest Income:                        |  |        |        |   |        |        |
| Short-term investments:                 |  |        |        |   |        |        |
| Interest-bearing deposits at banks      | \$(2 )   | \$(1 ) | \$(3 ) | \$-   | \$-    | \$-    |
| Interest bearing time deposits at banks | 20   | 4      | 24     | 39  | 5      | 44     |
| Investment securities:                  |  |        |        |   |        |        |
| Taxable                                 | (26 )  | 226    | 200    | (111 )  | 368    | 257    |
| Tax-exempt                              | (156 )   | (153 ) | (309 ) | (313 )  | (342 ) | (655 ) |
| Total investments                       | (182 )   | 73     | (109 ) | (424 )  | 26     | (398 ) |
| Loans:                                  |  |        |        |   |        |        |
| Residential mortgage loans              | 115  | 42     | 157    | 226   | 21     | 247    |
| Construction                            | (12 )  | 16     | 4      | (163 )  | 63     | (100 ) |
| Commercial Loans                        | 848  | 23     | 871    | 1,775   | 8      | 1,783  |
| Agricultural Loans                      | 1,071  | 62     | 1,133  | 2,300   | 58     | 2,358  |
| Loans to state & political subdivisions | 31   | (172 ) | (141 ) | 115   | (353 ) | (238 ) |
| Other loans                             | (16 )  | (6 )   | (22 )  | (35 )   | (12 )  | (47 )  |
| Total loans, net of discount            | 2,037  | (35 )  | 2,002  | 4,218   | (215 ) | 4,003  |
| Total Interest Income                   | 1,873  | 41     | 1,914  | 3,833   | (184 ) | 3,649  |
| Interest Expense:                       |  |        |        |   |        |        |
| Interest-bearing deposits:              |  |        |        |   |        |        |

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|                                 |         |           |          |          |           |          |
|---------------------------------|---------|-----------|----------|----------|-----------|----------|
| NOW accounts                    | 2       | 108       | 110      | 15       | 184       | 199      |
| Savings accounts                | 3       | 1         | 4        | 5        | 4         | 9        |
| Money Market accounts           | 47      | 158       | 205      | 85       | 235       | 320      |
| Certificates of deposit         | 18      | 105       | 123      | 27       | 158       | 185      |
| Total interest-bearing deposits | 70      | 372       | 442      | 132      | 581       | 713      |
| Other borrowed funds            | 437     | 24        | 461      | 743      | 107       | 850      |
| Total interest expense          | 507     | 396       | 903      | 875      | 688       | 1,563    |
| Net interest income             | \$1,366 | \$ (355 ) | \$ 1,011 | \$ 2,958 | \$ (872 ) | \$ 2,086 |

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

Tax equivalent net interest income increased from \$21,697,000 for the six month period ended June 30, 2017 to \$23,783,000 for the six month period ended June 30, 2018, an increase of \$2,086,000. The tax equivalent net interest margin decreased from 3.79% for the first six months of 2017 to 3.67% for the comparable period in 2018. A significant portion of the decrease is attributable to a change in the corporate tax rate from 34% to 21%, which resulted in the tax equivalent yield on our tax-exempt investments and loans to decrease.

Total tax equivalent interest income for the 2018 six month period increased \$3,649,000 as compared to the 2017 six month period. This increase was primarily a result of an increase of \$3,833,000 due to a change in volume as average interest-bearing assets increased \$152.9 million. This increase was offset by a decrease of \$184,000 as a result of a decrease in the average yield on loans of 8 basis points from 4.92% to 4.84% for the comparable periods. As a result of converting investment assets to loans, the yield on average interest earning assets increased 7 basis points from 4.26% to 4.33%.

Tax equivalent investment income for the six months ended June 30, 2018 decreased \$398,000 over the same period last year. The primary cause of the decrease was a decrease in the average outstanding balance of investments.

The average balance of taxable securities decreased by \$14.7 million, which resulted in a decrease in investment income of \$111,000. The decrease in the average balance of taxable securities was due to the Bank's strategy of funding loan growth through the cashflows of the investment portfolio. The yield on taxable securities increased 40 basis points from 1.69% to 2.09% as a result of the recent rise in rates and the calls and maturities of lower yielding investments. This resulted in an increase in investment income of \$368,000.

The average balance of tax-exempt securities decreased by \$15.7 million, which resulted in a decrease in investment income of \$313,000. The yield on tax-exempt securities decreased 86 basis points from 4.39% to 3.53%, which corresponds to a decrease in interest income of \$342,000. The yield decrease was partially attributable to the decrease in the federal statutory income tax rate as well as higher yielding securities being called and maturing and either being replaced by lower yielding securities or not replaced and utilized to fund loan growth. For a discussion of the Company's current investment strategy, see the "Financial Condition – Investments".

Total loan interest income increased \$4,003,000 for the six months ended June 30, 2018 compared to the same period last year, primarily as a result of loan growth achieved throughout 2017 and the first half of 2018 that was primarily due to the hiring of experienced lending teams in our central and south central Pennsylvania markets. It was also positively impacted by the acquisition of the State College branch in December of 2017.

The average balance of commercial loans increased \$68.1 million from a year ago. The growth was attributable to the State College branch acquisition and organic growth in our central and south central Pennsylvania markets. This had a positive impact of \$1,775,000 on total interest income due to volume.

Interest income on agricultural loans increased \$2,358,000 from 2017 to 2018. The increase in the average balance of agricultural loans of \$105.9 million is primarily attributable to the additional agricultural lenders hired in 2016 to serve the central and south central markets. The increase in the average balance of these loans resulted in an increase in interest income due to volume of \$2,300,000.

The average balance of construction loans decreased \$6.7 million from a year ago. This resulted in a decrease of \$163,000 on total interest income due to volume. Offsetting this decrease, there was a \$63,000 increase due to rate, as the yield earned increased from 4.25% to 4.66%.

The average balance of state and political subdivision loans increased \$5.1 million from a year ago. This resulted in an increase of \$115,000 on total interest income due to volume. The yield decreased 68 basis points to 3.54%, which decreased loan interest income \$353,000. The decrease in the yield on this portfolio was mostly due to the decrease in the Federal statutory income tax rate from 2017 to 2018.

Interest income on residential mortgage loans increased \$247,000. The average balance of residential loans increased \$8.7 million from a year ago, which resulted in an increase in loan interest income of \$226,000.

