

ORRSTOWN FINANCIAL SERVICES INC
Form 10-Q
August 08, 2017
Table of Contents

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10 – Q

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

For the quarterly period ended June 30, 2017

or

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

For the transition period from _____ to _____

Commission file number: 001-34292

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

Pennsylvania 23-2530374
(State or Other Jurisdiction of Incorporation or Organization) (I.R.S. Employer Identification No.)
77 East King Street, P. O. Box 250, Shippensburg, Pennsylvania 17257
(Address of Principal Executive Offices) (Zip Code)
Registrant’s Telephone Number, Including Area Code: (717) 532-6114

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

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

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

Large accelerated filer Accelerated filer x

Non-accelerated filer (Do not check if a smaller reporting company) 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

Number of shares outstanding of the registrant's Common Stock as of July 31, 2017: 8,343,018.

Table of Contents

ORRSTOWN FINANCIAL SERVICES, INC.
INDEX

	Page
<u>Part I – FINANCIAL INFORMATION</u>	
<u>Glossary</u>	3
Item 1. <u>Financial Statements (unaudited)</u>	4
<u>Consolidated Balance Sheets – June 30, 2017 and December 31, 2016</u>	4
<u>Consolidated Statements of Income – Three and Six Months Ended June 30, 2017 and 2016</u>	5
<u>Consolidated Statements of Comprehensive Income – Three and Six Months Ended June 30, 2017 and 2016</u>	6
<u>Consolidated Statements of Changes in Shareholders’ Equity – Six Months Ended June 30, 2017 and 2016</u>	7
<u>Consolidated Statements of Cash Flows – Six Months Ended June 30, 2017 and 2016</u>	8
<u>Notes to Consolidated Financial Statements</u>	9
Item 2. <u>Management’s Discussion and Analysis of Financial Condition and Results of Operations</u>	43
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	61
Item 4. <u>Controls and Procedures</u>	62
<u>PART II – OTHER INFORMATION</u>	
Item 1. <u>Legal Proceedings</u>	63
Item 1A. <u>Risk Factors</u>	63
Item 2. <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>	63
Item 3. <u>Defaults upon Senior Securities</u>	63
Item 4. <u>Mine Safety Disclosures</u>	63
Item 5. <u>Other Information</u>	63
Item 6. <u>Exhibits</u>	63
<u>SIGNATURES</u>	64
<u>EXHIBIT INDEX</u>	65

Table of Contents

Glossary of Defined Terms

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

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

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

Table of Contents

PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets (Unaudited)

ORRSTOWN FINANCIAL SERVICES, INC.

(Dollars in thousands, except per share data)	June 30, 2017	December 31, 2016
Assets		
Cash and due from banks	\$19,754	\$ 16,072
Interest-bearing deposits with banks	18,258	14,201
Cash and cash equivalents	38,012	30,273
Restricted investments in bank stocks	7,072	7,970
Securities available for sale	401,904	400,154
Loans held for sale	5,182	2,768
Loans	934,382	883,391
Less: Allowance for loan losses	(12,751)	(12,775)
Net loans	921,631	870,616
Premises and equipment, net	35,036	34,871
Cash surrender value of life insurance	32,523	32,102
Accrued interest receivable	4,467	4,672
Other assets	29,103	31,078
Total assets	\$1,474,930	\$ 1,414,504
Liabilities		
Deposits:		
Noninterest-bearing	\$157,703	\$ 150,747
Interest-bearing	1,038,233	1,001,705
Total deposits	1,195,936	1,152,452
Short-term borrowings	90,562	87,864
Long-term debt	23,991	24,163
Accrued interest and other liabilities	21,178	15,166
Total liabilities	1,331,667	1,279,645
Shareholders' Equity		
Preferred stock, \$1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding	0	0
Common stock, no par value—\$0.05205 stated value per share 50,000,000 shares authorized; 8,348,243 and 8,343,435 shares issued; 8,343,908 and 8,285,733 shares outstanding	435	437
Additional paid - in capital	124,727	124,935
Retained earnings	15,324	11,669
Accumulated other comprehensive income (loss)	2,857	(1,165)
Treasury stock—common, 4,335 and 57,702 shares, at cost	(80)	(1,017)
Total shareholders' equity	143,263	134,859
Total liabilities and shareholders' equity	\$1,474,930	\$ 1,414,504

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

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

	Three Months		Six Months	
	Ended		Ended	
(Dollars in thousands, except per share data)	June 30,	June 30,	June 30,	June 30,
	2017	2016	2017	2016
Interest and dividend income				
Interest and fees on loans	\$9,851	\$ 8,384	\$19,055	\$16,375
Interest and dividends on investment securities:				
Taxable	1,766	1,368	3,593	2,832
Tax-exempt	805	441	1,586	882
Short-term investments	46	79	64	144
Total interest and dividend income	12,468	10,272	24,298	20,233
Interest expense				
Interest on deposits	1,484	1,191	2,810	2,330
Interest on short-term borrowings	189	25	361	91
Interest on long-term debt	77	105	172	211
Total interest expense	1,750	1,321	3,343	2,632
Net interest income	10,718	8,951	20,955	17,601
Provision for loan losses	100	0	100	0
Net interest income after provision for loan losses	10,618	8,951	20,855	17,601
Noninterest income				
Service charges on deposit accounts	1,429	1,372	2,787	2,675
Other service charges, commissions and fees	283	289	492	449
Trust and investment management income	1,623	1,188	3,069	2,524
Brokerage income	518	577	985	1,026
Mortgage banking activities	813	727	1,316	1,369
Earnings on life insurance	271	270	539	538
Other income	32	114	113	201
Investment securities gains	654	0	657	1,420
Total noninterest income	5,623	4,537	9,958	10,202
Noninterest expenses				
Salaries and employee benefits	7,422	6,312	14,822	12,495
Occupancy expense	705	592	1,462	1,118
Furniture and equipment	826	748	1,562	1,534
Data processing	664	519	1,175	1,154
Telephone and communication	193	190	315	366
Automated teller and interchange fees	194	237	372	398
Advertising and bank promotions	391	355	778	811
FDIC insurance	178	223	315	455
Legal fees	108	225	261	406
Other professional services	377	345	732	684
Directors' compensation	249	257	491	488
Collection and problem loan	3	96	78	148
Real estate owned	(12)	58	8	101
Taxes other than income	220	253	448	408
Regulatory settlement	0	1,000	0	1,000
Other operating expenses	899	1,148	1,744	2,113
Total noninterest expenses	12,417	12,558	24,563	23,679

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Income before income tax expense	3,824	930	6,250	4,124
Income tax expense	516	252	940	866
Net income	\$3,308	\$ 678	\$5,310	\$3,258
Per share information:				
Basic earnings per share	\$0.41	\$ 0.08	\$0.66	\$0.40
Diluted earnings per share	0.40	0.08	0.65	0.40
Dividends per share	0.10	0.09	0.20	0.17

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

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

(Dollars in thousands)	Three Months Ended		Six Months Ended	
	June 30, 2017	June 30, 2016	June 30, 2017	June 30, 2016
Net income	\$ 3,308	\$ 678	\$5,310	\$3,258
Other comprehensive income, net of tax:				
Unrealized gains on securities available for sale arising during the period	5,130	4,596	6,750	10,992
Reclassification adjustment for gains realized in net income	(654)	0	(657)	(1,420)
Net unrealized gains	4,476	4,596	6,093	9,572
Tax effect	(1,521)	(1,609)	(2,071)	(3,350)
Total other comprehensive income, net of tax and reclassification adjustments	2,955	2,987	4,022	6,222
Total comprehensive income	\$ 6,263	\$ 3,665	\$9,332	\$9,480

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

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

(Dollars in thousands, except per share data)	Six Months Ended June 30, 2017 and 2016					
	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance, January 1, 2016	\$435	\$124,317	\$7,939	\$ 1,199	\$(829)	\$ 133,061
Net income	0	0	3,258	0	0	3,258
Total other comprehensive income, net of taxes	0	0	0	6,222	0	6,222
Cash dividends (\$0.17 per share)	0	0	(1,410)	0	0	(1,410)
Share-based compensation plans:						
Issuance of stock (37,462 common shares and 2,461 treasury shares), including compensation expense of \$499	2	490	0	0	47	539
Acquisition of treasury stock (35,648 shares)	0	0	0	0	(631)	(631)
Balance, June 30, 2016	\$437	\$124,807	\$9,787	\$ 7,421	\$(1,413)	\$ 141,039
Balance, January 1, 2017	\$437	\$124,935	\$11,669	\$ (1,165)	\$(1,017)	\$ 134,859
Net income	0	0	5,310	0	0	5,310
Total other comprehensive income, net of taxes	0	0	0	4,022	0	4,022
Cash dividends (\$0.20 per share)	0	0	(1,655)	0	0	(1,655)
Share-based compensation plans:						
Issuance of stock (4,808 net common shares and 53,367 treasury shares issued), including compensation expense of \$666	(2)	(208)	0	0	937	727
Balance, June 30, 2017	\$435	\$124,727	\$15,324	\$ 2,857	\$(80)	\$ 143,263

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

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

(Dollars in thousands)	Six Months Ended	
	June 30, 2017	June 30, 2016
Cash flows from operating activities		
Net income	\$5,310	\$3,258
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	2,477	2,577
Depreciation and amortization	1,539	1,458
Provision for loan losses	100	0
Share-based compensation	666	499
Gain on sales of loans originated for sale	(1,064)	(1,164)
Mortgage loans originated for sale	(44,710)	(44,052)
Proceeds from sales of loans originated for sale	43,011	44,237
Net gain on disposal of OREO	(10)	(92)
Writedown of OREO	4	95
Net (gain) loss on disposal of premises and equipment	(18)	46
Deferred income taxes	745	743
Investment securities gains	(657)	(1,420)
Earnings on cash surrender value of life insurance	(539)	(538)
Decrease in accrued interest receivable	205	86
Increase in accrued interest payable and other liabilities	589	684
Other, net	(95)	(1,045)
Net cash provided by operating activities	7,553	5,372
Cash flows from investing activities		
Proceeds from sales of available for sale securities	58,653	64,743
Maturities, repayments and calls of available for sale securities	13,824	13,258
Purchases of available for sale securities	(64,531)	0
Net redemptions of restricted investments in bank stocks	898	2,940
Net increase in loans	(51,835)	(50,762)
Purchases of bank premises and equipment	(1,498)	(8,585)
Improvements to OREO	(9)	(39)
Proceeds from disposal of OREO	185	508
Proceeds from disposal of bank premises and equipment	83	0
Net cash provided by (used in) investing activities	(44,230)	22,063
Cash flows from financing activities		
Net increase in deposits	43,484	55,802
Net increase (decrease) in short-term borrowings	2,698	(45,763)
Payments on long-term debt	(172)	(164)
Dividends paid	(1,655)	(1,410)
Acquisition of treasury stock	0	(631)
Issuance of treasury stock	61	40
Net cash provided by financing activities	44,416	7,874
Net increase in cash and cash equivalents	7,739	35,309
Cash and cash equivalents at beginning of period	30,273	28,340
Cash and cash equivalents at end of period	\$38,012	\$63,649
Supplemental disclosures of cash flow information:		
Cash paid during the period for:		

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Interest	\$3,332	\$2,620
Income taxes	150	450
Supplemental schedule of noncash investing activities:		
OREO acquired in settlement of loans	\$720	\$414
Security purchases not yet settled	5,423	0

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

8

Table of Contents

Notes to Consolidated Financial Statements

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

Nature of Operations – Orrstown Financial Services, Inc. and subsidiaries is a financial holding company that operates Orrstown Bank, a commercial bank with branches in Berks, Cumberland, Dauphin, Franklin, Lancaster, and Perry Counties of Pennsylvania and in Washington County, Maryland and Wheatland Advisors, Inc., a registered investment advisor non-bank subsidiary, headquartered in Lancaster, Pennsylvania, and which was acquired in December 2016. The Bank engages in lending activities including commercial, residential, commercial mortgages, construction, municipal, and various forms of consumer lending. Deposit services include checking, savings, time, and money market deposits. The Bank also provides investment and brokerage services through its OFA division. The Company and the Bank are subject to regulation by certain federal and state agencies and undergo periodic examinations by such regulatory authorities.

Basis of Presentation – The accompanying condensed consolidated financial statements include the accounts of Orrstown Financial Services, Inc. and its wholly owned subsidiaries, the Bank and Wheatland. The Company has prepared these unaudited condensed consolidated financial statements in accordance with GAAP for interim financial information, SEC rules that permit reduced disclosure for interim periods, and Article 10 of Regulation S-X. In the opinion of management, all adjustments (all of which are of a normal recurring nature) that are necessary for a fair statement are reflected in the unaudited condensed consolidated financial statements. The December 31, 2016 consolidated balance sheet information contained in this Quarterly Report on Form 10-Q was derived from the 2016 audited consolidated financial statements. The unaudited condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements, including the notes thereto, included in the Company's Annual Report on Form 10-K for the year ended December 31, 2016. Operating results for the three and six months ended June 30, 2017 are not necessarily indicative of the results that may be expected for the year ending December 31, 2017. All significant intercompany transactions and accounts have been eliminated. Certain reclassifications have been made to prior year amounts to conform with current year classifications.

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

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

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

The types of securities the Company invests in are included in Note 2, Securities Available for Sale and the type of lending the Company engages in are included in Note 3, Loans and Allowance for Loan Losses.

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

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

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

Table of Contents

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

Securities – The Company classifies debt and marketable equity securities as available for sale on the date of purchase. At June 30, 2017 and December 31, 2016, the Company had no held to maturity or trading securities. AFS securities are reported at fair value. Interest income and dividends are recognized in interest income on an accrual basis. Purchase premiums and discounts on debt securities are amortized to interest income using the interest method over the terms of the securities and approximate the level yield method.

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

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

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

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

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

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the ALL, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and amortized as a yield adjustment over the respective term of the loan.

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

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

Table of Contents

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

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

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

See Note 3, Loans and Allowance for Loan Losses, for additional details.

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

Loans Serviced – The Bank administers secondary market mortgage programs available through the FHLB and the Federal National Mortgage Association and offers residential mortgage products and services to customers. The Bank originates single-family residential mortgage loans for immediate sale in the secondary market, and retains the servicing of those loans sold to these investors. At June 30, 2017 and December 31, 2016, the balance of loans serviced for others totaled \$328,534,000 and \$328,701,000.

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

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

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

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

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

Table of Contents

Mortgage Servicing Rights – The estimated fair value of MSR's related to loans sold and serviced by the Company is recorded as an asset upon the sale of such loans. MSR's are amortized as a reduction to servicing income over the estimated lives of the underlying loans. MSR's are evaluated periodically for impairment by comparing the carrying amount to estimated fair value. Fair value is determined periodically through a discounted cash flows valuation performed by a third party. Significant inputs to the valuation include expected servicing income, net of expense, the discount rate and the expected life of the underlying loans. To the extent the amortized cost of the MSR's exceeds their estimated fair values, a valuation allowance is established for such impairment through a charge against servicing income on the consolidated statements of income. If the Company determines, based on subsequent valuations, that the impairment no longer exists or is reduced, the valuation allowance is reduced through a credit to earnings. MSR's totaled \$2,848,000 and \$2,835,000 at June 30, 2017 and December 31, 2016, and are included in Other Assets.

Foreclosed Real Estate – Real estate property acquired through foreclosure or other means is initially recorded at the fair value of the related real estate collateral at the transfer date less estimated selling costs, and subsequently at the lower of its carrying value or fair value less estimated costs to sell. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. Costs to maintain foreclosed real estate are expensed as incurred. Costs that significantly improve the value of the properties are capitalized. Foreclosed real estate totaled \$1,012,000 and \$346,000 as of June 30, 2017 and December 31, 2016 and is included in Other Assets.

Investments in Real Estate Partnerships – The Company has a 99% limited partner interest in several real estate partnerships in central Pennsylvania. These investments are affordable housing projects which entitle the Company to tax deductions and credits through 2025. The Company accounts for its investments in affordable housing projects under the proportional amortization method when the criteria are met, which is limited to one investment entered into in 2015, with the other investments accounted for under the equity method of accounting. The recorded investment in these real estate partnerships, included in Other Assets, totaled \$4,689,000 and \$4,909,000 at June 30, 2017 and December 31, 2016, of which \$1,888,000 and \$1,993,000 are accounted for under the proportional amortization method.

Losses accounted for under the equity method for investments in real estate partnerships totaled \$26,000 and \$89,000 for the three months ended June 30, 2017 and 2016, and \$115,000 and \$178,000 for the six months ended June 30, 2017 and 2016, and are included in other noninterest income. Losses on investments accounted for under the proportional amortization method are included in income tax expense, net of federal income tax benefit. These losses totaled \$52,000 and \$53,000 for the three months ended June 30, 2017 and 2016, and \$105,000 and \$86,000 for the six months ended June 30, 2017 and 2016. The Company recognized federal tax credits from these investments totaling \$252,000 and \$184,000 during the three months ended June 30, 2017 and 2016, and \$505,000, and \$368,000 during the six months ended June 30, 2017 and 2016, which are included in income tax expense.

Advertising – The Company expenses advertising as incurred. Advertising expense totaled \$214,000 and \$202,000 for the three months ended June 30, 2017 and 2016, and \$317,000 and \$353,000 for the six months ended June 30, 2017 and 2016.

