

PENNS WOODS BANCORP INC

Form 10-Q

August 08, 2017

Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934

for the Quarterly Period Ended June 30, 2017.

o Transition report pursuant to Section 13 or 15 (d) of the Exchange Act

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_ .

No. 0-17077

(Commission File Number)

PENNS WOODS BANCORP, INC.

(Exact name of Registrant as specified in its charter)

PENNSYLVANIA 23-2226454

(State or other jurisdiction of (I.R.S. Employer  
incorporation or organization) Identification No.)

300 Market Street, P.O. Box 967 Williamsport, Pennsylvania 17703-0967

(Address of principal executive offices) (Zip Code)

(570) 322-1111

Registrant's telephone number, including area code

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 ý NO o

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 ý NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definition of "large accelerated filer", "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer o Accelerated filer x

Non-accelerated filer o Small reporting company o

Emerging growth company

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

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

On August 1, 2017 there were 4,688,226 shares of the Registrant's common stock outstanding.

---

Table of Contents

PENNS WOODS BANCORP, INC.

INDEX TO QUARTERLY REPORT ON FORM 10-Q

|  | Page<br>Number |
|--|----------------|
| <u>Part I</u> <u>Financial Information</u>   |                |
| <u>Item 1.</u> <u>Financial Statements</u>   | <u>3</u>       |
| <u>Consolidated Balance Sheet (Unaudited) as of June 30, 2017 and December 31, 2016</u>                                      | <u>3</u>       |
| <u>Consolidated Statement of Income (Unaudited) for the Three and Six Months Ended June 30, 2017 and 2016</u>                | <u>4</u>       |
| <u>Consolidated Statement of Comprehensive Income (Unaudited) for the Three and Six Months Ended June 30, 2017 and 2016</u>  | <u>5</u>       |
| <u>Consolidated Statement of Changes in Shareholders' Equity (Unaudited) for the Six Months Ended June 30, 2017 and 2016</u> | <u>6</u>       |
| <u>Consolidated Statement of Cash Flows (Unaudited) for the Six Months Ended June 30, 2017 and 2016</u>                      | <u>7</u>       |
| <u>Notes to Consolidated Financial Statements (Unaudited)</u>  | <u>8</u>       |
| <u>Item 2.</u> <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>                  | <u>33</u>      |
| <u>Item 3.</u> <u>Quantitative and Qualitative Disclosures About Market Risk</u>   | <u>48</u>      |
| <u>Item 4.</u> <u>Controls and Procedures</u>  | <u>48</u>      |
| <u>Part II</u> <u>Other Information</u>  |                |
| <u>Item 1.</u> <u>Legal Proceedings</u>  | <u>49</u>      |
| <u>Item 1A.</u> <u>Risk Factors</u>  | <u>49</u>      |
| <u>Item 2.</u> <u>Unregistered Sales of Equity Securities and Use of Proceeds</u>  | <u>49</u>      |
| <u>Item 3.</u> <u>Defaults Upon Senior Securities</u>  | <u>49</u>      |
| <u>Item 4.</u> <u>Mine Safety Disclosures</u>  | <u>49</u>      |
| <u>Item 5.</u> <u>Other Information</u>  | <u>49</u>      |
| <u>Item 6.</u> <u>Exhibits</u>   | <u>50</u>      |

Signatures

51

Exhibit Index and Exhibits

52

2

---

Table of Contents

## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED BALANCE SHEET

## (UNAUDITED)

|   | June 30,<br>2017 | December<br>31,<br>2016 |
|---|------------------|-------------------------|
| (In Thousands, Except Share Data)   |                  |                         |
| ASSETS:   |                  |                         |
| Noninterest-bearing balances  | \$26,223         | \$26,766                |
| Interest-bearing balances in other financial institutions   | 11,979           | 16,905                  |
| Total cash and cash equivalents   | 38,202           | 43,671                  |
| Investment securities, available for sale, at fair value  | 138,504          | 133,492                 |
| Investment securities, trading  | 213              | 58                      |
| Loans held for sale   | 1,683            | 1,953                   |
| Loans   | 1,139,085        | 1,093,681               |
| Allowance for loan losses   | (13,109)         | (12,896)                |
| Loans, net  | 1,125,976        | 1,080,785               |
| Premises and equipment, net   | 25,497           | 24,275                  |
| Accrued interest receivable   | 3,641            | 3,672                   |
| Bank-owned life insurance   | 27,670           | 27,332                  |
| Goodwill  | 17,104           | 17,104                  |
| Intangibles   | 1,623            | 1,799                   |
| Deferred tax asset  | 8,139            | 8,397                   |
| Other assets  | 7,112            | 6,052                   |
| TOTAL ASSETS  | \$1,395,364      | \$1,348,590             |
| LIABILITIES:  |                  |                         |
| Interest-bearing deposits   | \$851,056        | \$791,937               |
| Noninterest-bearing deposits  | 300,054          | 303,277                 |
| Total deposits  | 1,151,110        | 1,095,214               |
| Short-term borrowings   | 15,737           | 13,241                  |
| Long-term borrowings  | 75,998           | 85,998                  |
| Accrued interest payable  | 414              | 455                     |
| Other liabilities   | 13,665           | 15,433                  |
| TOTAL LIABILITIES   | 1,256,924        | 1,210,341               |
| SHAREHOLDERS' EQUITY:   |                  |                         |
| Preferred stock, no par value, 3,000,000 shares authorized; no shares issued                        | —                | —                       |
| Common stock, par value \$8.33, 15,000,000 shares authorized; 5,008,192 and 5,007,109 shares issued | 41,735           | 41,726                  |
| Additional paid-in capital  | 50,117           | 50,075                  |
| Retained earnings   | 62,952           | 61,610                  |
| Accumulated other comprehensive loss:   |                  |                         |
| Net unrealized loss on available for sale securities  | (16)             | (639)                   |
| Defined benefit plan  | (4,233)          | (4,289)                 |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|  |             |   |             |   |
|--|-------------|---|-------------|---|
| Treasury stock at cost, 320,150 and 272,452 shares | (12,115     | ) | (10,234     | ) |
| TOTAL SHAREHOLDERS' EQUITY                         | 138,440     |   | 138,249     |   |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY         | \$1,395,364 |   | \$1,348,590 |   |

See accompanying notes to the unaudited consolidated financial statements.

3

---

Table of Contents

PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF INCOME  
(UNAUDITED)

| (In Thousands, Except Per Share Data)                   | Three Months           |           | Six Months Ended |           |
|---|------------------------|-----------|------------------|-----------|
|   | Ended June 30,<br>2017 | 2016      | June 30,<br>2017 | 2016      |
| INTEREST AND DIVIDEND INCOME:                           |                        |           |                  |           |
| Loans, including fees                                   | \$ 11,109              | \$ 10,466 | \$ 21,736        | \$ 20,821 |
| Investment securities:                                  |                        |           |                  |           |
| Taxable   | 570                    | 601       | 1,112            | 1,223     |
| Tax-exempt  | 323                    | 398       | 621              | 874       |
| Dividend and other interest income                      | 207                    | 204       | 422              | 477       |
| TOTAL INTEREST AND DIVIDEND INCOME                      | 12,209                 | 11,669    | 23,891           | 23,395    |
| INTEREST EXPENSE:                                       |                        |           |                  |           |
| Deposits  | 1,008                  | 881       | 1,910            | 1,716     |
| Short-term borrowings                                   | 4                      | 8         | 8                | 34        |
| Long-term borrowings                                    | 373                    | 492       | 813              | 983       |
| TOTAL INTEREST EXPENSE                                  | 1,385                  | 1,381     | 2,731            | 2,733     |
| NET INTEREST INCOME                                     | 10,824                 | 10,288    | 21,160           | 20,662    |
| PROVISION FOR LOAN LOSSES                               | 215                    | 258       | 545              | 608       |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES     | 10,609                 | 10,030    | 20,615           | 20,054    |
| NON-INTEREST INCOME:                                    |                        |           |                  |           |
| Service charges   | 559                    | 561       | 1,087            | 1,093     |
| Net securities (losses) gains, available for sale       | (12                    | ) 486     | 185              | 921       |
| Net securities gains, trading                           | —                      | 6         | 2                | 46        |
| Bank-owned life insurance                               | 161                    | 161       | 333              | 345       |
| Gain on sale of loans                                   | 503                    | 566       | 861              | 1,033     |
| Insurance commissions                                   | 99                     | 200       | 290              | 405       |
| Brokerage commissions                                   | 361                    | 272       | 692              | 527       |
| Debit Card Fees   | 501                    | 433       | 935              | 964       |
| Other   | 591                    | 493       | 1,029            | 841       |
| TOTAL NON-INTEREST INCOME                               | 2,763                  | 3,178     | 5,414            | 6,175     |
| NON-INTEREST EXPENSE:                                   |                        |           |                  |           |
| Salaries and employee benefits                          | 4,608                  | 4,346     | 9,378            | 8,926     |
| Occupancy   | 614                    | 545       | 1,252            | 1,086     |
| Furniture and equipment                                 | 664                    | 679       | 1,313            | 1,380     |
| Software amortization                                   | 242                    | 272       | 515              | 629       |
| Pennsylvania shares tax                                 | 230                    | 220       | 468              | 478       |
| Professional fees                                       | 550                    | 436       | 987              | 777       |
| Federal Deposit Insurance Corporation deposit insurance | 150                    | 236       | 320              | 468       |
| Debit card expenses                                     | 151                    | 159       | 310              | 286       |
| Marketing   | 204                    | 185       | 375              | 395       |
| Intangible amortization                                 | 86                     | 100       | 176              | 187       |
| Other   | 1,564                  | 1,488     | 2,954            | 3,115     |
| TOTAL NON-INTEREST EXPENSE                              | 9,063                  | 8,666     | 18,048           | 17,727    |
| INCOME BEFORE INCOME TAX PROVISION                      | 4,309                  | 4,542     | 7,981            | 8,502     |
| INCOME TAX PROVISION                                    | 1,223                  | 1,152     | 2,209            | 2,034     |
| NET INCOME  | \$ 3,086               | \$ 3,390  | \$ 5,772         | \$ 6,468  |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| EARNINGS PER SHARE - BASIC AND DILUTED                  | \$0.65    | \$0.72    | \$1.22    | \$1.37    |
| WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC AND DILUTED | 4,711,332 | 4,733,251 | 4,723,003 | 4,736,878 |
| DIVIDENDS DECLARED PER SHARE                            | \$0.47    | \$0.47    | \$0.94    | \$0.94    |

See accompanying notes to the unaudited consolidated financial statements.