Total interest expense increased \$1,563,000 for the six months ended June 30, 2018 compared with the comparative period last year primarily as a result of an increase in borrowings to fund loan growth in 2017 and 2018 and higher rates paid on deposits and overnight borrowings. Interest expense increased \$875,000 as a result of volume as the average balance of interest bearing liabilities increased \$129.2 million. In addition, there was an increase of \$688,000 due to rate as a result of an increase in the average rate paid on interest bearing liabilities from 0.57% to 0.80%.

The average balance of interest bearing deposits increased \$54.4 million from June 30, 2017 to June 30, 2018. Increases were experienced in NOW accounts of \$8.9 million, savings accounts of \$9.6 million, money market accounts of \$30.4 million and certificates of deposit of \$5.5 million. The cumulative effect of these volume changes was an increase in interest expense of \$132,000. (see also "Financial Condition – Deposits"). The rate paid on interest bearing deposits was 0.62% for the first six months of 2018 and 0.50% for the comparable period in 2017. This resulted in an increase in interest expense of \$581,000.

The average balance of other borrowed funds increased \$74.8 million from a year ago. This resulted in an increase in interest expense of \$743,000. There was also an increase in the average rate on other borrowed funds from 1.72% to 2.04% due to an increase in the overnight borrowing rate as a result of the Federal Reserve interest rate increases in 2017 resulting in an increase in interest expense of \$107,000.

Tax equivalent net interest income for the three months ended June 30, 2018 was \$12,044,000 which compares to \$11,033,000 for the same period last year. This represents an increase of \$1,011,000 or 9.2%. The tax equivalent net interest margin decreased from 3.82% for the three months ended June 30, 2017 to 3.70% for the comparable period in 2018 with the majority of the decrease attributable to the decrease in the statutory income tax rate from 34% in 2017 to 21% in 2018.

Total tax equivalent interest income was \$14,321,000 for the three month period ended June 30, 2018, compared to \$12,407,000 for the comparable period last year, an increase of \$1,914,000. The primary driver of this increase was an increase of \$1,873,000 due to a change in volume as interest-earning assets increased \$149.8 million that was primarily due to the hiring of experienced lending teams in our central and south central Pennsylvania markets. It was also positively impacted by the acquisition of the State College branch in December of 2017. In addition, the average yield on interest-earning assets increased 10 basis points from 4.30% to 4.40% for the comparable periods, resulting in an increase in tax equivalent interest income of \$41,000.

Total investment income decreased by \$109,000 compared to same period last year. The primary cause of the decrease was a decrease of \$22.0 million in the average outstanding balance of investment securities, which equates to a decrease of \$182,000. Offsetting this increase, there was a 5 point increase in rate on investments securities from 2.56% to 2.61%, which equates to a \$73,000 increase in income.

Total loan interest income increased \$2,002,000 compared to the same period last year. This was primarily due to an increase in volume of \$169.4 million, which corresponds to a \$2,037,000 increase in interest income. This was offset by a decrease in rate of 3 points from 4.91% to 4.88%, which corresponds to a decrease in loan interest income of \$35,000. The yield on commercial loans was impacted by a prepayment penalty received in the second quarter that was approximately \$90,000. This corresponds to 0.09% increase in rate for three months ended June 30, 2018.

Total interest expense increased \$903,000 for the three months ended June 30, 2018 compared with last year as a result of the increase in the average balance of interest-bearing liabilities of \$130.7 million, accounting for a \$507,000 increase in interest expense. The average rate on interest-bearing liabilities increased 27 basis points from 0.58% to 0.85%, which increased interest expense \$396,000.

The average balance of interest bearing deposits increased \$50.9 million from June 30, 2017 to June 30, 2018.

The cumulative effect of these volume changes was an increase in interest expense of \$70,000. The rate paid on interest bearing deposits was 0.67% for the first six months of 2018 and 0.51% for the comparable period in 2017. This results in an increase in interest expense of \$372,000.

The average balance of other borrowed funds increased \$80.0 million from a year ago. This resulted in an increase in interest expense of \$437,000. There was also an increase in the average rate on other borrowed fund from 2.02% to 2.21% due to an increase in the overnight borrowing rate as a result of the Federal Reserve interest rate moves in 2017 resulting in an increase in interest expense of \$24,000.





## Provision for Loan Losses

For the six month period ending June 30, 2018, we recorded a provision for loan losses of \$825,000, which represents a decrease of \$415,000 from the \$1,240,000 provision recorded in the corresponding six months of last year. The provision was lower in 2018 than 2017 primarily due to the loan growth that occurred in 2017 compared to the loan growth in 2018. (see "Financial Condition – Allowance for Loan Losses and Credit Quality Risk").

For the three months ending June 30, 2018, we recorded a provision of \$325,000 compared to \$625,000 in 2017 with the decrease for the three month period being due to the lower level of loan growth in 2018 compared to the same period in 2017.

## Non-interest Income

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

|  | Six months          |         | Change  |         |
|--|---------------------|---------|---------|---------|
|  | ended June 30, 2018 | 2017    | Amount  | %       |
| Service charges                        | \$2,274             | \$2,178 | \$96    | 4.4     |
| Trust                                  | 401                 | 409     | (8 )    | (2.0 )  |
| Brokerage and insurance                | 349                 | 305     | 44      | 14.4    |
| Gains on loans sold                    | 132                 | 249     | (117)   | (47.0 ) |
| Equity security gains, net             | 13                  | -       | 13      | NA      |
| Available for sale security gains, net | -                   | 195     | (195)   | (100.0) |
| Earnings on bank owned life insurance  | 306                 | 333     | (27 )   | (8.1 )  |
| Other                                  | 273                 | 254     | 19      | 7.5     |
| Total                                  | \$3,748             | \$3,923 | \$(175) | (4.5 )  |

|  | Three months        |         | Change  |         |
|--|---------------------|---------|---------|---------|
|  | ended June 30, 2018 | 2017    | Amount  | %       |
| Service charges                        | \$1,170             | \$1,120 | \$50    | 4.5     |
| Trust                                  | 150                 | 188     | (38 )   | (20.2 ) |
| Brokerage and insurance                | 168                 | 114     | 54      | 47.4    |
| Gains on loans sold                    | 60                  | 148     | (88 )   | (59.5 ) |
| Equity security gains, net             | 7                   | -       | 7       | NA      |
| Available for sale security gains, net | -                   | 23      | (23 )   | (100.0) |
| Earnings on bank owned life insurance  | 154                 | 167     | (13 )   | (7.8 )  |
| Other                                  | 133                 | 128     | 5       | 3.9     |
| Total                                  | \$1,842             | \$1,888 | \$(46 ) | (2.4 )  |

Non-interest income for the six months ended June 30, 2018 totaled \$3,748,000, a decrease of \$175,000 when compared to the same period in 2017. During the first six months of 2018, there were no gains or losses from the sale of available for sale securities as there were no sales in 2018 compared to a \$195,000 in 2017. In 2017, we sold seven agency securities for gains totaling \$10,000, two of our equity positions for a gain of \$158,000 and a mortgage backed security for a gain of \$20,000. We recognized a \$13,000 increase in the market value of our equity portfolio in 2018.