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

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

overnight.

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

Income Taxes – Income tax accounting guidance results in two components of income tax expense: current and deferred. Current income tax expense reflects taxes to be paid or refunded for the current period by applying the provisions of the enacted tax law to the taxable income or excess of deductions over revenues. The Company determines deferred income taxes

Table of Contents

using the liability (or balance sheet) method. Under this method, the net deferred tax asset or liability is based on the tax effects of the differences between the book and tax bases of assets and liabilities, and enacted changes in tax rates and laws are recognized in the period in which they occur.

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

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

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

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

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

Comprehensive Income – Comprehensive income consists of net income and OCI. OCI is limited to unrealized gains (losses) on AFS securities for all periods presented. Unrealized gains (losses) on AFS securities, net of tax, was the sole component of AOCI at June 30, 2017 and December 31, 2016.

Fair Value – Fair values of financial instruments are estimated using relevant market information and other assumptions, as more fully disclosed in Note 9, Fair Value. Fair value estimates involve uncertainties and matters of significant judgment. Changes in assumptions or in market conditions could significantly affect the estimates.

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

Recent Accounting Pronouncements - In May 2014, the FASB issued ASU 2014-9, Revenue from Contracts with Customers (Topic 606). ASU 2014-9, as amended, creates a new Topic 606 to provide guidance on revenue recognition for entities that enter into contracts with customers to transfer goods or services or enter into contracts for the transfer of nonfinancial assets. The core principle of the guidance is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Additional disclosures are required to provide quantitative and qualitative information regarding the nature, amount, timing, and uncertainty of revenue and cash flows arising from contracts with customers. These changes become effective for the Company on January 1, 2018. Because the guidance does not apply to revenue associated with financial instruments, including loans and securities, the new guidance is not expected to have a material impact on the components of the Consolidated Statements of Income most closely associated with financial instruments, including interest income and securities gains/losses. The Company is currently in the process of quantifying the potential impact of changes to the presentation and timing of certain items within noninterest income, and the related changes to disclosures that may be required. Management does not anticipate this update will have a material impact on the Company's financial position or results of operations.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments-Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 provides updated accounting and reporting requirements for both public and non-public entities. The most significant provisions that will impact the Company are: AFS equity securities will be measured at fair value, with the changes in fair value recognized in the income statement; the elimination of the requirement to disclose the method(s) and significant assumptions used to estimate the fair value that is

Table of Contents

required to be disclosed for financial instruments at amortized cost on the balance sheet; a provision to require the utilization of the exit price notion when measuring the fair value of financial instruments for disclosure purposes; and a requirement for separate presentation of both financial assets and liabilities by measurement category and form of financial asset on the balance sheet or accompanying notes to the financial statements. These changes become effective for the Company on January 1, 2018, using a cumulative-effect adjustment to the balance sheet. Management does not anticipate this update will have a material impact on the Company's financial position or results of operations.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). ASU 2016-12 provides updated accounting and reporting requirements, which, among other things, require lessees to recognize the following for all leases (with the exception of short-term leases) at the commencement date: a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis, and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. These changes become effective for the Company on January 1, 2019. Earlier application is permitted. Lessees must apply a modified retrospective transition approach for leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements. The modified retrospective approach would not require any transition accounting for leases that expired before the earliest comparative period presented. The Company anticipates that the impact on its balance sheet will result in an increase in assets and liabilities for its right of use assets and related lease liabilities for those leases that are outstanding at the date of adoption, however, it does not anticipate it will have a material impact on its results of operations. Management is evaluating other effects of this standard on the Company's financial position and regulatory capital.

In March 2016, the FASB issued ASU 2016-09, Compensation - Stock Compensation: Improvements to Employee Share-Based Payment Accounting (Topic 718). ASU 2016-09 requires recognition of the income tax effects of share-based awards in the income statement when the awards vest or are settled, eliminating additional paid-in capital pools. The adoption of these changes by the Company on January 1, 2017 did not have a material impact on its financial position or results of operations.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. ASU 2016-13 replaces the existing incurred loss impairment methodology in current GAAP with an expected loss impairment methodology, which considers a broader range of reasonable and supportable information to support credit loss estimates, including historical loss experience, current conditions and reasonable and foreseeable forecasts. ASU 2016-13 also requires enhanced and greater disclosure pertaining to significant estimates and judgments used in estimating credit losses, as well as the credit quality and underwriting standards of the Company's financial instrument portfolio, including loans and securities. These changes become effective for the Company on January 1, 2020 with adoption permitted one year earlier. Management is evaluating the impact of this standard on the Company's financial position, results of operations and regulatory capital.

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments. ASU 2016-15 makes eight target changes to how cash receipts and cash payments are presented and classified in the consolidated statement of cash flows. These changes become effective for the Company on January 1, 2018 with adoption on a retrospective basis. Management does not anticipate this update will have a material impact on the Company's financial position or results of operations.

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350): Simplifying the Test for Goodwill Impairment. ASU 2017-04 simplifies how all entities assess goodwill for impairment by eliminating Step 2 from the goodwill impairment test. As amended, the goodwill impairment test will consist of one step comparing the fair value of a reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. These changes become effective for the Company on January 1, 2020 with early adoption permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. Management does not anticipate this update will have a material impact on the Company's financial position or results of operations.

In March 2017, the FASB issued ASU 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20) which shortens the amortization period of certain callable debt securities held at a premium to the earliest call date.

This guidance would not require an accounting change for securities purchased at a discount. This change becomes effective for the Company on January 1, 2019 with early adoption permitted for interim and annual periods. Management does not anticipate this update will have a material impact on the Company's financial position or results of operations.

In May 2017, the FASB issued ASU 2017-09, Compensation - Stock Compensation (Topic 718) which is intended to provide clarity and reduce both diversity in practice and cost and complexity when applying the guidance in Topic 718, Compensation - Stock Compensation, to a change in the terms or conditions of a share-based payment award. This change becomes effective for the Company on January 1, 2018 with early adoption permitted for interim and annual periods.

Table of Contents

Management does not anticipate this update will have a material impact on the consolidated financial statements and related disclosures.

NOTE 2. SECURITIES AVAILABLE FOR SALE

The following table summarizes amortized cost and fair value of AFS securities at June 30, 2017 and December 31, 2016, and the corresponding amounts of gross unrealized gains and losses recognized in AOCI. At June 30, 2017 and December 31, 2016 all investment securities were classified as AFS.

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
June 30, 2017				
U.S. Government Agencies	\$ 7,311	\$ 23	\$ 0	\$7,334
States and political subdivisions	159,185	4,640	394	163,431
GSE residential MBSs	103,590	1,186	0	104,776
GSE residential CMOs	113,339	705	1,723	112,321
GSE commercial CMOs	5,141	0	168	4,973
Private label CMOs	3,542	18	20	3,540
Asset-backed	5,418	0	0	5,418
Total debt securities	397,526	6,572	2,305	401,793
Equity securities	50	61	0	111
Totals	\$ 397,576	\$ 6,633	\$ 2,305	\$401,904
December 31, 2016				
U.S. Government Agencies	\$ 39,569	\$ 147	\$ 124	\$39,592
States and political subdivisions	163,677	1,782	1,177	164,282
GSE residential MBSs	116,022	928	6	116,944
GSE residential CMOs	72,411	240	3,268	69,383
GSE commercial CMOs	5,148	0	292	4,856
Private label CMOs	5,042	0	36	5,006
Total debt securities	401,869	3,097	4,903	400,063
Equity securities	50	41	0	91
Totals	\$ 401,919	\$ 3,138	\$ 4,903	\$400,154

Table of Contents

The following table summarizes AFS securities with unrealized losses at June 30, 2017 and December 31, 2016, aggregated by major security type and length of time in a continuous unrealized loss position.

(Dollars in thousands)	Less Than 12 Months			12 Months or More			Total		
	# of Securities	Fair Value	Unrealized Losses	# of Securities	Fair Value	Unrealized Losses	# of Securities	Fair Value	Unrealized Losses
June 30, 2017									
States and political subdivisions	9	\$ 19,752	\$ 246	1	\$ 5,469	\$ 148	10	\$ 25,221	\$ 394
GSE residential CMOs	6	57,391	1,638	2	2,781	85	8	60,172	1,723
GSE commercial CMOs	1	4,973	168	0	0	0	1	4,973	168
Private label CMOs	0	0	0	1	1,268	20	1	1,268	20
Totals	16	\$ 82,116	\$ 2,052	4	\$ 9,518	\$ 253	20	\$ 91,634	\$ 2,305
December 31, 2016									
U.S. Government Agencies	6	\$ 10,710	\$ 23	2	\$ 13,531	\$ 101	8	\$ 24,241	\$ 124
States and political subdivisions	25	58,924	610	1	5,075	567	26	63,999	1,177
GSE residential MBSs	1	5,034	6	0	0	0	1	5,034	6
GSE residential CMOs	6	59,534	3,264	1	634	4	7	60,168	3,268
GSE commercial CMOs	1	4,856	292	0	0	0	1	4,856	292
Private label CMOs	0	0	0	3	5,005	36	3	5,005	36
Totals	39	\$ 139,058	\$ 4,195	7	\$ 24,245	\$ 708	46	\$ 163,303	\$ 4,903

U.S. Government Agencies and GSE Securities. The unrealized losses presented in the table above have been caused by a widening of spreads and/or a rise in interest rates from the time these securities were purchased. The contractual terms of these securities do not permit the issuer to settle the securities at a price less than its par value basis. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell them before recovery of their amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at June 30, 2017 or at December 31, 2016.

State and Political Subdivisions. The unrealized losses presented in the table above have been caused by a widening of spreads and/or a rise in interest rates from the time these securities were purchased. Management considers the investment rating, the state of the issuer of the security and other credit support in determining whether the security is OTTI. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell them before recovery of their amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at June 30, 2017 or at December 31, 2016.

Private Label CMOs. The unrealized losses presented in the table above have been caused by a widening of spreads and/or a rise in interest rates from the time the securities were purchased. Because the Company does not intend to sell these securities and it is not more likely than not that the Company will be required to sell them before recovery of

their amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at June 30, 2017 or at December 31, 2016.

Table of Contents

The following table summarizes amortized cost and fair value of AFS securities at June 30, 2017 by contractual maturity. Expected maturities may differ from contractual maturities if borrowers have the right to call or prepay obligations with or without call or prepayment penalties. Securities not due at a single maturity date are shown separately.

(Dollars in thousands)	Available for Sale	
	Amortized Cost	Fair Value
Due in one year or less	\$ 15	\$ 15
Due after one year through five years	11,734	11,990
Due after five years through ten years	59,744	61,267
Due after ten years	95,003	97,493
MBSs and CMOs	225,612	225,610
Asset-backed	5,418	5,418
Total debt securities	397,526	401,793
Equity securities	50	111
	\$397,576	\$ 401,904

The following table summarizes proceeds from sales of AFS securities and gross gains and gross losses for the three and six months ended March 31, 2017 and 2016.

(Dollars in thousands)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Proceeds from sale of AFS securities	\$23,581	\$ 0	\$58,653	\$64,743
Gross gains	654	0	807	1,468
Gross losses	0	0	150	48

AFS securities with a fair value of \$328,664,000 and \$317,282,000 at June 30, 2017 and December 31, 2016 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 3. LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

The Company has various types of commercial real estate loans which have differing levels of credit risk.

Owner-occupied commercial real estate loans are generally dependent upon the successful operation of the borrower's business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower's ability to repay the loan could be in jeopardy.

Non-owner occupied and multi-family commercial real estate loans and non-owner occupied residential loans present a different credit risk to the Company than owner-occupied commercial real estate loans, as the repayment of the loan is dependent upon the borrower's ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirements and operating expenses. Lower occupancy or lease rates may result in a reduction in cash flows, which hinders the ability of the borrower to meet debt service requirements, and may result in lower

collateral values. The Company generally recognizes that greater risk is inherent in these credit relationships as compared to owner-occupied loans mentioned above.

Table of Contents

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

Commercial and industrial loans include advances to local and regional businesses for general commercial purposes and include permanent and short-term working capital, machinery and equipment financing, and may be either in the form of lines of credit or term loans. Although commercial and industrial loans may be unsecured to our highest-rated borrowers, the majority of these loans are secured by the borrower's accounts receivable, inventory and machinery and equipment. In a significant number of these loans, the collateral also includes the business real estate or the business owner's personal real estate or assets. Commercial and industrial loans present credit exposure to the Company, as they are more susceptible to risk of loss during a downturn in the economy, as borrowers may have greater difficulty in meeting their debt service requirements and the value of the collateral may decline. The Company attempts to mitigate this risk through its underwriting standards, including evaluating the credit worthiness of the borrower and, to the extent available, credit ratings on the business. Additionally, monitoring of the loans through annual renewals and meetings with the borrowers are typical. However, these procedures cannot eliminate the risk of loss associated with commercial and industrial lending.

Municipal loans consist of extensions of credit to municipalities and school districts within the Company's market area. These loans generally present a lower risk than commercial and industrial loans, as they are generally secured by the municipality's full taxing authority, by revenue obligations, or by its ability to raise assessments on its customers for a specific utility.

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

Home equity loans, including term loans and lines of credit, present a slightly higher risk to the Company than 1-4 family first liens, as these loans can be first or second liens on 1-4 family owner-occupied residential property, but generally can have loan-to-value ratios of no greater than 90% of the value of the real estate taken as collateral. The credit worthiness of the borrower is considered including credit scores and debt-to-income ratios, which generally cannot exceed 43%.

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

Table of Contents

The following table presents the loan portfolio, excluding residential LHFS, broken out by classes at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	June 30, 2017	December 31, 2016
Commercial real estate:		
Owner-occupied	\$ 116,419	\$ 112,295
Non-owner occupied	217,070	206,358
Multi-family	48,637	47,681
Non-owner occupied residential	68,621	62,533
Acquisition and development:		
1-4 family residential construction	8,036	4,663
Commercial and land development	28,481	26,085
Commercial and industrial	97,913	88,465
Municipal	51,381	53,741
Residential mortgage:		
First lien	150,173	139,851
Home equity - term	13,019	14,248
Home equity - lines of credit	127,262	120,353
Installment and other loans	7,370	7,118
	\$934,382	\$ 883,391

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

The Company has a loan review policy and program which is designed to identify and manage risk in the lending function. The ERM Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Company's loan portfolio. This includes the monitoring of the lending activities of all Company personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. The Company's loan review program provides the Company with an independent review of the loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible negative credit event.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$500,000, which includes confirmation of risk rating by an independent credit officer. Credit Administration also reviews loans in excess of \$1,000,000. In addition, all relationships greater than \$250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Company's Problem Loan Committee, with subsequent reporting to the ERM Committee.

Table of Contents

The following table summarizes the Company's loan portfolio ratings based on its internal risk rating system at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
June 30, 2017						
Commercial real estate:						
Owner-occupied	\$ 111,737	\$ 1,814	\$ 1,959	\$ 909	\$ 0	\$ 116,419
Non-owner occupied	206,823	196	10,051	0	0	217,070
Multi-family	43,526	4,159	770	182	0	48,637
Non-owner occupied residential	66,024	1,062	1,117	418	0	68,621
Acquisition and development:						
1-4 family residential construction	8,036	0	0	0	0	8,036
Commercial and land development	27,849	7	625	0	0	28,481
Commercial and industrial	95,124	2,384	29	376	0	97,913
Municipal	49,392	1,989	0	0	0	51,381
Residential mortgage:						
First lien	146,200	0	0	3,973	0	150,173
Home equity - term	12,994	0	0	25	0	13,019
Home equity - lines of credit	126,648	81	61	472	0	127,262
Installment and other loans	7,361	0	0	9	0	7,370
	\$901,714	\$ 11,692	\$ 14,612	\$ 6,364	\$ 0	\$934,382
December 31, 2016						
Commercial real estate:						
Owner-occupied	\$ 103,652	\$ 5,422	\$ 2,151	\$ 1,070	\$ 0	\$ 112,295
Non-owner occupied	190,726	4,791	10,105	736	0	206,358
Multi-family	42,473	4,222	787	199	0	47,681
Non-owner occupied residential	59,982	949	1,150	452	0	62,533
Acquisition and development:						
1-4 family residential construction	4,560	103	0	0	0	4,663
Commercial and land development	25,435	10	639	1	0	26,085
Commercial and industrial	87,588	251	32	594	0	88,465
Municipal	53,741	0	0	0	0	53,741
Residential mortgage:						
First lien	135,558	0	0	4,293	0	139,851
Home equity - term	14,155	0	0	93	0	14,248
Home equity - lines of credit	119,681	82	61	529	0	120,353
Installment and other loans	7,112	0	0	6	0	7,118
	\$844,663	\$ 15,830	\$ 14,925	\$ 7,973	\$ 0	\$883,391

Classified loans may also be evaluated for impairment. For commercial real estate, acquisition and development and commercial and industrial loans, a loan is considered impaired when, based on current information and events, it is probable that the Company will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Generally, loans that are more than 90 days past due are deemed impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal

and interest owed to determine if the loan should be placed on nonaccrual status. Nonaccrual loans in the

20

Table of Contents

commercial and commercial real estate portfolios and any TDRs are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates of fair values are obtained, which may include updated appraisals. The updated fair values are incorporated into the impairment analysis as of the next reporting period. Loan charge-offs, which may include partial charge-offs, are taken on an impaired loan that is collateral dependent if the loan's carrying balance exceeds its collateral's appraised value; the loan has been identified as uncollectible; and it is deemed to be a confirmed loss. Typically, impaired loans with a partial charge-off will continue to be considered impaired, unless the note is split into two, and management expects the performing note to continue to perform and it is adequately secured. The second, or non-performing note, would be charged-off. Generally, an impaired loan with a partial charge-off may continue to have an impairment reserve on it after the partial charge-off, if factors warrant. At June 30, 2017 and December 31, 2016, nearly all of the Company's impaired loans' extent of impairment was measured based on the estimated fair value of the collateral securing the loan, except for TDRs. By definition, TDRs are considered impaired. All restructured loan impairments were determined based on discounted cash flows for those loans classified as TDRs and still accruing interest. For real estate loans, collateral generally consists of commercial real estate, but in the case of commercial and industrial loans, it would also consist of accounts receivable, inventory, equipment or other business assets. Commercial and industrial loans may also have real estate collateral. According to policy, updated appraisals are generally required every 18 months for classified loans in excess of \$250,000. The "as is value" provided in the appraisal is often used as the fair value of the collateral in determining impairment, unless circumstances, such as subsequent improvements, approvals, or other circumstances dictate that another value provided by the appraiser is more appropriate.