4

---



Table of Contents

PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME  
(UNAUDITED)

| (In Thousands)   | Three Months           |         | Six Months             |          |
|--|------------------------|---------|------------------------|----------|
|  | Ended June 30,<br>2017 | 2016    | Ended June 30,<br>2017 | 2016     |
| Net Income   | \$3,086                | \$3,390 | \$5,772                | \$6,468  |
| Other comprehensive income:  |                        |         |                        |          |
| Change in unrealized gain on available for sale securities                       | 389                    | 1,265   | 1,128                  | 3,316    |
| Tax effect   | (132 )                 | (430 )  | (382 )                 | (1,127 ) |
| Net realized loss (gain) on available for sale securities included in net income | 12                     | (486 )  | (185 )                 | (921 )   |
| Tax effect   | (4 )                   | 165     | 62                     | 312      |
| Amortization of unrecognized pension loss  | 40                     | 39      | 84                     | 78       |
| Tax effect   | (10 )                  | (13 )   | (28 )                  | (27 )    |
| Total other comprehensive income   | 295                    | 540     | 679                    | 1,631    |
| Comprehensive income   | \$3,381                | \$3,930 | \$6,451                | \$8,099  |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

PENNS WOODS BANCORP, INC.  
 CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
 (UNAUDITED)

| (In Thousands, Except Per Share Data)                 | COMMON STOCK |          | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE LOSS |            | TREASURY STOCK | TOTAL SHAREHOLDERS' EQUITY |
|---|--------------|----------|----------------------------|-------------------|--------------------------------------|------------|----------------|----------------------------|
|   | SHARES       | AMOUNT   |                            |                   |                                      |            |                |                            |
| Balance, December 31, 2015                            | 5,004,984    | \$41,708 | \$49,992                   | \$58,038          | \$(3,799)                            | \$(9,660)  |                | \$136,279                  |
| Net income  |              |          |                            | 6,468             |                                      |            |                | 6,468                      |
| Other comprehensive income                            |              |          |                            |                   | 1,631                                |            |                | 1,631                      |
| Dividends declared, (\$0.94 per share)                |              |          |                            | (4,452)           |                                      |            |                | (4,452)                    |
| Common shares issued for employee stock purchase plan | 1,052        | 9        | 33                         |                   |                                      |            |                | 42                         |
| Purchase of treasury stock (14,600 shares)            |              |          |                            |                   |                                      |            | (574)          | (574)                      |
| Balance, June 30, 2016                                | 5,006,036    | \$41,717 | \$50,025                   | \$60,054          | \$(2,168)                            | \$(10,234) |                | \$139,394                  |

| (In Thousands, Except Per Share Data)                 | COMMON STOCK |          | ADDITIONAL PAID-IN CAPITAL | RETAINED EARNINGS | ACCUMULATED OTHER COMPREHENSIVE LOSS |            | TREASURY STOCK | TOTAL SHAREHOLDERS' EQUITY |
|---|--------------|----------|----------------------------|-------------------|--------------------------------------|------------|----------------|----------------------------|
|   | SHARES       | AMOUNT   |                            |                   |                                      |            |                |                            |
| Balance, December 31, 2016                            | 5,007,109    | \$41,726 | \$50,075                   | \$61,610          | \$(4,928)                            | \$(10,234) |                | \$138,249                  |
| Net income  |              |          |                            | 5,772             |                                      |            |                | 5,772                      |
| Other comprehensive income                            |              |          |                            |                   | 679                                  |            |                | 679                        |
| Dividends declared, (\$0.94 per share)                |              |          |                            | (4,430)           |                                      |            |                | (4,430)                    |
| Common shares issued for employee stock purchase plan | 1,083        | 9        | 42                         |                   |                                      |            |                | 51                         |
| Purchase of treasury stock (47,698 shares)            |              |          |                            |                   |                                      |            | (1,881)        | (1,881)                    |
| Balance, June 30, 2017                                | 5,008,192    | \$41,735 | \$50,117                   | \$62,952          | \$(4,249)                            | \$(12,115) |                | \$138,440                  |

See accompanying notes to the unaudited consolidated financial statements.

Table of Contents

PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

| (In Thousands)  | Six Months Ended |                 |
|---|------------------|-----------------|
|   | June 30,<br>2017 | 2016            |
| <b>OPERATING ACTIVITIES:</b>  |                  |                 |
| Net Income  | \$5,772          | \$6,468         |
| Adjustments to reconcile net income to net cash provided by operating activities: |                  |                 |
| Depreciation and amortization   | 1,389            | 1,596           |
| Amortization of intangible assets   | 176              | 187             |
| Provision for loan losses   | 545              | 608             |
| Accretion and amortization of investment security discounts and premiums          | 465              | 439             |
| Net securities gains, available for sale  | (185 )           | (921 )          |
| Originations of loans held for sale   | (26,087 )        | (30,946 )       |
| Proceeds of loans held for sale   | 27,218           | 31,387          |
| Gain on sale of loans   | (861 )           | (1,033 )        |
| Net securities gains, trading   | (2 )             | (46 )           |
| Proceeds from the sale of trading securities                                      | 332              | 3,439           |
| Purchases of trading securities   | (485 )           | (3,320 )        |
| Earnings on bank-owned life insurance   | (333 )           | (345 )          |
| Decrease in deferred tax asset  | (63 )            | 776             |
| Other, net  | (3,461 )         | (2,822 )        |
| Net cash provided by operating activities   | 4,420            | 5,467           |
| <b>INVESTING ACTIVITIES:</b>  |                  |                 |
| Proceeds from sales of available for sale securities                              | 9,130            | 36,007          |
| Proceeds from calls and maturities of available for sale securities               | 5,388            | 13,591          |
| Purchases of available for sale securities  | (18,434 )        | (17,730 )       |
| Net increase in loans   | (46,226 )        | (9,130 )        |
| Acquisition of premises and equipment   | (2,004 )         | (1,235 )        |
| Proceeds from the sale of foreclosed assets                                       | 587              | 433             |
| Purchase of bank-owned life insurance   | (30 )            | (27 )           |
| Proceeds from redemption of regulatory stock                                      | 2,134            | 2,311           |
| Purchases of regulatory stock   | (2,566 )         | (1,813 )        |
| Net cash (used for) provided by investing activities                              | (52,021 )        | 22,407          |
| <b>FINANCING ACTIVITIES:</b>  |                  |                 |
| Net increase in interest-bearing deposits   | 59,119           | 59,068          |
| Net decrease in noninterest-bearing deposits                                      | (3,223 )         | (6,081 )        |
| Repayment of long-term borrowings   | (10,000 )        | —               |
| Net increase (decrease) in short-term borrowings                                  | 2,496            | (29,198 )       |
| Dividends paid  | (4,430 )         | (4,452 )        |
| Issuance of common stock  | 51               | 42              |
| Purchases of treasury stock   | (1,881 )         | (574 )          |
| Net cash provided by financing activities   | 42,132           | 18,805          |
| <b>NET (DECREASE) INCREASE IN CASH AND CASH EQUIVALENTS</b>                       | <b>(5,469 )</b>  | <b>46,679</b>   |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING</b>                                       | <b>43,671</b>    | <b>22,796</b>   |
| <b>CASH AND CASH EQUIVALENTS, ENDING</b>  | <b>\$38,202</b>  | <b>\$69,475</b> |
| <b>SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION:</b>                         |                  |                 |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|   |         |         |
|---|---------|---------|
| Interest paid                               | \$2,772 | \$2,703 |
| Income taxes paid                           | 2,350   | 2,750   |
| Transfer of loans to foreclosed real estate | 490     | 83      |

See accompanying notes to the unaudited consolidated financial statements.

7

---

Table of Contents

PENNS WOODS BANCORP, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

## Note 1. Basis of Presentation

The consolidated financial statements include the accounts of Penns Woods Bancorp, Inc. (the “Company”) and its wholly-owned subsidiaries: Woods Investment Company, Inc., Woods Real Estate Development Company, Inc., Luzerne Bank, and Jersey Shore State Bank (Jersey Shore State Bank and Luzerne Bank are referred to together as the “Banks”) and Jersey Shore State Bank’s wholly-owned subsidiary, The M Group, Inc. D/B/A The Comprehensive Financial Group (“The M Group”). All significant inter-company balances and transactions have been eliminated in the consolidation.

The interim financial statements are unaudited, but in the opinion of management reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2016.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 39 through 48 of the Form 10-K for the year ended December 31, 2016.

In reference to the attached financial statements, all adjustments are of a normal recurring nature pursuant to Rule 10-01(b) (8) of Regulation S-X.