For the first six months of 2018, account service charges totaled \$2,274,000, an increase of \$96,000 or 4.4%, when compared to the same period in 2017. The increase was associated with a \$69,000 increase in interchange revenue and a \$38,000 increase in ATM income. The decrease in gains on loans sold is due to a decrease in the amount of loans

sold in 2018 compared to 2017.

For the three month period ended June 30, 2018, the changes experienced from the prior year related to service charges and gains on loans sold correspond to the changes experienced for the six month period. The increase in brokerage and insurance revenues for the current period versus last year was the hiring of a broker in our south central market. The decrease in trust revenues is due to estate fees, which were higher in 2017.

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## Non-interest Expense

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

|                                | Six months ended |          | Change   |        |
|--------------------------------|------------------|----------|----------|--------|
|                                | June 30,<br>2018 | 2017     | Amount   | %      |
| Salaries and employee benefits | \$9,572          | \$8,743  | \$ 829   | 9.5    |
| Occupancy                      | 1,106            | 1,004    | 102      | 10.2   |
| Furniture and equipment        | 264              | 285      | (21 )    | (7.4 ) |
| Professional fees              | 557              | 568      | (11 )    | (1.9 ) |
| FDIC insurance                 | 207              | 200      | 7        | 3.5    |
| Pennsylvania shares tax        | 600              | 524      | 76       | 14.5   |
| Amortization of intangibles    | 150              | 149      | 1        | NA     |
| ORE expenses                   | 295              | 172      | 123      | 71.5   |
| Other                          | 2,783            | 2,712    | 71       | 2.6    |
| Total                          | \$15,534         | \$14,357 | \$ 1,177 | 8.2    |

|                                | Three months ended |         | Change |        |
|--------------------------------|--------------------|---------|--------|--------|
|                                | June 30,<br>2018   | 2017    | Amount | %      |
| Salaries and employee benefits | \$4,737            | \$4,377 | \$ 360 | 8.2    |
| Occupancy                      | 514                | 477     | 37     | 7.8    |
| Furniture and equipment        | 122                | 146     | (24 )  | (16.4) |
| Professional fees              | 262                | 258     | 4      | 1.6    |
| FDIC insurance                 | 107                | 95      | 12     | 12.6   |
| Pennsylvania shares tax        | 300                | 243     | 57     | 23.5   |
| Amortization of intangibles    | 74                 | 73      | 1      | 1.4    |
| ORE expenses                   | 157                | 82      | 75     | 91.5   |
| Other                          | 1,429              | 1,415   | 14     | 1.0    |
| Total                          | \$7,702            | \$7,166 | \$ 536 | 7.5    |

Non-interest expenses increased \$1,177,000 for the six months ended June 30, 2018 compared to the same period in 2017. Salaries and employee benefits increased \$829,000 or 10.7%. The increase was due to merit increases effective at the beginning of 2018, an increase in the number of full-time equivalent employees of 9.0 as a result of staffing for additional branch locations, specifically State College, and an increase in profit sharing and retirement expenses as a result of additional headcount and financial results.

The primary cause of the increase in occupancy expenses is due to the acquisition of the State College branch and the openings of the limited branch office in Narvon, Pennsylvania. The increase in ORE expenses is the result of legal fees associated with a customer that is in foreclosure.

For the three months ended, June 30, 2018, non-interest expenses increased \$536,000 when compared to the same period in 2017. The changes in salaries and employee benefits, occupancy expenses and ORE expenses for the quarter are consistent with the changes for the six month period.

## Provision for Income Taxes

The provision for income taxes was \$1,622,000 for the six month period ended June 30, 2018 compared to \$1,956,000 for the same period in 2017. The decrease is attributable to the decrease in the Federal statutory income tax rate from 35% in 2017 to 21% in 2018. Through management of our municipal loan and bond portfolios, management is focused on minimizing our effective tax rate. Our effective tax rate was 15.4% and 22.4% for the first six months of 2018 and 2017, respectively, compared to the statutory rate of 21% for 2018 and 34% for 2017.

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For the three months ended June 30, 2018, the provision for income taxes was \$875,000 compared to \$1,033,000 for the same period in 2017. The decrease is attributable to the decrease in the Federal statutory income tax rate. Our effective tax rate was 15.7% and 23.0% for the three months ended June 30, 2018 and 2017, respectively.

We are invested in four limited partnership agreements that have established low-income housing projects in our market areas. We anticipate recognizing an aggregate of \$634,000 of tax credits over the next 4.5 years, with an additional \$70,000 anticipated to be recognized during 2018.

Financial Condition

Total assets were \$1.40 billion at June 30, 2018, an increase of \$35.7 million from \$1.36 billion at December 31, 2017. Cash and cash equivalents decreased \$2.9 million to \$15.6 million. Investment securities decreased \$4.8 million and net loans increased \$38.9 million to \$1.0 billion at June 30, 2018. Total deposits increased \$13.6 million to \$1.12 billion since year-end 2017, while borrowed funds increased \$19.0 million to \$133.7 million.

Cash and Cash Equivalents

Cash and cash equivalents totaled \$15.6 million at June 30, 2018 compared to \$18.5 million at December 31, 2017, a decrease of \$2.9 million. Management actively measures and evaluates its liquidity position through our Asset-Liability Committee and believes its liquidity needs are satisfied by the current balance of cash and cash equivalents, readily available access to traditional funding sources including the Bank's core deposits, Federal Home Loan Bank financing, federal funds lines with correspondent banks, brokered certificates of deposit and the portion of the investment and loan portfolios that mature within one year. Management expects that these sources of funds will permit us to meet cash obligations and off-balance sheet commitments as they come due.

