

ORRSTOWN FINANCIAL SERVICES INC

Form 10-Q

November 06, 2018

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

FORM 10 – Q

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

For the quarterly period ended September 30, 2018

or

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

For the transition period from _____ to _____

Commission file number: 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 every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes No

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

Large accelerated filer Accelerated filer

Non-accelerated filer Smaller reporting company

Emerging growth company

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

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

Number of shares outstanding of the registrant's Common Stock as of October 31, 2018: 9,432,862.

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Glossary of Defined Terms

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

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

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

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PART I – FINANCIAL INFORMATION

Item 1. Financial Statements

Consolidated Balance Sheets (Unaudited)

ORRSTOWN FINANCIAL SERVICES, INC.

(Dollars in thousands, except per share information)	September 30, 2018	December 31, 2017
Assets		
Cash and due from banks	\$ 21,892	\$ 21,734
Interest-bearing deposits with banks	19,125	8,073
Cash and cash equivalents	41,017	29,807
Restricted investments in bank stocks	9,337	9,997
Securities available for sale	489,356	415,308
Loans held for sale	4,765	6,089
Loans	1,084,941	1,010,012
Less: Allowance for loan losses	(13,812) (12,796
Net loans	1,071,129	997,216
Premises and equipment, net	35,922	34,809
Cash surrender value of life insurance	34,799	33,570
Accrued interest receivable	5,393	5,048
Other assets	29,037	27,005
Total assets	\$ 1,720,755	\$ 1,558,849
Liabilities		
Deposits:		
Noninterest-bearing	\$ 187,721	\$ 162,343
Interest-bearing	1,241,449	1,057,172
Total deposits	1,429,170	1,219,515
Short-term borrowings	45,353	93,576
Long-term debt	83,543	83,815
Accrued interest and other liabilities	17,132	17,178
Total liabilities	1,575,198	1,414,084
Shareholders' Equity		
Preferred stock, \$1.25 par value per share; 500,000 shares authorized; no shares issued or outstanding	0	0
Common stock, no par value—\$0.05205 stated value per share 50,000,000 shares authorized; 8,393,158 and 8,347,856 shares issued; 8,385,627 and 8,347,039 shares outstanding	437	435
Additional paid - in capital	126,260	125,458
Retained earnings	24,529	16,042
Accumulated other comprehensive income (loss)	(5,472) 2,845
Treasury stock—common, 7,531 and 817 shares, at cost	(197) (15
Total shareholders' equity	145,557	144,765
Total liabilities and shareholders' equity	\$ 1,720,755	\$ 1,558,849

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

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

(Dollars in thousands, except per share information)	Three Months Ended		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Interest and dividend income				
Interest and fees on loans	\$12,281	\$ 10,337	\$35,068	\$ 29,392
Interest and dividends on investment securities				
Taxable	2,922	1,925	7,754	5,518
Tax-exempt	955	758	2,834	2,344
Short-term investments	68	78	169	142
Total interest and dividend income	16,226	13,098	45,825	37,396
Interest expense				
Interest on deposits	2,780	1,619	6,765	4,429
Interest on short-term borrowings	332	182	1,097	543
Interest on long-term debt	410	216	1,222	388
Total interest expense	3,522	2,017	9,084	5,360
Net interest income	12,704	11,081	36,741	32,036
Provision for loan losses	200	100	600	200
Net interest income after provision for loan losses	12,504	10,981	36,141	31,836
Noninterest income				
Service charges on deposit accounts	1,524	1,437	4,405	4,224
Other service charges, commissions and fees	492	205	1,430	697
Trust and investment management income	1,668	1,551	5,037	4,620
Brokerage income	455	424	1,514	1,409
Mortgage banking activities	735	797	2,049	2,113
Income from life insurance	533	275	1,101	814
Other income	56	34	272	147
Investment securities gains	29	533	891	1,190
Total noninterest income	5,492	5,256	16,699	15,214
Noninterest expenses				
Salaries and employee benefits	7,610	7,544	23,487	22,366
Occupancy	775	639	2,252	2,101
Furniture and equipment	990	937	2,977	2,499
Data processing	661	527	1,875	1,702
Telephone and communication	181	221	542	536
Automated teller and interchange fees	187	196	548	568
Advertising and bank promotions	279	325	898	1,103
FDIC insurance	169	139	507	454
Legal fees	215	565	364	826
Other professional services	361	380	1,140	1,112
Directors' compensation	207	254	663	745
Collection and problem loan	59	56	137	134
Real estate owned	18	41	96	49
Taxes other than income	259	211	761	659
Merger related	319	0	473	0
Other operating expenses	1,046	1,052	2,957	2,796
Total noninterest expenses	13,336	13,087	39,677	37,650
Income before income tax expense	4,660	3,150	13,163	9,400