## Note 2. Accumulated Other Comprehensive Loss

The changes in accumulated other comprehensive loss by component shown net of tax as of June 30, 2017 and 2016 were as follows:

| (In Thousands)   | Three Months Ended June 30, 2017                     |                      |           | Three Months Ended June 30, 2016                     |                      |           |
|--|--|----------------------|-----------|--|----------------------|-----------|
|  | Net Unrealized Loss on Available for Sale Securities | Defined Benefit Plan | Total     | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total     |
| Beginning balance  | \$(281)  | \$(4,263)            | \$(4,544) | \$1,324  | \$(4,032)            | \$(2,708) |
| Other comprehensive income before reclassifications            | 257  | —                    | 257       | 835  | —                    | 835       |
| Amounts reclassified from accumulated other comprehensive loss | 8  | 30                   | 38        | (321)  | 26                   | (295)     |
| Net current-period other comprehensive income                  | 265  | 30                   | 295       | 514  | 26                   | 540       |
| Ending balance   | \$(16)   | \$(4,233)            | \$(4,249) | \$1,838  | \$(4,006)            | \$(2,168) |

  

| (In Thousands) | Six Months Ended June 30, 2017                       |                      |       | Six Months Ended June 30, 2016                       |                      |       |
|----------------|--|----------------------|-------|--|----------------------|-------|
|                | Net Unrealized Loss on Available for Sale Securities | Defined Benefit Plan | Total | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total |
|                |  |                      |       |  |                      |       |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|  |          |            |            |          |            |            |
|--|----------|------------|------------|----------|------------|------------|
| Beginning balance  | \$ (639) | \$ (4,289) | \$ (4,928) | \$ 258   | \$ (4,057) | \$ (3,799) |
| Other comprehensive income before reclassifications            | 746      | —          | 746        | 2,189    | —          | 2,189      |
| Amounts reclassified from accumulated other comprehensive loss | (123 )   | 56         | (67 )      | (609 )   | 51         | (558 )     |
| Net current-period other comprehensive income                  | 623      | 56         | 679        | 1,580    | 51         | 1,631      |
| Ending balance   | \$ (16 ) | \$ (4,233) | \$ (4,249) | \$ 1,838 | \$ (4,006) | \$ (2,168) |

Table of Contents

The reclassifications out of accumulated other comprehensive loss shown, net of tax and parenthesis indicating debits to net income, as of June 30, 2017 and 2016 were as follows:

| Details about Accumulated Other Comprehensive Loss Components | Amount Reclassified from Accumulated Other Comprehensive Loss |                                  | Affected Line Item in the Consolidated Statement of Income |
|---|---|----------------------------------|--|
|   | Three Months Ended June 30, 2017                              | Three Months Ended June 30, 2016 |  |
| Net unrealized (loss) gain on available for sale securities   | \$ (12 )  | \$ 486                           | Net securities (losses) gains, available for sale          |
| Income tax effect   | 4   | (165 )                           | Income tax provision                                       |
| Total reclassifications for the period                        | \$ (8 )   | \$ 321                           |  |
| Net unrecognized pension costs                                | \$ (45 )  | \$ (39 )                         | Salaries and employee benefits                             |
| Income tax effect   | 15  | 13                               | Income tax provision                                       |
| Total reclassifications for the period                        | \$ (30 )  | \$ (26 )                         |  |
| Details about Accumulated Other Comprehensive Loss Components | Amount Reclassified from Accumulated Other Comprehensive Loss |                                  | Affected Line Item in the Consolidated Statement of Income |
|   | Six months ended June 30, 2017                                | Six months ended June 30, 2016   |  |
| Net unrealized gain on available for sale securities          | \$ 185  | \$ 921                           | Net securities gains, available for sale                   |
| Income tax effect   | (62 )   | (312 )                           | Income tax provision                                       |
| Total reclassifications for the period                        | \$ 123  | \$ 609                           |  |
| Net unrecognized pension costs                                | \$ (84 )  | \$ (78 )                         | Salaries and employee benefits                             |
| Income tax effect   | 28  | 27                               | Income tax provision                                       |
| Total reclassifications for the period                        | \$ (56 )  | \$ (51 )                         |  |

### Note 3. Recent Accounting Pronouncements

In August 2015, the FASB issued ASU 2015-14, Revenue from Contracts with Customers (Topic 606). The amendments in this Update defer the effective date of ASU 2014-09 for all entities by one year. Public business entities, certain not-for-profit entities, and certain employee benefit plans should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. All other entities should apply the guidance in ASU 2014-09 to annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. The Company is evaluating the effect of adopting this new accounting Update.

In January 2016, the FASB issued ASU 2016-01, Financial Instruments - Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at

amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. For all other entities, including not-for-profit entities and employee benefit plans within the scope of Topics 960 through 965 on plan accounting, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. All entities that are not public business entities may adopt the amendments in this Update earlier as of the fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.



Table of Contents

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842). The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. For all other entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2019, and for interim periods within fiscal years beginning after December 15, 2020. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. The Company is currently assessing the practical expedients it may elect at adoption, but does not anticipate the amendments will have a significant impact on the financial statements. Based on the Company's preliminary analysis of its current portfolio, the impact to the Company's balance sheet is estimated to result in less than a 1 percent increase in assets and liabilities. The Company also anticipates additional disclosures to be provided at adoption.

In March 2016, the FASB issued ASU 2016-05, Derivatives and Hedging (Topic 815). The amendments in this Update apply to all reporting entities for which there is a change in the counterparty to a derivative instrument that has been designated as a hedging instrument under Topic 815. The standards in this Update clarify that a change in the counterparty to a derivative instrument that has been designated as the hedging instrument under Topic 815 does not, in and of itself, require designation of that hedging relationship provided that all other hedge accounting criteria continue to be met. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For all other entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. An entity has an option to apply the amendments in this Update on either a prospective basis or a modified retrospective basis. Early adoption is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-06, Derivatives and Hedging (Topic 815). The amendments apply to all entities that are issuers of or investors in debt instruments (or hybrid financial instruments that are determined to have a debt host) with embedded call (put) options. The amendments in this Update clarify the requirements for assessing whether contingent call (put) options that can accelerate the payment of principal on debt instruments are clearly and closely related to their debt host. An entity performing the assessment under the amendments in this Update is required to assess the embedded call (put) options solely in accordance with the four-step decision sequence. For public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. For entities other than public business entities, the amendments in this Update are effective for financial statements issued for fiscal years beginning after December 15, 2017, and interim periods within fiscal years beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. This Update is not expected to have a significant impact on the Company's financial statements.

In March 2016, the FASB issued ASU 2016-08, Revenue from Contracts with Customers (Topic 606). The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services (that are an output of the entity's ordinary activities) in exchange for consideration. The amendments in this Update do not change the core principle of the guidance in Topic 606; they simply clarify the implementation guidance on principal versus agent considerations. The amendments in this Update are intended to improve the operability and understandability of the implementation

guidance on principal versus agent considerations. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements of Update 2014-09. ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In April 2016, the FASB issued ASU 2016-10, Revenue from Contracts with Customers (Topic 606). The amendments in this Update affect entities with transactions included within the scope of Topic 606, which includes entities that enter into contracts with customers to transfer goods or services in exchange for consideration. The amendments in this Update do not change the core principle for revenue recognition in Topic 606. Instead, the amendments provide (1) more detailed guidance in a few areas and (2) additional implementation guidance and examples based on feedback the FASB received from its stakeholders. The amendments are expected to reduce the degree of judgment necessary to comply with Topic 606, which the FASB expects will reduce the potential for diversity arising in practice and reduce the cost and complexity of applying the guidance. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective.

## Table of Contents

The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In May 2016, the FASB issued ASU 2016-12, Revenue from Contracts with Customers (Topic 606), which among other things clarifies the objective of the collectability criterion in Topic 606, as well as certain narrow aspects of Topic 606. The amendments in this Update affect the guidance in ASU 2014-09, Revenue from Contracts with Customers (Topic 606), which is not yet effective. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements for Topic 606 (and any other Topic amended by Update 2014-09). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, defers the effective date of Update 2014-09 by one year. This Update is not expected to have a significant impact on the Company's financial statements

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

In August 2016, the FASB issued ASU 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments, which addresses eight specific cash flow issues with the objective of reducing diversity in practice. Among these include recognizing cash payments for debt prepayment or debt extinguishment as cash outflows for financing activities; cash proceeds received from the settlement of insurance claims should be classified on the basis of the related insurance coverage; and cash proceeds received from the settlement of bank-owned life insurance policies should be classified as cash inflows from investing activities while the cash payments for premiums on bank-owned policies may be classified as cash outflows for investing activities, operating activities, or a combination of investing and operating activities. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity that elects early adoption must adopt all of the amendments in the same period. The amendments in this Update should be applied using a retrospective transition method to each period presented. If it is impracticable to apply the amendments retrospectively for some of the issues, the amendments for those issues would be applied prospectively as of the earliest date practicable. The Company is

currently evaluating the impact the adoption of the standard will have on the Company's statement of cash flows.

In October 2016, the FASB issued ASU 2016-16, Income Taxes (Topic 740), which requires recognition of current and deferred income taxes resulting from an intra-entity transfer of any asset (excluding inventory) when the transfer occurs. Consequently, the amendments in this Update eliminate the exception for an intra-entity transfer of an asset other than inventory. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, including interim periods within those annual reporting periods. For all other entities, the amendments are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual periods beginning after December 15, 2019. Early adoption is permitted for all entities as of the beginning of an annual reporting period for which financial statements (interim or annual) have not been issued or made available for issuance. That is, earlier adoption should be in the first interim period if an entity issues interim financial statements. The amendments in this Update should be applied on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. This Update is not expected to have a significant impact on the Company's financial statements.

In October 2016, the FASB issued ASU 2016-17, Consolidation (Topic 810), which amends the consolidation guidance on how a reporting entity that is the single decision maker of a VIE should treat indirect interests in the entity held through related parties

Table of Contents

that are under common control with the reporting entity when determining whether it is the primary beneficiary of that VIE. The primary beneficiary of a VIE is the reporting entity that has a controlling financial interest in a VIE and, therefore, consolidates the VIE. A reporting entity has an indirect interest in a VIE if it has a direct interest in a related party that, in turn, has a direct interest in the VIE. Under the amendments, a single decision maker is not required to consider indirect interests held through related parties that are under common control with the single decision maker to be the equivalent of direct interests in their entirety. Instead, a single decision maker is required to include those interests on a proportionate basis consistent with indirect interests held through other related parties. This Update is not expected to have a significant impact on the Company's financial statements.

In October 2016, the FASB issued ASU 2016-18, Statement of Cash Flows (Topic 230), which requires that a statement of cash flows explains 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. The amendments in this Update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within fiscal years beginning after December 15, 2019. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments in this Update should be applied using a retrospective transition method to each period presented. The Company is currently evaluating the impact the adoption of the standard will have on the Company's statement of cash flows.