Investments

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

Fair Market Value of Investment Portfolio

|   | June 30, 2018                                    |         | December 31, 2017 |       |
|---|--|---------|-------------------|-------|
|   | Amount   | %       | Amount            | %     |
| Debt securities:  |  |         |                   |       |
| U. S. Agency securities                                     | \$101,988  | 40.8    | \$98,887          | 38.8  |
| U. S. Treasury notes  | 32,992   | 13.2    | 28,604            | 11.2  |
| Obligations of state & political subdivisions               | 67,872   | 27.1    | 79,090            | 31.0  |
| Corporate obligations                                       | 3,023  | 1.2     | 3,083             | 1.2   |
| Mortgage-backed securities in government sponsored entities | 44,150   | 17.6    | 45,027            | 17.7  |
| Equity securities (a)                                       | 195  | 0.1     | 91                | 0.1   |
| Total   | \$250,220  | 100.0   | \$254,782         | 100.0 |
|   | June 30, 2018/<br>December 31,<br>2017<br>Change |         |                   |       |
|   | Amount   | %       |                   |       |
| Debt securities:  |  |         |                   |       |
| U. S. Agency securities                                     | \$3,101  | 3.1     |                   |       |
| U. S. Treasury notes  | 4,388  | 15.3    |                   |       |
| Obligations of state & political subdivisions               | (11,218 )  | (14.2 ) |                   |       |
| Corporate obligations                                       | (60 )  | (1.9 )  |                   |       |

|  |            |        |
|--|------------|--------|
| Mortgage-backed securities in<br>government sponsored entities | (877 )     | (1.9 ) |
| Equity securities  | 104        | 114.3  |
| Total  | \$(4,562 ) | (1.8 ) |

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

Our investment portfolio decreased by \$4.6 million, or 1.8%, from December 31, 2017 to June 30, 2018. During 2018, we purchased \$5.0 million of treasury securities, \$20.8 million of U.S. agency obligations, \$4.1 million of mortgage-backed securities in government sponsored entities and \$91,000 of equity securities, which helped offset the \$4.1 million of principal repayments and \$27.2 million of calls and maturities that occurred during the six month period. Excluding our short-term investments consisting of monies held primarily at the Federal Reserve for liquidity purposes, our investment portfolio for the six month period ended June 30, 2018 yielded 2.49%, compared to 2.51% in the comparable period in 2017 on a tax equivalent basis.

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

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

#### Loans

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

|                                     | June 30,<br>2018 |       | December 31,<br>2017 |       |
|-------------------------------------|------------------|-------|----------------------|-------|
|                                     | Amount           | %     | Amount               | %     |
| Real estate:                        |                  |       |                      |       |
| Residential                         | \$213,242        | 20.5  | \$214,479            | 21.4  |
| Commercial                          | 309,571          | 29.8  | 308,084              | 30.8  |
| Agricultural                        | 262,691          | 25.3  | 239,957              | 24.0  |
| Construction                        | 27,901           | 2.7   | 13,502               | 1.3   |
| Consumer                            | 9,740            | 0.9   | 9,944                | 1.0   |
| Other commercial loans              | 75,002           | 7.2   | 72,013               | 7.2   |
| Other agricultural loans            | 42,131           | 4.1   | 37,809               | 3.8   |
| State & political subdivision loans | 99,922           | 9.5   | 104,737              | 10.5  |
| Total loans                         | 1,040,200        | 100.0 | 1,000,525            | 100.0 |
| Less allowance for loan losses      | 11,941           |       | 11,190               |       |
| Net loans                           | \$1,028,259      |       | \$989,335            |       |

|              | June 30, 2018/<br>December 31, 2017<br>Change |       |
|--------------|---|-------|
|              | Amount  | %     |
| Real estate: |   |       |
| Residential  | \$(1,237)                                     | (0.6) |
| Commercial   | 1,487   | 0.5   |
| Agricultural | 22,734  | 9.5   |
| Construction | 14,399  | 106.6 |



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|                                     |          |          |
|-------------------------------------|----------|----------|
| Consumer                            | (204     | ) (2.1 ) |
| Other commercial loans              | 2,989    | 4.2      |
| Other agricultural loans            | 4,322    | 11.4     |
| State & political subdivision loans | (4,815   | ) (4.6 ) |
| Total loans                         | \$39,675 | 4.0      |

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The Bank's lending efforts have historically focused on north central Pennsylvania and southern New York. The acquisition of FNB in 2015 expanded the focus into Lebanon, Lancaster, Schuylkill and Berks County markets in south central Pennsylvania. The opening of the Winfield office in 2016 and the acquisition of the State College branch in 2017 has increased our presence in the central Pennsylvania market. We originate loans primarily through direct loans to our existing customer base, with new customers generated through the strong relationships our new lending teams have with their customers, as well as by referrals from real estate brokers, building contractors, attorneys, accountants, corporate and advisory board members, existing customers and the Bank's website. The Bank offers a variety of loans although historically most of our lending has focused on real estate loans including residential, commercial, agricultural, and construction loans. All lending is governed by a lending policy that is developed and administered by management and approved by the Board of Directors. As of June 30, 2018, the Company had one industry specific loan concentration, within the dairy industry, totaling \$144.4 million or 13.9% of total loans. During the first six months of 2018, the primary driver of growth in the loan portfolio continued to be commercial and agricultural real estate loans in both the central and south central Pennsylvania markets. We experienced some significant pay-offs of purchased participation loans in the second quarter, which limited our growth. Commercial and agricultural loan demand is subject to significant competitive pressures, the yield curve, and the strengthening of the overall national, regional and local economies.