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Income tax expense	644	376	1,510	1,316
Net income	\$4,016	\$ 2,774	\$11,653	\$ 8,084
Per share information:				
Basic earnings per share	\$0.50	\$ 0.34	\$1.44	\$ 1.00
Diluted earnings per share	0.49	0.34	1.41	0.98
Dividends per share	0.13	0.10	0.38	0.30

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		Nine Months Ended	
	September 30, 2018	September 30, 2017	September 30, 2018	September 30, 2017
Net income	\$ 4,016	\$ 2,774	\$ 11,653	\$ 8,084
Other comprehensive income (loss), net of tax:				
Unrealized gains (losses) on securities available for sale arising during the period	(3,488)	(1,400)	(9,637)	5,350
Reclassification adjustment for gains realized in net income	(29)	(533)	(891)	(1,190)
Net unrealized gains (losses)	(3,517)	(1,933)	(10,528)	4,160
Tax effect	738	656	2,211	(1,415)
Total other comprehensive income (loss), net of tax and reclassification adjustments	(2,779)	(1,277)	(8,317)	2,745
Total comprehensive income	\$ 1,237	\$ 1,497	\$ 3,336	\$ 10,829

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 information)	Nine Months Ended September 30, 2018 and 2017					
	Common Stock	Additional Paid-In Capital	Retained Earnings	Accumulated Other Comprehensive Income (Loss)	Treasury Stock	Total Shareholders' Equity
Balance, January 1, 2017	\$437	\$124,935	\$11,669	\$ (1,165)	\$(1,017)	\$ 134,859
Net income	0	0	8,084	0	0	8,084
Total other comprehensive income, net of taxes	0	0	0	2,745	0	2,745
Cash dividends (\$0.30 per share)	0	0	(2,489)	0	0	(2,489)
Share-based compensation plans:						
Issuance of stock (5,418 net common shares and 56,885 treasury shares issued), including compensation expense of \$1,048	(2)	185	0	0	1,002	1,185
Balance, September 30, 2017	\$435	\$125,120	\$17,264	\$ 1,580	\$(15)	\$ 144,384
Balance, January 1, 2018	\$435	\$125,458	\$16,042	\$ 2,845	\$(15)	\$ 144,765
Net income	0	0	11,653	0	0	11,653
Total other comprehensive loss, net of taxes	0	0	0	(8,317)	0	(8,317)
Cash dividends (\$0.38 per share)	0	0	(3,166)	0	0	(3,166)
Share-based compensation plans:						
Issuance of stock (45,302 net common shares issued and 6,714 net treasury shares acquired), including compensation expense of \$1,112	2	802	0	0	(182)	622
Balance, September 30, 2018	\$437	\$126,260	\$24,529	\$ (5,472)	\$(197)	\$ 145,557