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

Original appraisal – if the original appraisal provides a strong loan-to-value ratio (generally 70% or lower) and, after consideration of market conditions and knowledge of the property and area, it is determined by the Credit Administration staff that there has not been a significant deterioration in the collateral value, the original certified appraised value may be used. Discounts as deemed appropriate for selling costs are factored into the appraised value in arriving at fair value.

Discounted cash flows – in limited cases, discounted cash flows may be used on projects in which the collateral is liquidated to reduce the borrowings outstanding, and is used to validate collateral values derived from other approaches.

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

The Company distinguishes Substandard loans on both an impaired and nonimpaired basis, as it places less emphasis on a loan's classification, and increased reliance on whether the loan was performing in accordance with the contractual terms. A Substandard classification does not automatically meet the definition of "impaired." A Substandard loan is one that is inadequately protected by the current sound worth and paying capacity of the obligor or the collateral pledged, if any. Extensions of credit classified as Substandard have well-defined weaknesses which may jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the Bank will sustain some

loss if the deficiencies are not corrected. Loss potential, while existing in the aggregate amount of Substandard loans, does not have to exist in individual extensions of credit classified as Substandard. As a result, the Company's methodology includes an evaluation of certain accruing commercial real estate, acquisition and development and commercial and industrial loans rated Substandard to be collectively evaluated for impairment as opposed to evaluating these loans individually for impairment. Although we believe these loans have well defined weaknesses and meet the definition of Substandard, they are generally performing and management has concluded that

Table of Contents

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

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

The following table summarizes impaired loans by class, segregated by those for which a specific allowance was required and those for which a specific allowance was not required as of June 30, 2017 and December 31, 2016. The recorded investment in loans excludes accrued interest receivable due to insignificance. Related allowances established generally pertain to those loans in which loan forbearance agreements were in the process of being negotiated or updated appraisals were pending, and the partial charge-off will be recorded when final information is received.

(Dollars in thousands)	Impaired Loans with a Specific Allowance			Impaired Loans with No Specific Allowance	
	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)	Related Allowance	Recorded Investment (Book Balance)	Unpaid Principal Balance (Legal Balance)
June 30, 2017					
Commercial real estate:					
Owner-occupied	\$0	\$ 0	\$ 0	\$ 909	\$ 2,098
Multi-family	0	0	0	182	360
Non-owner occupied residential	0	0	0	418	688
Commercial and industrial	0	0	0	376	508
Residential mortgage:					
First lien	553	553	40	3,420	4,101
Home equity - term	0	0	0	25	29
Home equity - lines of credit	0	0	0	472	613
Installment and other loans	5	5	5	4	33
	\$558	\$ 558	\$ 45	\$ 5,806	\$ 8,430
December 31, 2016					
Commercial real estate:					
Owner-occupied	\$0	\$ 0	\$ 0	\$ 1,070	\$ 2,236
Non-owner occupied	0	0	0	736	1,323
Multi-family	0	0	0	199	368
Non-owner occupied residential	0	0	0	452	706
Acquisition and development:					
Commercial and land development	0	0	0	1	16
Commercial and industrial	0	0	0	594	715
Residential mortgage:					
First lien	643	643	43	3,650	4,399
Home equity - term	0	0	0	93	103
Home equity - lines of credit	0	0	0	529	659
Installment and other loans	0	0	0	6	34
	\$643	\$ 643	\$ 43	\$ 7,330	\$ 10,559

Table of Contents

The following tables summarize the average recorded investment in impaired loans and related interest income recognized on loans deemed impaired for the three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	2017		2016	
	Average Impaired Balance	Interest Income Recognized	Average Impaired Balance	Interest Income Recognized
Three Months Ended June 30,				
Commercial real estate:				
Owner-occupied	\$979	\$ 5	\$1,954	\$ 0
Non-owner occupied	0	0	7,251	0
Multi-family	186	0	221	0
Non-owner occupied residential	427	0	699	0
Acquisition and development:				
Commercial and land development	0	0	3	0
Commercial and industrial	404	0	514	0
Residential mortgage:				
First lien	4,192	21	4,618	8
Home equity – term	78	0	98	0
Home equity - lines of credit	503	1	499	0
Installment and other loans	6	0	14	0
	\$6,775	\$ 27	\$15,871	\$ 8
Six Months Ended June 30,				
Commercial real estate:				
Owner-occupied	\$1,036	\$ 5	\$2,012	\$ 0
Non-owner occupied	276	0	7,511	0
Multi-family	191	0	225	0
Non-owner occupied residential	437	0	787	0
Acquisition and development:				
Commercial and land development	0	0	4	0
Commercial and industrial	458	0	619	0
Residential mortgage:				
First lien	4,272	29	4,697	17
Home equity - term	87	0	100	0
Home equity - lines of credit	513	1	544	0
Installment and other loans	6	0	16	0
	\$7,276	\$ 35	\$16,515	\$ 17

Table of Contents

The following table presents impaired loans that are TDRs, with the recorded investment at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	June 30, 2017		December 31, 2016	
	Number of Contracts	Recorded Investment	Number of Contracts	Recorded Investment
Accruing:				
Commercial real estate:				
Owner-occupied	1	\$ 56	0	\$ 0
Residential mortgage:				
First lien	11	1,116	8	896
Home equity - lines of credit	1	32	1	34
	13	1,204	9	930
Nonaccruing:				
Commercial real estate:				
Owner-occupied	1	61	0	0
Residential mortgage:				
First lien	8	746	12	1,035
Installment and other loans	1	4	1	6
	10	811	13	1,041
	23	\$ 2,015	22	\$ 1,971

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

(Dollars in thousands)	2017		2016	
	Pre-Modification	Post Modification	Pre-Modification	Post Modification
	Number of Contracts Recorded	Recorded Investment	Number of Contracts Recorded	Recorded Investment
Three Months Ended June 30,				
Commercial real estate:				
Owner-occupied	1	\$ 56	0	\$ 0
Six Months Ended June 30,				
Commercial real estate:				
Owner-occupied	2	\$ 119	0	\$ 0
Residential mortgage:				
First lien	0	0	1	257
	2	\$ 119	1	\$ 257

There were no restructured loans for the three or six months ended June 30, 2017 and 2016 that were modified as TDRs within the previous twelve months which were in payment default.

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

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

Table of Contents

Management further monitors the performance and credit quality of the loan portfolio by analyzing the average length of time a portfolio is past due, by aggregating loans based on their delinquencies. The following table presents the classes of the loan portfolio summarized by aging categories of performing loans and nonaccrual loans at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	Days Past Due				Total Past Due	Non- Accrual	Total Loans
	Current	30-59	60-89	90+ (still accruing)			
June 30, 2017							
Commercial real estate:							
Owner-occupied	\$ 115,561	\$ 5	\$ 0	\$ 0	\$ 5	\$ 853	\$ 116,419
Non-owner occupied	217,070	0	0	0	0	0	217,070
Multi-family	48,455	0	0	0	0	182	48,637
Non-owner occupied residential	68,203	0	0	0	0	418	68,621
Acquisition and development:							
1-4 family residential construction	8,036	0	0	0	0	0	8,036
Commercial and land development	28,418	63	0	0	63	0	28,481
Commercial and industrial	97,507	30	0	0	30	376	97,913
Municipal	51,381	0	0	0	0	0	51,381
Residential mortgage:							
First lien	146,712	583	21	0	604	2,857	150,173
Home equity - term	12,964	30	0	0	30	25	13,019
Home equity - lines of credit	126,497	288	37	0	325	440	127,262
Installment and other loans	7,349	8	4	0	12	9	7,370
	\$ 928,153	\$ 1,007	\$ 62	\$ 0	\$ 1,069	\$ 5,160	\$ 934,382
December 31, 2016							
Commercial real estate:							
Owner-occupied	\$ 111,225	\$ 0	\$ 0	\$ 0	\$ 0	\$ 1,070	\$ 112,295
Non-owner occupied	205,622	0	0	0	0	736	206,358
Multi-family	47,482	0	0	0	0	199	47,681
Non-owner occupied residential	62,081	0	0	0	0	452	62,533
Acquisition and development:							
1-4 family residential construction	4,548	115	0	0	115	0	4,663
Commercial and land development	26,084	0	0	0	0	1	26,085
Commercial and industrial	87,871	0	0	0	0	594	88,465
Municipal	53,741	0	0	0	0	0	53,741
Residential mortgage:							
First lien	135,499	628	328	0	956	3,396	139,851
Home equity - term	14,155	0	0	0	0	93	14,248
Home equity - lines of credit	119,733	125	0	0	125	495	120,353
Installment and other loans	7,090	20	2	0	22	6	7,118
	\$ 875,131	\$ 888	\$ 330	\$ 0	\$ 1,218	\$ 7,042	\$ 883,391

Table of Contents

The Company maintains the ALL at a level believed to be adequate by management for probable incurred credit losses. The ALL is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the ALL utilizing a defined methodology, which considers specific credit evaluation of impaired loans as discussed above, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Subtopic 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

In connection with its quarterly evaluation of the adequacy of the ALL, management continually reviews its methodology to determine if it continues to properly address the risk in the loan portfolio. For each loan class presented above, general allowances are provided for loans that are collectively evaluated for impairment, which is based on quantitative factors, principally historical loss trends for the respective loan class, adjusted for qualitative factors. In addition, an adjustment to the historical loss factors is made to account for delinquency and other potential risk not elsewhere defined within the ALL methodology.

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

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

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

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

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

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

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

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

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

Table of Contents

The following table presents the activity in the ALL for the three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Commercial Real Estate	Commercial Acquisition and Development	Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Consumer Installment and Other	Total	Unallocated	Total
Three Months Ended										
June 30, 2017										
Balance, beginning of period	\$6,963	\$ 513	\$ 1,218	\$ 106	\$8,800	\$3,229	\$ 127	\$3,356	\$ 512	\$12,668
Provision for loan losses	(214)	65	69	11	(69)	198	13	211	(42)	100
Charge-offs	0	0	0	0	0	(51)	(27)	(78)	0	(78)
Recoveries	28	1	4	0	33	10	18	28	0	61
Balance, end of period	\$6,777	\$ 579	\$ 1,291	\$ 117	\$8,764	\$3,386	\$ 131	\$3,517	\$ 470	\$12,751
June 30, 2016										
Balance, beginning of period	\$7,996	\$ 739	\$ 1,030	\$ 62	\$9,827	\$2,677	\$ 179	\$2,856	\$ 664	\$13,347
Provision for loan losses	(12)	(152)	112	(1)	(53)	66	26	92	(39)	0
Charge-offs	(26)	0	0	0	(26)	(80)	(48)	(128)	0	(154)
Recoveries	175	0	6	0	181	43	23	66	0	247
Balance, end of period	\$8,133	\$ 587	\$ 1,148	\$ 61	\$9,929	\$2,706	\$ 180	\$2,886	\$ 625	\$13,440
Six Months Ended										
June 30, 2017										
Balance, beginning of period	\$7,530	\$ 580	\$ 1,074	\$ 54	\$9,238	\$2,979	\$ 144	\$3,123	\$ 414	\$12,775
Provision for loan losses	(738)	(3)	267	63	(411)	441	14	455	56	100
Charge-offs	(45)	0	(55)	0	(100)	(51)	(56)	(107)	0	(207)
Recoveries	30	2	5	0	37	17	29	46	0	83
Balance, end of period	\$6,777	\$ 579	\$ 1,291	\$ 117	\$8,764	\$3,386	\$ 131	\$3,517	\$ 470	\$12,751
June 30, 2016										
Balance, beginning of period	\$7,883	\$ 850	\$ 1,012	\$ 58	\$9,803	\$2,870	\$ 121	\$2,991	\$ 774	\$13,568
Provision for loan losses	21	(263)	149	3	(90)	111	128	239	(149)	0
Charge-offs	(26)	0	(21)	0	(47)	(324)	(112)	(436)	0	(483)
Recoveries	255	0	8	0	263	49	43	92	0	355
Balance, end of period	\$8,133	\$ 587	\$ 1,148	\$ 61	\$9,929	\$2,706	\$ 180	\$2,886	\$ 625	\$13,440

Table of Contents

The following table summarizes the ending loan balance individually evaluated for impairment based upon loan segment, as well as the related ALL allocation for each at June 30, 2017 and December 31, 2016:

(Dollars in thousands)	Commercial				Total	Consumer			Unallocated	Total
	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal		Residential Mortgage	Installment and Other	Total		
June 30, 2017										
Loans allocated by:										
Individually evaluated for impairment	\$1,509	\$0	\$376	\$0	\$1,885	\$4,470	\$9	\$4,479	\$0	\$6,364
Collectively evaluated for impairment	449,238	36,517	97,537	51,381	634,673	285,984	7,361	293,345	0	928,018
	\$450,747	\$36,517	\$97,913	\$51,381	\$636,558	\$290,454	\$7,370	\$297,824	\$0	\$934,382
ALL allocated by:										
Individually evaluated for impairment	\$0	\$0	\$0	\$0	\$0	\$40	\$5	\$45	\$0	\$45
Collectively evaluated for impairment	6,777	579	1,291	117	8,764	3,346	126	3,472	470	12,706
	\$6,777	\$579	\$1,291	\$117	\$8,764	\$3,386	\$131	\$3,517	\$470	\$12,751
December 31, 2016										
Loans allocated by:										
Individually evaluated for impairment	\$2,457	\$1	\$594	\$0	\$3,052	\$4,915	\$6	\$4,921	\$0	\$7,973
Collectively evaluated for impairment	426,410	30,747	87,871	53,741	598,769	269,537	7,112	276,649	0	875,418
	\$428,867	\$30,748	\$88,465	\$53,741	\$601,821	\$274,452	\$7,118	\$281,570	\$0	\$883,391
ALL allocated by:										
Individually evaluated for impairment	\$0	\$0	\$0	\$0	\$0	\$43	\$0	\$43	\$0	\$43
Collectively evaluated for impairment	7,530	580	1,074	54	9,238	2,936	144	3,080	414	12,732
	\$7,530	\$580	\$1,074	\$54	\$9,238	\$2,979	\$144	\$3,123	\$414	\$12,775

NOTE 4. INCOME TAXES

The Company files income tax returns in the U.S. federal jurisdiction, the Commonwealth of Pennsylvania and the State of Maryland. The Company is no longer subject to tax examination by tax authorities for years before 2013. The following table summarizes income tax expense for the three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Current year expense (benefit):				
Federal	\$145	\$238	\$202	\$126
State	(9)	(1)	(7)	(3)
	136	237	195	123
Deferred expense:				
Federal	371	10	735	732
State	9	5	10	11
	380	15	745	743

Income tax expense	\$516	\$252	\$940	\$866
--------------------	-------	-------	-------	-------

The provision for income taxes includes \$222,000 and \$0 of applicable income tax expense related to net securities gains for the three months ended June 30, 2017 and 2016, and \$223,000 and \$497,000 of applicable income tax expense related to net securities gains for the six months ended June 30, 2017 and 2016.

The base federal statutory rate used in determining the estimated annual effective tax rate for the quarter ended June 30, 2017 was 34%. The estimated annual effective tax rate used to determine tax expense in the quarter ended June 30, 2016 was

28

Table of Contents

based on a federal statutory rate of 35%. In the third quarter of 2016, the Company reassessed its estimated annual effective tax rate and changed the base federal statutory rate to 34% in expectation that the Company would not be in the higher tax bracket.

The following table presents the components of the net deferred tax asset, included in other assets on the consolidated balance sheets.

(Dollars in thousands)	June 30, December 31,	
	2017	2016
Deferred tax assets:		
Allowance for loan losses	\$4,719	\$ 4,725
Deferred compensation	548	545
Retirement plans and salary continuation	2,018	1,942
Share-based compensation	730	583
Off-balance sheet reserves	337	313
Nonaccrual loan interest	466	370
Net unrealized losses on securities available for sale	0	600
Goodwill	77	92
Bonus accrual	321	236
Low-income housing credit carryforward	2,148	1,983
Alternative minimum tax credit carryforward	4,348	4,048
Net operating loss carryforward	804	2,520
Other	523	479
Total deferred tax assets	17,039	18,436
Deferred tax liabilities:		
Depreciation	694	771
Net unrealized gains on securities available for sale	1,472	0
Mortgage servicing rights	814	777
Purchase accounting adjustments	420	435
Other	198	195
Total deferred tax liabilities	3,598	2,178
Net deferred tax asset	\$13,441	\$ 16,258

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

At June 30, 2017, the Company had low-income housing and net operating loss carryforwards that expire through 2036 and 2032, respectively.