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

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

#### Allowance for Loan Losses

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

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|  | June 30,<br>2018 | December 31,<br>2017 | 2016      | 2015      | 2014      |
|--|------------------|----------------------|-----------|-----------|-----------|
| Balance  |                  |                      |           |           |           |
| at beginning of period   | \$11,190         | \$8,886              | \$7,106   | \$6,815   | \$7,098   |
| Charge-offs:   |                  |                      |           |           |           |
| Real estate:   |                  |                      |           |           |           |
| Residential  | 17               | 107                  | 85        | 66        | 97        |
| Commercial   | -                | 41                   | 100       | 84        | 516       |
| Agricultural   | -                | 30                   | -         | -         | -         |
| Consumer   | 19               | 130                  | 100       | 47        | 47        |
| Other commercial loans   | 91               | -                    | 55        | 41        | 250       |
| Other agricultural loans   | 50               | 5                    | -         | -         | -         |
| Total loans charged-off  | 177              | 313                  | 340       | 238       | 910       |
| Recoveries:  |                  |                      |           |           |           |
| Real estate:   |                  |                      |           |           |           |
| Residential  | 69               | -                    | -         | -         | -         |
| Commercial   | 3                | 11                   | 479       | 14        | 15        |
| Agricultural   | -                | -                    | -         | -         | -         |
| Consumer   | 17               | 49                   | 88        | 33        | 27        |
| Other commercial loans   | 14               | 16                   | 33        | 2         | -         |
| Other agricultural loans   | -                | 1                    | -         | -         | -         |
| Total loans recovered  | 103              | 77                   | 600       | 49        | 42        |
| Net loans (recovered) charged-off                                  | 74               | 236                  | (260 )    | 189       | 868       |
| Provision charged to expense                                       | 825              | 2,540                | 1,520     | 480       | 585       |
| Balance at end of period   | \$11,941         | \$11,190             | \$8,886   | \$7,106   | \$6,815   |
| Loans outstanding at end of period                                 | \$1,040,200      | \$1,000,525          | \$799,611 | \$695,031 | \$554,105 |
| Average loans outstanding, net                                     | \$1,027,778      | \$883,355            | \$725,881 | \$577,992 | \$540,541 |
| Non-performing assets:   |                  |                      |           |           |           |
| Non-accruing loans   | \$10,931         | \$10,171             | \$11,454  | \$6,531   | \$6,599   |
| Accrual loans - 90 days or more past due                           | 1,046            | 555                  | 405       | 623       | 836       |
| Total non-performing loans   | \$11,977         | \$10,726             | \$11,859  | \$7,154   | \$7,435   |
| Foreclosed assets held for sale                                    | 471              | 1,119                | 1,036     | 1,354     | 1,792     |
| Total non-performing assets  | \$12,448         | \$11,845             | \$12,895  | \$8,508   | \$9,227   |
| Annualized net charge-offs to average loans                        | 0.02             | % 0.03               | % -0.04   | % 0.03    | % 0.16    |
| Allowance to total loans   | 1.15             | % 1.12               | % 1.11    | % 1.02    | % 1.23    |
| Allowance to total non-performing loans                            | 99.70            | % 104.33             | % 74.93   | % 99.33   | % 91.66   |
| Non-performing loans as a percent of loans net of unearned income  | 1.15             | % 1.07               | % 1.48    | % 1.03    | % 1.34    |
| Non-performing assets as a percent of loans net of unearned income | 1.20             | % 1.18               | % 1.61    | % 1.22    | % 1.67    |

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

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

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

The allowance for loan losses was \$11,941,000 or 1.15% of total loans as of June 30, 2018 as compared to \$11,190,000 or 1.12% of loans as of December 31, 2017. The \$751,000 increase in the allowance during the first six months of 2018 is the result of a \$825,000 provision and net charge-offs of \$74,000. The following table shows the distribution of the allowance for loan losses and the percentage of loans compared to total loans by loan category as of June 30, 2018 and December 31, 2017, 2016, 2015 and 2014 (dollars in thousands):

|  | June 30,<br>2018 |       | December 31<br>2017 |       | 2016    |       | 2015    |       | 2014    |       |
|--|------------------|-------|---------------------|-------|---------|-------|---------|-------|---------|-------|
|  | Amount           | %     | Amount              | %     | Amount  | %     | Amount  | %     | Amount  | %     |
| Real estate loans:                     |                  |       |                     |       |         |       |         |       |         |       |
| Residential                            | \$1,045          | 20.5  | \$1,049             | 21.4  | \$1,064 | 25.9  | \$905   | 29.3  | \$878   | 33.5  |
| Commercial                             | 3,794            | 29.8  | 3,867               | 30.8  | 3,589   | 31.6  | 3,376   | 34.2  | 3,419   | 34.5  |
| Agricultural                           | 3,673            | 25.3  | 3,143               | 24.0  | 1,494   | 15.5  | 409     | 8.3   | 451     | 4.4   |
| Construction                           | 44               | 2.7   | 23                  | 1.3   | 47      | 3.2   | 24      | 2.2   | 26      | 1.1   |
| Consumer                               | 115              | 0.9   | 124                 | 1.0   | 122     | 1.4   | 102     | 1.7   | 84      | 1.5   |
| Other commercial loans                 | 1,266            | 7.2   | 1,272               | 7.2   | 1,327   | 7.3   | 1,183   | 8.2   | 1,007   | 8.6   |
| Other agricultural loans               | 589              | 4.1   | 492                 | 3.8   | 312     | 2.9   | 122     | 2.0   | 217     | 2.0   |
| State & political<br>subdivision loans | 767              | 9.5   | 816                 | 10.5  | 833     | 12.2  | 593     | 14.1  | 545     | 14.4  |
| Unallocated                            | 648              | N/A   | 404                 | N/A   | 98      | N/A   | 392     | N/A   | 188     | N/A   |
| Total allowance for loan<br>losses     | \$11,941         | 100.0 | \$11,190            | 100.0 | \$8,886 | 100.0 | \$7,106 | 100.0 | \$6,815 | 100.0 |

As a result of previous loss experiences and other risk factors utilized in determining the allowance, the Bank's allocation of the allowance does not directly correspond to the actual balances of the loan portfolio. While commercial and agricultural real estate total 55.1% of the loan portfolio, 62.5% of the allowance is assigned to this segment of the loan portfolio as these loans have more inherent credit risk than residential real estate or loans to state and political subdivisions.

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

| June 30, 2018        |            |      |            | December 31, 2017    |            |      |            |
|----------------------|------------|------|------------|----------------------|------------|------|------------|
| Non-Performing Loans |            |      |            | Non-Performing Loans |            |      |            |
| 30 - 89<br>Days      |            |      |            | 30 - 89<br>Days      |            |      |            |
| Past<br>Due          | 90<br>Days | Non- | Total Non- | Past<br>Due          | 90<br>Days | Non- | Total Non- |
|                      |            |      |            |                      |            |      |            |

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| (in thousands)            | Past Due |          |          |            | Past Due |          |          |            |
|---------------------------|----------|----------|----------|------------|----------|----------|----------|------------|
|                           | Accruing | Accruing | accrual  | Performing | Accruing | Accruing | accrual  | Performing |
| Real estate:              |          |          |          |            |          |          |          |            |
| Residential               | \$905    | \$-      | \$1,493  | \$ 1,493   | \$1,550  | \$218    | \$1,386  | \$ 1,604   |
| Commercial                | 2,864    | 38       | 6,262    | 6,300      | 1,519    | 162      | 5,192    | 5,354      |
| Agricultural              | 1,105    | 543      | 167      | 710        | 242      | 30       | 175      | 205        |
| Construction              | -        | -        | -        | -          | -        | -        | 133      | 133        |
| Consumer                  | 32       | 32       | 25       | 57         | 86       | 7        | 42       | 49         |
| Other commercial loans    | 55       | -        | 2,415    | 2,415      | 50       | 32       | 2,637    | 2,669      |
| Other agricultural loans  | 182      | 433      | 569      | 1,002      | 42       | 106      | 606      | 712        |
| Total nonperforming loans | \$5,143  | \$1,046  | \$10,931 | \$ 11,977  | \$3,489  | \$555    | \$10,171 | \$ 10,726  |

|                           | Change in<br>Non-Performing<br>Loans<br>June 30, 2018<br>/December 31,<br>2017 |          |
|---------------------------|--|----------|
| (in thousands)            | Amount   | %        |
| Real estate:              |  |          |
| Residential               | \$(111 )   | (6.9 )   |
| Commercial                | 946  | 17.7     |
| Agricultural              | 505  | 246.3    |
| Construction              | (133 )   | (100.0 ) |
| Consumer                  | 8  | 16.3     |
| Other commercial loans    | (254 )   | (9.5 )   |
| Other agricultural loans  | 290  | 40.7     |
| Total nonperforming loans | \$1,251  | 11.7     |