In December 2016, the FASB issued ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers. This Update, among others things, clarifies that guarantee fees within the scope of Topic 460, Guarantees, (other than product or service warranties) are not within the scope of Topic 606. The effective date and transition requirements for ASU 2016-20 are the same as the effective date and transition requirements for the new revenue recognition guidance. For public entities with a calendar year-end, the new guidance is effective in the quarter and year beginning January 1, 2018. For all other entities with a calendar year-end, the new guidance is effective in the year ending December 31, 2019, and interim periods in 2020. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In January 2017, the FASB issued ASU 2017-01, Business Combinations (Topic 805), Clarifying the Definition of a Business, which provides a more robust framework to use in determining when a set of assets and activities (collectively referred to as a "set") is a business. The screen requires that when substantially all of the fair value of the gross assets acquired (or disposed of) is concentrated in a single identifiable asset or a group of similar identifiable assets, the set is not a business. This screen reduces the number of transactions that need to be further evaluated. Public business entities should apply the amendments in this Update to annual periods beginning after December 15, 2017, including interim periods within those periods. All other entities should apply the amendments to annual periods beginning after December 15, 2018, and interim periods within annual periods beginning after December 15, 2019. The amendments in this Update should be applied prospectively on or after the effective date. This Update is not expected to have a significant impact on the Company's financial statements.

In January 2017, the FASB issued ASU 2017-03, Accounting Changes and Error Corrections (Topic 250) and Investments-Equity Method and Joint Ventures (Topic 323), Amendments to SEC Paragraphs Pursuant to Staff Announcements at the September 22, 2016 and November 17, 2016 EITF Meetings. This Update adds an SEC paragraph to the Codification following an SEC Staff Announcement about applying Staff Accounting Bulletin (SAB) Topic 11.M. Specifically, this announcement applies to ASU 2014-09, Revenue from Contracts with Customers

(Topic 606); ASU 2016-02, Leases (Topic 842); and ASU 2016-13, Financial Instruments-Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments. A registrant should evaluate Updates that have not yet been adopted to determine the appropriate financial statement disclosures about the potential material effects of those Updates on the financial statements when adopted. If a registrant does not know or cannot reasonably estimate the impact that adoption of the Updates referenced in this announcement are expected to have on the financial statements, then in addition to making a statement to that effect, that registrant should consider additional qualitative financial statement disclosures to assist the reader in assessing the significance of the impact that the standard will have on the financial statements of the registrant when adopted. In this regard, the SEC staff expects the additional qualitative disclosures to include a description of the effect of the accounting policies that the registrant expects to apply, if determined, and a comparison to the registrant's current accounting policies. Also, a registrant should describe the status of its process to implement the new standards and the significant implementation matters yet to be addressed. The amendments in this Update are effective immediately.

In January 2017, the FASB issued ASU 2017-04, Simplifying the Test for Goodwill Impairment. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. In computing the implied fair value of goodwill under Step 2, an entity had to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities (including unrecognized assets and liabilities) following the procedure that would be required in determining

Table of Contents

the fair value of assets acquired and liabilities assumed in a business combination. Instead, under the amendments in this Update, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting units fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. A public business entity that is a U.S. Securities and Exchange Commission (“SEC”) filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. A public business entity that is not an SEC filer should adopt the amendments in this Update for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2020. All other entities, including not-for-profit entities, that are adopting the amendments in this Update should do so for their annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2021. This Update is not expected to have a significant impact on the Company’s financial statements.

In February 2017, the FASB issued ASU 2017-05, Other Income-Gains and Losses from the Derecognition of Nonfinancial Assets (Subtopic 610-20). The amendments in this Update clarify what constitutes a financial asset within the scope of Subtopic 610-20. The amendments also clarify that entities should identify each distinct nonfinancial asset or in substance nonfinancial asset that is promised to a counterparty and to derecognize each asset when the counterparty obtains control. There is also additional guidance provided for partial sales of a nonfinancial asset and when derecognition, and the related gain or loss, should be recognized. The amendments in this Update are effective at the same time as the amendments in Update 2014-09. Therefore, for public entities, the amendments are effective for annual reporting periods beginning after December 15, 2017, including interim reporting periods within that reporting period. For all other entities, the amendments in this Update are effective for annual reporting periods beginning after December 15, 2018, and interim reporting periods within annual reporting periods beginning after December 15, 2019. This Update is not expected to have a significant impact on the Company’s financial statements.

In March 2017, the FASB issued ASU 2017-07, Compensation-Retirement Benefits (Topic 715). The amendments in this Update require that an employer report the service cost component in the same line item or items as other compensation costs arising from services rendered by the pertinent employees during the period. The other components of net benefit cost as defined in paragraphs 715-30-35-4 and 715-60-35-9 are required to be presented in the income statement separately from the service cost component and outside a subtotal of income from operations, if one is presented. If a separate line item or items are used to present the other components of net benefit cost, that line item or items must be appropriately described. If a separate line item or items are not used, the line item or items used in the income statement to present the other components of net benefit cost must be disclosed. This Update is not expected to have a significant impact on the Company’s financial statements.

In March 2017, the FASB issued ASU 2017-08, Receivables - Nonrefundable Fees and Other Costs (Subtopic 310-20). The amendments in this Update shorten the amortization period for certain callable debt securities held at a premium. Specifically, the amendments require the premium to be amortized to the earliest call date. The amendments do not require an accounting change for securities held at a discount; the discount continues to be amortized to maturity. For public business entities, the amendments in this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. An entity should apply the amendments in this Update on a modified retrospective basis through a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. Additionally, in the period of adoption, an entity should provide disclosures about a change in accounting principle. This Update is not expected to have a significant impact on the Company’s financial statements.

In May 2017, the FASB issued ASU 2017-09, Compensation - Stock Compensation (Topic 718), which affects any entity that changes the terms or conditions of a share-based payment award. This Update amends the definition of modification by qualifying that modification accounting does not apply to changes to outstanding share-based payment awards that do not affect the total fair value, vesting requirements, or equity/liability classification of the awards. The amendments in this Update are effective for all entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2017. Early adoption is permitted, including adoption in any interim period, for (1) public business entities for reporting periods for which financial statements have not yet been issued and (2) all other entities for reporting periods for which financial statements have not yet been made available for issuance. The amendments in this Update should be applied prospectively to an award modified on or after the adoption date. This Update is not expected to have a significant impact on the Company's financial statements.

In May 2017, the FASB issued ASU 2017-10, Service Concession Arrangements (Topic 853), which applies to the accounting by operating entities for service concession arrangements within the scope of Topic 853. The amendments in this Update clarify that the grantor (government), rather than the third-party drivers, is the customer of the operation services in all cases for service concession arrangements within the scope of Topic 853. For an entity that has not adopted Topic 606 before the issuance of this Update, the effective date and transition requirements for the amendments in this Update generally are the same as the effective



Table of Contents

date and transition requirements for Topic 606 (and any other Topic amended by ASU 2014-09, Revenue from Contracts with Customers (Topic 606)). ASU 2015-14, Revenue from Contracts with Customers (Topic 606): Deferral of the Effective Date, deferred the effective date of Update 2014-09 by one year. This Update is not expected to have a significant impact on the Company's financial statements.

In July 2017, the FASB issued ASU 2017-11, Earnings Per Share (Topic 260), Distinguishing Liabilities from Equity (Topic 480), and Derivative and Hedging (Topic 815). The amendments in Part I of this Update change the classification analysis of certain equity-linked financial instruments (or embedded features) with down-round features. When determining whether certain financial instruments should be classified as liabilities or equity instruments, a down-round feature no longer precludes equity classification when assessing whether the instrument is indexed to an entity's own stock. The amendments also clarify existing disclosure requirements for equity-classified instruments. As a result, a freestanding equity-linked financial instrument (or embedded conversion option) no longer would be accounted for as a derivative liability at fair value as a result of the existence of a down-round feature. For freestanding equity classified financial instruments, the amendments require entities that present earnings per share ("EPS") in accordance with Topic 260 to recognize the effect of the down-round feature when it is triggered. That effect is treated as a dividend and as a reduction of income available to common shareholders in basic EPS. Convertible instruments with embedded conversion options that have down-round features are now subject to the specialized guidance for contingent beneficial conversion features (in Subtopic 470-20, Debt-Debt with Conversion and Other Options), including related EPS guidance (in Topic 260). The amendments in Part II of this Update recharacterize the indefinite deferral of certain provisions of Topic 480 that now are presented as pending content in the Accounting Standards Codification, to a scope exception. Those amendments do not have an accounting effect. For public business entities, the amendments in Part I of this Update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. For all other entities, the amendments in Part I of this Update are effective for fiscal years beginning after December 15, 2019, and interim periods within fiscal years beginning after December 15, 2020. Early adoption is permitted for all entities, including adoption in an interim period. If an entity early adopts the amendments in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments in Part I of this Update should be applied either retrospectively to outstanding financial instruments with a down-round feature by means of a cumulative-effect adjustment to the statement of financial position as of the beginning of the first fiscal year and interim period(s) in which the pending content that links to this paragraph is effective or retrospectively to outstanding financial instruments with a down-round feature for each prior reporting period presented in accordance with the guidance on accounting changes in paragraphs 250-10-45-5 through 45-10. The amendments in Part II of this Update do not require any transition guidance because those amendments do not have an accounting effect. This Update is not expected to have a significant impact on the Company's financial statements.

## Note 4. Per Share Data

There are no convertible securities which would affect the denominator in calculating basic and dilutive earnings per share. There were a total of 96,500 stock options, with an average exercise price of \$43.61, outstanding on June 30, 2017. These options were excluded, on a weighted average basis, in the computation of diluted earnings per share for the period due to the average market price of common shares of \$43.26 being in excess of the exercise price of the options. There were a total of 31,000 stock options outstanding for the same period end in 2016 that had an average exercise price of \$42.03 and were excluded from the computation of diluted earnings per share because the average market price of common shares was \$40.06 for the period. Net income as presented on the consolidated statement of income will be used as the numerator. The following table sets forth the composition of the weighted average common shares (denominator) used in the basic and dilutive earnings per share computation.

