

FRANKLIN FINANCIAL SERVICES CORP /PA/

Form 10-Q

November 05, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

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

For the quarterly period ended September 30, 2018

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 0-12126

FRANKLIN FINANCIAL SERVICES CORPORATION

(Exact name of registrant as specified in its charter)

PENNSYLVANIA

(State or other jurisdiction of incorporation or organization)

25-1440803

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

20 South Main Street, Chambersburg, PA 17201-0819

(Address of principal executive offices) (Zip Code)

(717) 264-6116

(Registrant's telephone number, including area code)

Not Applicable

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

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

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

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company Emerging growth company

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

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

There were 4,399,135 outstanding shares of the Registrant’s common stock as of October 31, 2018.

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Part I FINANCIAL INFORMATION

Item 1 Financial Statements

Consolidated Balance Sheets

(Dollars in thousands, except share and per share data)(unaudited)	September 30, 2018	December 31, 2017
Assets		
Cash and due from banks	\$ 16,281	\$ 21,433
Interest-bearing deposits in other banks	28,496	37,170
Total cash and cash equivalents	44,777	58,603
Debt securities available for sale, at fair value	125,403	126,971
Equity securities	383	365
Restricted stock	452	456
Loans held for sale	1,072	442
Loans	970,983	943,700
Allowance for loan losses	(12,526)	(11,792)
Net Loans	958,457	931,908
Premises and equipment, net	13,267	13,741
Bank owned life insurance	23,366	22,980
Goodwill	9,016	9,016
Other real estate owned	2,665	2,598
Deferred tax asset, net	4,170	5,803
Other assets	11,596	6,930
Total assets	\$ 1,194,624	\$ 1,179,813
Liabilities		
Deposits		
Non-interest bearing checking	\$ 196,478	\$ 196,853
Money management, savings and interest checking	807,643	774,857
Time	67,736	75,471
Total deposits	1,071,857	1,047,181
Other liabilities	8,739	17,488
Total liabilities	1,080,596	1,064,669
Shareholders' equity		
Common stock, \$1 par value per share, 15,000,000 shares authorized with 4,701,367 shares issued and 4,398,361 shares outstanding at September 30, 2018 and 4,689,099 shares issued and 4,354,788 shares outstanding at December 31, 2017	4,701	4,689
Capital stock without par value, 5,000,000 shares authorized with no shares issued and outstanding	—	—
Additional paid-in capital	41,380	40,396
Retained earnings	81,330	82,218
Accumulated other comprehensive loss	(7,790)	(6,028)

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Treasury stock, 303,006 shares at September 30, 2018 and 334,311 shares at December 31, 2017, at cost	(5,593)	(6,131)
Total shareholders' equity	114,028	115,144
Total liabilities and shareholders' equity	\$ 1,194,624	\$ 1,179,813

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

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Consolidated Statements of Income

(Dollars in thousands, except per share data) (unaudited)	For the Three Months Ended		For the Nine Months Ended	
	September 30, 2018	2017	September 30, 2018	2017
Interest income				
Loans, including fees	\$ 10,565	\$ 9,130	\$ 30,268	\$ 26,808
Interest and dividends on investments:				
Taxable interest	507	509	1,548	1,558
Tax exempt interest	293	275	862	861
Dividend income	4	2	15	23
Deposits and obligations of other banks	108	147	326	297
Total interest income	11,477	10,063	33,019	29,547
Interest expense				
Deposits	1,101	629	2,847	1,785
Short-term borrowings	21	—	24	15
Total interest expense	1,122	629	2,871	1,800
Net interest income	10,355	9,434	30,148	27,747
Provision for loan losses	250	250	9,579	420
Net interest income after provision for loan losses	10,105	9,184	20,569	27,327
Noninterest income				
Investment and trust services fees	1,424	1,353	4,285	3,991
Loan service charges	191	201	640	657
Deposit service charges and fees	578	611	1,726	1,789
Other service charges and fees	357	340	1,043	996
Debit card income	422	325	1,224	1,062
Increase in cash surrender value of life insurance	129	130	386	391
Net loss on sale of other real estate owned	—	(23)	—	(23)
Debt securities gains, net	5	1	56	3
Change in fair value of equity securities	(20)	—	18	—
Other	34	33	111	186
Total noninterest income	3,120	2,971	9,489	9,052
Noninterest Expense				
Salaries and employee benefits	4,947	4,694	15,029	14,190
Occupancy, furniture and equipment, net	780	809	2,383	2,386
Advertising	345	332	1,113	873
Legal and professional	436	502	1,207	1,173
Data processing	591	567	1,791	1,643
Pennsylvania bank shares tax	239	243	712	728
FDIC Insurance	159	82	452	281
ATM/debit card processing	258	190	734	630
Foreclosed real estate	(8)	24	46	95
Telecommunications	95	106	327	308
Provision for credit losses on off-balance sheet exposures	—	—	2,361	—
Other	729	756	2,253	2,116
Total noninterest expense	8,571	8,305	28,408	24,423
Income before federal income taxes	4,654	3,850	1,650	11,956

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Federal income tax expense (benefit)	654	774	(671)	2,517
Net income	\$ 4,000	\$ 3,076	\$ 2,321	\$ 9,439
Per share				
Basic earnings per share	\$ 0.91	\$ 0.71	\$ 0.53	\$ 2.18
Diluted earnings per share	\$ 0.91	\$ 0.70	\$ 0.53	\$ 2.17
Cash dividends declared	\$ 0.27	\$ 0.24	\$ 0.78	\$ 0.69

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

Consolidated Statements of Comprehensive Income

(Dollars in thousands) (unaudited)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Net Income	\$ 4,000	\$ 3,076	\$ 2,321	\$ 9,439
Debt Securities:				
Unrealized (losses) gains arising during the period	(638)	(97)	(1,974)	924
Reclassification adjustment included in net income (1)	(5)	(1)	(56)	(3)
Net unrealized (losses) gains	(643)	(98)	(2,030)	921
Tax effect	135	33	469	(313)
Net of tax amount	(508)	(65)	(1,561)	608
Total other comprehensive (loss) income	(508)	(65)	(1,561)	608
Total Comprehensive Income	\$ 3,492	\$ 3,011	\$ 760	\$ 10,047

Reclassification adjustment / Statement line item	Tax expense (benefit)			
(1) Debt securities gains, net	\$ 1	\$ —	\$ 12	\$ 1

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

Consolidated Statements of Changes in Shareholders' Equity

For the three and nine months ended September 30, 2018 and 2017

	Common	Additional Paid-in	Retained	Accumulated Other Comprehensive	Treasury	Total
(Dollars in thousands, except per share data) (unaudited)	Stock	Capital	Earnings	Loss	Stock	Total
Balance at June 30, 2018	\$ 4,700	\$ 41,079	\$ 78,514	\$ (7,282)	\$ (5,839)	\$ 111,172
Net income	—	—	4,000	—	—	4,000
Other comprehensive loss	—	—	—	(508)	—	(508)
Cash dividends declared, \$.27 per share	—	—	(1,184)	—	—	(1,184)
Treasury shares issued under employee stock purchase plan, 381 shares	—	5	—	—	7	12
Treasury shares issued under dividend reinvestment plan, 12,957 shares	—	210	—	—	239	449
Common stock issued under incentive stock option plan, 1,600 shares	1	24	—	—	—	25
Stock option compensation expense	—	62	—	—	—	62
Balance at September 30, 2018	\$ 4,701	\$ 41,380	\$ 81,330	\$ (7,790)	\$ (5,593)	\$ 114,028
Balance at December 31, 2017	\$ 4,689	\$ 40,396	\$ 82,218	\$ (6,028)	\$ (6,131)	\$ 115,144
Cumulative adjustment for fair value of equity securities	—	—	201	(201)	—	—
Net income	—	—	2,321	—	—	2,321
Other comprehensive (loss)	—	—	—	(1,561)	—	(1,561)
Cash dividends declared, \$.78 per share	—	—	(3,410)	—	—	(3,410)
Acquisition of 2,605 shares of treasury stock	—	—	—	—	(88)	(88)
Treasury shares issued under employee stock purchase plan, 2,944 shares	—	34	—	—	54	88
Treasury shares issued under dividend reinvestment plan, 30,966 shares	—	513	—	—	572	1,085
Common stock issued under incentive stock option plan, 12,268 shares	12	252	—	—	—	264
Stock option compensation expense	—	185	—	—	—	185
Balance at September 30, 2018	\$ 4,701	\$ 41,380	\$ 81,330	\$ (7,790)	\$ (5,593)	\$ 114,028
Balance at June 30, 2017	\$ 4,688	\$ 40,096	\$ 87,498	\$ (3,542)	\$ (6,380)	\$ 122,360
Net income	—	—	3,076	—	—	3,076
Other comprehensive (loss)	—	—	—	(65)	—	(65)
Cash dividends declared, \$.24 per share	—	—	(1,042)	—	—	(1,042)

Treasury shares issued under employee stock purchase plan, 241 shares	—	3	—	—	4	7
Treasury shares issued under dividend reinvestment plan, 5,723 shares	—	85	—	—	105	190
Stock option compensation expense	—	54	—	—	—	54
Balance at September 30, 2017	\$ 4,688	\$ 40,238	\$ 89,532	\$ (3,607)	\$ (6,271)	\$ 124,580
Balance at December 31, 2016	\$ 4,688	\$ 39,752	\$ 83,081	\$ (4,215)	\$ (6,813)	\$ 116,493
Net income	—	—	9,439	—	—	9,439
Other comprehensive income	—	—	—	608	—	608
Cash dividends declared, \$.69 per share	—	—	(2,988)	—	—	(2,988)
Treasury shares issued under employee stock purchase plan, 6,568 shares	—	29	—	—	120	149
Treasury shares issued under dividend reinvestment plan, 22,990 shares	—	296	—	—	422	718
Stock option compensation expense	—	161	—	—	—	161
Balance at September 30, 2017	\$ 4,688	\$ 40,238	\$ 89,532	\$ (3,607)	\$ (6,271)	\$ 124,580