NOTE 5. SHARE-BASED COMPENSATION PLANS

The Company maintains share-based compensation plans under the shareholder-approved 2011 Plan. The purpose of the share-based compensation plans is to provide officers, employees, and non-employee members of the Board of Directors of the Company with additional incentive to further the success of the Company. Under the 2011 Plan, 381,920 shares of the common stock of the Company were reserved to be issued. At June 30, 2017, 81,890 shares were available to be issued under the 2011 Plan.

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

Table of Contents

The following table presents a summary of nonvested restricted shares activity for the six months ended June 30, 2017.

	Shares	Weighted Average Grant Date Fair Value
Nonvested restricted shares, beginning of year	227,337	\$ 16.88
Granted	62,253	22.26
Forfeited	(7,192)	18.31
Vested	(12,000)	17.95
Nonvested restricted shares, at period end	270,398	\$ 18.04

The following table presents restricted shares compensation expense, with tax benefit information, and fair value of shares vested, for the three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Restricted share award expense	\$363	\$259	\$659	\$496
Restricted share award tax benefit	123	91	224	174
Fair value of shares vested	263	193	263	237

At June 30, 2017 and December 31, 2016, the unrecognized compensation expense related to the share awards totaled \$2,660,000 and \$2,169,000. The unrecognized compensation expense at June 30, 2017 is expected to be recognized over a weighted-average period of 2.1 years.

The following table presents a summary of outstanding stock options activity for the six months ended June 30, 2017.

	Shares	Weighted Average Exercise Price
Outstanding at beginning of year	80,370	\$ 27.37
Forfeited	(1,100)	21.14
Expired	(3,087)	33.98
Options outstanding and exercisable, at period end	76,183	\$ 27.19

The exercise price of each option equals the market price of the Company's stock on the grant date. An option's maximum term is ten years. All options are fully vested upon issuance.

The following table presents information pertaining to options outstanding and exercisable at June 30, 2017.

Range of Exercise Prices	Number Outstanding	Weighted Average Remaining Contractual Life (Years)	Weighted Average Exercise Price
\$21.14 - \$24.99	33,899	2.92	\$ 21.48
\$25.00 - \$29.99	2,792	2.76	25.76
\$30.00 - \$34.99	32,144	0.49	31.08
\$35.00 - \$37.59	7,348	2.06	37.08

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

\$21.14 - \$37.59

76,183

1.80

\$ 27.19

Outstanding and exercisable options had an intrinsic value of \$52,000 at June 30, 2017 and \$39,000 at December 31, 2016.

30

Table of Contents

The Company maintains an employee stock purchase plan to provide employees of the Company an opportunity to purchase Company common stock. Eligible employees may purchase shares in an amount that does not exceed 10% of their annual salary, at the lower of 95% of the fair market value of the shares on the semi-annual offering date or related purchase date. The Company reserved 350,000 shares of its common stock to be issued under the employee stock purchase plan. At June 30, 2017, 182,890 shares were available to be issued.

The following table presents information for the employee stock purchase plan for the three and six months ended June 30, 2017 and 2016.

	Three months ended June 30,		Six months ended June 30,	
(Dollars in thousands except share information)	2017	2016	2017	2016

Shares purchased	0	0	3,114	2,461
Weighted average price of shares purchased	\$0.00	\$0.00	\$19.71	\$16.57
Compensation expense recognized	0	0	7	3

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

NOTE 6. SHAREHOLDERS' EQUITY AND REGULATORY CAPITAL

Banks and bank holding companies are subject to regulatory capital requirements administered by federal banking agencies. Capital adequacy guidelines and, additionally for banks, prompt corrective action regulations, involve quantitative measures of assets, liabilities and certain off-balance sheet items calculated under regulatory accounting practices. Capital amounts and classifications are also subject to qualitative judgments by regulators. Failure to meet capital requirements can initiate regulatory action. The final rules implementing the Basel Committee on Banking Supervision's capital guidelines for U.S. Banks are being phased in through January 1, 2019. Under these rules, the Company must hold a capital conservation buffer above the adequately capitalized risk-based capital ratios. The capital conservation buffer for the Company was 0.625% for 2016 and is 1.25% for 2017, with a total buffer of 2.50% being phased in through 2019. The net unrealized gain or loss on available for sale securities is not included in computing regulatory capital. Management believes at June 30, 2017 the Company and the Bank met all capital adequacy requirements to which they were subject.

Prompt corrective action regulations provide five classifications: well capitalized, adequately capitalized, undercapitalized, significantly undercapitalized and critically undercapitalized, although these terms are not used to represent overall financial condition. If adequately capitalized, regulatory approval is required to accept brokered deposits. If undercapitalized, capital distributions are limited, as is asset growth and expansion and capital restoration plans are required. At June 30, 2017, the most recent regulatory notifications categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. There are no conditions or events since that notification that management believes have changed the Bank's category.

Table of Contents

The following table presents capital amounts and ratios at June 30, 2017 and December 31, 2016.

	Actual		For Capital Adequacy Purposes (includes applicable capital conservation buffer)		To Be Well Capitalized Under Prompt Corrective Action Provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
June 30, 2017						
Total Capital to risk weighted assets						
Consolidated	\$ 145,122	14.5 %	\$ 92,523	9.250 %	n/a	n/a
Bank	139,953	14.0 %	92,457	9.250 %	\$ 99,954	10.0 %
Tier 1 (Core) Capital to risk weighted assets						
Consolidated	132,589	13.3 %	72,518	7.250 %	n/a	n/a
Bank	127,429	12.7 %	72,467	7.250 %	79,963	8.0 %
Common Equity Tier 1 (CET1) to risk weighted assets						
Consolidated	132,589	13.3 %	57,514	5.750 %	n/a	n/a
Bank	127,429	12.7 %	57,473	5.750 %	64,970	6.5 %
Tier 1 (Core) Capital to average assets						
Consolidated	132,589	9.1 %	58,397	4.0 %	n/a	n/a
Bank	127,429	8.7 %	58,429	4.0 %	73,037	5.0 %
December 31, 2016						
Total Capital to risk weighted assets						
Consolidated	\$ 139,033	14.6 %	\$ 82,391	8.625 %	n/a	n/a
Bank	126,408	13.2 %	82,328	8.625 %	\$ 95,453	10.0 %
Tier 1 (Core) Capital to risk weighted assets						
Consolidated	127,033	13.3 %	63,286	6.625 %	n/a	n/a
Bank	114,417	12.0 %	63,238	6.625 %	76,363	8.0 %
Common Equity Tier 1 (CET1) to risk weighted assets						
Consolidated	127,033	13.3 %	48,957	5.125 %	n/a	n/a
Bank	114,417	12.0 %	48,920	5.125 %	62,045	6.5 %
Tier 1 (Core) Capital to average assets						
Consolidated	127,033	9.3 %	54,453	4.0 %	n/a	n/a
Bank	114,417	8.4 %	54,500	4.0 %	68,126	5.0 %

In September 2015, the Board of Directors of the Company authorized a share repurchase program under which the Company may repurchase up to 5% of the Company's outstanding shares of common stock, or approximately 416,000 shares, in accordance with all applicable securities laws and regulations, including Rule 10b-18 of the Exchange Act. When and if appropriate, repurchases may be made in open market or privately negotiated transactions, depending on market conditions, regulatory requirements and other corporate considerations, as determined by management. Share repurchases may not occur and may be discontinued at any time. At June 30, 2017, 82,725 shares had been repurchased under the program at a total cost of \$1,438,000, or \$17.38 per share.

On July 26, 2017, the Board declared a cash dividend of \$0.10 per common share, to be paid on August 15, 2017 to shareholders of record at August 8, 2017.

Table of Contents

NOTE 7. EARNINGS PER SHARE

The following table presents earnings per share for the three and six months ended June 30, 2017 and 2016.

	Three Months Ended June 30,		Six Months Ended June 30,	
	2017	2016	2017	2016
(Dollars in thousands, except per share data)				
Net income	\$3,308	\$678	\$5,310	\$3,258
Weighted average shares outstanding - basic	8,069	8,053	8,064	8,062
Dilutive effect of share-based compensation	139	83	139	76
Weighted average shares outstanding - diluted	8,208	8,136	8,203	8,138
Per share information:				
Basic earnings per share	\$0.41	\$0.08	\$0.66	\$0.40
Diluted earnings per share	0.40	0.08	0.65	0.40

Average outstanding stock options of 46,000 and 96,000 for the three months ended June 30, 2017 and 2016, and of 48,000 and 101,000 for the six months ended June 30, 2017 and 2016, were not included in the computation of earnings per share because the effect was antidilutive, due to the exercise price exceeding the average market price. The dilutive effect of share-based compensation in each period above relates principally to restricted stock awards.

NOTE 8. FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK

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

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

(Dollars in thousands)	Contract or Notional Amount	
	June 30, 2017	December 31, 2016
Commitments to fund:		
Home equity lines of credit	\$ 131,944	\$ 126,811
1-4 family residential construction loans	12,709	7,820
Commercial real estate, construction and land development loans	39,339	43,830
Commercial, industrial and other loans	136,092	111,884
Standby letters of credit	7,668	7,097

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

Standby letters of credit and financial guarantees written are conditional commitments issued by the Company to guarantee the performance of a customer to a third party. Those guarantees are primarily issued to support public and private

33

Table of Contents

borrowing arrangements. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loans to customers. The Company holds collateral supporting those commitments when deemed necessary by management. The liability, at June 30, 2017 and December 31, 2016, for guarantees under standby letters of credit issued was not material.

The Company currently maintains a reserve in other liabilities totaling \$829,000 and \$784,000 at June 30, 2017 and December 31, 2016 for off-balance sheet credit exposures that currently are not funded, based on historical loss experience of the related loan class. The following table presents the net amount expensed for the off-balance sheet credit exposures reserve for the three and six months ended June 30, 2017 and 2016.

	Three months ended June 30, 2017		Six months ended June 30, 2016	
(Dollars in thousands)	2017	2016	2017	2016

Off-balance sheet credit exposures expense \$140 \$252 \$45 \$299

The Company sells loans to the FHLB of Chicago as part of its MPF Program. Under the terms of the MPF Program, there is limited recourse back to the Company for loans that do not perform in accordance with the terms of the loan agreement. Each loan that is sold under the program is "credit enhanced" such that the individual loan's rating is raised to "AA," as determined by the FHLB of Chicago. The total outstanding balance of loans sold under the MPF Program was \$32,554,000 and \$35,678,000 at June 30, 2017 and December 31, 2016, with limited recourse back to the Company on these loans of \$1,029,000 at each period end. Many of the loans sold under the MPF Program have primary mortgage insurance, which reduces the Company's overall exposure. The net amount expensed (recovered) for the Company's estimate of losses under its recourse exposure for loans foreclosed, or in the process of foreclosure, is recorded in other expenses. The following table presents the net amounts recovered for the three and six months ended June 30, 2017 and 2016.

	Three months ended June 30, 2017		Six months ended June 30, 2016	
(Dollars in thousands)	2017	2016	2017	2016

MPF program recourse loss recoveries \$(35) \$(59) \$(26) \$(112)

NOTE 9. FAIR VALUE

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

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

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

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

observable or can be corroborated by observable market data.

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

In instances in which multiple levels of inputs are used to measure fair value, hierarchy classification is based on the lowest level input that is significant to the fair value measurement in its entirety. The Company's assessment of the significance

34

Table of Contents

of a particular input to the fair value measurement in its entirety requires judgment, and considers factors specific to the asset or liability.

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

Securities

Where quoted prices are available in an active market, securities are classified within Level 1 of the valuation hierarchy. Level 1 securities would include highly liquid government bonds, mortgage products and exchange traded equities. If quoted market prices are not available, securities are classified within Level 2 and fair values are estimated by using pricing models, quoted prices of securities with similar characteristics or discounted cash flow. Level 2 securities would include U.S. agency securities, mortgage-backed agency securities, obligations of states and political subdivisions and certain corporate, asset backed and other securities. In certain cases where there is limited activity or less transparency around inputs to the valuation, securities are classified within Level 3 of the valuation hierarchy. All of the Company's securities are classified as available for sale.

The Company had no fair value liabilities measured on a recurring basis at June 30, 2017 and December 31, 2016. The following table summarizes assets at June 30, 2017 and December 31, 2016, measured at fair value on a recurring basis.

(Dollars in Thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
June 30, 2017				
AFS Securities:				
U.S. Government Agencies	\$ 0	\$7,334	\$ 0	\$ 7,334
States and political subdivisions	0	163,431	0	163,431
GSE residential MBSs	0	104,776	0	104,776
GSE residential CMOs	0	112,321	0	112,321
GSE commercial CMOs	0	4,973	0	4,973
Private label CMOs	0	3,540	0	3,540
Asset-backed	0	5,418	0	5,418
Total debt securities	0	401,793	0	401,793
Equity securities	0	111	0	111
Total securities	\$ 0	\$401,904	\$ 0	\$ 401,904

December 31, 2016**AFS Securities:**

U.S. Government Agencies	\$ 0	\$39,592	\$ 0	\$ 39,592
States and political subdivisions	0	164,282	0	164,282
GSE residential MBSs	0	116,944	0	116,944
GSE residential CMOs	0	69,383	0	69,383
GSE commercial CMOs	0	4,856	0	4,856
Private label CMOs	0	5,006	0	5,006
Total debt securities	0	400,063	0	400,063
Equity securities	0	91	0	91
Total securities	\$ 0	\$400,154	\$ 0	\$ 400,154

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

Table of Contents

Impaired Loans

Loans are designated as impaired when, in the judgment of management and based on current information and events, it is probable that all amounts due, according to the contractual terms of the loan agreement, will not be collected. The measurement of loss associated with impaired loans for all loan classes can be based on either the observable market price of the loan, the fair value of the collateral, or discounted cash flows based on a market rate of interest for performing TDRs. For collateral-dependent loans, fair value is measured based on the value of the collateral securing the loan, less estimated costs to sell. Collateral may be in the form of real estate or business assets including equipment, inventory, and accounts receivable. The value of the real estate collateral is determined utilizing an income or market valuation approach based on an appraisal conducted by an independent, licensed appraiser outside of the Company using observable market data (Level 2). However, if the collateral is a house or building in the process of construction, or if management adjusts the appraisal value, then the fair value is considered Level 3. The value of business equipment is based upon an outside appraisal, if deemed significant, or the net book value on the applicable business' financial statements if not considered significant using observable market data. Likewise, values for inventory and accounts receivable collateral are based on financial statement balances or aging reports (Level 3). Impaired loans with an allocation to the ALL are measured at fair value on a nonrecurring basis. Any fair value adjustments are recorded in the period incurred as provision for loan losses on the consolidated statements of income. Specific allocations to the ALL or partial charge-offs totaled \$1,445,000 and \$1,967,000 at June 30, 2017 and December 31, 2016. The following table presents changes in the fair value for impaired loans still held at June 30, considered in the determination of the provision for loan losses, for the three and six months ended June 30, 2017 and 2016.

	Three months ended June 30, 2017	Six months ended June 30, 2016
(Dollars in thousands)		

Changes in fair value of impaired loans still held at June 30 \$4 \$183 \$2 \$162

Foreclosed Real Estate

OREO property acquired through foreclosure is initially recorded at the fair value of the property at the transfer date less estimated selling cost. Subsequently, OREO is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based upon an independent third-party appraisal of the property or occasionally upon a recent sales offer. Specific charges to value the real estate owned at the lower of cost or fair value on properties held at June 30, 2017 and December 31, 2016 totaled \$11,000 and \$43,000. The following table presents changes in the fair value of OREO for properties still held at June 30, charged to real estate expenses, for the three and six months ended June 30, 2017 and 2016.