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)	Nine Months Ended	
	September 30, 2018	September 30, 2017
Cash flows from operating activities		
Net income	\$11,653	\$ 8,084
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of premiums on securities available for sale	1,356	3,388
Depreciation and amortization	2,572	2,382
Provision for loan losses	600	200
Share-based compensation	1,112	1,048
Gain on sales of loans originated for sale	(1,687)	(1,751)
Mortgage loans originated for sale	(71,008)	(75,484)
Proceeds from sales of loans originated for sale	73,679	71,409
Gain on sale of portfolio loans	(291)	(32)
Net gain on disposal of OREO	(111)	(11)
Writedown of OREO	24	4
Net (gain) loss on disposal of premises and equipment	16	(18)
Deferred income taxes	756	229
Investment securities gains	(891)	(1,190)
Income from life insurance	(1,101)	(814)
(Increase) decrease in accrued interest receivable	(345)	420
Increase in accrued interest payable and other liabilities	(46)	1,835
Other, net	(1,158)	(360)
Net cash provided by operating activities	15,130	9,339
Cash flows from investing activities		
Proceeds from sales of available for sale securities	113,180	162,319
Maturities, repayments and calls of available for sale securities	12,793	22,060
Purchases of available for sale securities	(211,014)	(203,719)
Net (purchases) redemptions of restricted investments in bank stocks	660	(1,499)
Net increase in loans	(78,497)	(101,203)
Proceeds from sales of portfolio loans	3,589	2,195
Purchases of bank premises and equipment	(3,078)	(2,372)
Improvements to OREO	0	(9)
Proceeds from disposal of OREO	1,260	237
Proceeds from disposal of bank premises and equipment	7	83
Purchases of bank owned life insurance	(900)	(600)
Death benefit proceeds from life insurance contracts	576	0
Net cash used in investing activities	(161,424)	(122,508)
Cash flows from financing activities		
Net increase in deposits	209,655	64,275
Net decrease in borrowings with original maturities less than 90 days	(8,223)	(36,293)
Proceeds from other short-term borrowings	0	70,000
Payments on other short-term borrowings	(40,000)	(30,000)
Proceeds from long-term debt	0	60,000
Payments on long-term debt	(272)	(20,260)
Dividends paid	(3,166)	(2,489)
Treasury shares repurchased for employee taxes associated with restricted stock vesting	(651)	0

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Proceeds from issuance of stock for option exercises and employee stock purchase plan	161	137	
Net cash provided by financing activities	157,504	105,370	
Net increase (decrease) in cash and cash equivalents	11,210	(7,799)
Cash and cash equivalents at beginning of period	29,807	30,273	
Cash and cash equivalents at end of period	\$41,017	\$ 22,474	

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Supplemental disclosures of cash flow information:

Cash paid during the period for:

Interest	\$8,991	\$5,335
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Income taxes	60	1,108
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Supplemental schedule of noncash investing activities:

OREO acquired in settlement of loans	\$538	\$1,007
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The Notes to Consolidated Financial Statements are an integral part of these statements.

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Notes to Consolidated Financial Statements (Unaudited)

NOTE 1. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Loans Serviced – The Bank administers secondary market mortgage programs available through the FHLB and the Federal National Mortgage Association and offers residential mortgage products and services to customers. The Bank originates single-family residential mortgage loans for immediate sale in the secondary market and retains the servicing of those loans. At September 30, 2018 and December 31, 2017, the balance of loans serviced for others totaled \$337,379,000 and \$334,802,000.

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

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

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

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

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

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Mortgage Servicing Rights – The estimated fair value of 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 \$2,931,000 and \$2,897,000 at September 30, 2018 and December 31, 2017, and are included in Other Assets.

Foreclosed Real Estate – Real estate acquired through foreclosure or other means is initially recorded at the fair value of the related real estate collateral at the transfer date less estimated selling costs, and subsequently at the lower of its carrying value or fair value less estimated costs to sell. Fair value is usually determined based on an independent third party appraisal of the property or occasionally on a recent sales offer. Costs to maintain foreclosed real estate are expensed as incurred. Costs that significantly improve the value of the properties are capitalized. Foreclosed real estate totaled \$286,000 and \$961,000 at September 30, 2018 and December 31, 2017 and is included in Other Assets.