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

Consolidated Statements of Cash Flows

	Nine Months Ended September 30,	
	2018	2017
(Dollars in thousands) (unaudited)		
Cash flows from operating activities		
Net income	\$ 2,321	\$ 9,439
Adjustments to reconcile net income to net cash (used in) provided by operating activities:		
Depreciation and amortization	989	973
Net amortization of loans and investment securities	1,307	1,269
Amortization and net change in mortgage servicing rights valuation	—	41
Provision for loan losses	9,579	420
Change in fair value of equity securities	(18)	—
Debt securities gains, net	(56)	(3)
Pay-out of legal settlement	(10,000)	—
Provision for credit losses on off-balance sheet exposures	2,361	—
Loans originated for sale	(16,137)	(6,773)
Proceeds from sale of loans	15,507	6,861
Write-down of other real estate owned	6	60
Acquisition of other real estate owned	105	—
Write-down on premises and equipment available for sale	—	45
Loss on sale of premises	17	23
Increase in cash surrender value of life insurance	(386)	(391)
Stock option compensation	185	161
Contribution to pension plan	(1,000)	—
Increase in other assets	(4,441)	(1,242)
Increase in other liabilities	1,638	2,753
Net cash provided by operating activities	1,977	13,636
Cash flows from investing activities		
Proceeds from sales and calls of investment securities available for sale	4,115	875
Proceeds from maturities and pay-downs of securities available for sale	14,289	16,875
Purchase of investment securities available for sale	(20,276)	(6,533)
Net decrease in restricted stock	4	1,311
Net increase in loans	(36,188)	(17,643)
Capital expenditures	(599)	(871)
Proceeds from sale of other assets	117	154
Net proceeds from the sale of other real estate	32	2,255
Net cash used in investing activities	(38,506)	(3,577)
Cash flows from financing activities		
Net increase in demand deposits, interest-bearing checking, and savings accounts	32,411	50,325
Net (decrease) increase in time deposits	(7,735)	703
Net decrease in short-term borrowings	—	(24,270)
Dividends paid	(3,410)	(2,988)
Treasury shares issued under employee stock purchase plan	88	149
Treasury shares issued under dividend reinvestment plan	1,085	718
Common stock issued under stock option plans	264	—

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Net cash provided by financing activities	22,703	24,637
(Decrease) increase in cash and cash equivalents	(13,826)	34,696
Cash and cash equivalents as of January 1	58,603	36,665
Cash and cash equivalents as of September 30	\$ 44,777	\$ 71,361
Supplemental Disclosures of Cash Flow Information		
Cash paid during the year for:		
Interest on deposits and other borrowed funds	\$ 2,818	\$ 1,786
Income taxes	\$ 250	\$ 3,405

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

FRANKLIN FINANCIAL SERVICES CORPORATION and SUBSIDIARIES

UNAUDITED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

Note 1 - Basis of Presentation

The consolidated financial statements include the accounts of Franklin Financial Services Corporation (the Corporation), and its wholly-owned subsidiaries, Farmers and Merchants Trust Company of Chambersburg (the Bank) and Franklin Future Fund Inc. Farmers and Merchants Trust Company of Chambersburg is a commercial bank that has one wholly-owned subsidiary, Franklin Financial Properties Corp. Franklin Financial Properties Corp. holds real estate assets that are leased by the Bank. Franklin Future Fund Inc. is a non-bank investment company. The activities of non-bank entities are not significant to the consolidated totals. All significant intercompany transactions and account balances have been eliminated.

In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the consolidated financial position, results of operations, and cash flows as of September 30, 2018, and for all other periods presented have been made.

Certain information and footnote disclosures normally included in consolidated financial statements prepared in accordance with accounting principles generally accepted in the United States of America ("GAAP") have been condensed or omitted. It is suggested that these consolidated financial statements be read in conjunction with the audited consolidated financial statements and notes thereto included in the Corporation's 2017 Annual Report on Form 10-K. The consolidated results of operations for the nine month period ended September 30, 2018 are not necessarily indicative of the operating results for the full year. Management has evaluated subsequent events for potential recognition and/or disclosure through the date these consolidated financial statements were issued.

The consolidated balance sheet at December 31, 2017 has been derived from the audited consolidated financial statements at that date, but does not include all of the information and footnotes required by GAAP for complete consolidated financial statements.

For purposes of reporting cash flows, cash and cash equivalents include cash and due from banks, interest-bearing deposits in other banks and federal funds sold. Generally, federal funds are purchased and sold for one-day periods.

Earnings per share are computed based on the weighted average number of shares outstanding during each period end. A reconciliation of the weighted average shares outstanding used to calculate basic earnings per share and diluted earnings per share follows:

(Dollars and shares in thousands, except per share data)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Weighted average shares outstanding (basic)	4,391	4,343	4,375	4,332
Impact of common stock equivalents	21	21	24	21
Weighted average shares outstanding (diluted)	4,412	4,364	4,399	4,353

Anti-dilutive options excluded from calculation	—	—	—	—
Net income	\$ 4,000	\$ 3,076	\$ 2,321	\$ 9,439
Basic earnings per share	\$ 0.91	\$ 0.71	\$ 0.53	\$ 2.18
Diluted earnings per share	\$ 0.91	\$ 0.70	\$ 0.53	\$ 2.17

Note 2. Recent Accounting Pronouncements

Standard	Description	Effective Date	Effect on the financial statements or other significant matters
ASU 2018-02, Income Statement (Topic 220), Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income	Under ASU 2018-02, entities are allowed, but not required, to reclassify from Accumulated Other Comprehensive Income (AOCI) to retained earnings stranded tax effects resulting from the new federal corporate income tax rate of the Tax Cuts and Jobs Act (the Act). The reclassification could include other stranded tax effects that related to the Act but do not directly related to the change in the federal rate. Tax effects that are stranded in AOCI for other reasons may not be reclassified. Entities also will have an option to adopt the standard retrospectively or in the period of adoption.	January 1, 2018	The Corporation adopted the provisions of the ASU in the fourth quarter of 2017. The Company reclassified the disproportionate tax effect resulting from the Act by increasing retained earnings by \$992 thousand and reducing AOCI by \$992 thousand.
ASU 2016-15, Statements of Cash Flow (Topic 320): Classification of Certain Cash Receipts and Cash Payments	The standard clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments are intended to reduce diversity in practice. The standard contains additional guidance clarifying when an entity should separate cash receipts and cash payments and classifies them into more than one class of cash flows (including when reasonable judgement is required to estimate and allocate cash flows) versus when an entity should classify the aggregate amount into one class of cash flows on the basis of predominance.	January 1, 2018	The Corporation adopted the provisions of the ASU on January 1, 2018 and it had no material effect on the consolidated financial statements.
ASU 2017-07, Employee Benefits Plan (Topic 715): Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost	This standard requires an employer to 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 and outside a subtotal of income from operations. The amendments in this update also allow only the service cost component to be eligible for capitalization when applicable.	January 1, 2018	The Corporation adopted the provisions of the ASU on January 1, 2018 and it had no material effect on the consolidated financial statements. The service cost is reported in Salaries and Benefits expense and the nonservice cost is included in Other Expense on the Consolidated Statement of Income, which totaled \$107 thousand and was reclassified for the first nine months of 2017.

ASU 2014-09, Revenue from Contracts with Customers (Topic 606)	The amendments in this Update (ASU 2014-09) establish a comprehensive revenue recognition standard. The revenue standard's core principle is built on the contract between a vendor and a customer for the provision of goods and services. It attempts to depict the exchange of rights and obligations between the parties in the pattern of revenue recognition based on the consideration to which the vendor is entitled. To accomplish this objective, the standard requires five basic steps: (i) identify the contract with the customer, (ii) identify the performance obligations in the contract, (iii) determine the transaction price, (iv) allocate the transaction price to the performance obligations in the contract, and (v) recognize revenue when (or as) the entity satisfies a performance obligation. Three basic transition methods are available – full retrospective, retrospective with certain practical expedients, and a cumulative effect approach.	January 1, 2018	The Corporation adopted this ASU on January 1, 2018, on a modified retrospective approach, and it did not have a material effect on the Corporation's consolidated financial statements. See Note 11. Revenue Recognition for more information.
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<p>ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities</p>	<p>The standard amends the guidance on the classification and measurement of financial instruments. Some of the amendments include the following: 1) requires equity investments to be measured at fair value with changes in fair value recognized in net income; 2) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; 3) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and 4) requires an entity to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in the instrument-specific credit risk when the entity has elected to measure the liability at fair value; among others.</p>	<p>January 1, 2018</p>	<p>The Corporation adopted the provisions of the ASU on January 1, 2018 and it had no material effect on the consolidated financial statements. The Corporation reclassified the fair value of equity securities by increasing retained earnings by \$201 thousand and decreasing AOCI by \$201 thousand. In addition, according to the standard, the Corporation measured the fair value of the loan portfolio beginning March 31, 2018 using an exit price notion. See Note 9. Fair Value Measurements and Fair Values of Financial Instruments for more information.</p>
<p>ASU 2016-02, Leases (Topic 842)</p>	<p>From the lessee's perspective, the new standard established a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for lessees. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as financing. If the lessor doesn't convey risks and rewards or control, an operating lease results.</p>	<p>January 1, 2019</p>	<p>The Corporation currently has real estate and equipment leases that it classifies as operating leases that are not recognized on the balance sheet. Under the new standard, these leases will move onto the balance sheet in the form of a lease liability (the present value of a lessee's obligation to make lease payments) and a right-of-use asset (an asset that represents the lessee's right to use a specified asset for the lease term). The offsetting transactions will gross-up the Consolidated Balance Sheet. The Corporation has identified all of its leases (approximately 63, primarily equipment and property leases), but has not determined the effect on the Consolidated Balance Sheet. The Corporation has acquired a lease accounting model to implement the standard to be used in a test mode during 2018. The Corporation expects to adopt the standard using the modified retrospective approach and elect the transition options of ASU 2018-11. The Corporation currently expects that the new standard will not have a material effect on its consolidated results of operations.</p>

ASU 2018-11, Leases - Targeted Improvements (Topic 842)	This guidance provides entities with relief from the costs of implementing certain aspects of the new leasing standard, ASU No. 2016-02. Specifically, under the amendments in ASU 2018-11: (1) entities may elect not to recast the comparative periods presented when transitioning to the new leasing standard, and (2) lessors may elect not to separate lease and non-lease components when certain conditions are met. The amendments have the same effective date as ASU 2016-02 (January 1, 2019 for the Corporation).	
ASU 2018-15, Accounting for Implementation Costs in a Cloud Computing Arrangement (Topic 350)	This ASU required an entity in a cloud computing arrangement (i.e., hosting arrangement) that is a service contract to follow the internal-use software guidance in ASC 350-40 to determine which implementation costs to capitalize as assets or expense as incurred. Capitalized implementation costs should be presented in the same line item on the balance sheet as amounts prepaid for the hosted service, if any (generally as an "other asset"). The capitalized costs will be amortized over the term of the hosting arrangement, with the amortization expense being presented in the same income statement line item as the fees paid for the hosted service.	January 1, 2019 The Corporation is reviewing its internal accounting procedures for this implementation. The Corporation does not expect the standard will have a material effect on its consolidated results of operations.