For the six months ended June 30, 2018, we recorded a provision for loan losses of \$825,000, which compares to \$1,240,000 for the same period in 2017. The decrease was primarily attributable to the loan growth experienced during 2018 being lower than the growth experienced during the comparable period of 2017. Non-performing loans increased \$1.3 million or 11.7%, from December 31, 2017 to June 30, 2018, primarily due to one customer relationship. Approximately 58.5% of the Bank's non-performing loans at June 30, 2018 are associated with the following three customer relationships:

A commercial customer with a total loan relationship of \$3.0 million, secured by undeveloped land, stone quarries and equipment, was on non-accrual status as of June 30, 2018. The slowdown in the exploration for natural gas has significantly impacted the cash flows of the customer, who provides excavation services and stone for pad construction related to these activities. During 2017, the Company had the underlying collateral appraised. The appraisals indicated a decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. Management determined that no specific reserve was required as of June 30, 2018.

A commercial customer with a total loan relationship of \$2.5 million, secured by residential rental properties, was on non-accrual status as of June 30, 2018. In the first quarter of 2011, the Company and borrower entered into a forbearance agreement to restructure the debt. In July of 2013, the customer filed for bankruptcy under Chapter 11 and a Trustee was appointed in January of 2014. In 2015, the Trustee decreased the loan payments below what was agreed to in the forbearance agreement. This decrease is currently being litigated in bankruptcy court. As a result of the decrease, the relationship has become more than 90 days past due. During 2016, the Company appraised the underlying collateral. The appraisals indicated a slight decrease in collateral values compared to the appraisals ordered for the loan origination, however, the loan is still considered well secured on a loan to value basis. We continue to monitor the bankruptcy proceedings to identify potential changes in the customer's operations and the impact these would have on the loan payments for our loans to the customer and the underlying collateral that supports these loans. As of June 30, 2018, there was no specific reserve for this relationship.

An agricultural customer with a total loan relationship of \$2.9 million, secured by real estate, equipment and cattle had \$1.5 million in loans that were non-performing as of June 30, 2018. The remaining \$1.4 million was considered performing as of June 30, 2018 as the loans were less than 90 days past due. Included within the non-performing portion of loans to this customer are \$1,001,000 of loans which are subject to Farm Service Agency guarantees. Depressed milk prices have created cash flow difficulties for this customer. Absent a sizable and sustained increase in milk prices, which is not assured, we will need to rely upon the collateral for repayment of interest and principal. As of June 30, 2018, there was no specific reserve for this relationship.

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

Three loan relationships comprise 58.5% of the non-performing loan balance, whose debt is considered well collateralized and has no specific reserves as of June 30, 2018.

The Company has a history of low charge-offs, which continued in 2018 as the net charge-offs were .02% of average loans and only \$74,000. In 2016, a net recovery was experienced as the result of recovering a loan that was partially charged off in 2014.



### Bank Owned Life Insurance

The Company holds bank owned life insurance policies to offset future employee benefit costs. These policies provide the Bank with an asset that generates earnings to partially offset the current costs of benefits, and eventually (at the death of the insureds) provide partial recovery of cash outflows associated with the benefits. As of June 30, 2018 and December 31, 2017, the cash surrender value of the life insurance was \$27.2 million and \$26.9 million, respectively. The change in cash surrender value, net of purchases and amounts acquired through acquisitions, is recognized in the results of operations. The amounts recorded as non-interest income totaled \$154,000 and \$167,000 for the three month periods ended June 30, 2018 and 2017, respectively. For the six months ended June 30, 2018 and 2017, \$306,000 and \$333,000, respectively, was recorded in non-interest income. The Company evaluates annually the risks associated with the life insurance policies, including limits on the amount of coverage and an evaluation of the various carriers' credit ratings.

The Company agreements that were purchased directly from insurance companies are structured so that any death benefits received from a policy while the insured person is an active employee of the Bank will be split with the beneficiary of the policy. Under these agreements, the employee's beneficiary will be entitled to receive 50% of the net amount at risk from the proceeds. The net amount at risk is the total death benefit payable less the cash surrender value of the policy as of the date of death. The policies acquired as part of the acquisition of FNB provide a fixed split-dollar benefit for the beneficiaries estate, which is dependent on several factors including whether the covered individual was a Director of FNB or an employee of FNB and their salary level. As of June 30, 2018 and December 31, 2017, included in other liabilities on the Consolidated Balance Sheet was a liability of \$615,000 and \$578,000, respectively, for the obligation under the split-dollar benefit agreements.

### Premises and Equipment

Premises and equipment decreased \$234,000 to \$16.3 million as of June 30, 2018 from December 31, 2017. This occurred primarily as a result of normal depreciation expense recorded in the first six months of 2018.

### Deposits

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

|                               | June 30,<br>2018 |       | December 31,<br>2017 |       |
|-------------------------------|------------------|-------|----------------------|-------|
|                               | Amount           | %     | Amount               | %     |
| Non-interest-bearing deposits | \$ 169,014       | 15.1  | \$ 171,840           | 15.6  |
| NOW accounts                  | 321,799          | 28.8  | 337,307              | 30.5  |
| Savings deposits              | 190,557          | 17.0  | 184,057              | 16.7  |
| Money market deposit accounts | 165,781          | 14.8  | 145,287              | 13.1  |
| Certificates of deposit       | 271,441          | 24.3  | 266,452              | 24.1  |
| Total                         | \$ 1,118,592     | 100.0 | \$ 1,104,943         | 100.0 |

|                               | June 30, 2018/<br>December 31,<br>2017<br>Change |        |
|-------------------------------|--|--------|
|                               | Amount   | %      |
| Non-interest-bearing deposits | \$(2,826 )                                       | (1.6 ) |
| NOW accounts                  | (15,508)   | (4.6 ) |
| Savings deposits              | 6,500  | 3.5    |
| Money market deposit accounts | 20,494   | 14.1   |
| Certificates of deposit       | 4,989  | 1.9    |
| Total                         | \$13,649   | 1.2    |

Deposits increased \$13.6 million since December 31, 2017. Customers, including local municipalities transferred balances from NOW accounts to money market accounts, which accounts for the majority of the changes in those accounts. As a result of strategic initiatives, we have increased our focus and have enhanced our cash management services.