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|  | Three Months Ended |           | Six Months Ended |           |
|--|--------------------|-----------|------------------|-----------|
|  | June 30,           |           | June 30,         |           |
|  | 2017               | 2016      | 2017             | 2016      |
| Weighted average common shares outstanding - basic   | 4,711,332          | 4,733,251 | 4,723,003        | 4,736,878 |
| Dilutive effect of outstanding stock options         | —                  | —         | —                | —         |
| Weighted average common shares outstanding - diluted | 4,711,332          | 4,733,251 | 4,723,003        | 4,736,878 |

Table of Contents

## Note 5. Investment Securities

The amortized cost, gross unrealized gains and losses, and fair values of investment securities available for sale at June 30, 2017 and December 31, 2016 are as follows:

| (In Thousands)                              | June 30, 2017  |                        |                         |            |
|---|----------------|------------------------|-------------------------|------------|
|   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale (AFS):                   |                |                        |                         |            |
| Mortgage-backed securities                  | \$4,649        | \$ 83                  | \$ (106 )               | \$4,626    |
| State and political securities              | 69,091         | 1,006                  | (130 )                  | 69,967     |
| Other debt securities                       | 53,671         | 135                    | (1,650 )                | 52,156     |
| Total debt securities                       | 127,411        | 1,224                  | (1,886 )                | 126,749    |
| Financial institution equity securities     | 9,818          | 679                    | —                       | 10,497     |
| Non-financial institution equity securities | 1,300          | —                      | (42 )                   | 1,258      |
| Total equity securities                     | 11,118         | 679                    | (42 )                   | 11,755     |
| Total investment securities AFS             | \$138,529      | \$ 1,903               | \$ (1,928 )             | \$138,504  |

| (In Thousands)                              | December 31, 2016 |                        |                         |            |
|---|-------------------|------------------------|-------------------------|------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale (AFS):                   |                   |                        |                         |            |
| Mortgage-backed securities                  | \$9,295           | \$ 182                 | \$ (164 )               | \$9,313    |
| Asset-backed securities                     | 109               | —                      | —                       | 109        |
| State and political securities              | 60,777            | 666                    | (509 )                  | 60,934     |
| Other debt securities                       | 53,046            | 137                    | (2,065 )                | 51,118     |
| Total debt securities                       | 123,227           | 985                    | (2,738 )                | 121,474    |
| Financial institution equity securities     | 9,566             | 969                    | —                       | 10,535     |
| Non-financial institution equity securities | 1,667             | —                      | (184 )                  | 1,483      |
| Total equity securities                     | 11,233            | 969                    | (184 )                  | 12,018     |
| Total investment securities AFS             | \$134,460         | \$ 1,954               | \$ (2,922 )             | \$133,492  |

The amortized cost and fair values of trading investment securities at June 30, 2017 and December 31, 2016 are as follows.

| (In Thousands)                              | June 30, 2017  |                        |                         |            |
|---|----------------|------------------------|-------------------------|------------|
|   | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Trading:                                    |                |                        |                         |            |
| Financial institution equity securities     | \$61           | \$ 1                   | \$ —                    | \$62       |
| Non-financial institution equity securities | 157            | —                      | (6 )                    | 151        |
| Total trading securities                    | \$218          | \$ 1                   | \$ (6 )                 | \$213      |

Table of Contents

| (In Thousands)                              | December 31, 2016 |                        |                         |            |
|---|-------------------|------------------------|-------------------------|------------|
|   | Amortized Cost    | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Trading:                                    |                   |                        |                         |            |
| Financial institution equity securities     | \$—               | \$ —                   | \$ —                    | —\$ —      |
| Non-financial institution equity securities | \$56              | \$ 2                   | \$ —                    | —\$ 58     |
| Total trading securities                    | \$56              | \$ 2                   | \$ —                    | —\$ 58     |

Total net trading gains of \$0 and \$2,000 for the three and six month periods ended June 30, 2017 compared to net trading gains of \$6,000 and \$46,000 for the three and six month periods ended June 30, 2016 were included in the Consolidated Statement of Income.

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at June 30, 2017 and December 31, 2016.

| (In Thousands)                              | June 30, 2017           |                         |            |                          |            |                         |
|---|-------------------------|-------------------------|------------|--------------------------|------------|-------------------------|
|   | Less than Twelve Months |                         |            | Twelve Months or Greater |            | Total                   |
|   | Fair Value              | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses  | Fair Value | Gross Unrealized Losses |
| Available for sale (AFS):                   |                         |                         |            |                          |            |                         |
| Mortgage-backed securities                  | \$3,415                 | \$ (106 )               | \$ —       | \$ —                     | \$3,415    | \$ (106 )               |
| State and political securities              | 12,175                  | (130 )                  | —          | —                        | 12,175     | (130 )                  |
| Other debt securities                       | 30,906                  | (914 )                  | 11,297     | (736 )                   | 42,203     | (1,650 )                |
| Total debt securities                       | 46,496                  | (1,150 )                | 11,297     | (736 )                   | 57,793     | (1,886 )                |
| Financial institution equity securities     | —                       | —                       | —          | —                        | —          | —                       |
| Non-financial institution equity securities | 1,258                   | (42 )                   | —          | —                        | 1,258      | (42 )                   |
| Total equity securities                     | 1,258                   | (42 )                   | —          | —                        | 1,258      | (42 )                   |
| Total investment securities AFS             | \$47,754                | \$ (1,192 )             | \$ 11,297  | \$ (736 )                | \$59,051   | \$ (1,928 )             |

| (In Thousands)                              | December 31, 2016       |                         |            |                          |            |                         |
|---|-------------------------|-------------------------|------------|--------------------------|------------|-------------------------|
|   | Less than Twelve Months |                         |            | Twelve Months or Greater |            | Total                   |
|   | Fair Value              | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses  | Fair Value | Gross Unrealized Losses |
| Available for sale (AFS):                   |                         |                         |            |                          |            |                         |
| Mortgage-backed securities                  | \$3,572                 | \$ (106 )               | \$ 3,627   | \$ (58 )                 | \$7,199    | \$ (164 )               |
| State and political securities              | 26,113                  | (509 )                  | —          | —                        | 26,113     | (509 )                  |
| Other debt securities                       | 28,140                  | (1,179 )                | 12,240     | (886 )                   | 40,380     | (2,065 )                |
| Total debt securities                       | 57,825                  | (1,794 )                | 15,867     | (944 )                   | 73,692     | (2,738 )                |
| Financial institution equity securities     | —                       | —                       | —          | —                        | —          | —                       |
| Non-financial institution equity securities | 727                     | (140 )                  | 756        | (44 )                    | 1,483      | (184 )                  |
| Total equity securities                     | 727                     | (140 )                  | 756        | (44 )                    | 1,483      | (184 )                  |
| Total investment securities AFS             | \$58,552                | \$ (1,934 )             | \$ 16,623  | \$ (988 )                | \$75,175   | \$ (2,922 )             |

At June 30, 2017 there were a total of 54 securities in a continuous unrealized loss position for less than twelve months and 7 individual securities that were in a continuous unrealized loss position for twelve months or greater.

Table of Contents

The Company reviews its position quarterly and has determined that, at June 30, 2017, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at June 30, 2017, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

| (In Thousands)                    | Amortized Cost | Fair Value |
|-----------------------------------|----------------|------------|
| Due in one year or less           | \$ 2,140       | \$ 2,140   |
| Due after one year to five years  | 46,434         | 45,944     |
| Due after five years to ten years | 63,600         | 63,222     |
| Due after ten years               | 15,237         | 15,443     |
| Total                             | \$ 127,411     | \$ 126,749 |

Total gross proceeds from sales of securities available for sale for the three and six months ended June 30, 2017 were \$6,478,000 and \$9,130,000, a decrease from the 2016 totals of \$16,168,000 and \$36,007,000.

The following table represents gross realized gains and losses within the available for sale portfolio:

| (In Thousands)                              | Three Months Ended June 30, |       | Six Months Ended June 30, |         |
|---|-----------------------------|-------|---------------------------|---------|
|   | 2017                        | 2016  | 2017                      | 2016    |
| Gross realized gains:                       |                             |       |                           |         |
| Mortgage-backed securities                  | \$24                        | \$6   | 69                        | 6       |
| State and political securities              | 15                          | 339   | 29                        | 638     |
| Other debt securities                       | —                           | 226   | —                         | 258     |
| Financial institution equity securities     | —                           | —     | 288                       | 82      |
| Non-financial institution equity securities | —                           | —     | —                         | 144     |
| Total gross realized gains                  | \$39                        | \$571 | \$386                     | \$1,128 |
| Gross realized losses:                      |                             |       |                           |         |
| U.S. Government and agency securities       | \$—                         | \$3   | \$—                       | \$3     |
| Mortgage-backed securities                  | —                           | —     | —                         | —       |
| Asset-backed securities                     | —                           | —     | —                         | —       |
| State and political securities              | —                           | —     | —                         | —       |
| Other debt securities                       | 51                          | 82    | 51                        | 163     |
| Financial institution equity securities     | —                           | —     | —                         | —       |
| Non-financial institution equity securities | —                           | —     | 150                       | 41      |
| Total gross realized losses                 | \$51                        | \$85  | \$201                     | \$207   |



Table of Contents

The following table represents gross realized gains and losses within the trading portfolios:

|   | Three<br>Months<br>Ended<br>June 30,<br>2017 | Six<br>Months<br>Ended<br>June 30,<br>2016 | Three<br>Months<br>Ended<br>June 30,<br>2017 | Six<br>Months<br>Ended<br>June 30,<br>2016 |
|---|--|--|--|--|
| (In Thousands)                              |  |  |  |  |
| Gross realized gains:                       |  |  |  |  |
| Financial institution equity securities     | \$ —   | \$ —                                       | \$ —   | \$ 6                                       |
| Non-financial institution equity securities | 6  | 9  | 8  | 68   |
| Total gross realized gains                  | \$ 6   | \$ 9                                       | \$ 8   | \$ 74                                      |
| Gross realized losses:                      |  |  |  |  |
| Financial institution equity securities     | \$ —   | \$ 3                                       | \$ —   | \$ 16                                      |
| Non-financial institution equity securities | 6  | —  | 6  | 12   |
| Total gross realized losses                 | \$ 6   | \$ 3                                       | \$ 6   | \$ 28                                      |

There were no impairment charges included in gross realized losses for the three and six months ended June 30, 2017 and 2016, respectively.