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ASU 2018-13, Disclosure Framework (Topic 820)	This guidance eliminates, adds and modifies certain disclosure requirements for fair value measurements. Among the changes, entities will no longer be required to disclose the amount of and reason for transfers between Level 1 and Level 2 of the fair value hierarchy, but will be required to disclose the range and weighted average used to develop significant unobservable inputs for Level 3 fair value measurements.	January 1, 2019	The Corporation is reviewing its financial reporting procedures for this implementation. The Corporation does not expect the standard will have a material effect on its consolidated results of operations.
ASU 2017-04, Goodwill (Topic 350)	This guidance, among other things, removes step 2 of the goodwill impairment test thus eliminating the need to determine the fair value of individual assets and liabilities of the reporting unit. Upon adoption of this standard, goodwill impairment will be the amount by which a reporting unit's carrying value exceeds its fair value, not to exceed the carrying amount of goodwill. This may result in more or less impairment being recognized than under the current guidance. Early adoption is permitted for any impairment tests performed after January 1, 2017, applied prospectively.	January 1, 2020	The Corporation expects to early adopt the ASU in the fourth quarter of 2018 with the completion of the 2018 impairment analysis. We do not expect this guidance to have a material effect on the Corporation's consolidated financial statements based upon the prior goodwill impairment analysis.
ASU 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments	This standard requires credit losses on most financial assets measured at amortized cost and certain other instruments to be measured using an expected credit loss model (referred to as the current expected credit loss (CECL) model). Under this model, entities will estimate credit losses over the entire contractual term of the instrument (considering estimated prepayments, but not expected extensions or modifications unless reasonable expectation of a troubled debt restructuring exists) from the date of initial recognition of that instrument. The ASU replaces the current accounting model for purchased credit impaired loans and debt securities. The allowance for credit losses for purchased financial assets with a more-than insignificant amount of credit deterioration since origination ("PCD assets"), should be determined in a similar manner to other financial assets measured on an amortized cost basis. However, upon initial recognition, the allowance for credit losses is added to the purchase price ("gross up approach") to determine the initial amortized cost basis. The subsequent accounting for PCD financial assets is the same expected loss model described above.	January 1, 2020	We have formed an implementation team led by the Corporation's Risk Management function. The team is reviewing the requirements of the ASU and evaluating methods and models for implementation. The new standard will result in earlier recognition of additions to the allowance for loan losses and possibly a larger allowance for loan loss balance with a corresponding increase in the provision for loan losses in results of operations; however, the Corporation is continuing to evaluate the impact of the pending adoption of the new standard on its consolidated financial statements. A third-party vendor has been selected to assist with the CECL calculations and the implementation process has started. The Corporation expects to be able to run the CECL model in test mode starting near the end of the first quarter of 2019.

Note 3. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive losses included in shareholders' equity are as follows:

	September 30, 2018	December 31, 2017
(Dollars in thousands)		
Net unrealized (losses) gains on debt securities	\$ (2,077)	\$ 154
Tax effect	436	(33)
Net of tax amount	(1,641)	121
Accumulated pension adjustment	(7,784)	(7,784)
Tax effect	1,635	1,635
Net of tax amount	(6,149)	(6,149)
Total accumulated other comprehensive loss	\$ (7,790)	\$ (6,028)

Note 4. Investments

Available for Sale (AFS) Securities

The amortized cost and estimated fair value of AFS securities as of September 30, 2018 and December 31, 2017 are as follows:

(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
September 30, 2018				
U.S. Government and Agency securities	\$ 9,405	\$ 15	\$ (144)	\$ 9,276
Municipal securities	63,221	176	(994)	62,403
Trust preferred securities	4,069	—	(122)	3,947
Agency mortgage-backed securities	46,394	39	(1,063)	45,370
Private-label mortgage-backed securities	474	43	—	517
Asset-backed securities	3,917	—	(27)	3,890
	\$ 127,480	\$ 273	\$ (2,350)	\$ 125,403

(Dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2017				
Equity securities	\$ 164	\$ 201	\$ —	\$ 365
U.S. Government and Agency securities	11,451	64	(43)	11,472
Municipal securities	57,374	650	(252)	57,772
Trust preferred securities	6,000	—	(183)	5,817
Agency mortgage-backed securities	51,307	197	(567)	50,937
Private-label mortgage-backed securities	858	88	—	946
Asset-backed securities	28	—	(1)	27
	\$ 127,182	\$ 1,200	\$ (1,046)	\$ 127,336

At September 30, 2018 and December 31, 2017, the fair value of AFS securities pledged to secure public funds and trust deposits totaled \$86.9 million and \$84.1 million, respectively.

The amortized cost and estimated fair value of debt securities at September 30, 2018, by contractual maturity are shown below. Actual maturities may differ from contractual maturities because of prepayment or call options embedded in the securities.

(Dollars in thousands)	Amortized cost	Fair value
Due in one year or less	\$ 14,466	\$ 14,508
Due after one year through five years	33,277	33,081
Due after five years through ten years	31,927	31,026
Due after ten years	942	901
	80,612	79,516
Mortgage-backed securities	46,868	45,887
	\$ 127,480	\$ 125,403

The composition of the net realized gains on AFS securities for the three and nine months ended are as follows:

(Dollars in thousands)	For the Three Months Ended September 30,		For the Nine Months Ended September 30,	
	2018	2017	2018	2017
Gross gains realized	\$ 5	\$ 1	\$ 67	\$ 3
Gross losses realized	—	—	(11)	—
Net gains realized	\$ 5	\$ 1	\$ 56	\$ 3

Impairment:

The AFS investment portfolio contained 192 securities with \$100 million of temporarily impaired fair value and \$2.4 million in unrealized losses at September 30, 2018. The total unrealized loss position has increased \$1.3 million since year-end 2017.

For securities with an unrealized loss, Management applies a systematic methodology in order to perform an assessment of the potential for other-than-temporary impairment. In the case of debt securities, investments considered for other-than-temporary impairment: (1) had a specified maturity or repricing date; (2) were generally expected to be redeemed at par, and (3) were expected to achieve a recovery in market value within a reasonable period of time. In addition, the Bank considers whether it intends to sell these securities or whether it will be forced to sell these securities before the earlier of amortized cost recovery or maturity. The impairment identified on debt securities and subject to assessment at September 30, 2018, was deemed to be temporary and required no further adjustments to the financial statements, unless otherwise noted.

The following table reflects temporary impairment in the AFS portfolio, aggregated by investment category, length of time that individual securities have been in a continuous unrealized loss position and the number of securities in each category as of September 30, 2018 and December 31, 2017:

(Dollars in thousands)	September 30, 2018			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	\$ 4,011	\$ (54)	5	\$ 4,381	\$ (90)	12	\$ 8,392	\$ (144)	17
Municipal securities	28,938	(520)	47	13,014	(474)	23	41,952	(994)	70
Trust preferred securities	2,102	(62)	3	1,845	(60)	2	3,947	(122)	5
Agency mortgage-backed securities	18,326	(311)	40	22,996	(752)	53	41,322	(1,063)	93
Asset-backed securities	3,886	(26)	6	4	(1)	1	3,890	(27)	7
Total temporarily impaired securities	\$ 57,263	\$ (973)	101	\$ 42,240	\$ (1,377)	91	\$ 99,503	\$ (2,350)	192

December 31, 2017

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(Dollars in thousands)	Less than 12 months			12 months or more			Total		
	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count	Fair Value	Unrealized Losses	Count
U.S. Government and Agency securities	\$ 2,315	\$ (11)	5	\$ 3,528	\$ (32)	10	\$ 5,843	\$ (43)	15
Municipal securities	13,767	(89)	22	7,507	(163)	14	21,274	(252)	36
Trust preferred securities	1,216	(12)	2	4,601	(171)	5	5,817	(183)	7
Agency mortgage-backed securities	16,287	(129)	29	20,563	(438)	39	36,850	(567)	68
Asset-backed securities	—	—	—	4	(1)	1	4	(1)	1
Total temporarily impaired securities	\$ 33,585	\$ (241)	58	\$ 36,203	\$ (805)	69	\$ 69,788	\$ (1,046)	127

The following table represents the cumulative credit losses on AFS securities recognized in earnings for:

(Dollars in thousands)	Nine Months Ended	
	September 30, 2018	2017
Balance of cumulative credit-related OTTI at January 1	\$ 595	\$ 595
Additions for credit-related OTTI not previously recognized	—	—
Additional increases for credit-related OTTI previously recognized when there is no intent to sell and no requirement to sell before recovery of amortized cost basis	—	—
Decreases for previously recognized credit-related OTTI because there was an intent to sell	(323)	—
Reduction for increases in cash flows expected to be collected	—	—
Balance of credit-related OTTI at September 30	\$ 272	\$ 595

Equity Securities at fair value

The Corporation owns one equity investment. At September 30, 2018, this investment was reported at fair value (\$383 thousand) with changes in value reported through income. At December 31, 2017, this investment was reported at fair value with changes in value recorded through other comprehensive income and was included in the Available for Sale Securities table of this note.

Restricted Stock at Cost

The Bank held \$452 thousand of restricted stock at September 30, 2018. Except for \$30 thousand, this investment represents stock in FHLB Pittsburgh. The Bank is required to hold this stock to be a member of FHLB and it is carried at cost of \$100 per share. The level of FHLB stock held is determined by FHLB and is comprised of a minimum membership amount plus a variable activity amount. FHLB stock is evaluated for impairment primarily based on an assessment of the ultimate recoverability of its cost. As a government sponsored entity, FHLB has the ability to raise funding through the U.S. Treasury that can be used to support its operations. There is not a public market for FHLB stock and the benefits of FHLB membership (e.g., liquidity and low cost funding) add value to the stock beyond purely financial measures. Management intends to remain a member of the FHLB and believes that it will be able to fully recover the cost basis of this investment.