	Three months ended June 30, 2017	Six months ended June 30, 2016
(Dollars in thousands)		

Changes in fair value of OREO still held at June 30 \$0 \$44 \$0 \$95

Table of Contents

The following table summarizes assets at June 30, 2017 and December 31, 2016, measured at fair value on a nonrecurring basis:

(Dollars in thousands)	Level 1	Level 2	Level 3	Total Fair Value Measurements
June 30, 2017				
Impaired Loans				
Commercial real estate:				
Owner-occupied	\$ 0	\$ 0	\$517	\$ 517
Multi-family	0	0	182	182
Non-owner occupied residential	0	0	378	378
Commercial and industrial	0	0	63	63
Residential mortgage:				
First lien	0	0	1,781	1,781
Home equity - lines of credit	0	0	154	154
Installment and other loans	0	0	5	5
Total impaired loans	\$ 0	\$ 0	\$3,080	\$ 3,080
Foreclosed real estate				
Residential	\$ 0	\$ 0	\$22	\$ 22
December 31, 2016				
Impaired Loans				
Commercial real estate:				
Owner-occupied	\$ 0	\$ 0	\$777	\$ 777
Non-owner occupied	0	0	736	736
Multi-family	0	0	199	199
Non-owner occupied residential	0	0	409	409
Acquisition and development:				
Commercial and land development	0	0	1	1
Commercial and industrial	0	0	66	66
Residential mortgage:				
First lien	0	0	1,994	1,994
Home equity - lines of credit	0	0	162	162
Installment and other loans	0	0	6	6
Total impaired loans	\$ 0	\$ 0	\$4,350	\$ 4,350
Foreclosed real estate				
Residential	\$ 0	\$ 0	\$88	\$ 88

Table of Contents

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

(Dollars in thousands)	Fair Value Estimate	Valuation Techniques	Unobservable Input	Range
June 30, 2017				
Impaired loans	\$ 3,080	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity - Management adjustments for liquidation expenses	10% - 75% discount 0% - 38% discount
Foreclosed real estate	22	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity - Management adjustments for liquidation expenses	17% discount 10% discount
December 31, 2016				
Impaired loans	\$ 4,350	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity - Management adjustments for liquidation expenses	10% - 75% discount 0% - 41% discount
Foreclosed real estate	88	Appraisal of collateral	Management adjustments on appraisals for property type and recent activity - Management adjustments for liquidation expenses	13% - 17% discount 10% - 18% discount

Fair values of financial instruments

In addition to those disclosed above, the Company used the following methods and significant assumptions to estimate fair value for the indicated instruments:

Cash and Due from Banks and Interest-Bearing Deposits with Banks

The carrying amounts of cash and due from banks and interest-bearing deposits with banks approximate fair value.

Loans Held for Sale

LHFS are carried at the lower of cost or fair value. These loans typically consist of one-to-four family residential loans originated for sale into the secondary market. Fair value is based on the price secondary markets are currently offering for similar loans using observable market data which is not materially different than cost due to the short duration between origination and sale.

Loans

For variable rate loans that reprice frequently and have no significant change in credit risk, fair value is based on carrying value. Fair value for fixed rate loans is estimated using discounted cash flow analyses, using interest rates currently being offered in the market for loans with similar terms to borrowers of similar credit quality.

Restricted Investment in Bank Stock

These investments are carried at cost. The Company is required to maintain minimum investment balances in these stocks, which are not actively traded and therefore have no readily determinable market value.

Deposits

The fair value disclosed for demand deposits is, by definition, equal to the amount payable on demand at the reporting date (that is, the carrying amount). The carrying amount of variable rate, fixed-term money market accounts and certificates of deposit approximates fair value at the reporting date. Fair value for fixed rate certificates of deposits and Individual Retirement Accounts are estimated using a discounted cash flow calculation that applies interest rates currently being offered in the market to a schedule of aggregated expected maturities on time deposits.

Short-Term Borrowings

The carrying amounts of federal funds purchased, borrowings under Repurchase Agreements, and other short-term borrowings maturing within 90 days approximate their fair values. Fair values of other short-term borrowings are estimated

Table of Contents

using discounted cash flow analysis based on the Company's current borrowing rates for similar types of borrowing arrangements.

Long-Term Debt

Fair value of the Company's fixed rate long-term borrowings is estimated using a discounted cash flow analysis based on the Company's current incremental borrowing rate for similar types of borrowing arrangements. The carrying amounts of variable rate long-term borrowings approximates fair value at the reporting date.

Accrued Interest

The carrying amounts of accrued interest receivable and payable approximate their fair values.

Off-Balance-Sheet Instruments

The Company generally does not charge commitment fees. Fees for standby letters of credit and other off-balance sheet instruments are not significant.

Table of Contents

The following table presents estimated fair values of the Company's financial instruments at June 30, 2017 and December 31, 2016:

(Dollars in thousands)	Carrying Amount	Fair Value	Level 1	Level 2	Level 3
June 30, 2017					
Financial Assets					
Cash and due from banks	\$ 19,754	\$ 19,754	\$19,754	\$ 0	\$ 0
Interest-bearing deposits with banks	18,258	18,258	18,258	0	0
Restricted investments in bank stocks	7,072	n/a	n/a	n/a	n/a
AFS securities	401,904	401,904	0	401,904	0
Loans held for sale	5,182	5,320	0	5,320	0
Loans, net of allowance for loan losses	921,631	922,642	0	0	922,642
Accrued interest receivable	4,467	4,467	0	2,501	1,966
Financial Liabilities					
Deposits	1,195,936	1,193,225	0	1,193,225	0
Short-term borrowings	90,562	90,562	0	90,562	0
Long-term debt	23,991	24,487	0	24,487	0
Accrued interest payable	448	448	0	448	0
Off-balance sheet instruments	0	0	0	0	0
December 31, 2016					
Financial Assets					
Cash and due from banks	\$ 16,072	\$ 16,072	\$16,072	\$ 0	\$ 0
Interest-bearing deposits with banks	14,201	14,201	14,201	0	0
Restricted investments in bank stocks	7,970	n/a	n/a	n/a	n/a
AFS securities	400,154	400,154	0	400,154	0
Loans held for sale	2,768	2,843	0	2,843	0
Loans, net of allowance for loan losses	870,616	870,470	0	0	870,470
Accrued interest receivable	4,672	4,672	0	2,643	2,029
Financial Liabilities					
Deposits	1,152,452	1,149,727	0	1,149,727	0
Short-term borrowings	87,864	87,864	0	87,864	0
Long-term debt	24,163	24,966	0	24,966	0
Accrued interest payable	437	437	0	437	0
Off-balance sheet instruments	0	0	0	0	0

NOTE 10. CONTINGENCIES

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

On May 25, 2012, SEPTA filed a putative class action complaint in the United States District Court for the Middle District of Pennsylvania against the Company, the Bank and certain current and former directors and executive officers (collectively, the "Defendants"). The complaint alleged, among other things, that (i) in connection with the Company's Registration Statement on Form S-3 dated February 23, 2010 and its Prospectus Supplement dated March 23, 2010, and (ii) during the purported class period of March 24, 2010 through October 27, 2011, the Company issued materially false and misleading statements regarding the Company's lending practices and financial results, including misleading statements concerning the stringent nature of the Bank's credit practices and underwriting standards, the quality of its loan portfolio, and

Table of Contents

the intended use of the proceeds from the Company's March 2010 public offering of common stock. The complaint asserted claims under Sections 11, 12(a) and 15 of the Securities Act, Sections 10(b) and 20(a) of the Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, and seeks class certification, unspecified money damages, interest, costs, fees and equitable or injunctive relief. Under the Private Securities Litigation Reform Act of 1995 ("PSLRA"), motions for appointment of Lead Plaintiff in this case were due by July 24, 2012. SEPTA was the sole movant and the Court appointed SEPTA Lead Plaintiff on August 20, 2012.

Pursuant to the PSLRA and the Court's September 27, 2012 Order, SEPTA was given until October 26, 2012 to file an amended complaint and the Defendants until December 7, 2012 to file a motion to dismiss the amended complaint. SEPTA's opposition to the Defendant's motion to dismiss was originally due January 11, 2013. Under the PSLRA, discovery and all other proceedings in the case were stayed pending the Court's ruling on the motion to dismiss. The September 27, 2012 Order specified that if the motion to dismiss were denied, the Court would schedule a conference to address discovery and the filing of a motion for class certification. On October 26, 2012, SEPTA filed an unopposed motion for enlargement of time to file its amended complaint in order to permit the parties and new defendants to be named in the amended complaint time to discuss plaintiff's claims and defendants' defenses. On October 26, 2012, the Court granted SEPTA's motion, mooted its September 27, 2012 scheduling Order, and requiring SEPTA to file its amended complaint on or before January 16, 2013 or otherwise advise the Court of circumstances that require a further enlargement of time. On January 14, 2013, the Court granted SEPTA's second unopposed motion for enlargement of time to file an amended complaint on or before March 22, 2013.

On March 4, 2013, SEPTA filed an amended complaint. The amended complaint expanded the list of defendants in the action to include the Company's independent registered public accounting firm and the underwriters of the Company's March 2010 public offering of common stock. In addition, among other things, the amended complaint extended the purported 1934 Exchange Act class period from March 15, 2010 through April 5, 2012. Pursuant to the Court's March 28, 2013 Second Scheduling Order, on May 28, 2013 all defendants filed their motions to dismiss the amended complaint, and on July 22, 2013 SEPTA filed its "omnibus" opposition to all of the defendants' motions to dismiss. On August 23, 2013, all defendants filed reply briefs in further support of their motions to dismiss. On December 5, 2013, the Court ordered oral argument on the Orrstown Defendants' motion to dismiss the amended complaint to be heard on February 7, 2014. Oral argument on the pending motions to dismiss SEPTA's amended complaint was held on April 29, 2014.

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

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

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

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

On February 25, 2016, the Court issued a scheduling Order directing: all defendants to file any motions to dismiss by March 18, 2016; SEPTA to file an omnibus opposition to defendants' motions to dismiss by April 8, 2016; and all defendants to file reply briefs in support of their motions to dismiss by April 22, 2016. Defendants timely filed their motions to dismiss the second amended complaint and the parties filed their briefs in accordance with the

Court-ordered schedule, above. The February 25, 2016 Order stayed all discovery and other deadlines in the case (including the filing of SEPTA's motion for class certification) pending the outcome of the motions to dismiss. The allegations of SEPTA's proposed second amended complaint disclosed the existence of a confidential, non-public, fact-finding inquiry regarding the Company being conducted by the SEC. As disclosed in the Company's Form 8-K filed on September 27, 2016, on that date the Company entered into a settlement agreement with the SEC resolving the investigation of accounting and related matters at the Company for the periods ended June 30, 2010, to December 31, 2011. As part of the

Table of Contents

settlement of the SEC's administrative proceedings and pursuant to the cease-and-desist order, without admitting or denying the SEC's findings, the Company, its Chief Executive Officer, its former Chief Financial Officer, its former Executive Vice President and Chief Credit Officer, and its Chief Accounting Officer, agreed to pay civil money penalties to the SEC. The Company agreed to pay a civil money penalty of \$1,000,000. The Company had previously established a reserve for that amount which was expensed in the second fiscal quarter of 2016. In the settlement agreement with the SEC, the Company also agreed to cease and desist from committing or causing any violations and any future violations of Securities Act Sections 17(a)(2) and 17(a)(3) and Exchange Act Sections 13(a), 13(b)(2)(A) and 13(b)(2)(B), and Rules 12b-20, 13a-1 and 13a-13 promulgated thereunder.

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

On December 7, 2016, the Court issued an Order and Memorandum granting in part and denying in part defendants' motions to dismiss SEPTA's second amended complaint. The Court granted the motions to dismiss the Securities Act claims against all defendants, and granted the motions to dismiss the Exchange Act section 10(b) and Rule 10b-5 claims against all defendants except Orrstown Financial Services, Inc., Orrstown Bank, Thomas R. Quinn, Jr., Bradley S. Everly, and Jeffrey W. Embly. The Court also denied the motions to dismiss the Exchange Act section 20(a) claims against Quinn, Everly, and Embly.

On January 31, 2017, the Court entered a Case Management Order establishing the schedule for the litigation. The Case Management Order, among other things, set the following deadlines: all fact discovery closes on November 3, 2017, and SEPTA's motion for class certification is due the same day; expert merits discovery closes March 30, 2018; summary judgment motions are due by April 27, 2018; the mandatory pretrial and settlement conference is set for September 11, 2018; and trial is scheduled for the month of October 2018. Document discovery has begun in the case and is ongoing.

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

Table of Contents

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

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

Overview

The Company, headquartered in Shippensburg, Pennsylvania, is a one-bank holding company that has elected status as a financial holding company. The consolidated financial information presented herein reflects the Company and its wholly-owned subsidiaries, the Bank and Wheatland. At June 30, 2017, the Company had total assets of \$1,474,930,000, total liabilities of \$1,331,667,000 and total shareholders' equity of \$143,263,000.

Caution About Forward-Looking Statements

Certain statements appearing herein which are not historical in nature are forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. In addition, we may make other written and oral communications, from time to time, that contain such statements. Such forward-looking statements refer to a future period or periods, reflecting our current beliefs as to likely future developments, and use words like "may," "will," "expect," "estimate," "anticipate" or similar terms. Forward-looking statements are statements that include projections, predictions, expectations, or beliefs about events or results or otherwise are not statements of historical facts, including, but not limited to, statements related to new business development, new loan opportunities, growth in the balance sheet and fee based revenue lines of business, reducing risk assets, and mitigating losses in the future. Actual results and trends could differ materially from those set forth in such statements and there can be no assurances that we will achieve the desired level of new business development and new loans, growth in the balance sheet and fee based revenue lines of business, continue to reduce risk assets or mitigate losses in the future. Factors that could cause actual results to differ from those expressed or implied by the forward-looking statements include, but are not limited to, the following: ineffectiveness of the Company's business strategy due to changes in current or future market conditions; the effects of competition, including industry consolidation and development of competing financial products and services; changes in laws and regulations; interest rate movements; changes in credit quality; inability to raise capital under favorable conditions, volatilities in the securities markets; deteriorating economic conditions; and other risks and uncertainties, including those detailed in our Annual Report on Form 10-K for the year ended December 31, 2016, and our Quarterly Report on Form 10-Q for the quarter ended March 31, 2017, under the sections titled "Risk Factors" and "Management's Discussion and Analysis of Financial Condition and Results of Operations" and in other filings made with the SEC. The statements are valid only as of the date hereof and we disclaims any obligation to update this information. The following is a discussion of our consolidated financial condition at June 30, 2017 and results of operations for the three and six months ended June 30, 2017 and 2016. Throughout this discussion, the yield on earning assets is stated on a fully taxable-equivalent basis and balances represent average daily balances unless otherwise stated. The discussion and analysis should be read in conjunction with our Consolidated Financial Statements (Unaudited) and Notes thereto presented elsewhere in this report. Certain prior period amounts, presented in this discussion and analysis, have been reclassified to conform to current period classifications.

Critical Accounting Policies

The Company's accounting and reporting policies are in accordance with GAAP and follow accounting and reporting guidelines prescribed by bank regulatory authorities and general practices within the financial services industry in which it operates. Our financial position and results of operations are affected by management's application of accounting policies, including estimates, and assumptions and judgments that affect the amounts reported in the consolidated financial statements and accompanying notes. These estimates, assumptions, and judgments are based on information available as of the balance sheet date and through the date the financial statements are filed with the SEC. Different assumptions in the application of these policies could result in material changes in the consolidated financial position and/or consolidated results of operations and related disclosures. The more critical accounting and reporting policies include accounting for the ALL and income taxes. Accordingly, the critical accounting policies are discussed in detail in "Management's Discussion and Analysis of Financial Condition and Results of Operations" in our Annual Report on Form 10-K for the year ended December 31, 2016. Significant accounting policies and changes in accounting principles and effects of new accounting pronouncements are discussed in detail in Note 1, Summary of Significant Accounting Policies, to the Consolidated Financial Statements under Part II, Item 8, "Financial Statements

and Supplementary Data," in our Annual Report on Form 10-K for the year ended December 31, 2016. Additional disclosures regarding the effects of new accounting pronouncements are included in Note 1, Summary of Significant Accounting Policies, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information." There have been no other changes to the significant accounting policies during 2017.

Table of Contents

RESULTS OF OPERATIONS

QUARTER ENDED JUNE 30, 2017 COMPARED WITH QUARTER ENDED JUNE 30, 2016

Summary

The Company recorded net income of \$3,308,000 for the three months ended June 30, 2017 compared with net income of \$678,000 for the same period in 2016. Diluted EPS for the three months ended June 30, 2017 totaled \$0.40, compared with \$0.08 for the three months ended June 30, 2016. Net interest income positively influenced results of operations, and totaled \$10,718,000 for the three months ended June 30, 2017, a 19.7% increase compared with 2016. Noninterest income, excluding investment securities gains, increased 9.5% from the second quarter of 2016 to the second quarter of 2017, driven principally by increased trust and investment management income. Investment securities gains totaled \$654,000 in the three months ended June 30, 2017, compared with \$0 for the same period in 2016. Noninterest expenses totaled \$12,417,000 and \$12,558,000 for the three months ended June 30, 2017 and 2016. Noninterest expenses in 2017 included increased expenses associated with the Company's ongoing growth strategy in comparison with 2016, while the second quarter of 2016 included a \$1,000,000 expense for a regulatory settlement reserve.

Net Interest Income

Net interest income increased \$1,767,000, from \$8,951,000 for the three months ended June 30, 2016 to \$10,718,000 for the three months ended June 30, 2017. Interest income on loans increased \$1,467,000 from \$8,384,000 to \$9,851,000 and securities interest income increased \$762,000 from \$1,809,000 to \$2,571,000 in comparing the three months ended June 30, 2016 with the same period in 2017.