Investments in Real Estate Partnerships – The Company has a 99% limited partner interest in several real estate partnerships in central Pennsylvania. These investments are affordable housing projects, which entitle the Company to tax deductions and credits that expire through 2025. The Company accounts for its investments in affordable housing projects under the proportional amortization method when the criteria are met, which is limited to one investment entered into in 2015. Other investments are accounted for under the equity method of accounting. The investment in these real estate partnerships, included in Other Assets, totaled \$4,006,000 and \$4,416,000 at September 30, 2018 and December 31, 2017, of which \$1,616,000 and \$1,776,000 are accounted for under the proportional amortization method.

Equity method losses totaled \$81,000 for the three months ended September 30, 2018 and 2017, and \$250,000 and \$196,000 for the nine months ended September 30, 2018 and 2017, and are included in other noninterest income. Proportional amortization method losses totaled \$53,000 and \$52,000 for the three months ended September 30, 2018 and 2017, and \$160,000 and \$157,000 for the nine months ended September 30, 2018 and 2017 and are included in income tax expense. The Company recognized federal tax credits from these projects totaling \$144,000 and \$253,000 during the three months ended September 30, 2018 and 2017, and \$433,000, and \$758,000 during the nine months ended September 30, 2018 and 2017, which are included in income tax expense.

Advertising – The Company expenses advertising as incurred. Advertising expense totaled \$83,000 and \$138,000 for the three months ended September 30, 2018 and 2017, and \$209,000 and \$455,000 for the nine months ended September 30, 2018 and 2017.

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

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

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

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

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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 when, based on the weight of available evidence, it is more likely than not that some portion or all of a deferred tax asset will not be realized. The Company recognizes interest and penalties, if any, on income taxes as a component of income tax expense.

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

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

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

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

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

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

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

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

ASU 2016-01, Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01, among other things, (i) requires equity investments, with certain exceptions, to be measured at fair value with changes in fair value recognized in net income, (ii) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment, (iii) eliminates the requirement for public business entities to disclose the methods and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet, (iv) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes, (v) requires an entity to present separately in other comprehensive income the portion of the total change

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

ASU 2016-02, Leases (Topic 842). ASU 2016-02 will, among other things, require lessees to recognize a lease liability, which is a lessee's obligation to make lease payments arising from a lease, measured on a discounted basis, and a right-of-use asset, which is an asset that represents the lessee's right to use, or control the use of, a specified asset for the lease term. ASU 2016-02 will be effective for the Company on January 1, 2019. In July 2018, the FASB issued amendments in ASU 2018-11, which provide a transition election to not restate comparative periods for the effects of applying the new standard. The Company expects to elect this transition election, which permits entities to change the date of initial application to the beginning of the year of adoption and to recognize the effects of applying the new standard as a cumulative-effect adjustment to the opening balance of retained earnings. The Company anticipates that the impact on its consolidated balance sheet will result in an increase in assets and liabilities for its right of use assets and related lease liabilities for those leases that are outstanding at the date of adoption, however, it does not anticipate it will have a material impact on its results of operations. Management is evaluating other effects of this standard on our consolidated financial position and regulatory capital.

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

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

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

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

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

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

In August 2018, the SEC adopted the final rule under SEC Release No. 33-10532, Disclosure Update and Simplification, amending certain disclosure requirements. In addition, the amendments expanded the disclosure requirements on the analysis of stockholders' equity for interim financial statements. Under the amendments, an analysis of changes in each caption of stockholders' equity presented in the balance sheet must be provided in a note or separate statement and should present a reconciliation of the beginning balance to the ending balance for each period for which a statement of comprehensive income is presented. The disclosure requirements amendment will be effective for the Company with its first interim reporting filing in 2019. The Company expects these changes will result in additional disclosures for the consolidated statement of changes in stockholders' equity and is evaluating any additional impact of these changes on its consolidated financial statements.