Note 5. Loans

The Bank reports its loan portfolio based on the primary collateral of the loan. It further classifies these loans by the primary purpose, either consumer or commercial. The Bank's residential real estate loans include long-term loans to individuals and businesses secured by mortgages on the borrower's real property and include home equity loans. Construction loans are made to finance the purchase of land and the construction of residential and commercial buildings thereon, and are secured by mortgages on real estate. Commercial real estate loans include construction, owner and non-owner occupied properties and farm real estate. Commercial loans are made to businesses of various

sizes for a variety of purposes including property, plant and equipment, working capital and loans to government municipalities. Commercial lending is concentrated in the Bank's primary market, but also includes purchased loan participations. Consumer loans are comprised of installment loans and unsecured personal lines of credit.

A summary of loans outstanding, by class, at the end of the reporting periods is as follows:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Residential Real Estate 1-4 Family		
Consumer first liens	\$ 90,029	\$ 97,159
Commercial first lien	60,142	61,275
Total first liens	150,171	158,434
Consumer junior liens and lines of credit	43,044	45,043
Commercial junior liens and lines of credit	5,040	5,328
Total junior liens and lines of credit	48,084	50,371
Total residential real estate 1-4 family	198,255	208,805
Residential real estate - construction		
Consumer	2,779	1,813
Commercial	9,510	8,088
Total residential real estate construction	12,289	9,901
Commercial real estate	475,838	428,428
Commercial	279,835	291,519
Total commercial	755,673	719,947
Consumer	4,766	5,047
	970,983	943,700
Less: Allowance for loan losses	(12,526)	(11,792)
Net Loans	\$ 958,457	\$ 931,908
Included in the loan balances are the following:		
Net unamortized deferred loan costs	\$ 73	\$ 98
Loans pledged as collateral for borrowings and commitments from:		
FHLB	\$ 762,292	\$ 737,313
Federal Reserve Bank	34,685	35,740
	\$ 796,977	\$ 773,053

Note 6. Loan Quality and Allowance for Loan Losses

The following table presents, by class, the activity in the Allowance for Loan Losses (ALL) for the periods shown:

(Dollars in thousands)	Residential Real Estate 1-4 Family			Commercial			Unallocated	Total
	First Liens	Junior & Lines of Credit	Construction	Real Estate	Commercial	Consumer		
ALL at June 30, 2018	\$ 1,022	\$ 318	\$ 282	\$ 7,028	\$ 2,233	\$ 107	\$ 1,492	\$ 12,482
Charge-offs	—	—	—	—	(208)	(23)	—	(231)
Recoveries	—	—	—	1	19	5	—	25
Provision	(16)	(4)	(4)	242	122	12	(102)	250
ALL at September 30, 2018	\$ 1,006	\$ 314	\$ 278	\$ 7,271	\$ 2,166	\$ 101	\$ 1,390	\$ 12,526
ALL at December 31, 2017	\$ 1,060	\$ 330	\$ 224	\$ 6,526	\$ 2,110	\$ 105	\$ 1,437	\$ 11,792
Charge-offs	—	—	—	—	(8,944)	(78)	—	(9,022)
Recoveries	1	—	—	17	135	24	—	177
Provision	(55)	(16)	54	728	8,865	50	(47)	9,579
ALL at September 30, 2018	\$ 1,006	\$ 314	\$ 278	\$ 7,271	\$ 2,166	\$ 101	\$ 1,390	\$ 12,526
ALL at June 30, 2017	\$ 1,075	\$ 322	\$ 281	\$ 6,052	\$ 2,023	\$ 100	\$ 1,454	\$ 11,307
Charge-offs	—	—	—	(9)	(6)	(31)	—	(46)
Recoveries	1	5	—	17	5	4	—	32
Provision	(15)	(3)	(42)	198	(19)	19	112	250
ALL at September 30, 2017	\$ 1,061	\$ 324	\$ 239	\$ 6,258	\$ 2,003	\$ 92	\$ 1,566	\$ 11,543
ALL at December 31, 2016	\$ 1,105	\$ 323	\$ 224	\$ 6,109	\$ 1,893	\$ 100	\$ 1,321	\$ 11,075
Charge-offs	(13)	—	—	(14)	(8)	(83)	—	(118)
Recoveries	2	6	—	17	111	30	—	166
Provision	(33)	(5)	15	146	7	45	245	420
ALL at September 30, 2017	\$ 1,061	\$ 324	\$ 239	\$ 6,258	\$ 2,003	\$ 92	\$ 1,566	\$ 11,543

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The following table presents, by class, loans that were evaluated for the ALL under the specific reserve (individually) and those that were evaluated under the general reserve (collectively) and the amount of the ALL established in each class as of September 30, 2018 and December 31, 2017:

(Dollars in thousands)	Residential Real Estate 1-4 Family							Unallocated	Total
	First Liens	Junior Liens & Lines of Credit	Construction	Commercial Real Estate	Commercial	Consumer			
September 30, 2018									
Loans evaluated for ALL:									
Individually	\$ 408	\$ —	\$ 460	\$ 10,574	\$ 3,106	\$ —	\$ —	\$ —	\$ 14,548
Collectively	149,763	48,084	11,829	465,264	276,729	4,766	—	—	956,435
Total	\$ 150,171	\$ 48,084	\$ 12,289	\$ 475,838	\$ 279,835	\$ 4,766	\$ —	\$ —	\$ 970,983
ALL established for loans evaluated:									
Individually	\$ —	\$ —	\$ —	\$ —	\$ 181	\$ —	\$ —	\$ —	\$ 181
Collectively	1,006	314	278	7,271	1,985	101	1,390	—	12,345
ALL at September 30, 2018	\$ 1,006	\$ 314	\$ 278	\$ 7,271	\$ 2,166	\$ 101	\$ 1,390	\$ —	\$ 12,526
December 31, 2017									
Loans evaluated for ALL:									
Individually	\$ 459	\$ —	\$ 466	\$ 10,981	\$ —	\$ —	\$ —	\$ —	\$ 11,906
Collectively	157,975	50,371	9,435	417,447	291,519	5,047	—	—	931,794
Total	\$ 158,434	\$ 50,371	\$ 9,901	\$ 428,428	\$ 291,519	\$ 5,047	\$ —	\$ —	\$ 943,700
ALL established for loans evaluated:									
Individually	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —	\$ —
Collectively	1,060	330	224	6,526	2,110	105	1,437	—	11,792
ALL at December 31, 2017	\$ 1,060	\$ 330	\$ 224	\$ 6,526	\$ 2,110	\$ 105	\$ 1,437	\$ —	\$ 11,792

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The following table shows additional information about those loans considered to be impaired at September 30, 2018 and December 31, 2017:

(Dollars in thousands)	Impaired Loans				
	With No Allowance Unpaid		With Allowance Unpaid		Related Allowance
September 30, 2018	Recorded Investment	Principal Balance	Recorded Investment	Principal Balance	
Residential Real Estate 1-4 Family					
First liens	\$ 754	\$ 870	\$ —	\$ —	\$ —
Junior liens and lines of credit	66	66	—	—	—
Total	820	936	—	—	—
Residential real estate - construction	460	531	—	—	—
Commercial real estate	10,715	11,248	—	—	—
Commercial	3,082	10,653	181	181	181
Total	\$ 15,077	\$ 23,368	\$ 181	\$ 181	\$ 181

December 31, 2017					
Residential Real Estate 1-4 Family					
First liens	\$ 869	\$ 950	\$ —	\$ —	\$ —
Junior liens and lines of credit	—	—	—	—	—
Total	869	950	—	—	—
Residential real estate - construction	466	531	—	—	—
Commercial real estate	11,061	11,541	—	—	—
Commercial	187	201	—	—	—
Total	\$ 12,583	\$ 13,223	\$ —	\$ —	\$ —

The following table shows the average of impaired loans and related interest income for the three and nine months ended September 30, 2018 and 2017:

(Dollars in thousands)	Three Months Ended September 30, 2018		Nine Months Ended September 30, 2018	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 1,091	\$ 10	\$ 899	\$ 31
Junior liens and lines of credit	268	2	750	2

Total	1,359	12	1,649	33
Residential real estate - construction	461	—	463	—
Commercial real estate	10,789	107	10,314	316
Commercial	3,465	—	5,284	—
Total	\$ 16,074	\$ 119	\$ 17,710	\$ 349

(Dollars in thousands)	Three Months Ended September 30, 2017		Nine Months Ended September 30, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
Residential Real Estate 1-4 Family				
First liens	\$ 1,157	\$ 10	\$ 1,152	\$ 32
Junior liens and lines of credit	54	—	85	—
Total	1,211	10	1,237	32
Residential real estate - construction	471	—	475	—
Commercial real estate	11,218	109	12,216	328
Commercial	292	—	263	—
Total	\$ 13,192	\$ 119	\$ 14,191	\$ 360

The following table presents the aging of payments of the loan portfolio:

(Dollars in thousands)	Loans Past Due and Still Accruing					Non-Accrual	Total Loans
	Current	30-59 Days	60-89 Days	90 Days+	Total		
September 30, 2018							
Residential Real Estate 1-4 Family							
First liens	\$ 149,366	\$ 503	\$ 231	\$ —	\$ 734	\$ 71	\$ 150,171
Junior liens and lines of credit	47,907	40	71	43	154	23	48,084
Total	197,273	543	302	43	888	94	198,255
Residential real estate - construction	11,359	70	400	—	470	460	12,289
Commercial real estate	468,202	2,224	3,606	—	5,830	1,806	475,838
Commercial	276,180	328	64	—	392	3,263	279,835
Consumer	4,726	39	1	—	40	—	4,766
Total	\$ 957,740	\$ 3,204	\$ 4,373	\$ 43	\$ 7,620	\$ 5,623	\$ 970,983

December 31, 2017

Residential Real Estate 1-4 Family							
First liens	\$ 157,247	\$ 485	\$ 534	\$ —	\$ 1,019	\$ 168	\$ 158,434
Junior liens and lines of credit	50,202	139	30	—	169	—	50,371
Total	207,449	624	564	—	1,188	168	208,805
Residential real estate - construction	9,435	—	—	—	—	466	9,901
Commercial real estate	425,806	421	347	—	768	1,854	428,428
Commercial	291,221	111	—	—	111	187	291,519
Consumer	5,017	23	7	—	30	—	5,047
Total	\$ 938,928	\$ 1,179	\$ 918	\$ —	\$ 2,097	\$ 2,675	\$ 943,700

The following table reports the internal credit rating for the loan portfolio. Consumer purpose loans are assigned a rating of either pass or substandard based on the performance status of the loans. Substandard consumer loans are comprised of loans 90 days or more past due and still accruing, and nonaccrual loans. Commercial purpose loans may be assigned any rating in accordance with the Bank's internal risk rating system.