The following table presents net interest income, net interest spread and net interest margin for the three months ended June 30, 2017 and 2016 on a taxable-equivalent basis:

(Dollars in thousands)	Three Months Ended June 30, 2017			Three Months Ended June 30, 2016		
	Average Balance	Taxable- Equivalent Interest	Taxable- Equivalent Rate	Average Balance	Taxable- Equivalent Interest	Taxable- Equivalent Rate
Assets						
Federal funds sold & interest bearing bank balances	\$12,380	\$46	1.49 %	\$50,491	\$79	0.63 %
Securities	416,823	2,986	2.87	330,973	2,046	2.49
Loans	928,739	10,065	4.35	824,004	8,652	4.22
Total interest-earning assets	1,357,942	13,097	3.87	1,205,468	10,777	3.60
Other assets	109,793			98,376		
Total	\$1,467,735			\$1,303,844		
Liabilities and Shareholders' Equity						
Interest-bearing demand deposits	\$641,111	474	0.30	\$542,075	282	0.21
Savings deposits	96,261	38	0.16	91,341	36	0.16
Time deposits	303,473	972	1.28	300,244	873	1.17
Short-term borrowings	99,983	189	0.76	47,810	25	0.21
Long-term debt	10,634	77	2.90	24,378	105	1.73
Total interest-bearing liabilities	1,151,462	1,750	0.61	1,005,848	1,321	0.53
Noninterest-bearing demand deposits	161,236			146,233		
Other	15,205			13,364		
Total Liabilities	1,327,903			1,165,445		
Shareholders' Equity	139,832			138,399		
Total	\$1,467,735			\$1,303,844		
Taxable-equivalent net interest income / net interest spread		11,347	3.26 %		9,456	3.07 %
Taxable-equivalent net interest margin			3.35 %			3.15 %

Edgar Filing: ORRSTOWN FINANCIAL SERVICES INC - Form 10-Q

Taxable-equivalent adjustment	(629)	(505)
Net interest income	\$ 10,718	\$ 8,951

44

Table of Contents

NOTES: (1) Yields and interest income on tax-exempt assets have been computed on a fully taxable equivalent basis assuming a 34% tax rate in 2017 and a 35% tax rate in 2016.

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

Net interest income, the difference between interest income and fees on interest-earning assets and interest expense on interest-bearing liabilities, is the primary component of the Company's revenue. Interest-earning assets include loans and AFS securities and federal funds sold. Interest-bearing liabilities include deposits and borrowed funds. To compare tax-exempt yields to taxable yields, amounts were adjusted to pretax equivalents based on a 34% federal corporate tax rate for 2017, and 35% in 2016, reflective of the change in the Company's estimated incremental tax rate during 2016.

Net interest income is affected by changes in interest rates, volumes of interest-earning assets and interest-bearing liabilities and the composition of those assets and liabilities. Net interest spread and net interest margin are two common statistics related to changes in net interest income. Net interest spread represents the difference between the yields earned on interest-earning assets and the rates paid for interest-bearing liabilities. Net interest margin is the ratio of net interest income to average earning assets. Through the use of noninterest-bearing demand deposits and shareholders' equity, the net interest margin exceeds the net interest spread, as these funding sources are noninterest-bearing.

For the three months ended June 30, 2017, taxable-equivalent net interest income increased \$1,891,000 to \$11,347,000 from \$9,456,000 in the corresponding period in 2016. The principal drivers of the increase were an increase in the average balance of loans and securities and average rates earned on them, partially offset by a higher average balance of interest-bearing liabilities and an 8 basis point increase in the average rate paid on such interest-bearing liabilities.

Taxable-equivalent interest income earned on loans increased \$1,413,000 from \$8,652,000 for the three months ended June 30, 2016 to \$10,065,000 for the same period in 2017. The increase resulted from growth in the average loan balance from \$824,004,000 for the three months ended June 30, 2016 to \$928,739,000 for the same period in 2017, coupled with a 13 basis point increase in the yield on loans to 4.35% for the three months ended June 30, 2017. An increased rate environment in 2017, due to 25 basis point increases in the prime lending rate late in 2016, in March 2017 and again in late June 2017, contributed to the increase in yield.

Taxable-equivalent securities interest income increased \$940,000 to \$2,986,000 for the three months ended June 30, 2017, from \$2,046,000 for the same period in 2016. The average balance of securities increased from \$330,973,000 for the three months ended June 30, 2016 to \$416,823,000 for the same period in 2017. The increase in taxable-equivalent interest income on securities was also attributable to a higher composition of tax-free securities with higher taxable-equivalent yields, as well as increases in GSE residential CMOs, also with higher yields, and resulted in an after-tax yield earned on securities of 2.87% in 2017 compared with 2.49% for the same period in 2016. Interest expense on deposits and borrowings for the three months ended June 30, 2017 totaled \$1,750,000, an increase of \$429,000, from \$1,321,000 in the same period in 2016. The Company has been able to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings as it increases its commercial relationships. The Company's cost of funds on interest-bearing liabilities increased to 0.61% for the three months ended June 30, 2017 from 0.53% for the same period in 2016, reflecting the increased rate environment in 2017. The cost of funds for deposits has increased at a slower pace than the yields earned on interest-earning assets as the market has been slow to respond to interest rate changes for deposits.

Provision for Loan Losses

The Company recorded a \$100,000 provision for loan losses for the three months ended June 30, 2017. No provision was recorded for the same period in 2016. In calculating the required provision for loan losses, both quantitative and qualitative factors were considered in the determination of the adequacy of the ALL. Net charge-offs and loan growth resulted in the determination that a provision was required. However, favorable historical charge-off data, combined with stable economic and market conditions, moderated the amount of provision needed.

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

Table of Contents

Noninterest Income

The following table compares noninterest income for the three months ended June 30, 2017 and 2016.

(Dollars in thousands)	Three Months Ended June 30,		\$ Change 2017-2016	% Change 2017-2016
	2017	2016		
Service charges on deposit accounts	\$1,429	\$1,372	\$ 57	4.2 %
Other service charges, commissions and fees	283	289	(6)	(2.1)%
Trust and investment management income	1,623	1,188	435	36.6 %
Brokerage income	518	577	(59)	(10.2)%
Mortgage banking activities	813	727	86	11.8 %
Earnings on life insurance	271	270	1	0.4 %
Other income	32	114	(82)	(71.9)%
Subtotal before securities gains	4,969	4,537	432	9.5 %
Investment securities gains	654	0	654	0.0 %
Total noninterest income	\$5,623	\$4,537	\$ 1,086	23.9 %

The following factors contributed to the more significant changes in noninterest income between the quarters ended June 30, 2017 and 2016.

Increased service charges income has resulted from new product offerings and increased activity associated with deposit growth.

Approximately 30% of the increase in trust and investment management income is attributable to income generated by Wheatland, which was acquired in December 2016. Trust department fees principally account for the remaining increase as additional revenues have been realized from favorable market conditions and the addition of an office in Berks County, Pennsylvania.

Mortgage banking income increased in the second quarter comparison of 2017 with 2016 after decreasing \$53,000 in the first quarter comparison. This reflects some seasonality in mortgage production normally experienced in the second quarter over the first quarter. Refinance activity generally decreases as interest rates increase. Other factors that influenced the change in mortgage banking income include some slight compression in margins in the second quarter of 2017, as well as the portion of mortgage production retained for the Company's loan portfolio.

Other line items within noninterest income showed fluctuations between 2017 and 2016 attributable to normal business operations.

Securities gains totaled \$654,000 for the three months ended June 30, 2017 compared with \$0 for the same period in 2016. Asset/liability management strategies resulted in net gains on sales of securities, as market and interest rate conditions in the quarter presented opportunities to accelerate earnings on securities, while meeting funding and/or other requirements of the Company.

Table of Contents

Noninterest Expenses

The following table compares noninterest expenses for the three months ended June 30, 2017 and 2016.

(Dollars in thousands)	Three Months		\$ Change	% Change	
	Ended June 30,				
	2017	2016	2017-2016	2017-2016	
Salaries and employee benefits	\$7,422	\$6,312	\$ 1,110	17.6	%
Occupancy expense	705	592	113	19.1	%
Furniture and equipment	826	748	78	10.4	%
Data processing	664	519	145	27.9	%
Telephone and communication	193	190	3	1.6	%
Automated teller machine and interchange fees	194	237	(43)	(18.1)	%
Advertising and bank promotions	391	355	36	10.1	%
FDIC insurance	178	223	(45)	(20.2)	%
Legal fees	108	225	(117)	(52.0)	%
Other professional services	377	345	32	9.3	%
Directors compensation	249	257	(8)	(3.1)	%
Collection and problem loan	3	96	(93)	(96.9)	%
Real estate owned	(12)	58	(70)	(120.7)	%
Taxes other than income	220	253	(33)	(13.0)	%
Regulatory settlement	0	1,000	(1,000)	(100.0)	%
Other operating expenses	899	1,148	(249)	(21.7)	%
Total noninterest expenses	\$12,417	\$12,558	\$ (141)	(1.1)	%

The following factors contributed to the more significant changes in noninterest expenses between the quarters ended June 30, 2017 and 2016.

The salaries and employee benefits increase includes the impact in 2017 of additional employees, including new customer-facing employees in targeted expansion markets, throughout 2016 and 2017. Higher costs in 2017 also include annual merit increases awarded in 2017, increased medical benefit costs for the expanded workforce and increased claim activity, incentive compensation increases and additional share-based awards granted in 2017.

Occupancy, furniture and equipment expenses reflect a full period of expense for new facilities acquired in 2016 in Berks, Cumberland, Dauphin and Lancaster counties, Pennsylvania, as well as a new branch opened in Lancaster county in 2017.

Data processing expense in 2017 includes additional costs incurred for periodic processing updates and increased activity from higher volumes.

The FDIC reached its 1.15% of insured funds target in June 2016 and lower assessments have resulted. Our FDIC insurance expense in 2017 benefited from that lower assessment applied to our increased deposit base.

In the second quarter of 2016, a reserve of \$1,000,000 was established for a matter which was resolved in the third quarter of 2016 with the Company's agreement to pay a civil money penalty in that amount to the Securities and Exchange Commission to settle administrative proceedings. Resolution of that matter in 2016 resulted in lower legal fees incurred in 2017.

The decrease in other operating expenses is principally attributable to a decrease in 2017 in reduced new hire fees to employment agencies; reduced consumer fraud expenses ("Reg E"); and provision expense for off-balance sheet reserves on loans that have been committed to borrowers, but not funded, resulting from changes in qualitative factors similar to those used in the determination of the provision for loan losses.

Other line items within noninterest expenses showed fluctuations between 2017 and 2016 attributable to normal business operations.

The Company's efficiency ratio improved to 76.0% for the three months ended June 30, 2017, compared with 82.3% for the same period in 2016. The lower, or more favorable, ratio between the two periods was primarily the result of the growth in

Table of Contents

net interest and noninterest income which outpaced the change in noninterest expenses. The efficiency ratio expresses noninterest expense as a percentage of taxable-equivalent net interest income and noninterest income, excluding securities gains, intangible asset amortization, other real estate income and expenses and the regulatory settlement expense which was recorded in 2016.

Income Tax Expense

Income tax expense totaled \$516,000, an effective tax rate of 13.5%, for the three months ended June 30, 2017, compared with \$252,000, an effective tax rate of 27.1%, for the three months ended June 30, 2016. The Company's effective tax rate is significantly less than the federal statutory rate of 34.0% principally due to tax-free income; including interest earned on tax-free loans and securities and earnings on the cash surrender value of life insurance policies; federal income tax credits; and non-tax deductible expenses. The lower effective tax rate for the three months ended June 30, 2017, compared with the same period in 2016, is the result of a larger percentage of tax-free income and additional federal income tax credits in the current year's results, coupled with a larger percentage of non-tax deductible expenses in 2016. In addition, the estimated annual effective tax rate in the quarter ended June 30, 2016 was based on a federal statutory rate of 35%. In the third quarter of 2016, the Company reassessed its estimated annual effective tax rate and changed the base federal statutory rate to 34% in expectation that the Company would not be in the higher tax bracket.

SIX MONTHS ENDED JUNE 30, 2017 COMPARED WITH SIX MONTHS ENDED JUNE 30, 2016

Summary

The Company recorded net income of \$5,310,000 for the six months ended June 30, 2017 compared with net income of \$3,258,000 for the same period in 2016. Diluted EPS for the six months ended June 30, 2017 totaled \$0.65, compared with \$0.40 for the six months ended June 30, 2016. Net interest income positively influenced results of operations, and totaled \$20,955,000 for the six months ended June 30, 2017, a 19.1% increase compared with 2016. Noninterest income, excluding investment securities gains, increased 5.9%, due principally to increased trust and management income. Investment securities gains totaled \$657,000 in the six months ended June 30, 2017, compared with \$1,420,000 for the same period in 2016. Noninterest expenses totaled \$24,563,000 and \$23,679,000 for the six months ended June 30, 2017 and 2016. The principal driver of the increase was salaries and employee benefits associated with the Company's ongoing growth strategy. Noninterest expenses in 2016 included a \$1,000,000 expense for a regulatory settlement reserve.

Table of Contents

Net Interest Income

Net interest income increased \$3,354,000, from \$17,601,000 for the three months ended June 30, 2016 to \$20,955,000 for the three months ended June 30, 2017. Interest income on loans increased \$2,680,000 from \$16,375,000 to \$19,055,000 and securities interest income increased \$1,465,000 from \$3,714,000 to \$5,179,000 in comparing the six months ended June 30, 2016 with the same period in 2017.

The following table presents net interest income, net interest spread and net interest margin for the six months ended June 30, 2017 and 2016 on a taxable-equivalent basis:

(Dollars in thousands)	Six Months Ended June 30, 2017			Six Months Ended June 30, 2016		
	Average Balance	Taxable-Equivalent Interest	Taxable-Equivalent Rate	Average Balance	Taxable-Equivalent Interest	Taxable-Equivalent Rate
Assets						
Federal funds sold & interest-bearing bank balances	\$8,981	\$64	1.44 %	\$46,867	\$144	0.62 %
Securities	416,087	5,996	2.91	347,294	4,189	2.43
Loans	912,127	19,487	4.31	809,894	16,914	4.20
Total interest-earning assets	1,337,195	25,547	3.85	1,204,055	21,247	3.55
Other assets	108,696			96,334		
Total	\$1,445,891			\$1,300,389		
Liabilities and Shareholders' Equity						
Interest-bearing demand deposits	\$625,170	837	0.27	\$531,757	532	0.20
Savings deposits	94,795	74	0.16	89,522	71	0.16
Time deposits	300,117	1,899	1.28	302,523	1,727	1.15
Short-term borrowings	102,303	361	0.71	62,076	91	0.29
Long-term debt	16,017	172	2.17	24,419	211	1.74
Total interest-bearing liabilities	1,138,402	3,343	0.59	1,010,297	2,632	0.52
Noninterest-bearing demand deposits	154,904			139,723		
Other	14,900			13,286		
Total Liabilities	1,308,206			1,163,306		
Shareholders' Equity	137,685			137,083		
Total	\$1,445,891			\$1,300,389		
Taxable-equivalent net interest income /net interest spread		22,204	3.26 %		18,615	3.03 %
Taxable-equivalent net interest margin			3.35 %			3.11 %
Taxable-equivalent adjustment		(1,249)			(1,014)	
Net interest income		\$20,955			\$17,601	

NOTES: (1) Yields and interest income on tax-exempt assets have been computed on a fully taxable equivalent basis assuming a 34% tax rate in 2017 and a 35% tax rate in 2016.

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

For the six months ended June 30, 2017, taxable-equivalent basis net interest income increased \$3,589,000 to \$22,204,000 from \$18,615,000 in the corresponding period in 2016. Similar to the comparison of the second quarter of 2017 with the second quarter of 2016, the principal drivers of the increase were an increase in the average balance of loans and securities and average rates earned on them, partially offset by a higher average balance of interest-bearing liabilities and a 7 basis point increase in the average rate paid on such interest-bearing liabilities. Taxable-equivalent interest income earned on loans increased \$2,573,000 from \$16,914,000 for the six months ended June 30, 2016 to \$19,487,000 for the same period in 2017. The increase resulted from growth in the average loan balance from \$809,894,000 for the six months ended June 30, 2016 to \$912,127,000 for the same period in 2017,

coupled with an 11 basis

49

Table of Contents

point increase in the yield on loans to 4.31% for the six months ended June 30, 2017. As noted previously, the prime lending rate increased in late 2016, in March 2017 and in late June 2017 and contributed to the increased yield. Taxable-equivalent securities interest income increased \$1,807,000 to \$5,996,000 for the six months ended June 30, 2017, from \$4,189,000 for the same period in 2016. The average balance of securities increased from \$347,294,000 for the six months ended June 30, 2016 to \$416,087,000 for the same period in 2017. The increase in taxable-equivalent interest income on securities was also attributable to a higher composition of tax-free securities with higher taxable-equivalent yields, as well as increases in GSE residential CMOs, also with higher yields, and resulted in an after-tax yield earned on securities of 2.91% in 2017 compared with 2.43% for the same period in 2016. Interest expense on deposits and borrowings for the six months ended June 30, 2017 totaled \$3,343,000, an increase of \$711,000, from \$2,632,000 in the same period in 2016. In comparing 2017 with 2016, the Company has been able to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings as it increases its commercial relationships. The Company's cost of funds on interest-bearing liabilities increased to 0.59% for the six months ended June 30, 2017 from 0.52% for the same period in 2016, reflecting the increased rate environment in 2017. The cost of funds for deposits has increased at a slower pace than the yields earned on interest-earning assets as the market has been slower to respond to interest rate changes for deposits.

Provision for Loan Losses

The Company recorded a \$100,000 provision for loan losses for the six months ended June 30, 2017. No provision was recorded for the same period in 2016. In calculating the required provision for loan losses, both quantitative and qualitative factors were considered in the determination of the adequacy of the ALL. Net charge-offs and loan growth resulted in the determination that a provision was required. However, favorable historical charge-off data, combined with stable economic and market conditions, moderated the amount of provision needed.