NOTE 2. MERGERS AND ACQUISITIONS

Mercersburg Financial Corporation

On October 1, 2018, the Company completed its acquisition of Mercersburg Financial Corporation ("Mercersburg"), the holding company for First Community Bank of Mercersburg. The transaction was valued at approximately \$30,000,000 with the Company issuing 1,052,635 shares of common stock and paying cash totaling approximately \$4,900,000. At September 30, 2018, First Community Bank of Mercersburg reported total assets of \$184,161,000, total loans of \$147,386,000 and total deposits of \$160,947,000 on a Call Report filed with federal banking regulators on October 30, 2018. The acquisition expanded the Company's operations in Franklin County, Pennsylvania. The initial purchase accounting for this acquisition is not yet completed and the Company is not yet able to disclose the preliminary fair value of the Mercersburg assets acquired and liabilities assumed.

Hamilton Bancorp, Inc.

On October 23, 2018, the Company entered into an Agreement and Plan of Merger (the "Merger Agreement") with Hamilton Bancorp, Inc., a Maryland corporation ("Hamilton") and the holding company for Hamilton Bank, based in Towson, Maryland. At September 30, 2018, Hamilton had \$502,187,000 in assets, \$374,649,000 in loans, \$388,471,000 in deposits and 3,416,414 shares outstanding. The Merger Agreement provides that, subject to the terms and conditions thereof, Hamilton will merge with and into the Company, with the Company as the surviving corporation, and that Hamilton Bank will merge with and into Orrstown Bank, with Orrstown Bank as the surviving bank. The merger is expected to close in the second quarter of 2019, subject to receipt of regulatory approvals, the approval of Hamilton's shareholders, and the satisfaction of other customary closing conditions. The acquisition will introduce the Company's operations into the Greater Baltimore area of Maryland.

Pursuant to the Merger Agreement, for each share of Hamilton common stock outstanding as of the effective date, the Company will issue \$4.10 in cash, without interest, and 0.54 shares of of the Company's common stock, no par value per share. The cash consideration is subject to reduction based on potential losses, write-downs, or reserves related to certain identified loans.

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NOTE 3. SECURITIES AVAILABLE FOR SALE

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

(Dollars in thousands)	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
September 30, 2018				
States and political subdivisions	\$ 161,146	\$ 1,251	\$ 2,977	\$ 159,420
GSE residential CMOs	113,335	39	4,720	108,654
Private label residential CMOs	313	0	1	312
Private label commercial CMOs	61,560	18	368	61,210
Asset-backed and other	159,928	503	671	159,760
Totals	\$ 496,282	\$ 1,811	\$ 8,737	\$ 489,356
December 31, 2017				
States and political subdivisions	\$ 153,803	\$ 6,133	\$ 478	\$ 159,458
GSE residential MBSs	48,600	930	0	49,530
GSE residential CMOs	113,658	296	2,835	111,119
Private label residential CMOs	999	4	0	1,003
Private label commercial CMOs	7,809	0	156	7,653
Asset-backed and other	86,837	133	425	86,545
Totals	\$ 411,706	\$ 7,496	\$ 3,894	\$ 415,308

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

(Dollars in thousands)	Less Than 12 Months			12 Months or More			Total		
	# of Securities	Fair Value	Unrealized Losses	# of Securities	Fair Value	Unrealized Losses	# of Securities	Fair Value	Unrealized Losses
September 30, 2018									
States and political subdivisions	46	\$ 67,649	\$ 1,591	5	\$ 22,667	\$ 1,386	51	\$ 90,316	\$ 2,977
GSE residential CMOs	4	59,708	1,125	7	46,729	3,595	11	106,437	4,720
Private label residential CMOs	1	312	1	0	0	0	1	312	1
Private label commercial CMOs	5	33,258	70	2	6,597	298	7	39,855	368
Asset-backed and other	4	61,660	274	3	11,426	397	7	73,086	671
Totals	60	\$ 222,587	\$ 3,061	17	\$ 87,419	\$ 5,676	77	\$ 310,006	\$ 8,737
December 31, 2017									
States and political subdivisions	7	\$ 24,577	\$ 473	1	\$ 5,585	\$ 5	8	\$ 30,162	\$ 478

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GSE residential CMOs	4	25,155	914	5	37,459	1,921	9	62,614	2,835
Private label commercial CMOs	2	7,653	156	0	0	0	2	7,653	156
Asset-backed and other	6	60,006	425	0	0	0	6	60,006	425
Totals	19	\$ 117,391	\$ 1,968	6	\$ 43,044	\$ 1,926	25	\$ 160,435	\$ 3,894

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

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

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amortized cost basis, which may be maturity, the Company does not consider these securities to be OTTI at September 30, 2018 or at December 31, 2017.