(Dollars in thousands)	Pass	Special	Substandard	Doubtful	Total
	(1-5)	Mention (6)	(7)	(8)	

September 30, 2018

Residential Real Estate 1-4 Family

First liens	\$ 149,741	\$ —	\$ 430	\$ —	\$ 150,171
Junior liens and lines of credit	48,018	—	66	—	48,084
Total	197,759	—	496	—	198,255
Residential real estate - construction	11,556	—	733	—	12,289
Commercial real estate	466,800	665	8,373	—	475,838
Commercial	275,249	—	4,586	—	279,835
Consumer	4,766	—	—	—	4,766
Total	\$ 956,130	\$ 665	\$ 14,188	\$ —	\$ 970,983

December 31, 2017

Residential Real Estate 1-4 Family

First liens	\$ 157,395	\$ —	\$ 1,039	\$ —	\$ 158,434
Junior liens and lines of credit	50,371	—	—	—	50,371
Total	207,766	—	1,039	—	208,805
Residential real estate - construction	8,893	—	1,008	—	9,901
Commercial real estate	419,277	680	8,471	—	428,428
Commercial	289,916	—	1,603	—	291,519
Consumer	5,047	—	—	—	5,047
Total	\$ 930,899	\$ 680	\$ 12,121	\$ —	\$ 943,700

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The following table presents information on the Bank's Troubled Debt Restructuring (TDR) loans:

(Dollars in thousands)	Troubled Debt Restructurings				Troubled Debt Restructurings Within the Last 12 Months That Have Defaulted On Modified Terms	
	Number of Contracts	Recorded Investment	Performing*	Nonperforming*	Number of Contracts	Recorded Investment
September 30, 2018						
Residential real estate - construction	1	\$ 460	\$ —	\$ 460	—	\$ —
Residential real estate	4	683	683	—	—	—
Commercial real estate	11	10,574	8,909	1,665	—	—
Total	16	\$ 11,717	\$ 9,592	\$ 2,125	—	\$ —
December 31, 2017						
Residential real estate - construction	1	\$ 466	\$ 466	\$ —	—	\$ —
Residential real estate	5	737	701	36	—	—
Commercial real estate	11	10,983	10,388	595	—	—
Total	17	\$ 12,186	\$ 11,555	\$ 631	—	\$ —

*The performing status is determined by the loan's compliance with the modified terms.

There were no new TDR loans during 2018 and 2017.

Note 7. Other Real Estate Owned

Changes in other real estate owned during the nine months ended September 30, 2018 and 2017 were as follows:

(Dollars in thousands)	September 30,	
	2018	2017
Balance at beginning of the period	\$ 2,598	\$ 4,915
Additions	105	52
Proceeds from dispositions	(32)	(2,255)
Loss on sales, net	—	(23)

Valuation adjustment	(6)	(60)
Balance at the end of the period	\$ 2,665	\$ 2,629

Note 8. Pension

The components of pension expense for the periods presented are as follows:

(Dollars in thousands)	Three Months		Nine Months	
	Ended		Ended	
	September 30,		September 30,	
	2018	2017	2018	2017
Components of net periodic cost:				
Service cost	\$ 90	\$ 80	\$ 270	\$ 237
Interest cost	138	167	414	500
Expected return on plan assets	(279)	(268)	(837)	(804)
Recognized net actuarial loss	176	137	528	411
Net period cost	\$ 125	\$ 116	\$ 375	\$ 344

The Bank expects its pension expense to increase to approximately \$500 thousand in 2018 compared to \$459 thousand in 2017, due primarily to increases in interest costs and recognized net actuarial losses. A pension contribution of \$1.0 million was made in first quarter of 2018. The service cost component of pension expense is in the salaries and employee benefits line on the income statement. All other cost components are in the other expense line on the income statement.

Note 9. Fair Value Measurements and Fair Values of Financial Instruments

Management uses its best judgment in estimating the fair value of the Corporation's financial instruments; however, there are inherent weaknesses in any estimation technique. Therefore, for substantially all financial instruments, the fair value estimates herein are not necessarily indicative of the amounts the Corporation could have realized in a sales transaction on the dates indicated. The estimated fair value amounts have been measured as of their respective period-ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values of these financial instruments subsequent to the respective reporting dates may be different than the amounts reported at each year-end.

FASB ASC Topic 820, "Financial Instruments", requires disclosure of the fair value of financial assets and liabilities, including those financial assets and liabilities that are not measured and reported at fair value on a recurring and nonrecurring basis. The Corporation does not report any nonfinancial assets at fair value. FASB ASC Topic 820 establishes a fair value hierarchy that prioritizes the inputs to valuation methods used to measure fair value. The hierarchy gives the highest priority to unadjusted quoted prices in active markets for identical assets or liabilities (Level 1 measurements) and the lowest priority to unobservable inputs (Level 3 measurements). The three levels of the fair value hierarchy under FASB ASC Topic 820 are as follows:

Level 1: Valuation is based on unadjusted, quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities.

Level 2: Valuation is based upon quoted prices for similar instruments in active markets, quoted prices for identical or similar instruments in markets that are not active, and model-based valuation techniques for which all significant assumptions are observable in the market. There may be substantial differences in the assumptions used for securities within the same level. For example, prices for U.S. Agency securities have fewer assumptions and are closer to level 1 valuations than the private label mortgage backed securities that require more assumptions and are closer to level 3 valuations.

Level 3: Valuation is generated from model-based techniques that use significant assumptions not observable in the market. These unobservable assumptions reflect the Corporation's assumptions regarding what market participants would assume when pricing a financial instrument.

An asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement.

On January 1, 2018, the Corporation adopted ASU 2016-01, which requires the use of the exit price notion to measure the fair value of financial instruments.

The following information regarding the fair value of the Corporation's financial instruments should not be interpreted as an estimate of the fair value of the entire Corporation since a fair value calculation is only provided for a limited portion of the Corporation's assets and liabilities. Due to a wide range of valuation techniques and the degree of subjectivity used in making the estimates, comparisons between the Corporation's disclosures and those of other companies may not be meaningful.

The fair value of the Corporation's financial instruments are as follows:

(Dollars in thousands)	September 30, 2018		Level 1	Level 2	Level 3
	Carrying Amount	Fair Value			
Financial assets, carried at cost:					
Cash and cash equivalents	\$ 44,777	\$ 44,777	\$ 44,777	\$ —	\$ —
Restricted stock	452	452	—	452	—
Loans held for sale	1,072	1,072	—	1,072	—
Net loans	958,457	933,824	—	—	933,824
Accrued interest receivable	3,733	3,733	—	3,733	—
Financial assets, available for sale					
Debt securities	125,403	125,403	—	125,403	—
Financial assets, fair value					
Equity securities	383	383	383	—	—
Financial liabilities:					
Deposits	\$ 1,071,857	\$ 1,071,744	\$ —	\$ 1,071,744	\$ —
Accrued interest payable	202	202	—	202	—
Off balance sheet financial instruments	—	—	—	—	—
December 31, 2017					
(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
Financial assets:					
Cash and cash equivalents	\$ 58,603	\$ 58,603	\$ 58,603	\$ —	\$ —
Investment securities available for sale	127,336	127,336	365	126,971	—
Restricted stock	456	456	—	45	—
Loans held for sale	442	442	—	442	—
Net loans	931,908	929,891	—	—	929,891
Accrued interest receivable	3,847	3,847	—	3,847	—
Financial liabilities:					
Deposits	\$ 1,047,181	\$ 1,046,476	\$ —	\$ 1,046,476	\$ —
Accrued interest payable	149	149	—	149	—

Recurring Fair Value Measurements

For financial assets and liabilities measured at fair value on a recurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and December 31, 2017 are as follows:

(Dollars in Thousands)	Fair Value at September 30, 2018			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities, at fair value	\$ 383	\$ —	\$ —	\$ 383
Available for sale:				
U.S. Government and Agency securities	—	9,276	—	9,276
Municipal securities	—	62,403	—	62,403
Trust Preferred Securities	—	3,947	—	3,947
Agency mortgage-backed securities	—	45,370	—	45,370
Private-label mortgage-backed securities	—	517	—	517
Asset-backed securities	—	3,890	—	3,890
Total assets	\$ 383	\$ 125,403	\$ —	\$ 125,786

(Dollars in Thousands)	Fair Value at December 31, 2017			
	Level 1	Level 2	Level 3	Total
Asset Description				
Equity securities	\$ 365	\$ —	\$ —	\$ 365
U.S. Government and Agency securities	—	11,472	—	11,472
Municipal securities	—	57,772	—	57,772
Trust Preferred Securities	—	5,817	—	5,817
Agency mortgage-backed securities	—	50,937	—	50,937
Private-label mortgage-backed securities	—	946	—	946
Asset-backed securities	—	27	—	27
Total assets	\$ 365	\$ 126,971	\$ —	\$ 127,336

Investment securities: Level 1 securities represent equity securities that are valued using quoted market prices from nationally recognized markets. Level 2 securities represent debt securities that are valued using a mathematical model based upon the specific characteristics of a security in relationship to quoted prices for similar securities.