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

Noninterest Income

The following table compares noninterest income for the six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Six Months		\$ Change	%	
	Ended June 30, 2017	2016		2017-2016	2017-2016
Service charges on deposit accounts	\$2,787	\$2,675	\$ 112	4.2	%
Other service charges, commissions and fees	492	449	43	9.6	%
Trust and investment management income	3,069	2,524	545	21.6	%
Brokerage income	985	1,026	(41)	(4.0)	%
Mortgage banking activities	1,316	1,369	(53)	(3.9)	%
Earnings on life insurance	539	538	1	0.2	%
Other income	113	201	(88)	(43.8)	%
Subtotal before securities gains	9,301	8,782	519	5.9	%
Investment securities gains	657	1,420	(763)	(53.7)	%
Total noninterest income	\$9,958	\$10,202	\$ (244)	(2.4)	%

The following factors contributed to the more significant changes in noninterest income between the six months ended June 30, 2017 and 2016. The factors noted are consistent with those noted in comparing changes between the three months ended June 30, 2017 and 2016.

Increased service charges on deposit accounts income has resulted from new product offerings and increased activity associated with deposit growth.

Approximately half of the increase in trust and investment management income is attributable to income generated by Wheatland, which was acquired in December 2016. Trust department fees principally account for the remaining increase as additional revenues have been realized from favorable market conditions and the addition of an office in Berks County, Pennsylvania.

Table of Contents

The decrease in mortgage banking activities reflects a combination of overall decreased refinance activity as interest rates have increased, some slight compression in margins the Company has experienced in the second quarter of 2017 and the portion of mortgage production retained for the Company's loan portfolio.

Other line items within noninterest income showed fluctuations between 2017 and 2016 attributable to normal business operations.

Securities gains totaled \$657,000 for the six months ended June 30, 2017 compared with \$1,420,000 for the same period in 2016. Asset/liability management strategies resulted in net gains on sales of securities, as market and interest rate conditions in the periods presented opportunities to accelerate earnings on securities, while meeting funding and/or other requirements of the Company.

Noninterest Expenses

The following table compares noninterest expenses for the six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Six Months Ended June 30,		\$ Change	% Change	
	2017	2016	2017-2016	2017-2016	
Salaries and employee benefits	\$14,822	\$12,495	\$ 2,327	18.6	%
Occupancy expense	1,462	1,118	344	30.8	%
Furniture and equipment	1,562	1,534	28	1.8	%
Data processing	1,175	1,154	21	1.8	%
Telephone and communication	315	366	(51)	(13.9)	%
Automated teller machine and interchange fees	372	398	(26)	(6.5)	%
Advertising and bank promotions	778	811	(33)	(4.1)	%
FDIC insurance	315	455	(140)	(30.8)	%
Legal fees	261	406	(145)	(35.7)	%
Other professional services	732	684	48	7.0	%
Directors' compensation	491	488	3	0.6	%
Collection and problem loan	78	148	(70)	(47.3)	%
Real estate owned	8	101	(93)	(92.1)	%
Taxes other than income	448	408	40	9.8	%
Regulatory settlement	0	1,000	(1,000)	(100.0)	%
Other operating expenses	1,744	2,113	(369)	(17.5)	%
Total noninterest expenses	\$24,563	\$23,679	\$ 884	3.7	%

The following factors contributed to the more significant changes in noninterest expenses between the six months ended June 30, 2017 and 2016. The factors noted are consistent with those noted in comparing changes between the three months ended June 30, 2017 and 2016.

The salaries and employee benefits increase includes the impact in 2017 of additional employees, including new customer-facing employees in targeted expansion markets, throughout 2016 and 2017. Higher costs in 2017 also include annual merit increases awarded in 2017, increased medical benefit costs for the expanded workforce and increased claim activity, incentive compensation increases and additional share-based awards granted in 2017.

Occupancy expense reflect a full period of expense for new facilities acquired in 2016 in Berks, Cumberland, Dauphin and Lancaster counties, Pennsylvania.

The FDIC reached its 1.15% of insured funds target in June 2016 and lower assessments have resulted. Our FDIC insurance expense in 2017 benefited from that lower assessment applied to our increased deposit base.

In the second quarter of 2016, a reserve of \$1,000,000 was established for a matter which was resolved in the third quarter of 2016 with the Company's agreement to pay a civil money penalty in that amount to the Securities and Exchange Commission to settle administrative proceedings. Resolution of that matter in 2016 resulted in lower legal fees incurred in 2017.

Table of Contents

The decrease in other operating expenses is principally attributable to a decrease in 2017 in reduced new hire fees to employment agencies; reduced consumer fraud expenses ("Reg E"); and provision expense for off-balance sheet reserves on loans that have been committed to borrowers, but not funded, resulting from changes in qualitative factors similar to those used in the determination of the provision for loan losses.

Other line items within noninterest expenses showed fluctuations between 2017 and 2016 attributable to normal business operations.

The Company's efficiency ratio improved to 77.8% for the six months ended June 30, 2017, compared with 82.5% for the same period in 2016. The lower, or more favorable, ratio between the two periods was primarily the result of the growth in net interest and noninterest income which outpaced the change in noninterest expenses. The efficiency ratio expresses noninterest expense as a percentage of taxable-equivalent net interest income and noninterest income, excluding securities gains, intangible asset amortization, other real estate income and expenses and the regulatory settlement expense which was recorded in 2016.

Income Tax Expense

Income tax expense totaled \$940,000, an effective tax rate of 15.0%, for the six months ended June 30, 2017, compared with \$866,000, an effective tax rate of 21.0%, for the six months ended June 30, 2016. The Company's effective tax rate is significantly less than the federal statutory rate of 34.0% principally due to tax-free income; including interest earned on tax-free loans and securities and earnings on the cash surrender value of life insurance policies; federal income tax credits; and non-tax deductible expenses. The lower effective tax rate for the six months ended June 30, 2017, compared with the same period in 2016, is the result of a larger percentage of tax-free income and additional federal income tax credits in the current year's results, coupled with a larger percentage of non-tax deductible expenses in 2016. In addition, the estimated annual effective tax rate in the first half of 2016 was based on a federal statutory rate of 35%. In the third quarter of 2016, the Company reassessed its estimated annual effective tax rate and changed the base federal statutory rate to 34% in expectation that the Company would not be in the higher tax bracket.

FINANCIAL CONDITION

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

AFS Securities

The Company utilizes AFS securities as a tool for managing interest rate risk, to enhance income through interest and dividend income, to provide liquidity, and to provide collateral for certain deposits and borrowings. At June 30, 2017, AFS securities totaled \$401,904,000, an increase of \$1,750,000, from December 31, 2016's balance of \$400,154,000. In the quarter ended June 30, 2017, the Company sold state and political subdivision investments at a gain of \$654,000. Sale proceeds totaled \$23,581,000 and were principally used to fund loan demand. In the first quarter of 2017, the Company sold a substantial portion of its U.S. Government Agency investments at a net loss of \$70,000, which was offset by gains on other investment sales during the quarter. The Company sold these securities because it expected the interest rate yield curve to continue to flatten and did not believe that these U.S. Government Agency investments would perform as well in that environment. Proceeds from sales during the first quarter totaled \$35,072,000, which were redeployed in higher-yielding investment securities.

Loan Portfolio

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

The risks associated with lending activities differ among the various loan classes, and are subject to the impact of changes in interest rates, market conditions of collateral securing the loans, and general economic conditions. All of these factors may adversely impact the borrower's ability to repay its loans, and impact the associated collateral. See Note 3, Loans Receivable and Allowance for Loan Losses, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information," for a description of the Company's loan classes and differing levels of credit risk associated

with each class.

52

Table of Contents

The following table presents the loan portfolio, excluding residential LHFS, broken out by classes as of June 30, 2017 and December 31, 2016.

(Dollars in thousands)	June 30, 2017	December 31, 2016
Commercial real estate:		
Owner-occupied	\$ 116,419	\$ 112,295
Non-owner occupied	217,070	206,358
Multi-family	48,637	47,681
Non-owner occupied residential	68,621	62,533
Acquisition and development:		
1-4 family residential construction	8,036	4,663
Commercial and land development	28,481	26,085
Commercial and industrial	97,913	88,465
Municipal	51,381	53,741
Residential mortgage:		
First lien	150,173	139,851
Home equity - term	13,019	14,248
Home equity - lines of credit	127,262	120,353
Installment and other loans	7,370	7,118
	\$934,382	\$ 883,391

The loan portfolio at June 30, 2017 reflected an increase of \$50,991,000, or 5.8% (11.6% annualized), from December 31, 2016. Growth has been experienced in nearly all loan segments, with the largest dollar increases in the commercial real estate segment, which grew by \$21,880,000, or 5.1% (10.3% annualized), representing 42.9% of portfolio growth in the period. The residential mortgage segment also showed substantial growth of \$16,002,000, or 5.8% (11.8% annualized), in the first half of 2017. The Company continues to grow in both core markets and new markets through expansion of its sales force and by capitalizing on market disruption caused by the acquisition of some of our competitors by larger institutions.

Asset Quality

Risk Elements

The Company's loan portfolio is subject to varying degrees of credit risk. We mitigate credit risk through our underwriting standards, on-going credit review, and monitoring of asset quality measures. Additionally, loan portfolio diversification, limiting exposure to a single industry or borrower, and requiring collateral also mitigate our risk of credit loss.

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

Nonperforming assets include nonaccrual loans and foreclosed real estate. In addition, restructured loans still accruing and loans past due 90 days or more and still accruing are also deemed to be risk assets. For all loan classes, generally the accrual of interest income ceases when principal or interest is past due 90 days or more and collateral is inadequate to cover principal and interest or immediately if, in the opinion of management, full collection is unlikely. Interest will continue to accrue on loans past due 90 days or more if the collateral is adequate to cover principal and interest, and the loan is in the process of collection. Interest accrued, but not collected, as of the date of placement on nonaccrual status, is generally reversed and charged against interest income, unless fully collateralized. Subsequent payments received are either applied to the outstanding principal balance or recorded as interest income, depending on management's assessment of the ultimate collectability of principal. Loans are returned to accrual status, for all loan classes, when all the principal and interest amounts contractually due are brought current, the loans have performed in accordance with the contractual terms of the note for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is reasonably assured. Past due status is based on

contract terms of the loan.

53

Table of Contents

Loans, the terms of which are modified, are classified as TDRs if a concession was granted for legal or economic reasons related to a borrower's financial difficulties. Concessions granted under a TDR typically involve a temporary deferral of scheduled loan payments, an extension of a loan's stated maturity date, temporary reduction in interest rates, or below market rates. If a modification occurs while the loan is on accruing status, it will continue to accrue interest under the modified terms. Nonaccrual TDRs are restored to accrual status if scheduled principal and interest payments, under the modified terms, are current for six months after modification, and the borrower continues to demonstrate its ability to meet the modified terms. TDRs are evaluated individually for impairment if they have been restructured during the most recent calendar year, or if they are not performing according to their modified terms. The following table presents the Company's risk elements, including information concerning the aggregate balances of nonaccrual, restructured loans still accruing, loans past due 90 days or more, and OREO as of June 30, 2017, December 31, 2016 and June 30, 2016. Relevant asset quality ratios are also presented.

(Dollars in thousands)	June 30, 2017	December 31, 2016	June 30, 2016
Nonaccrual loans (cash basis)	\$5,160	\$ 7,043	\$14,092
OREO	1,012	346	651
Total nonperforming assets	6,172	7,389	14,743
Restructured loans still accruing	1,204	930	907
Loans past due 90 days or more and still accruing	0	0	0
Total nonperforming and other risk assets	\$7,376	\$ 8,319	\$15,650
Loans 30-89 days past due	\$1,069	\$ 1,218	\$1,051
Asset Quality Ratios:			
Total nonperforming loans to loans	0.55	% 0.80	% 1.69 %
Total nonperforming assets to total assets	0.42	% 0.52	% 1.12 %
Total nonperforming assets to total loans and OREO	0.66	% 0.84	% 1.77 %
Total risk assets to total loans and OREO	0.79	% 0.94	% 1.88 %
Total risk assets to total assets	0.50	% 0.59	% 1.19 %
ALL to total loans	1.36	% 1.45	% 1.62 %
ALL to nonperforming loans	247.11	% 181.39	% 95.37 %
ALL to nonperforming loans and restructured loans still accruing	200.36	% 160.23	% 89.61 %

Total nonperforming and other risk assets decreased modestly from December 31, 2016 to June 30, 2017 and by \$8,274,000, or 52.9% from June 30, 2016. The decrease from June 30, 2016 is principally due to the sale in the fourth quarter of 2016 of a loan with a carrying balance of \$5,946,000 to a third party.

Table of Contents

The following table presents additional detail of impaired loans at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	June 30, 2017			December 31, 2016		
	Nonaccrual Loans	Restructured Loans Still Accruing	Total	Nonaccrual Loans	Restructured Loans Still Accruing	Total
Commercial real estate:						
Owner-occupied	\$853	\$ 56	\$909	\$1,070	\$ 0	\$1,070
Non-owner occupied	0	0	0	736	0	736
Multi-family	182	0	182	199	0	199
Non-owner occupied residential	418	0	418	452	0	452
Acquisition and development:						
Commercial and land development	0	0	0	1	0	1
Commercial and industrial	376	0	376	595	0	595
Residential mortgage:						
First lien	2,857	1,116	3,973	3,396	896	4,292
Home equity - term	25	0	25	93	34	127
Home equity - lines of credit	440	32	472	495	0	495
Installment and other loans	9	0	9	6	0	6
	\$5,160	\$ 1,204	\$6,364	\$7,043	\$ 930	\$7,973

The following table presents exposure to borrowers with impaired loans, together with partial charge-offs taken to date and specific reserves established on the relationships at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	# of Relationships	Recorded Investment	Partial Charge-offs to Date	Specific Reserves
June 30, 2017				
Relationships greater than \$1,000,000	0	\$ 0	\$ 0	\$ 0
Relationships greater than \$500,000 but less than \$1,000,000	1	542	145	0
Relationships greater than \$250,000 but less than \$500,000	1	315	120	0
Relationships less than \$250,000	70	5,507	1,135	45
	72	\$ 6,364	\$ 1,400	\$ 45
December 31, 2016				
Relationships greater than \$1,000,000	0	\$ 0	\$ 0	\$ 0
Relationships greater than \$500,000 but less than \$1,000,000	2	1,327	620	0
Relationships greater than \$250,000 but less than \$500,000	2	640	120	0
Relationships less than \$250,000	75	6,006	1,184	43
	79	\$ 7,973	\$ 1,924	\$ 43

The Company takes partial charge-offs on collateral-dependent loans for which the carrying value exceeded their estimated fair value, as determined by the most recent appraisal adjusted for current (within the quarter) conditions less costs to dispose. Impairment reserves remain in those situations in which updated appraisals are pending, and represent management's estimate of potential loss, or on restructured loans that are still accruing, and the impairment is based on discounted cash flows.

At June 30, 2017, none of the relationships deemed to be impaired had an outstanding balance in excess of \$1,000,000 and nearly all of them (97.2%) had recorded balances less than \$250,000, which reduces the likelihood of a large loss on any particular loan.

Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$500,000, which includes confirmation of risk rating by the internally designated credit authority, including Credit Administration for loans in excess of \$1,000,000. In addition, all relationships greater than \$250,000 rated Substandard, Doubtful or Loss are reviewed and corresponding risk ratings are reaffirmed by the Bank's Problem

Loan Committee, with subsequent reporting to the ERM Committee.

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

55

Table of Contents

includes an evaluation of the outstanding loan balance and the related collateral securing the credit. Through a combination of collateral securing the loans and partial charge-offs taken to date, the Company believes that it has adequately provided for the potential losses that it may incur on these relationships as of June 30, 2017. However, over time, additional information may become known that could result in increased reserve allocations or, alternatively, it may be deemed that the reserve allocations exceed those that are needed.

The Company's OREO totaled \$1,012,000 at June 30, 2017 and consisted of four properties owned by the Company, one of which was a commercial property carried at \$816,000, and three residential properties totaling \$196,000. The increase in OREO from \$346,000 at December 31, 2016 was principally the result of the commercial property, which was added during the first quarter of 2017 and migrated to foreclosed real estate from a nonaccrual loan. All properties are carried at the lower of cost or fair value, less costs to dispose.

At June 30, 2017, the Company believes the value of OREO represents their fair values, but if the real estate market changes, additional charges may be needed.

Credit Risk Management

Allowance for Loan Losses

The Company maintains the ALL at a level believed adequate by management for probable incurred credit losses. The allowance is established and maintained through a provision for loan losses charged to earnings. Quarterly, management assesses the adequacy of the ALL utilizing a defined methodology, which considers specific credit evaluation of impaired loans, past loan loss historical experience, and qualitative factors. Management believes the approach properly addresses the requirements of ASC Section 310-10-35 for loans individually identified as impaired, and ASC Subtopic 450-20 for loans collectively evaluated for impairment, and other bank regulatory guidance.

The ALL is evaluated on a regular basis by management and is based upon management's periodic review of the collectability of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower's ability to repay, estimated value of any underlying collateral and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available. A description of the methodology for establishing the allowance and provision for loan losses and related procedures in establishing the appropriate level of reserve is included in Note 3, Loans Receivable and Allowance for Loan Losses, to the Consolidated Financial Statements under Part I, Item 1, "Financial Information."