Private Label Residential CMOs. The unrealized losses presented in the table above have been caused by a widening of spreads and/or a rise in interest rates from the time 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 September 30, 2018 or at December 31, 2017.

Private Label Commercial CMOs and Asset-backed and Other. The unrealized losses presented in the table above have been caused by 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 September 30, 2018 or at December 31, 2017.

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

(Dollars in thousands)	Available for Sale	
	Amortized Cost	Fair Value
Due after one year through five years	\$5,066	\$5,053
Due after five years through ten years	38,129	37,619
Due after ten years	117,951	116,748
CMOs	175,208	170,176
Asset-backed and other	159,928	159,760
	\$496,282	\$489,356

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

(Dollars in thousands)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Proceeds from sale of AFS securities	\$25,070	\$103,666	\$113,180	\$162,319
Gross gains	185	670	1,237	1,477
Gross losses	156	137	346	287

AFS securities with a fair value of \$297,469,000 and \$319,907,000 at September 30, 2018 and December 31, 2017 were pledged to secure public funds and for other purposes as required or permitted by law.

NOTE 4. LOANS AND ALLOWANCE FOR LOAN LOSSES

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

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

The Company has various types of commercial real estate loans, which have differing levels of credit risk. Owner occupied commercial real estate loans are generally dependent upon the successful operation of the borrower's business, with the cash flows generated from the business being the primary source of repayment of the loan. If the business suffers a downturn in sales or profitability, the borrower's ability to repay the loan could be in jeopardy. Non-owner occupied and multi-family commercial real estate loans and non-owner occupied residential loans present a different credit risk to the Company than owner occupied commercial real estate loans, as the repayment of the loan is

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dependent upon the borrower's ability to generate a sufficient level of occupancy to produce rental income that exceeds debt service requirements and operating expenses. Lower occupancy or lease rates may result in a reduction in cash flows, which hinders the ability of the borrower to meet debt service requirements, and may result in lower collateral values. The Company generally recognizes that greater risk is inherent in these credit relationships as compared to owner occupied loans mentioned above.

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

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

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

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

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

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

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

(Dollars in thousands)	September 30, 2018	December 31, 2017
Commercial real estate:		
Owner occupied	\$ 119,056	\$ 116,811
Non-owner occupied	249,529	244,491
Multi-family	75,314	53,634
Non-owner occupied residential	84,598	77,980
Acquisition and development:		
1-4 family residential construction	10,217	11,730
Commercial and land development	33,735	19,251
Commercial and industrial	127,011	115,663
Municipal	39,429	42,065
Residential mortgage:		
First lien	167,178	162,509
Home equity - term	10,513	11,784
Home equity - lines of credit	135,578	132,192
Installment and other loans	32,783	21,902
	\$ 1,084,941	\$ 1,010,012

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

The Company has a loan review policy and program which is designed to identify and monitor risk in the lending function. The ERM Committee, comprised of executive officers and loan department personnel, is charged with the oversight of overall credit quality and risk exposure of the Company's loan portfolio. This includes the monitoring of the lending activities of all Company personnel with respect to underwriting and processing new loans and the timely follow-up and corrective action for loans showing signs of deterioration in quality. A loan review program provides the Company with an independent review of the loan portfolio on an ongoing basis. Generally, consumer and residential mortgage loans are included in the Pass categories unless a specific action, such as extended delinquencies, bankruptcy, repossession or death of the borrower occurs, which heightens awareness as to a possible credit event. Internal loan reviews are completed annually on all commercial relationships with a committed loan balance in excess of \$500,000, which includes confirmation of risk rating by an independent credit officer. In addition, all commercial relationships greater than \$250,000 rated Substandard, Doubtful or Loss are reviewed quarterly and corresponding risk ratings are reaffirmed by the Company's Problem Loan Committee, with subsequent reporting to the ERM Committee.