Nonrecurring Fair Value Measurements

For financial assets measured at fair value on a nonrecurring basis, the fair value measurements by level within the fair value hierarchy used at September 30, 2018 and December 31, 2017 are as follows:

(Dollars in Thousands)

Asset Description	Fair Value at September 30, 2018			
	Level Level			Total
	1	2	Level 3	
Impaired Loans (1)	\$ —	\$ —	\$ 2,925	\$ 2,925
Total assets	\$ —	\$ —	\$ 2,925	\$ 2,925

Asset Description	Fair Value at December 31, 2017			
	Level Level Level			Total
	1	2	3	
Other real estate owned (1)	\$ —	\$ —	\$ 90	\$ 90
Total assets	\$ —	\$ —	\$ 90	\$ 90

(1) Includes assets directly charged-down to fair value during the year-to-date period.

The Corporation used the following methods and significant assumptions to estimate the fair values for financial assets measured at fair value on a nonrecurring basis.

Other real estate: The fair value of other real estate, upon initial recognition, is estimated using Level 2 inputs within the fair value hierarchy based on observable market data and Level 3 inputs based on customized discounting criteria. In connection with the measurement and initial recognition of the foregoing assets, the Corporation recognizes charge-offs through the allowance for loan losses. Subsequent charge-offs are recognized as an expense.

The Corporation did not record any liabilities at fair value for which measurement of the fair value was made on a nonrecurring basis at September 30, 2018. For financial assets and liabilities measured at fair value on a recurring basis, there were no transfers of financial assets or liabilities between Level 1 and Level 2 during the period ending September 30, 2018.

The following table presents additional quantitative information about Level 3 assets measured at fair value on a nonrecurring basis:

(Dollars in Thousands)	Quantitative Information about Level 3 Fair Value Measurements			
	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
September 30, 2018 Impaired loans (1)	\$ 2,925	Appraisal	Unobservable Input Appraisal Adjustments (2) Cost to sell	0%-50% (45%)
December 31, 2017 Other real estate owned (1)	\$ 90	Appraisal	Unobservable Input Cost to sell	Weighted Average 8%

(1) Includes assets directly charged-down to fair value during the year-to-date period.

(2) Qualitative adjustments are discounts specific to each asset and are made as needed.

Note 10. Capital Ratios

Capital adequacy is currently defined by regulatory agencies through the use of several minimum required ratios. In July 2013, Federal banking regulators approved the final rules from the Basel Committee on Banking Supervision for the regulation of capital requirements for bank holding companies and U.S banks, generally referred to as "Basel III." The Basel III standards were effective for the Corporation and the Bank, effective January 1, 2015 (subject to a phase-in period for certain provisions). Basel III imposes significantly higher capital requirements and more restrictive leverage and liquidity ratios than those previously in place. The capital ratios to be considered "well capitalized" under Basel III are: (1) Common Equity Tier 1 (CET1) of 6.5%, (2) Tier 1 Leverage of 5%, (3) Tier 1 Risk-Based Capital of 8%, and (4) Total Risk-Based Capital of 10%. The CET1 ratio is a new capital ratio under Basel III and the Tier 1 risk-based capital ratio of 8% has been increased from 6%. The rules also include changes in the risk weights of certain assets to better reflect credit and other risk exposures. In addition, a capital conservation buffer will be phased-in beginning January 1, 2016 at 0.625%, 1.25% for 2017, 1.875% for 2018 and 2.50% for 2019 and thereafter. The capital conservation buffer will be applicable to all of the capital ratios except for the Tier 1 Leverage ratio. The capital conservation buffer is equal to the lowest value of the three applicable capital ratios less the regulatory minimum for each respective capital measurement. The Bank's capital conservation buffer at September 30, 2018 was 6.89% (total risk-based capital 14.89% less 8.00%) compared to the 2018 regulatory buffer of 1.875%. Compliance with the capital conservation buffer is required in order to avoid limitations to certain capital distributions. As of September 30, 2018, the Bank was "well capitalized" under the Basel III requirements and believes it would be "well capitalized" on a fully phased-in basis had such a requirement been in effect.

The following table summarizes regulatory capital information as of September 30, 2018 and December 31, 2017 for the Corporation and the Bank:

(Dollars in thousands)	September 30, 2018	December 31, 2017	Regulatory Ratios	
			Adequately Capitalized Minimum	Well Capitalized Minimum
Common Equity Tier 1 Risk-based Capital Ratio (1)				
Franklin Financial Services Corporation	13.64%	14.06%	4.500%	N/A
Farmers & Merchants Trust Company	13.42%	13.93%	4.500%	6.50%
Tier 1 Risk-based Capital Ratio (2)				
Franklin Financial Services Corporation	13.64%	14.06%	6.000%	N/A
Farmers & Merchants Trust Company	13.42%	13.93%	6.000%	8.00%
Total Risk-based Capital Ratio (3)				
Franklin Financial Services Corporation	14.89%	15.31%	8.000%	N/A
Farmers & Merchants Trust Company	14.68%	15.19%	8.000%	10.00%
Tier 1 Leverage Ratio (4)				
Franklin Financial Services Corporation	9.59%	9.73%	4.000%	N/A
Farmers & Merchants Trust Company	9.48%	9.64%	4.000%	5.00%

(1) Common equity Tier 1 capital / total risk-weighted assets (2) Tier 1 capital / total risk-weighted assets
(3) Total risk-based capital / total risk-weighted assets, (4) Tier 1 capital / average quarterly assets

Note 11. Revenue Recognition

The Corporation adopted ASC 606 on January 1, 2018 using the modified retrospective approach applied to all contracts initiated on or after the effective date, and for contracts which have remaining obligations as of the effective date. Results for the reporting period beginning January 1, 2018 are presented under ASC 606 while the prior period results continue to be reported under legacy GAAP. Adoption of the standard did not have a material effect on any of the reported periods. The Corporation did not record a cumulative effect adjustment to the beginning retained earnings balance as of January 1, 2018 from the adoption of ASC 606 as it was determined the transition adjustment was immaterial to Corporation's consolidated financial statements.

All of the Corporation's revenue from contracts with customers within the scope of ASC 606 is recognized in non-interest income as presented in our consolidated statements of income. Revenue generating activities that fall within the scope of ASC 606 are described as follows:

Investment and Trust Service Fees - these represent fees from wealth management (assets under management), fees from the management and settlement of estates and commissions from the sale of investment and insurance products.

- Asset management fees are generally assessed based on a tiered fee schedule, based on the value of assets under management, and are recognized monthly when the service obligation is completed. Fees recognized were \$3.8 million for the first nine months of 2018 and \$1.3 million for the third quarter of 2018.

- Fees for estate management services are based on the estimated fair value of the estate. These fees are generally recognized monthly over an 18 month period that Management has determined to represent the average time to fulfill the performance obligations of the contract. Management has the discretion to adjust this time period as needed based upon the nature and complexity of an individual estate. Fees recognized were \$228 thousand for the first nine months of 2018 and \$86 thousand for the third quarter of 2018.
- Commissions from the sale of investment and insurance products are recognized upon the completion of the transaction. Fees recognized were \$218 thousand for the first nine months of 2018 and \$75 thousand for the third quarter of 2018.

Loan Service Charges – these represent fees on loans for services or charges that occur after the loan has been booked, for example, late payment fees. These also include fees for mortgages settled for a third party mortgage company. All of these fees are transactional in nature and are recognized upon completion of the transaction which represents the performance obligation.

Deposit Service Charges and Fees – these represent fees from deposit customers for transaction based, account maintenance, and overdraft services. Transaction based fees include, but are not limited to stop payment fees and overdraft fees. These fees are recognized at the time of the transaction when the performance obligation has been fulfilled. Account maintenance fees and account analysis fee are earned over the course of a month, representing the period of the performance obligation, and are recognized monthly.

Debit Card Income – this represents interchange fees from cardholder transactions conducted through the card payment network. Cardholders use the debit card to conduct point-of-sale transactions that produce interchange fees. The fees are transaction based and the fee is recognized with the processing of the transaction. These fees are reported net of cardholder rewards.

Other Service Charges and Fees – these are comprised primarily of merchant card fees, credit card fees, ATM surcharges and interchange fees and wire transfer fees. Merchant card fees represent fees the Bank earns from a third party for enrolling a customer in the processor’s program. Credit card fees represent a fee earned by the Bank for a successful referral to a card-issuing company. ATM surcharges and interchange fees are the result of Bank customers conducting ATM transactions that generate fee income and are processed through multiple card networks. All of these fees are transaction based and are recognized at the time of the transaction.

Gains/Losses on the Sale of Other Real Estate – these are recognized when control of the property transfers to the buyer.

Increases in the cash surrender value of life insurance and security transactions are not within the scope of ASC 606.

Contract Balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before payment is due (resulting in a contract asset). A contract liability balance is an entity’s obligation to transfer a service to a customer for which the entity has already received payment (or payment is due) from the customer. The Company’s noninterest revenue streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company does not typically enter into longer-term revenue contracts with customers, and therefore, does not experience significant contract balances.

Contract Acquisition Costs

The Corporation expenses all contract acquisition costs as costs are incurred.

1Note 12. Commitments and Contingencies

In the normal course of business, the Bank is a party to financial instruments that are not reflected in the accompanying financial statements and are commonly referred to as off-balance-sheet instruments. These financial instruments are entered into primarily to meet the financing needs of the Bank’s customers and include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk not recognized in the consolidated balance sheet.

The Corporation’s exposure to credit loss in the event of nonperformance by other parties to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contract or notional amount of those instruments. The Bank uses the same credit policies in making commitments and conditional obligations as they

do for on-balance-sheet instruments.

The Bank had the following outstanding commitments for the periods presented:

(Dollars in thousands)	September 30, 2018	December 31, 2017
Financial instruments whose contract amounts represent credit risk		
Commercial commitments to extend credit	\$ 226,069	\$ 249,526
Consumer commitments to extend credit (secured)	46,166	44,866
Consumer commitments to extend credit (unsecured)	5,663	5,668
	\$ 277,898	\$ 300,060
Standby letters of credit	\$ 25,692	\$ 28,630

Commitments to extend credit are agreements to lend to a customer as long as there is no violation of any condition established in the contract. Commitments generally have fixed expiration dates or other termination clauses with the exception of home equity lines and personal lines of credit and may require payment of a fee. Since many of the

commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements. The Bank evaluates each customer's creditworthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Bank, is based on Management's credit evaluation of the counterparty. Collateral for most commercial commitments varies but may include accounts receivable, inventory, property, plant, and equipment, and income-producing commercial properties. Collateral for secured consumer commitments consists of liens on residential real estate.