Certificates of deposits increased \$5.0 million in 2018. The rates paid on certificates of deposits have increased in the first part of 2018 making them more attractive to customers who typically utilize certificate of deposits as a means of generating income or as a longer term investment option. The rates paid on certificates of deposit by the Company remain competitive with rates paid by our competition. As of June 30, 2018, the Bank did not have any outstanding brokered certificates of deposit.

#### Borrowed Funds

Borrowed funds increased \$19.0 million during the first six months of 2018. The increase was the result of borrowing an additional \$18.9 million of overnight advances from the FHLB as a result of the loan growth experienced in the first half of 2018. The Bank's current strategy for borrowings is to consider terms and structures to manage interest rate risk and liquidity in a potential rising interest rate environment. The Company's daily cash requirements or short-term investments are primarily met by using the financial instruments available through the Federal Home Loan Bank of Pittsburgh.

#### Stockholders' Equity

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

Total stockholders' equity was \$132.3 million at June 30, 2018 compared to \$129.0 million at December 31, 2017, an increase of \$3,270,000, or 2.5%. Excluding accumulated other comprehensive income, stockholders' equity increased \$5.2 million, or 4.0%. The Company purchased 8,711 shares of treasury stock at a weighted average cost of \$62.29 per share. The Company reissued 217 shares to certain employees as a reward for years of services at a weighted average cost of \$62.47 per share. The Company awarded employees 4,869 shares of restricted stock at a weighted average cost of \$62.91 per share during the first six months of 2018. For the first six months of 2018, the Company had net income of \$8.9 million and declared cash dividends of \$3.1 million, or \$0.87 per share, representing a cash dividend payout ratio of 34.2%.

All of the Company's debt investment securities are classified as available-for-sale, making this portion of the Company's balance sheet more sensitive to the changing market value of investments. As a result of changes in the interest rate environment and the defined benefit plan obligations, accumulated other comprehensive income decreased approximately \$2.0 million from December 31, 2017.

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

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

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

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

|   | Actual     |         | For Capital Adequacy Purposes |        | To Be Well Capitalized Under Prompt Corrective Action Provisions |         |
|---|------------|---------|-------------------------------|--------|--|---------|
|   | Amount     | Ratio   | Amount                        | Ratio  | Amount   | Ratio   |
| June 30, 2018   |            |         |                               |        |  |         |
| Total Capital (to Risk Weighted Assets):                |            |         |                               |        |  |         |
| Company   | \$ 134,566 | 13.23 % | \$ 81,356                     | 8.00 % | \$ 101,695   | 10.00 % |
| Bank  | \$ 128,570 | 12.65 % | \$ 81,339                     | 8.00 % | \$ 101,674   | 10.00 % |
| Tier 1 Capital (to Risk Weighted Assets):               |            |         |                               |        |  |         |
| Company   | \$ 122,460 | 12.04 % | \$ 61,017                     | 6.00 % | \$ 81,356  | 8.00 %  |
| Bank  | \$ 116,464 | 11.45 % | \$ 61,004                     | 6.00 % | \$ 81,339  | 8.00 %  |
| Common Equity Tier 1 Capital (to Risk Weighted Assets): |            |         |                               |        |  |         |
| Company   | \$ 114,960 | 11.30 % | \$ 45,763                     | 4.50 % | \$ 66,101  | 6.50 %  |
| Bank  | \$ 116,464 | 11.45 % | \$ 45,753                     | 4.50 % | \$ 66,088  | 6.50 %  |
| Tier 1 Capital (to Average Assets):                     |            |         |                               |        |  |         |
| Company   | \$ 122,460 | 8.94 %  | \$ 54,767                     | 4.00 % | \$ 68,459  | 5.00 %  |
| Bank  | \$ 116,464 | 8.51 %  | \$ 54,748                     | 4.00 % | \$ 68,435  | 5.00 %  |
| December 31, 2017                                       |            |         |                               |        |  |         |
| Total Capital (to Risk Weighted Assets):                |            |         |                               |        |  |         |
| Company   | \$ 128,578 | 13.20 % | \$ 77,906                     | 8.00 % | \$ 97,383  | 10.00 % |
| Bank  | \$ 122,469 | 12.58 % | \$ 77,852                     | 8.00 % | \$ 97,315  | 10.00 % |
| Tier 1 Capital (to Risk Weighted Assets):               |            |         |                               |        |  |         |
| Company   | \$ 117,224 | 12.04 % | \$ 58,430                     | 6.00 % | \$ 77,906  | 8.00 %  |
| Bank  | \$ 111,114 | 11.42 % | \$ 58,389                     | 6.00 % | \$ 77,852  | 8.00 %  |
| Common Equity Tier 1 Capital (to Risk Weighted Assets): |            |         |                               |        |  |         |
| Company   | \$ 109,724 | 11.27 % | \$ 43,822                     | 4.50 % | \$ 63,299  | 6.50 %  |
| Bank  | \$ 111,114 | 11.42 % | \$ 43,792                     | 4.50 % | \$ 63,255  | 6.50 %  |
| Tier 1 Capital (to Average Assets):                     |            |         |                               |        |  |         |
| Company   | \$ 117,224 | 9.18 %  | \$ 51,085                     | 4.00 % | \$ 63,857  | 5.00 %  |

|      |           |        |          |        |          |        |
|------|-----------|--------|----------|--------|----------|--------|
| Bank | \$111,114 | 8.71 % | \$51,023 | 4.00 % | \$63,778 | 5.00 % |
|------|-----------|--------|----------|--------|----------|--------|

Off-Balance Sheet Activities

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

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|                              | June 30,<br>2018 | December<br>31, 2017 |
|------------------------------|------------------|----------------------|
| Commitments to extend credit | \$209,549        | \$188,482            |
| Standby letters of credit    | 15,465           | 15,244               |
|                              | \$225,014        | \$203,726            |

We also offer limited overdraft protection as a non-contractual courtesy which is available to demand deposit accounts in good standing. Overdraft charges as a result of ATM withdrawals and one time point of sale (non-recurring) transactions require prior approval of the customer. The non-contractual amount of financial instruments with off-balance sheet risk at June 30, 2018 and December 31, 2017 was \$9,418,000 and \$9,335,000, respectively. The Company reserves the right to discontinue this service without prior notice.