Table of Contents

The following table summarizes the Company's loan ratings based on its internal risk rating system at June 30, 2017 and December 31, 2016:

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
June 30, 2017						
Commercial real estate:						
Owner-occupied	\$ 111,737	\$ 1,814	\$ 1,959	\$ 909	\$ 0	\$ 116,419
Non-owner occupied	206,823	196	10,051	0	0	217,070
Multi-family	43,526	4,159	770	182	0	48,637
Non-owner occupied residential	66,024	1,062	1,117	418	0	68,621
Acquisition and development:						
1-4 family residential construction	8,036	0	0	0	0	8,036
Commercial and land development	27,849	7	625	0	0	28,481
Commercial and industrial	95,124	2,384	29	376	0	97,913
Municipal	49,392	1,989	0	0	0	51,381
Residential mortgage:						
First lien	146,200	0	0	3,973	0	150,173
Home equity - term	12,994	0	0	25	0	13,019
Home equity - lines of credit	126,648	81	61	472	0	127,262
Installment and other loans	7,361	0	0	9	0	7,370
	\$901,714	\$ 11,692	\$ 14,612	\$ 6,364	\$ 0	\$934,382
December 31, 2016						
Commercial real estate:						
Owner-occupied	\$ 103,652	\$ 5,422	\$ 2,151	\$ 1,070	\$ 0	\$ 112,295
Non-owner occupied	190,726	4,791	10,105	736	0	206,358
Multi-family	42,473	4,222	787	199	0	47,681
Non-owner occupied residential	59,982	949	1,150	452	0	62,533
Acquisition and development:						
1-4 family residential construction	4,560	103	0	0	0	4,663
Commercial and land development	25,435	10	639	1	0	26,085
Commercial and industrial	87,588	251	32	594	0	88,465
Municipal	53,741	0	0	0	0	53,741
Residential mortgage:						
First lien	135,558	0	0	4,293	0	139,851
Home equity - term	14,155	0	0	93	0	14,248
Home equity - lines of credit	119,681	82	61	529	0	120,353
Installment and other loans	7,112	0	0	6	0	7,118
	\$844,663	\$ 15,830	\$ 14,925	\$ 7,973	\$ 0	\$883,391

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

Table of Contents

The following table presents activity in the ALL for the three and six months ended June 30, 2017 and 2016.

(Dollars in thousands)	Commercial Real Estate	Acquisition and Development	Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Installment and Other	Total	Unallocated	Total
Three Months Ended										
June 30, 2017										
Balance, beginning of period	\$6,963	\$ 513	\$ 1,218	\$ 106	\$8,800	\$3,229	\$ 127	\$3,356	\$ 512	\$ 12,668
Provision for loan losses	(214)	65	69	11	(69)	198	13	211	(42)	100
Charge-offs	0	0	0	0	0	(51)	(27)	(78)	0	(78)
Recoveries	28	1	4	0	33	10	18	28	0	61
Balance, end of period	\$6,777	\$ 579	\$ 1,291	\$ 117	\$8,764	\$3,386	\$ 131	\$3,517	\$ 470	\$ 12,751
June 30, 2016										
Balance, beginning of period	\$7,996	\$ 739	\$ 1,030	\$ 62	\$9,827	\$2,677	\$ 179	\$2,856	\$ 664	\$ 13,347
Provision for loan losses	(12)	(152)	112	(1)	(53)	66	26	92	(39)	0
Charge-offs	(26)	0	0	0	(26)	(80)	(48)	(128)	0	(154)
Recoveries	175	0	6	0	181	43	23	66	0	247
Balance, end of period	\$8,133	\$ 587	\$ 1,148	\$ 61	\$9,929	\$2,706	\$ 180	\$2,886	\$ 625	\$ 13,440
Six Months Ended										
June 30, 2017										
Balance, beginning of period	\$7,530	\$ 580	\$ 1,074	\$ 54	\$9,238	\$2,979	\$ 144	\$3,123	\$ 414	\$ 12,775
Provision for loan losses	(738)	(3)	267	63	(411)	441	14	455	56	100
Charge-offs	(45)	0	(55)	0	(100)	(51)	(56)	(107)	0	(207)
Recoveries	30	2	5	0	37	17	29	46	0	83
Balance, end of period	\$6,777	\$ 579	\$ 1,291	\$ 117	\$8,764	\$3,386	\$ 131	\$3,517	\$ 470	\$ 12,751
June 30, 2016										
Balance, beginning of period	\$7,883	\$ 850	\$ 1,012	\$ 58	\$9,803	\$2,870	\$ 121	\$2,991	\$ 774	\$ 13,568
Provision for loan losses	21	(263)	149	3	(90)	111	128	239	(149)	0
Charge-offs	(26)	0	(21)	0	(47)	(324)	(112)	(436)	0	(483)
Recoveries	255	0	8	0	263	49	43	92	0	355
Balance, end of period	\$8,133	\$ 587	\$ 1,148	\$ 61	\$9,929	\$2,706	\$ 180	\$2,886	\$ 625	\$ 13,440

The ALL at June 30, 2017, decreased \$24,000 from December 31, 2016, due to net charge-offs for the period largely offset by the provision for loan losses. The ALL to nonperforming loans ratio was 247.1% at June 30, 2017 compared with 181.4% at December 31, 2016, and the ALL to nonperforming loans and restructured loans still accruing ratio was 200.4% at June 30, 2017, compared with 160.2% at December 31, 2016. Management believes the ALL to total loans ratio remains adequate at 1.36% at June 30, 2017. Classified loans, which are loans rated Substandard, Doubtful

or Loss, totaled \$20,976,000 at June 30, 2017, or 2.2% of total loans outstanding, and decreased from \$22,898,000 at December 31, 2016, or 2.6% of loans outstanding.

Net charge-offs totaled \$17,000 and \$124,000 for the three and six months ended June 30, 2017 compared with a net recovery of \$93,000 and net charge-offs of \$128,000 for the three and six months ended June 30, 2016. The ratio of annualized net charge-offs to average loans outstanding was 0.01% and 0.03% for the three and six months ended June 30, 2017 compared with (0.05)% and 0.03% for the same periods in 2016. Net charge-offs and loan growth resulted in the determination that a provision was required in the second quarter of 2017. However, favorable historical charge-off data, combined with stable economic and market conditions, moderated the amount of provision needed. Despite such favorable historical charge-off data and improved asset quality ratios, the growth the Company has experienced in its loan portfolio may result in the need for additional provisions for loan losses in future quarters.

Table of Contents

The following table summarizes the ending loan balances individually or collectively evaluated for impairment based upon loan type, as well as the ALL allocation for each at June 30, 2017 and December 31, 2016.

(Dollars in thousands)	Commercial Real Estate	Commercial Acquisition and Development	Commercial and Industrial	Municipal	Total	Consumer Residential Mortgage	Installment and Other	Total	Unallocated	Total
June 30, 2017										
Loans allocated by:										
Individually evaluated for impairment	\$ 1,509	\$ 0	\$ 376	\$ 0	\$ 1,885	\$ 4,470	\$ 9	\$ 4,479	\$ 0	\$ 6,364
Collectively evaluated for impairment	449,238	36,517	97,537	51,381	634,673	285,984	7,361	293,345	0	928,018
	\$ 450,747	\$ 36,517	\$ 97,913	\$ 51,381	\$ 636,558	\$ 290,454	\$ 7,370	\$ 297,824	\$ 0	\$ 934,382
ALL allocated by:										
Individually evaluated for impairment	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 40	\$ 5	\$ 45	\$ 0	\$ 45
Collectively evaluated for impairment	6,777	579	1,291	117	8,764	3,346	126	3,472	470	12,706
	\$ 6,777	\$ 579	\$ 1,291	\$ 117	\$ 8,764	\$ 3,386	\$ 131	\$ 3,517	\$ 470	\$ 12,751
December 31, 2016										
Loans allocated by:										
Individually evaluated for impairment	\$ 2,457	\$ 1	\$ 594	\$ 0	\$ 3,052	\$ 4,915	\$ 6	\$ 4,921	\$ 0	\$ 7,973
Collectively evaluated for impairment	426,410	30,747	87,871	53,741	598,769	269,537	7,112	276,649	0	875,418
	\$ 428,867	\$ 30,748	\$ 88,465	\$ 53,741	\$ 601,821	\$ 274,452	\$ 7,118	\$ 281,570	\$ 0	\$ 883,391
ALL allocated by:										
Individually evaluated for impairment	\$ 0	\$ 0	\$ 0	\$ 0	\$ 0	\$ 43	\$ 0	\$ 43	\$ 0	\$ 43
Collectively evaluated for impairment	7,530	580	1,074	54	9,238	2,936	144	3,080	414	12,732
	\$ 7,530	\$ 580	\$ 1,074	\$ 54	\$ 9,238	\$ 2,979	\$ 144	\$ 3,123	\$ 414	\$ 12,775

The ALL allocations presented above represent reserve allocations on loan balances outstanding at June 30, 2017 and December 31, 2016. In addition to the reserve allocations on impaired loans noted above, 19 loans, with aggregate outstanding general ledger principal balances of \$2,567,000, have had cumulative partial charge-offs to the ALL

recorded totaling \$1,400,000 at June 30, 2017. As updated appraisals were received on collateral-dependent loans, partial charge-offs were taken to the extent the loans' principal balance exceeded their fair value.

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

The unallocated portion of the ALL reflects estimated probable incurred losses within the portfolio that have not been identified to specific loans or portfolio segments. This reserve results due to risk of error in the specific and general reserve allocation, other potential exposure in the loan portfolio, variances in management's assessment of national and local economic conditions and other factors management believes appropriate at the time. The unallocated portion of the allowance increased from \$414,000 at December 31, 2016 to \$470,000 at June 30, 2017 and represents 3.7% of the ALL balance at June 30, 2017 compared with 3.2% at December 31, 2016.

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

Table of Contents

Deposits

Deposits totaled \$1,195,936,000 at June 30, 2017, an increase of \$43,484,000, or 3.8%, from \$1,152,452,000 at December 31, 2016. Noninterest-bearing deposits increased \$6,956,000, or 4.6%, from December 31, 2016 to June 30, 2017 and totaled \$157,703,000. Interest-bearing deposits totaled \$1,038,233,000 at June 30, 2017, an increase of \$36,528,000, or 3.6% from the \$1,001,705,000 balance at December 31, 2016. The Company has continued to gather both noninterest-bearing and interest-bearing deposit relationships from enhanced cash management offerings as its expanded sales force increases its commercial relationships. Deposit growth in the first half of 2017 has been used to fund a large portion of the growth in the loan and investment portfolios.

Shareholders' Equity, Capital Adequacy and Regulatory Matters

The management of capital in a regulated financial services industry must properly balance return on equity to its shareholders while maintaining sufficient levels of capital and related risk-based regulatory capital ratios to satisfy statutory regulatory requirements. The Company's capital management strategies have historically been developed to provide attractive rates of returns to its shareholders, while maintaining a "well capitalized" position of regulatory strength.

Shareholders' equity totaled \$143,263,000 at June 30, 2017, an increase of \$8,404,000 or 6.2%, from \$134,859,000 at December 31, 2016. This increase was primarily the result of net income of \$5,310,000 for the six months ended June 30, 2017, a change in net unrealized gains/losses in AOCI, net of taxes, of \$4,022,000 and offset by dividends declared on common stock of \$1,655,000.

Capital Adequacy. The Company and the Bank are subject to various regulatory capital requirements administered by federal and state banking agencies. Management believes, at June 30, 2017 and December 31, 2016, the Company and the Bank met all capital adequacy requirements to which they are subject. At June 30, 2017 and December 31, 2016, the Bank was considered well capitalized under applicable banking regulations. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Company and the Bank must meet specific guidelines that involve quantitative measures of assets, liabilities and certain off-balance sheet items as calculated under regulatory accounting practices. Although applicable to the Bank, prompt corrective action provisions are not applicable to bank holding companies, including financial holding companies.

Note 6, Shareholders' Equity and Regulatory Capital, to the Notes to Consolidated Financial Statements under Part I, Item 1, "Financial Information," includes a table presenting capital amounts and ratios for the Company and the Bank at June 30, 2017 and December 31, 2016.

The Company routinely evaluates its capital levels in light of its risk profile to assess its capital needs. In addition to the minimum capital ratio requirement and minimum capital ratio to be well capitalized presented in the referenced table in Note 6, the Company and the Bank must maintain a capital conservation buffer as more fully described in the Company's Annual Report on Form 10-K for the year ended December 31, 2016, Item 1 - Business, under the topic Basel III Capital Rules. At June 30, 2017, the Company's and the Bank's capital conservation buffer, based on the most restrictive Total Capital to risk weighted assets capital ratio, was 6.5% and 6.0%, which is above the phase in requirements of 1.25% for December 31, 2017.

Liquidity

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

Table of Contents

Item 3. Quantitative and Qualitative Disclosures about Market Risk

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

Interest Rate Risk

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

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

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

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

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

Earnings at Risk

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

The simulation analysis results are presented in the Earnings at Risk table below. At June 30, 2017, similar to at December 31, 2016, these results indicate the Company would be better positioned in a rising interest rate environment than it would be if interest rates fell.

Although the Fed increased short-term interest rates by a quarter point in December 2016 and again in March and June 2017, a decrease in interest rates of 1.00% would create an environment in which deposit rates could not practically decline further.

Table of Contents

Value at Risk

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

The net present value analysis results are presented in the Value at Risk table below. At June 30, 2017, these results indicate the Company would be better positioned in a rising interest rate environment than it would be if interest rates fell.

Earnings at Risk			Value at Risk		
% Change in Net Interest Income			% Change in Market Value		
Change in June 30, 2017	December 31, 2016		Change in June 30, 2017	December 31, 2016	
(100)	(6.6%)	(3.3 %)	(100)	(5.8%)	(1.0 %)
100	(1.2%)	(1.5 %)	100	(0.7%)	(1.5 %)
200	(2.2%)	(2.5 %)	200	(3.4%)	(2.9 %)

Item 4. Controls and Procedures

Based on the evaluation required by Securities Exchange Act Rules 13a-15(b) and 15d-15(b), the Company's management, including the Chief Executive Officer and Chief Financial Officer, conducted an evaluation of the effectiveness of disclosure controls and procedures, as defined in Securities Exchange Act Rules 13a-15(e) and 15d-15(e), at June 30, 2017. Based on that evaluation, the Chief Executive Officer and Chief Financial Officer concluded that the disclosure controls and procedures were effective at June 30, 2017. There have been no changes in internal control over financial reporting that have materially affected, or are reasonably likely to materially affect, internal control over financial reporting during the second quarter of 2017.

Table of Contents

PART II – OTHER INFORMATION

Item 1 – Legal Proceedings

Information regarding legal proceedings is included in Note 10, Contingencies, to the Consolidated Financial Statements under Part I, Item 1, "Financial Statements (unaudited)" and incorporated herein by reference.

Item 1A – Risk Factors

There have been no material changes from the risk factors as disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2016.

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

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

No shares were repurchased from January 1, 2017 to June 30, 2017. At June 30, 2017, 82,725 shares had been repurchased under the program at a total cost of \$1,438,000, or \$17.38 per share. The maximum number of shares that may yet be purchased under the plan is 333,275 at June 30, 2017.

Item 3 – Defaults Upon Senior Securities

Not applicable.

Item 4 – Mine Safety Disclosures

Not applicable.

Item 5 – Other Information

None.

Item 6 – Exhibits

A list of exhibits to this Form 10-Q appears on the Exhibit Index and is incorporated herein by reference.

Table of Contents

SIGNATURES

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

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

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

Date: August 8, 2017

Table of Contents

ORRSTOWN FINANCIAL SERVICES, INC. AND SUBSIDIARIES
EXHIBIT INDEX

- 3.1 Articles of Incorporation as amended, incorporated by reference to Exhibit 3.1 of the Registrant's Report on Form 8-K filed on January 29, 2010.
- 3.2 By-laws as amended, incorporated by reference to Exhibit 3.1 to the Registrant's Report on Form 8-K filed March 1, 2013.
- 4.1 Specimen Common Stock Certificate, incorporated by reference to the Registrant's Registration Statement on Form S-3 filed February 8, 2010 (File No. 333-164780).
- 31.1 Rule 13a – 14(a)/15d-14(a) Certification (Principal Executive Officer)
- 31.2 Rule 13a – 14(a)/15d-14(a) Certifications (Principal Financial Officer)
- 32.1 Section 1350 Certifications (Principal Executive Officer)
- 32.2 Section 1350 Certifications (Principal Financial Officer)
- 101.LAB XBRL Taxonomy Extension Label Linkbase *
- 101.PRE XBRL Taxonomy Extension Presentation Linkbase *
- 101.INS XBRL Instance Document *
- 101.SCH XBRL Taxonomy Extension Schema *
- 101.CAL XBRL Taxonomy Extension Calculation Linkbase *
- 101.DEF XBRL Taxonomy Extension Definition Linkbase *
- All other exhibits for which provision is made in the applicable accounting regulations of the Securities and Exchange Commission are not required under the related instructions or are inapplicable and therefore have been omitted.

* Attached as Exhibits 101 to this Form 10-Q are documents formatted in XBRL (eXtensible Business Reporting Language).