Standby letters of credit are instruments issued by the Bank, which guarantee the beneficiary payment by the Bank in the event of default by the Bank's customer in the nonperformance of an obligation or service. Most standby letters of credit are extended for one-year periods. Generally, the credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Bank holds collateral supporting those commitments for which collateral is deemed necessary primarily in the form of certificates of deposit and liens on real estate. Management believes that the proceeds obtained through a liquidation of such collateral would be sufficient to cover the maximum potential amount of future payments required under the corresponding guarantees. As of June 30, 2018, the Bank established a \$2.4 million allowance against letters of credit issued in connection with a commercial borrower that declared bankruptcy in the second quarter as a result of apparent fraudulent activities within the business. Except for the liability recorded for standby letters of credit, liabilities for credit loss associated with off-balance sheet commitments were not material at September 30, 2018 and December 31, 2017.

Most of the Bank's business activity is with customers located within its primary market and does not involve any significant concentrations of credit to any one entity or industry.

Legal Proceedings

The nature of the Corporation's business generates a certain amount of litigation.

We establish accruals for legal proceedings when information related to the loss contingencies represented by those matters indicates both that a loss is probably and the amount of the loss can be reasonably estimated. When we are able to do so, we also determine estimates of possible losses, whether in excess of any accrued liability or where there is no accrued liability.

These assessments are based on our analysis of currently available information and are subject to significant judgment and a variety of assumptions and uncertainties. As new information is obtained, we may change our assessments and, as a result, take or adjust the amounts of our accruals and change our estimates of possible losses or ranges of possible losses. Due to the inherent subjectivity of the assessments and the unpredictability of outcomes of legal proceedings, any amounts that may be accrued or included in estimates of possible losses or ranges of possible losses may not represent the actual loss to the Corporation from any legal proceeding. Our exposure and ultimate losses may be higher, possibly significantly higher, than amounts we may accrue or amounts we may estimate.

In management's opinion, we do not anticipate, at the present time, that the ultimate aggregate liability, if any, arising out of all litigation to which the Corporation is a party will have a material adverse effect on our financial position. We cannot now determine, however, whether or not any claim asserted against us, other than the Kalan case described below, will have a material adverse effect on our results of operations in any future reporting period, which will depend on, among other things, the amount of loss resulting from the claim and the amount of income otherwise reported for the reporting period. Thus, at June 30, 2018, we are unable to provide an evaluation of the likelihood of an unfavorable outcome or an estimate of the amount or range of potential loss with respect to such other matters and, accordingly, have not yet established any specific accrual for such other matters, except in connection with the Kalan case described below.

No material proceedings are pending or are known to be threatened or contemplated against us by governmental authorities.

On July 31, 2018, the court entered an order granting final approval of the settlement agreements in the Kalan et al. v. Farmers and Merchants Trust Company of Chambersburg et al. (Case No. 2:15-CV-01435-WB) case filed against F&M Trust in the United States District Court for the Eastern District of Pennsylvania in March, 2015. Among other things, the order also dismissed the case against F&M Trust with prejudice; certified the settlement class; and, permanently enjoined the named plaintiffs and the members of the settlement class from asserting any further claims arising out of or related to the claims alleged or that could have been alleged in the case against F&M Trust. The settlement agreements provide for the Bank to make a settlement payment of \$10 million in full and final settlement of all such claims. The settlement agreements further provide for general releases by all parties. F&M Trust made the settlement payment in May, 2018, in accordance with the court's earlier order preliminarily approving the settlement agreements. The settlement payment was funded out of available assets. The Corporation previously accrued the \$10 million settlement payment in the Kalan case as an expense for the year ended December 31, 2017.

Management's Discussion and Analysis of Results of Operations and Financial Condition

For the Three and Nine Months Ended September 30, 2018 and 2017

Forward Looking Statements

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. Such forward-looking statements refer to a future period or periods, reflecting management's current views as to likely future developments, and use words such as "may," "will," "expect," "believe," "estimate," "anticipate," or similar terms. Because forward-looking statements involve certain risks, uncertainties and other factors over which the Corporation has no direct control, actual results could differ materially from those contemplated in such statements. These factors include (but are not limited to) the following: general economic conditions, changes in interest rates, changes in the Corporation's cost of funds, changes in government monetary policy, changes in government regulation and taxation of financial institutions, changes in the rate of inflation, changes in technology, the intensification of competition within the Corporation's market area, and other similar factors. We caution readers not to place undue reliance on these forward-looking statements. They only reflect management's analysis as of this date. The Corporation does not revise or update these forward-looking statements to reflect events or changed circumstances.

Critical Accounting Policies

Management has identified critical accounting policies for the Corporation. These policies are particularly sensitive, requiring significant judgements, estimates and assumptions to be made by Management. There were no changes to the critical accounting policies disclosed in the 2017 Annual Report on Form 10-K in regards to application or related judgments and estimates used. Please refer to Item 7 of the Corporation's 2017 Annual Report on Form 10-K for a more detailed disclosure of the critical accounting policies.

Results of Operations

Results for the nine months ended September 30, 2018 were affected by impairment charges on a loan participation (the Participation) that was initially reported in our current report on Form 8-K filed May 31, 2018. The Participation represented the Bank's portion of loans and off-balance sheet items to a single, large commercial lending relationship with the lead bank. The impairment is believed to be the result of fraudulent activities believed to be perpetrated by one or more of the executives and personnel employed by the borrower.

During the second quarter, \$8.7 million of the Participation was charged-off resulting in an increase in the provision for loan loss expense to replenish the allowance for loan losses. In addition, a \$2.4 million noninterest expense was recorded to establish a reserve for existing off-balance sheet commitments related to the Participation. The impairment charges had a significant effect on various performance measurements for the year-to-date period. For

additional information on the Participation, please refer to the Loan Quality discussion.

Year-to-Date Summary

Reported net income of \$4.0 million for the third quarter and \$2.3 million year-to-date

- Net interest income increased \$921 thousand quarter over quarter and \$2.4 million year-to-date due to the growth in interest income from the loan portfolio that outpaced higher interest expense.
- The provision for loan losses was unchanged quarter over quarter and increased \$9.2 million year-to-date due to the previously mentioned charge-off.
- Noninterest income increased \$149 thousand quarter over quarter and \$437 thousand year-to-date primarily from asset management fees in the Bank's Investment and Trust Services department and debit card income.
- Noninterest expense increased \$266 thousand quarter over quarter and \$4.0 million year-to-date primarily from increases in salaries and benefits and the off-balance sheet reserve expense for the Participation.

Total assets were \$1.195 billion at September 30, 2018, an increase of \$15.0 million from the 2017 year-end balance of \$1.180 billion

- The loan portfolio increased approximately \$27 million net of the Participation charge-off.
 - Deposits increased \$24.7 million (2.4%) year-to-date, primarily in municipal non-maturity deposits.
- Shareholders' equity decreased \$1.1 million, mainly the result of the Corporation's year-to-date cash dividend of \$3.4 million exceeding year-to-date income of \$2.3 million.

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Key performance ratios as of, or for the nine months ended September 30, 2018 and 2017 and the year ended December 31, 2017 are listed below:

	September 30, 2018	December 31, 2017	September 30, 2017
(Dollars in thousands, except per share)			
Balance Sheet Highlights			
Total assets	\$ 1,194,624	\$ 1,179,813	\$ 1,165,549
Investment and equity securities	125,786	127,336	132,322
Loans, net	958,457	931,908	899,960
Deposits	1,071,857	1,047,181	1,033,148
Shareholders' equity	114,028	115,144	124,580
Summary of Operations			
Interest income	\$ 33,019	\$ 39,885	\$ 29,547
Interest expense	2,871	2,491	1,800
Net interest income	30,148	37,394	27,747
Provision for loan losses	9,579	670	420
Net interest income after provision for loan losses	20,569	36,724	27,327
Noninterest income	9,489	12,189	9,052
Noninterest expense	28,408	43,172	24,423
Income before income taxes	1,650	5,741	11,956
Federal income tax (benefit) expense	(671)	3,565	2,517
Net income	\$ 2,321	\$ 2,176	\$ 9,439
Performance Measurements			
Return on average assets*	0.26%	0.19%	1.11%
Return on average equity*	2.70%	1.80%	10.50%
Return on average tangible equity (1)*	2.93%	1.94%	11.35%
Efficiency ratio (1)	69.79%	82.59%	63.00%
Net interest margin*	3.77%	3.72%	3.71%
Shareholders' Value (per common share)			
Diluted earnings per share	\$ 0.53	\$ 0.50	\$ 2.17
Basic earnings per share	0.53	0.50	2.18
Regular cash dividends declared	0.78	0.93	\$0.69
Book value	25.93	26.44	28.66
Tangible book value (1)	23.88	24.37	26.59
Market value	34.77	37.36	35.05
Market value/book value ratio	134.09%	141.30%	122.30%
Price/earnings multiple*	48.97	74.72	12.13
Current quarter dividend yield	3.11%	2.49%	2.74%
Dividend payout ratio year-to-date	146.92%	185.25%	31.66%

Safety and Soundness

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Risk-based capital ratio (Total)	14.85%	15.31%	16.25%
Leverage ratio (Tier 1)	9.57%	9.73%	10.31%
Common equity ratio (Tier 1)	13.60%	14.06%	14.99%
Nonperforming loans/gross loans	0.58%	0.28%	0.34%
Nonperforming assets/total assets	0.70%	0.45%	0.49%
Allowance for loan losses as a % of loans	1.29%	1.25%	1.27%
Net loans charged-off(recoveries)/average loans*	1.23%	-0.01%	-0.01%

Assets under Management

Trust assets under management (fair value)	\$ 737,102	\$ 686,941	\$ 662,733
Held at third-party brokers (fair value)	134,267	158,145	153,200

*Year-to-date annualized

(1) See the section titled “GAAP versus Non-GAAP Presentation” that follows.

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GAAP versus non-GAAP Presentations – The Corporation supplements its traditional GAAP measurements with certain non-GAAP measurements to evaluate its performance and to eliminate the effect of intangible assets. By eliminating intangible assets (Goodwill), the Corporation believes it presents a measurement that is comparable to companies that have no intangible assets or to companies that have eliminated intangible assets in similar calculations. However, not all companies may use the same calculation method for each measurement. The non-GAAP measurements are not intended to be used as a substitute for the related GAAP measurements. The following table shows the calculation of the non-GAAP measurements.