Investment securities with a carrying value of approximately \$103,864,000 and \$95,199,000 at June 30, 2017 and December 31, 2016, respectively, were pledged to secure certain deposits, repurchase agreements, and for other purposes as required by law.

## Note 6. Loans

Management segments the Banks' loan portfolio to a level that enables risk and performance monitoring according to similar risk characteristics. Loans are segmented based on the underlying collateral characteristics. Categories include commercial, financial, and agricultural, real estate, and installment loans to individuals. Real estate loans are further segmented into three categories: residential, commercial, and construction.

The following table presents the related aging categories of loans, by segment, as of June 30, 2017 and December 31, 2016:

|   | June 30, 2017 |                              |   |                 |            |   |
|---|---------------|------------------------------|---|-----------------|------------|---|
|   | Current       | Past Due<br>30 To 89<br>Days | Past Due 90<br>Days Or More<br>& Still Accruing | Non-<br>Accrual | Total      |   |
| (In Thousands)                          |               |                              |   |                 |            |   |
| Commercial, financial, and agricultural | \$ 147,297    | \$ 424                       | \$ 9  | \$ 564          | \$ 148,294 |   |
| Real estate mortgage:                   |               |                              |   |                 |            |   |
| Residential                             | 566,188       | 2,509                        | 67  | 1,932           | 570,696    |   |
| Commercial                              | 307,285       | 632                          | 1,152   | 8,649           | 317,718    |   |
| Construction                            | 33,986        | 18                           | 101   | —               | 34,105     |   |
| Installment loans to individuals        | 68,862        | 637                          | —   | 24              | 69,523     |   |
|   | 1,123,618     | \$ 4,220                     | \$ 1,329  | \$ 11,169       | 1,140,336  |   |
| Net deferred loan fees and discounts    | (1,251        | )                            |   |                 | (1,251     | ) |
| Allowance for loan losses               | (13,109       | )                            |   |                 | (13,109    | ) |



|            |             |             |
|------------|-------------|-------------|
| Loans, net | \$1,109,258 | \$1,125,976 |
|------------|-------------|-------------|

18

---

Table of Contents

| (In Thousands)  | December 31, 2016 |                        |   |             | Total       |
|---|-------------------|------------------------|---|-------------|-------------|
|   | Current           | Past Due 30 To 89 Days | Past Due 90 Days Or More & Still Accruing | Non-Accrual |             |
| Commercial, financial, and agricultural Real estate mortgage: | \$145,179         | \$785                  | \$ 14                                     | \$132       | \$146,110   |
| Residential   | 553,053           | 9,112                  | 587                                       | 1,988       | 564,740     |
| Commercial  | 296,537           | 786                    | 268                                       | 8,591       | 306,182     |
| Construction  | 33,879            | 771                    | —   | —           | 34,650      |
| Installment loans to individuals                              | 43,008            | 202                    | 1   | 45          | 43,256      |
|   | 1,071,656         | \$11,656               | \$ 870                                    | \$10,756    | 1,094,938   |
| Net deferred loan fees and discounts                          | (1,257 )          |                        |   |             | (1,257 )    |
| Allowance for loan losses                                     | (12,896 )         |                        |   |             | (12,896 )   |
| Loans, net  | \$1,057,503       |                        |   |             | \$1,080,785 |

Purchased loans acquired are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses.

The following table presents interest income the Banks would have recorded if interest had been recorded based on the original loan agreement terms and rate of interest for non-accrual loans and interest income recognized on a cash basis for non-accrual loans for the three and six months ended June 30, 2017 and 2016:

| (In Thousands)  | Three Months Ended June 30,  |   |  |   |
|---|--|---|--|---|
|   | 2017   |   | 2016   |   |
|   | Interest Income That Would Have Been Recorded Based on Original Cash Basis | Interest Income That Would Have Been Recorded Based on Original Term Rate | Interest Income That Would Have Been Recorded Based on Original Cash Basis | Interest Income That Would Have Been Recorded Based on Original Term Rate |
| Commercial, financial, and agricultural Real estate mortgage: | \$11   | \$ 6  | \$ 1   | \$ —  |
| Residential   | 51   | 32  | 24   | 13  |
| Commercial  | 114  | 9   | 110  | 16  |
| Construction  | —  | —   | 2  | —   |
| Installment   | 1  | —   | —  | —   |
|   | \$177  | \$ 47   | \$ 137   | \$ 29   |
| (In Thousands)  | Six Months Ended June 30,  |   |  |   |
|   | 2017   |   | 2016   |   |
|   | Interest Income That Would Have Been Recorded Based on Original Cash Basis | Interest Income That Would Have Been Recorded Based on Original Term Rate | Interest Income That Would Have Been Recorded Based on Original Cash Basis | Interest Income That Would Have Been Recorded Based on Original Term Rate |
| Commercial, financial, and agricultural Real estate mortgage: | \$13   | \$ 6  | \$ 4   | \$ 1  |
| Residential   | 94   | 51  | 56   | 27  |
| Commercial  | 232  | 19  | 279  | 80  |
| Construction  | —  | —   | 2  | —   |
| Installment   | 2  | 1   | —  | —   |
|   | \$341  | \$ 77   | \$ 341   | \$ 108  |



Table of Contents

## Impaired Loans

Impaired loans are loans for which it is probable the Banks will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Banks evaluate such loans for impairment individually and does not aggregate loans by major risk classifications. The definition of “impaired loans” is not the same as the definition of “non-accrual loans,” although the two categories overlap. The Banks may choose to place a loan on non-accrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loan. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$100,000 and if the loan is either on non-accrual status or has a risk rating of substandard. Management may also elect to measure an individual loan for impairment if less than \$100,000 on a case-by-case basis.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower’s prior payment record, and the amount of shortfall in relation to the principal and interest owed. Interest income for impaired loans is recorded consistent with the Banks' policy on non-accrual loans.

The following table presents the recorded investment, unpaid principal balance, and related allowance of impaired loans by segment as of June 30, 2017 and December 31, 2016:

| (In Thousands)                          | June 30, 2017       |                          |                   |
|---|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded:     |                     |                          |                   |
| Commercial, financial, and agricultural | \$ 39               | \$ 39                    | \$ —              |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,900               | 1,900                    | —                 |
| Commercial                              | 3,708               | 3,708                    | —                 |
| Installment loans to individuals        | —                   | —                        | —                 |
|   | 5,647               | 5,647                    | —                 |
| With an allowance recorded:             |                     |                          |                   |
| Commercial, financial, and agricultural | 564                 | 564                      | 375               |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,262               | 1,304                    | 243               |
| Commercial                              | 9,927               | 10,022                   | 1,584             |
| Installment loans to individuals        | 17                  | 17                       | 17                |
|   | 11,770              | 11,907                   | 2,219             |
| Total:                                  |                     |                          |                   |
| Commercial, financial, and agricultural | 603                 | 603                      | 375               |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 3,162               | 3,204                    | 243               |

|                                  |          |           |          |
|----------------------------------|----------|-----------|----------|
| Commercial                       | 13,635   | 13,730    | 1,584    |
| Installment loans to individuals | 17       | 17        | 17       |
|                                  | \$17,417 | \$ 17,554 | \$ 2,219 |

Table of Contents

| (In Thousands)                          | December 31, 2016   |                          |                   |
|---|---------------------|--------------------------|-------------------|
|   | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded:     |                     |                          |                   |
| Commercial, financial, and agricultural | \$ 109              | \$ 109                   | \$ —              |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,584               | 1,584                    | —                 |
| Commercial                              | 1,833               | 1,833                    | —                 |
| Installment loans to individuals        | —                   | —                        | —                 |
|   | 3,526               | 3,526                    | —                 |
| With an allowance recorded:             |                     |                          |                   |
| Commercial, financial, and agricultural | 132                 | 132                      | 74                |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 1,893               | 1,893                    | 437               |
| Commercial                              | 10,425              | 10,520                   | 1,668             |
| Installment loans to individuals        | —                   | —                        | —                 |
|   | 12,450              | 12,545                   | 2,179             |
| Total:                                  |                     |                          |                   |
| Commercial, financial, and agricultural | 241                 | 241                      | 74                |
| Real estate mortgage:                   |                     |                          |                   |
| Residential                             | 3,477               | 3,477                    | 437               |
| Commercial                              | 12,258              | 12,353                   | 1,668             |
| Installment loans to individuals        | —                   | —                        | —                 |
|   | \$ 15,976           | \$ 16,071                | \$ 2,179          |

The following table presents the average recorded investment in impaired loans and related interest income recognized for the three and six months ended for June 30, 2017 and 2016:

| (In Thousands)                          | Three Months Ended June 30, 2017     |  |  | 2016                                 |  |  |
|---|--------------------------------------|--|--|--------------------------------------|--|--|
|   | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans |
| Commercial, financial, and agricultural | \$ 394                               | \$ 3   | \$ 6   | \$ 513                               | \$ 4   | \$ —   |
| Real estate mortgage:                   |                                      |  |  |                                      |  |  |
| Residential                             | 3,199                                | 14   | 30   | 2,985                                | 22   | 13   |
| Commercial                              | 12,885                               | 52   | 9  | 11,724                               | 82   | 16   |
| Construction                            | —                                    | —  | —  | 173                                  | —  | —  |
| Installment loans to individuals        | 10                                   | —  | 2  | —                                    | —  | —  |
|   | \$ 16,488                            | \$ 69  | \$ 47  | \$ 15,395                            | \$ 108   | \$ 29  |

Table of Contents

| (In Thousands)                             | Six Months Ended June 30,<br>2017                |  |   | 2016   |  |   |
|--|--|--|---|--|--|---|
|  | Average<br>Investment<br>in<br>Impaired<br>Loans | Interest Income<br>Recognized on a<br>Accrual Basis on<br>Impaired Loans | Interest Income<br>Recognized on a<br>Cash Basis on<br>Impaired Loans | Average<br>Investment<br>in<br>Impaired<br>Loans | Interest Income<br>Recognized on a<br>Accrual Basis on<br>Impaired Loans | Interest Income<br>Recognized on a<br>Cash Basis on<br>Impaired Loans |
| Commercial, financial, and<br>agricultural | \$ 324   | \$ 7   | \$ 6  | \$ 498   | \$ 8   | \$ 4  |
| Real estate mortgage:                      |  |  |   |  |  |   |
| Residential                                | 3,212  | 36   | 46  | 3,208  | 44   | 22  |
| Commercial                                 | 12,635   | 85   | 19  | 12,410   | 164  | 82  |
| Construction                               | —  | —  | —   | 186  | —  | —   |
| Installment loans to individuals           | 8  | —  | 2   | —  | —  | —   |
|  | \$ 16,179  | \$ 128   | \$ 73   | \$ 16,302  | \$ 216   | \$ 108  |

Currently, there is \$78,000 committed to be advanced in connection with impaired loans.