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

(Dollars in thousands)	Pass	Special Mention	Non-Impaired Substandard	Impaired - Substandard	Doubtful	Total
September 30, 2018						
Commercial real estate:						
Owner occupied	\$ 114,871	\$ 1,962	\$ 275	\$ 1,948	\$ 0	\$ 119,056
Non-owner occupied	239,429	5,700	4,400	0	0	249,529
Multi-family	68,981	5,468	726	139	0	75,314
Non-owner occupied residential	82,381	744	1,144	329	0	84,598
Acquisition and development:						
1-4 family residential construction	10,016	0	0	201	0	10,217
Commercial and land development	33,120	25	590	0	0	33,735
Commercial and industrial	124,819	1,883	0	309	0	127,011
Municipal	39,429	0	0	0	0	39,429
Residential mortgage:						
First lien	164,247	0	0	2,931	0	167,178
Home equity - term	10,495	0	0	18	0	10,513
Home equity - lines of credit	134,716	77	59	726	0	135,578
Installment and other loans	32,783	0	0	0	0	32,783
	\$ 1,055,287	\$ 15,859	\$ 7,194	\$ 6,601	\$ 0	\$ 1,084,941
December 31, 2017						
Commercial real estate:						
Owner occupied	\$ 113,240	\$ 413	\$ 1,921	\$ 1,237	\$ 0	\$ 116,811
Non-owner occupied	235,919	0	4,507	4,065	0	244,491
Multi-family	48,603	4,113	753	165	0	53,634
Non-owner occupied residential	76,373	142	1,084	381	0	77,980
Acquisition and development:						
1-4 family residential construction	11,238	0	0	492	0	11,730
Commercial and land development	18,635	5	611	0	0	19,251
Commercial and industrial	113,162	2,151	0	350	0	115,663
Municipal	42,065	0	0	0	0	42,065
Residential mortgage:						
First lien	158,673	0	0	3,836	0	162,509
Home equity - term	11,762	0	0	22	0	11,784
Home equity - lines of credit	131,585	80	60	467	0	132,192
Installment and other loans	21,891	0	0	11	0	21,902
	\$ 983,146	\$ 6,904	\$ 8,936	\$ 11,026	\$ 0	\$ 1,010,012

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

nonaccrual status. Nonaccrual loans in the commercial and commercial real estate portfolios and any TDRs are, by definition, deemed to be impaired. Impairment is measured on a loan-by-loan basis for commercial, construction and restructured loans by either the present value of the expected future cash flows discounted at the loan's effective interest rate, the loan's obtainable market price, or the fair value of the collateral if the loan is collateral dependent. A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral. For loans that are deemed to be impaired for extended periods of time, periodic updates on fair values are obtained,

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which may include updated appraisals. Updated fair values are incorporated into the impairment analysis in the next reporting period.

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

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

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

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

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

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

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

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

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

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

(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)
September 30, 2018					
Commercial real estate:					
Owner occupied	\$0	\$ 0	\$ 0	\$ 1,948	\$ 2,602
Multi-family	0	0	0	139	340
Non-owner occupied residential	0	0	0	329	642
Acquisition and development:					
1-4 family residential construction	0	0	0	201	201
Commercial and industrial	0	0	0	309	474
Residential mortgage:					
First lien	853	853	39	2,078	3,497
Home equity - term	0	0	0	18	24
Home equity - lines of credit	0	0	0	726	994
	\$853	\$ 853	\$ 39	\$ 5,748	\$ 8,774
December 31, 2017					
Commercial real estate:					