(Dollars in thousands, except per share)	Nine Months Ended September 30, 2018	Twelve Months Ended December 31, 2017	Nine Months Ended September 30, 2017
Return on Tangible Equity (non-GAAP)			
Net income	\$ 2,321	\$ 2,176	\$ 9,439
Average shareholders' equity	114,704	120,993	119,886
Less average intangible assets	(9,016)	(9,016)	(9,016)
Average shareholders' equity (non-GAAP)	105,688	111,977	110,870
Return on average tangible equity (non-GAAP)*	2.93%	1.94%	11.35%
Tangible Book Value (per share) (non-GAAP)			
Shareholders' equity	\$ 114,028	\$ 115,144	\$ 124,580
Less intangible assets	(9,016)	(9,016)	(9,016)
Shareholders' equity (non-GAAP)	105,012	106,128	115,564
Shares outstanding (in thousands)	4,398	4,355	4,346
Tangible book value (non-GAAP)	23.88	24.37	26.59
Efficiency Ratio			
Noninterest expense	\$ 28,408	\$ 43,172	\$ 24,423
Net interest income	30,148	37,394	27,747
Plus tax equivalent adjustment to net interest income	1,141	2,690	1,970
Plus noninterest income, net of securities transactions	9,415	12,186	9,049
Total revenue	40,704	52,270	38,766
Efficiency ratio	69.79%	82.59%	63.00%

* Year-to-date annualized

Net Interest Income

The largest source of the Corporation's earnings is net interest income, which is defined as the difference between income on interest-earning assets and the expense of interest-bearing liabilities supporting those assets. Principal

categories of interest-earning assets are loans and securities, while deposits, short-term borrowings and long-term debt are the principal categories of interest-bearing liabilities. Demand deposits enhance net interest income because they are noninterest-bearing deposits. For the purpose of this discussion, balance sheet items refer to the average balance for the year and net interest income is adjusted to a fully taxable-equivalent basis. This tax-equivalent adjustment 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 Corporation's 21% Federal statutory rate.

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Comparison of the three months ended September 30, 2018 to the three months ended September 30, 2017:

Tax equivalent net interest income increased \$623 thousand to \$10.7 million in the third quarter of 2018 compared to \$10.1 million in the same period in 2017. Balance sheet volume contributed \$525 thousand to this increase and \$98 thousand was the result of changes in rates. Due to the lower corporate tax rate, the benefit of tax-exempt income was less in 2018 as compared to 2017.

The following table presents average balances, tax-equivalent (T/E) interest income, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis using a tax rate of 21% for 2018 and 34% for 2017.

(Dollars in thousands)	For the Three Months Ended September 30,					
	2018			2017		
	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	\$ 21,216	\$ 108	2.02%	\$ 43,692	\$ 147	1.33%
Investment securities:						
Taxable	81,881	511	2.48%	92,074	511	2.20%
Tax Exempt	46,447	368	3.17%	43,032	412	3.83%
Investments	128,328	879	2.72%	135,106	923	2.71%
Loans:						
Commercial, industrial and agricultural	829,586	9,254	4.40%	757,619	8,029	4.15%
Residential mortgage	69,422	723	4.17%	74,095	742	4.01%
Home equity loans and lines	67,241	825	4.87%	72,162	843	4.63%
Consumer	4,994	75	5.96%	4,644	64	5.47%
Loans	971,243	10,877	4.42%	908,520	9,678	4.18%
Total interest-earning assets	1,120,787	\$ 11,864	4.20%	1,087,318	\$ 10,748	3.92%
Other assets	63,914			64,536		
Total assets	\$ 1,184,701			\$ 1,151,854		
Interest-bearing liabilities:						
Deposits:						
Interest-bearing checking	\$ 304,480	\$ 236	0.31%	\$ 280,727	\$ 91	0.13%
Money Management	408,131	637	0.62%	412,209	391	0.38%
Savings	81,968	86	0.42%	78,683	36	0.18%
Time	68,385	142	0.82%	72,154	111	0.61%
Total interest-bearing deposits	862,964	1,101	0.51%	843,773	629	0.30%
Other borrowings	3,830	21	2.27%	—	—	0.00%
Total interest-bearing liabilities	866,794	1,122	0.51%	843,773	629	0.30%
Noninterest-bearing deposits	200,865			180,034		

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Other liabilities	5,269		5,185	
Shareholders' equity	111,773		122,862	
Total liabilities and shareholders' equity	\$ 1,184,701		\$ 1,151,854	
T/E net interest income/Net interest margin	10,742	3.80%	10,119	3.69%
Tax equivalent adjustment	(387)		(685)	
Net interest income	\$ 10,355		\$ 9,434	

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Provision for Loan Losses

Provision for loan loss expense for the third quarter was \$250 thousand, the same as in 2017. For more information refer to the Loan Quality and Allowance for Loan Losses discussion in the Financial Condition section.

Noninterest Income

For the third quarter of 2018, noninterest income increased \$149 thousand from the same period in 2017. Investment and trust service fees increased due to growth in assets under management and a higher number of estates under management compared to the same period in 2017. Debit card income was higher due to an increase in transaction volume. The change in the fair value of equity investments recorded through income was a loss of \$20 thousand. In 2017 the change in fair value of equity investments was recorded through other comprehensive income.

The following table presents a comparison of noninterest income for the three months ended September 30, 2018 and 2017

(Dollars in thousands)	For the Three Months Ended		Change	
	September 30, 2018	2017	Amount	%
Noninterest Income				
Investment and trust services fees	\$ 1,424	\$ 1,353	\$ 71	5.2
Loan service charges	191	201	(10)	(5.0)
Deposit service charges and fees	578	611	(33)	(5.4)
Other service charges and fees	357	340	17	5.0
Debit card income	422	325	97	29.8
Increase in cash surrender value of life insurance	129	130	(1)	(0.8)
Net loss on sale of other real estate owned	—	(23)	23	(100.0)
Debt securities gains, net	5	1	4	400.0
Change in fair value of equity securities	(20)	—	(20)	N/A
Other	34	33	1	3.0
Total noninterest income	\$ 3,120	\$ 2,971	\$ 149	5.0

Noninterest Expense

Noninterest expense for the third quarter of 2018 increased \$266 thousand compared to the same period in 2017. The increase in salaries and benefits was primarily due to an increase in salary expense (\$338 thousand) from merit increases and increased staffing levels, partially offset by a decrease in health insurance expense (\$145 thousand) compared to the same period in 2017. Legal and professional decreased due to the resolution of the Kalan lawsuit more thoroughly described in Part II, Item 1. Legal Proceedings. FDIC insurance increased due to an increase in the Bank's base assessment rate. ATM/debit card processing expense increased due to purchasing EMV card inventory and increased fees from Mastercard.

The following table presents a comparison of noninterest expense for the three months ended September 30, 2018 and 2017

(Dollars in thousands)	For the Three Months Ended		Change	
	September 30, 2018	September 30, 2017	Amount	%
Noninterest Expense				
Salaries and benefits	\$ 4,947	\$ 4,694	\$ 253	5.4
Occupancy, furniture and equipment, net	780	809	(29)	(3.6)
Advertising	345	332	13	3.9
Legal and professional	436	502	(66)	(13.1)
Data processing	591	567	24	4.2
Pennsylvania bank shares tax	239	243	(4)	(1.6)
FDIC insurance	159	82	77	93.9
ATM/debit card processing	258	190	68	35.8
Foreclosed real estate	(8)	24	(32)	(133.3)
Telecommunications	95	106	(11)	(10.4)
Other	729	756	(27)	(3.6)
Total noninterest expense	\$ 8,571	\$ 8,305	\$ 266	3.2

Provision for Income Taxes

For the third quarter, the Corporation recorded a Federal income tax expense of \$654 thousand compared to a \$774 thousand tax expense for the same quarter in 2017. The effective tax rate for the third quarter of 2018 was 14.1% compared to 20.1% for the same period in 2017. The federal statutory tax rate is 21% for 2018 and was 34% in 2017.

Comparison of the nine months ended September 30, 2018 to the nine months ended September 30, 2017:

Tax equivalent net interest income increased \$1.6 million to \$31.3 million in the first nine months of 2018 compared to \$29.7 million in the same period in 2017. Balance sheet volume contributed \$1.5 million to this increase and \$44 thousand was the result of changes in rates. Due to the lower corporate tax rate, the benefit of tax-exempt income was less in 2018 as compared to 2017.

The following table presents average balances, tax-equivalent (T/E) interest income, and yields earned or rates paid on the assets or liabilities. All nontaxable interest income has been adjusted to a tax-equivalent basis using a tax rate of 21% for 2018 and 34% for 2017.

(Dollars in thousands)	For the Nine Months Ended September 30, 2018				For the Nine Months Ended September 30, 2017	
	Average balance	Income or expense	Average yield/rate	Average balance	Income or expense	Average yield/rate
Interest-earning assets:						
Interest-bearing obligations of other banks and federal funds sold	\$ 24,108	\$ 326	1.81%	\$ 31,431	\$ 297	1.26%
Investment securities:						
Taxable	84,518	1,563	2.47%	92,660	1,581	2.28%
Tax Exempt	46,054	1,084	3.14%	44,617	1,291	3.86%
Investments	130,572	2,647	2.71%	137,277	2,872	2.80%
Loans:						
Commercial, industrial and agricultural	810,622	26,332	4.30%	749,693	23,462	4.13%
Residential mortgage	70,576	2,176	4.11%	75,243	2,241	3.97%
Home equity loans and lines	69,194	2,453	4.74%	71,945	2,457	4.57%
Consumer	5,044	226	5.99%	4,672	188	5.38%
Loans	955,436	31,187	4.33%	901,553	28,348	4.16%
Total interest-earning assets	1,110,116	\$ 34,160	4.11%	1,070,261	\$ 31,517	3.94%
Other assets	63,550			63,530		
Total assets	\$ 1,173,666			\$ 1,133,791		

Interest-bearing liabilities:

Deposits:

Interest-bearing checking	\$ 295,046	\$ 633	0.29%	\$ 271,454	\$ 257	0.13%
Money Management	409,920	1,609	0.52%	414,988	1,119	0.36%
Savings	81,804	218	0.36%			