#### Troubled Debt Restructurings

The loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (“TDR”), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower’s sustained repayment performance for a reasonable period, generally six months.

There were no loan modifications that were considered TDRs completed during the three and six months ended June 30, 2017. Loan modifications that are considered TDRs completed during the three and six months ended June 30, 2016 were as follows.

| (In Thousands, Except Number of Contracts) | Three Months Ended June 30,<br>2016                                     |  |
|--|---|--|
|  | Pre-Modification<br>Number<br>of<br>Recorded<br>Contracts<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial, financial, and agricultural    | —\$ —   | \$ —   |
| Real estate mortgage:                      |   |  |
| Residential                                | 2 342   | 342  |
| Commercial                                 | 1 838   | 838  |
| Construction                               | —   | —  |
|  | 3 \$ 1,180  | \$ 1,180   |
| (In Thousands, Except Number of Contracts) | Six Months Ended June 30,<br>2016                                       |  |
|  | Pre-Modification<br>Number<br>of<br>Recorded<br>Contracts<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial, financial, and agricultural    | —\$ —   | \$ —   |

Real estate mortgage:

|              |            |          |
|--------------|------------|----------|
| Residential  | 2 342      | 342      |
| Commercial   | 1 838      | 838      |
| Construction | —          | —        |
|              | 3 \$ 1,180 | \$ 1,180 |



Table of Contents

There were no loan modifications considered to be TDRs made during the twelve months previous to June 30, 2017 that defaulted during the six months ended June 30, 2017. There were five loan modifications considered TDRs made during the twelve months previous to June 30, 2016 that defaulted during the six months ended June 30, 2016. The defaulted loan types and recorded investments at March 31, 2016 are as follows: one commercial loan with a recorded investment of \$103,000, one commercial real estate loan with a recorded investment of \$239,000, and three residential real estate loan with a recorded investment of \$173,000.

Troubled debt restructurings amounted to \$8,402,000 and \$9,180,000 as of June 30, 2017 and December 31, 2016.

The amount of foreclosed residential real estate held at June 30, 2017 and December 31, 2016, totaled \$278,000 and \$839,000, respectively. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process at June 30, 2017 and December 31, 2016, totaled \$69,000 and \$167,000, respectively.

Internal Risk Ratings

Management uses a ten point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as “Pass” rated. The criticized rating categories utilized by management generally follow bank regulatory definitions. The special mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a substandard classification. Loans in the substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are evaluated for substandard classification. Loans in the doubtful category exhibit the same weaknesses found in the substandard loans, however, the weaknesses are more pronounced. Such loans are static and collection in full is improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Loans classified loss are considered uncollectible and charge-off is imminent.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Banks have a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the pass category unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. An external annual loan review of large commercial relationships is performed, as well as a sample of smaller transactions. Confirmation of the appropriate risk category is included in the review. Detailed reviews, including plans for resolution, are performed on loans classified as substandard, doubtful, or loss on a quarterly basis.

The following table presents the credit quality categories identified above as of June 30, 2017 and December 31, 2016:

| (In Thousands)  | June 30, 2017               |                       |                         |                                  |          | Totals      |
|-----------------|-----------------------------|-----------------------|-------------------------|----------------------------------|----------|-------------|
|                 | Commercial and Agricultural | Real Estate Mortgages | Commercial Construction | Installment Loans to Individuals |          |             |
| Pass            | \$143,855                   | \$567,603             | \$292,505               | \$33,953                         | \$69,523 | \$1,107,439 |
| Special Mention | 1,777                       | 1,152                 | 9,404                   | —                                | —        | 12,333      |
| Substandard     | 2,662                       | 1,941                 | 15,809                  | 152                              | —        | 20,564      |
|                 | \$148,294                   | \$570,696             | \$317,718               | \$34,105                         | \$69,523 | \$1,140,336 |

| (In Thousands)  | December 31, 2016                               |   |                            |                                |          | Totals      |
|-----------------|---|---|----------------------------|--------------------------------|----------|-------------|
|                 | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial<br>Construction | Installation<br>to Individuals | Loans    |             |
| Pass            | \$140,497                                       | \$561,440                               | \$277,916                  | \$34,493                       | \$43,256 | \$1,057,602 |
| Special Mention | 2,943   | 740                                     | 11,143                     | —                              | —        | 14,826      |
| Substandard     | 2,670   | 2,560                                   | 17,123                     | 157                            | —        | 22,510      |
|                 | \$146,110                                       | \$564,740                               | \$306,182                  | \$34,650                       | \$43,256 | \$1,094,938 |

Table of Contents

## Allowance for Loan Losses

An allowance for loan losses (“ALL”) is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated future loss experience, and the amount of non-performing loans.

The Banks' methodology for determining the ALL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (previously discussed) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses and other bank regulatory guidance. The total of the two components represents the Banks' ALL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. Allowances are segmented based on collateral characteristics previously disclosed, and consistent with credit quality monitoring. Loans that are collectively evaluated for impairment are grouped into two classes for evaluation. A general allowance is determined for “Pass” rated credits, while a separate pool allowance is provided for “Criticized” rated credits that are not individually evaluated for impairment.

For the general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors. A historical charge-off factor is calculated utilizing a twelve quarter moving average. However, management may adjust the moving average time frame by up to four quarters to adjust for variances in the economic cycle. Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency rates and non-accrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability, and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors. Management also monitors industry loss factors by loan segment for applicable adjustments to actual loss experience.

Management reviews the loan portfolio on a quarterly basis in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

Activity in the allowance is presented for the three and six months ended June 30, 2017 and 2016:

| (In Thousands)    | Three Months Ended June 30, 2017 |             |            |              |                                  |             | Totals   |
|-------------------|----------------------------------|-------------|------------|--------------|----------------------------------|-------------|----------|
|                   | Commercial and Agricultural      | Real Estate | Commercial | Construction | Installment Loans to Individuals | Unallocated |          |
| Beginning Balance | \$1,441                          | \$5,571     | \$ 4,466   | \$ 187       | \$ 548                           | \$ 692      | \$12,905 |
| Charge-offs       | 200                              | (287 )      | —          | —            | (54 )                            | —           | (141 )   |
| Recoveries        | 105                              | 5           | 1          | 2            | 17                               | —           | 130      |
| Provision         | (15 )                            | 48          | (740 )     | (17 )        | 268                              | 671         | 215      |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

Ending Balance \$1,731 \$5,337 \$ 3,727 \$ 172 \$ 779 \$ 1,363 \$13,109

Three Months Ended June 30, 2016

Commercial Real Estate Mortgages

Financial,

Installment Loans

(In Thousands)

and Residential Commercial Construction to Individuals Unallocated Totals

Agricultural

|                   |         |         |          |        |        |          |          |
|-------------------|---------|---------|----------|--------|--------|----------|----------|
| Beginning Balance | \$1,254 | \$5,123 | \$ 4,472 | \$ 147 | \$ 264 | \$ 1,122 | \$12,382 |
| Charge-offs       | (149 )  | (7 )    | —        | —      | (53 )  | —        | (209 )   |
| Recoveries        | 52      | 3       | —        | 2      | 29     | —        | 86       |
| Provision         | 116     | 732     | (471 )   | (6 )   | 37     | (150 )   | 258      |
| Ending Balance    | \$1,273 | \$5,851 | \$ 4,001 | \$ 143 | \$ 277 | \$ 972   | \$12,517 |

Table of Contents

| (In Thousands)    | Six Months Ended June 30, 2017                  |   |            |              |                                     |             |           |
|-------------------|---|---|------------|--------------|-------------------------------------|-------------|-----------|
|                   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial | Construction | Installment Loans<br>to Individuals | Unallocated | Totals    |
| Beginning Balance | \$ 1,554  | \$ 5,383                                | \$ 4,975   | \$ 178       | \$ 416                              | \$ 390      | \$ 12,896 |
| Charge-offs       | (13 )   | (385 )                                  | —          | —            | (131 )                              | —           | (529 )    |
| Recoveries        | 111   | 35                                      | 1          | 5            | 45                                  | —           | 197       |
| Provision         | 79  | 304                                     | (1,249 )   | (11 )        | 449                                 | 973         | 545       |
| Ending Balance    | \$ 1,731  | \$ 5,337                                | \$ 3,727   | \$ 172       | \$ 779                              | \$ 1,363    | \$ 13,109 |
| (In Thousands)    | Six Months Ended June 30, 2016                  |   |            |              |                                     |             |           |
|                   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial | Construction | Installment Loans<br>to Individuals | Unallocated | Totals    |
| Beginning Balance | \$ 1,532  | \$ 5,116                                | \$ 4,217   | \$ 160       | \$ 243                              | \$ 776      | \$ 12,044 |
| Charge-offs       | (149 )  | (7 )                                    | —          | —            | (104 )                              | —           | (260 )    |
| Recoveries        | 52  | 6                                       | 5          | 5            | 57                                  | —           | 125       |
| Provision         | (162 )  | 736                                     | (221 )     | (22 )        | 81                                  | 196         | 608       |
| Ending Balance    | \$ 1,273  | \$ 5,851                                | \$ 4,001   | \$ 143       | \$ 277                              | \$ 972      | \$ 12,517 |

The shifts in allocation of the loan provision is due to an increase in residential originations along with a tapering of commercial originations along with the increase in installment loan volume.