## Liquidity

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

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

The Company's use of funds is shown in the investing activity section of the Consolidated Statement of Cash Flows, where the net loan activity is presented. Other uses of funds include purchasing stock from the Federal Home Loan Bank (FHLB) of Pittsburgh, as well as capital expenditures. Capital expenditures (including software purchases), during the first six months of 2018 were \$140,000 compared to \$131,000 during the same time period in 2017.

Short-term debt from the FHLB supplements the Bank's availability of funds. The Bank achieves liquidity primarily from temporary or short term investments in the Federal Reserve and the FHLB. The Bank has a maximum borrowing capacity at the FHLB of approximately \$494.4 million, of which \$151.1 million was outstanding via loans and letters of credits at June 30, 2018. Additionally, we have a Federal funds line totaling \$10.0 million from a third party bank at market rates. This line is not drawn upon. We also have a borrower in custody line with the Federal Reserve Bank of approximately \$4.4 million, which also is not drawn upon as of June 30, 2018. The Company continues to evaluate its liquidity needs and as necessary finds additional sources.

Citizens Financial Services, Inc. is a separate legal entity from the Bank and must provide for its own liquidity. In addition to its operating expenses, Citizens Financial Services, Inc. is responsible for paying any dividends declared to its shareholders. Citizens Financial also has repurchased shares of its common stock. Citizens Financial Services, Inc.'s primary source of income is dividends received from the Bank. Both federal and state laws impose restrictions on the ability of the Bank to pay dividends. In particular, the Bank may not, as a state-chartered bank which is a member of the Federal Reserve System, declare a dividend without approval of the Federal Reserve, unless the dividend to be declared by the Bank's Board of Directors does not exceed the total of: (i) the Bank's net profits for the current year to date, plus (ii) its retained net profits for the preceding two current years, less any required transfers to surplus. The Federal Reserve Board and the FDIC have formal and informal policies which provide that insured banks and bank holding companies should generally pay dividends only out of current operating earnings, with some exceptions. The Prompt Corrective Action Rules, described above, further limit the ability of banks to pay dividends,

because banks which are not classified as well capitalized or adequately capitalized may not pay dividends and no dividend may be paid which would make the Bank undercapitalized after the dividend. At June 30, 2018, Citizens Financial Services, Inc. (on an unconsolidated basis) had liquid assets of \$5.7 million.

## Interest Rate and Market Risk Management

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

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

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

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

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

| Changes in Rates | Prospective<br>One-Year<br>Net<br>Interest<br>Income | % Change   |   |
|------------------|--|--|---|
|                  |  | Change In<br>Prospective<br>Net Interest<br>Income | In<br>Prospective<br>Net Interest<br>Income |
| -100 Shock       | \$ 46,316  | \$ (1,069 )  | (2.26 )                                     |
| Base             | 47,385   | -  | -   |
| +100 Shock       | 46,074   | (1,311 )   | (2.77 )                                     |
| +200 Shock       | 44,564   | (2,821 )   | (5.95 )                                     |
| +300 Shock       | 43,090   | (4,295 )   | (9.06 )                                     |
| +400 Shock       | 41,595   | (5,790 )   | (12.22 )                                    |

The model makes estimates, at each level of interest rate change, regarding cash flows from principal repayments on loans and mortgage backed securities, call activity of other investment securities, and deposit selection, re-pricing and maturity structure. Because of these assumptions, actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change on net interest income. Additionally, the changes above do not necessarily represent the level of change under which management would undertake specific



measures to realign its portfolio in order to reduce the projected level of change. It should be noted that the changes in net interest income noted above are in line with Company policy for interest rate risk.

Item 3-Quantitative and Qualitative Disclosure about Market Risk

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

## Item 4-Control and Procedures

## (a) Disclosure Controls and Procedures

The Company's management, including the Company's principal executive officer and principal financial officer, have evaluated the effectiveness of the Company's "disclosure controls and procedures," as such term is defined in Rule 13a-15(e) promulgated under the Securities Exchange Act of 1934, as amended, (the "Exchange Act"). Based upon their evaluation, the principal executive officer and principal financial officer concluded that, as of the end of the period covered by this report, the Company's disclosure controls and procedures were effective for the purpose of ensuring that the information required to be disclosed in the reports that the Company files or submits under the Exchange Act with the SEC (1) is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and (2) is accumulated and communicated to the Company's management, including its principal executive and principal financial officers, as appropriate to allow timely decisions regarding required disclosure.

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

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

## PART II OTHER INFORMATION

## Item 1 Legal Proceedings

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

## Item 1A – Risk Factors

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

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

## ISSUER PURCHASES OF EQUITY SECURITIES

| Period | Total<br>Number of<br>Shares<br>(or units<br>Purchased) | Average<br>Price<br>Paid<br>per<br>Share<br>(or<br>Unit) | Total<br>Number of<br>Shares (or<br>Units)<br>Purchased<br>as Part of<br>Publicly | Maximum<br>Number (or<br>Approximate<br>Dollar Value)<br>of Shares (or<br>Units) that |
|--------|---|--|---|---|
|--------|---|--|---|---|

|                   |       |          | Announced<br>Plans of<br>Programs | May Yet Be<br>Purchased<br>Under the<br>Plans<br>or Programs<br>(1) |
|-------------------|-------|----------|-----------------------------------|---|
| 4/1/18 to 4/30/18 | 75    | \$ 61.00 | 75                                | 84,068  |
| 5/1/18 to 5/31/18 | -     | \$ 0.00  | -                                 | 84,068  |
| 6/1/18 to 6/30/18 | 3,307 | \$ 62.66 | 3,307                             | 80,761  |
| Total             | 3,382 | \$ 62.62 | 3,382                             | 80,761  |

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

Item 3 Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosure

Not applicable.

Item 5 Other Information

None

Item 6 Exhibits

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

3.1 Articles of Incorporation of Citizens Financial Services, Inc., as amended

3.2 Bylaws of Citizens Financial Services, Inc. <sup>(1)</sup>

4.1 Form of Common Stock Certificate. <sup>(2)</sup>

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

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

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

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

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

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

\*\* Furnished, not filed.

Signatures

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

**Citizens Financial Services, Inc.**  
**(Registrant)**

August 9, 2018 By: /s/ Randall E. Black  
Randall E. Black  
President & Chief Executive Officer  
(Principal Executive Officer)

August 9, 2018 By: /s/ Mickey L. Jones  
Mickey L. Jones  
Chief Financial Officer  
(Principal Financial and Accounting Officer)