The Company grants commercial, industrial, residential, and installment loans to customers primarily throughout north-east and central Pennsylvania. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

The Company has a concentration of the following to gross loans at June 30, 2017 and 2016:

|   | June 30, |        |
|---|----------|--------|
|   | 2017     | 2016   |
| Owners of residential rental properties | 15.64%   | 16.74% |
| Owners of commercial rental properties  | 14.56%   | 14.14% |

The following table presents the balance in the allowance for loan losses and the recorded investment in loans by portfolio segment based on impairment method as of June 30, 2017 and December 31, 2016:

| (In Thousands)                                  | June 30, 2017                                   |   |            |              |                                     |             |          |
|---|---|---|------------|--------------|-------------------------------------|-------------|----------|
|   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Mortgages<br>Residential | Commercial | Construction | Installment Loans<br>to Individuals | Unallocated | Totals   |
| Allowance for Loan Losses:                      |   |   |            |              |                                     |             |          |
| Ending allowance balance attributable to loans: |   |   |            |              |                                     |             |          |
| Individually evaluated for impairment           | \$ 375  | \$ 243                                  | \$ 1,584   | \$ —         | \$ 17                               | \$ —        | \$ 2,219 |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|                                       |           |           |           |          |          |         |             |
|---------------------------------------|-----------|-----------|-----------|----------|----------|---------|-------------|
| Collectively evaluated for impairment | 1,356     | 5,094     | 2,143     | 172      | 762      | 1,363   | 10,890      |
| Total ending allowance balance        | \$1,731   | \$5,337   | \$3,727   | \$172    | \$779    | \$1,363 | \$13,109    |
| Loans:                                |           |           |           |          |          |         |             |
| Individually evaluated for impairment | \$603     | \$3,162   | \$13,635  | \$—      | \$17     |         | \$17,417    |
| Collectively evaluated for impairment | 147,691   | 567,534   | 304,083   | 34,105   | 69,506   |         | 1,122,919   |
| Total ending loans balance            | \$148,294 | \$570,696 | \$317,718 | \$34,105 | \$69,523 |         | \$1,140,336 |

Table of Contents

| (In Thousands)                                  | December 31, 2016                               |                            |                         |              |  |             |             |
|---|---|----------------------------|-------------------------|--------------|--|-------------|-------------|
|   | Commercial<br>Financial,<br>and<br>Agricultural | Real Estate<br>Residential | Mortgages<br>Commercial | Construction | Installment<br>Loans<br>to Individuals | Unallocated | Totals      |
| Allowance for Loan Losses:                      |   |                            |                         |              |  |             |             |
| Ending allowance balance attributable to loans: |   |                            |                         |              |  |             |             |
| Individually evaluated for impairment           | \$74  | \$437                      | \$1,668                 | \$—          | \$—                                    | \$—         | \$2,179     |
| Collectively evaluated for impairment           | 1,480   | 4,946                      | 3,307                   | 178          | 416                                    | 390         | 10,717      |
| Total ending allowance balance                  | \$1,554   | \$5,383                    | \$4,975                 | \$178        | \$416                                  | \$390       | \$12,896    |
| Loans:  |   |                            |                         |              |  |             |             |
| Individually evaluated for impairment           | \$241   | \$3,477                    | \$12,258                | \$—          | \$—                                    |             | \$15,976    |
| Collectively evaluated for impairment           | 145,869   | 561,263                    | 293,924                 | 34,650       | 43,256                                 |             | 1,078,962   |
| Total ending loans balance                      | \$146,110                                       | \$564,740                  | \$306,182               | \$34,650     | \$43,256                               |             | \$1,094,938 |

## Note 7. Net Periodic Benefit Cost-Defined Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 13 of the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2016.

The following sets forth the components of the net periodic benefit/cost of the domestic non-contributory defined benefit plan for the three and six months ended June 30, 2017 and 2016, respectively:

| (In Thousands)                 | Three<br>Months<br>Ended<br>June 30, |       | Six<br>Months<br>Ended<br>June 30, |       |
|--------------------------------|--------------------------------------|-------|------------------------------------|-------|
|                                | 2017                                 | 2016  | 2017                               | 2016  |
| Service cost                   | \$42                                 | \$17  | \$83                               | \$34  |
| Interest cost                  | 189                                  | 193   | 378                                | 386   |
| Expected return on plan assets | (263)                                | (251) | (525)                              | (502) |
| Amortization of net loss       | 40                                   | 39    | 84                                 | 78    |
| Net periodic benefit cost      | \$8                                  | \$(2) | \$20                               | \$(4) |

## Employer Contributions

The Company previously disclosed in its consolidated financial statements, included in the Annual Report on Form 10-K for the year ended December 31, 2016, that it expected to contribute a minimum of \$500,000 to its defined benefit plan in 2017. As of June 30, 2017, there were contributions of \$500,000 made to the plan with additional

contributions of at least \$250,000 anticipated during the remainder of 2017.

Note 8. Employee Stock Purchase Plan

The Company maintains an Employee Stock Purchase Plan (“Plan”). The Plan is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the six months ended June 30, 2017 and 2016, there were 1,083 and 1,052 shares issued under the plan, respectively.



Table of Contents

## Note 9. Off Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments are primarily comprised of commitments to extend credit, standby letters of credit, and credit exposure from the sale of assets with recourse. These instruments involve, to varying degrees, elements of credit, interest rate, or liquidity risk in excess of the amount recognized in the Consolidated Balance Sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support financial instruments with off-balance sheet credit risk.

Financial instruments whose contract amounts represent credit risk are as follows at June 30, 2017 and December 31, 2016:

| (In Thousands)  | June 30,<br>2017 | December 31,<br>2016 |
|---|------------------|----------------------|
| Commitments to extend credit                          | \$281,335        | \$ 263,487           |
| Standby letters of credit                             | 10,474           | 6,515                |
| Credit exposure from the sale of assets with recourse | 6,761            | 6,341                |
|   | \$298,570        | \$ 276,343           |

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity 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, on an extension of credit is based on management's credit assessment of the counterparty.

Standby letters of credit represent conditional commitments issued by the Company to guarantee the performance of a customer to a third party. These instruments are issued primarily to support bid or performance related contracts. The coverage period for these instruments is typically a one year period with an annual renewal option subject to prior approval by management. Fees earned from the issuance of these letters are recognized upon expiration of the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

## Note 10. Fair Value Measurements

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value.

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

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are

available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

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

This hierarchy requires the use of observable market data when available.

Table of Contents

The following table presents the assets reported on the Consolidated Balance Sheet at their fair value on a recurring basis as of June 30, 2017 and December 31, 2016, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (In Thousands)                              | June 30, 2017     |           |           |            |
|---|-------------------|-----------|-----------|------------|
|   | Level I           | Level II  | Level III | Total      |
| Assets measured on a recurring basis:       |                   |           |           |            |
| Investment securities, available for sale:  |                   |           |           |            |
| Mortgage-backed securities                  | \$—               | \$4,626   | \$—       | —\$4,626   |
| State and political securities              | —                 | 69,967    | —         | 69,967     |
| Other debt securities                       | —                 | 52,156    | —         | 52,156     |
| Financial institution equity securities     | 10,497            | —         | —         | 10,497     |
| Non-financial institution equity securities | 1,258             | —         | —         | 1,258      |
| Investment securities, trading:             |                   |           |           |            |
| Financial institution equity securities     | 62                | —         | —         | 62         |
| Non-financial institution equity securities | 151               | —         | —         | 151        |
|   |                   |           |           |            |
|   | December 31, 2016 |           |           |            |
| (In Thousands)                              | Level I           | Level II  | Level III | Total      |
| Assets measured on a recurring basis:       |                   |           |           |            |
| Investment securities, available for sale:  |                   |           |           |            |
| Mortgage-backed securities                  | \$—               | \$9,313   | \$—       | —\$9,313   |
| Asset-backed securities                     | —                 | 109       | —         | 109        |
| State and political securities              | —                 | 60,934    | —         | 60,934     |
| Other debt securities                       | —                 | 51,118    | —         | 51,118     |
| Financial institution equity securities     | 10,535            | —         | —         | 10,535     |
| Other equity securities                     | 1,483             | —         | —         | 1,483      |
| Investment securities, trading:             |                   |           |           |            |
| Non-financial institution equity securities | 58                | —         | —         | 58         |
| Total assets measured on a recurring basis  | \$12,076          | \$121,474 | \$—       | —\$133,550 |

The following table presents the assets reported on the Consolidated Balance Sheet at their fair value on a non-recurring basis as of June 30, 2017 and December 31, 2016, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (In Thousands)                            | June 30, 2017     |           |           |
|---|-------------------|-----------|-----------|
|   | Level I           | Level II  | Level III |
| Assets measured on a non-recurring basis: |                   |           |           |
| Impaired loans                            | \$—               | —\$15,198 | \$15,198  |
| Other real estate owned                   | —                 | 531       | 531       |
|   |                   |           |           |
|   | December 31, 2016 |           |           |
| (In Thousands)                            | Level I           | Level II  | Level III |
| Assets measured on a non-recurring basis: |                   |           |           |
| Impaired loans                            | \$—               | —\$13,797 | \$13,797  |
| Other real estate owned                   | —                 | 839       | 839       |



Table of Contents

The following tables present a listing of significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques as of June 30, 2017 and December 31, 2016:

June 30, 2017

| Quantitative Information About Level III Fair Value Measurements |            |                             |                                       |            |                  |
|--|------------|-----------------------------|---------------------------------------|------------|------------------|
| (In Thousands)   | Fair Value | Valuation Technique(s)      | Unobservable Inputs                   | Range      | Weighted Average |
| Impaired loans   | \$6,133    | Discounted cash flow        | Temporary reduction in payment amount | 0 to (70)% | (18)%            |
|  | 9,065      | Appraisal of collateral (1) | Appraisal adjustments (1)             | 0 to (50)% | (16)%            |
| Other real estate owned  | \$531      | Appraisal of collateral (1) | Appraisal adjustments (1)             | (20)%      | (20)%            |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

December 31, 2016

| Quantitative Information About Level III Fair Value Measurements |            |                             |                                       |            |                  |
|--|------------|-----------------------------|---------------------------------------|------------|------------------|
| (In Thousands)   | Fair Value | Valuation Technique(s)      | Unobservable Inputs                   | Range      | Weighted Average |
| Impaired loans   | \$5,304    | Discounted cash flow        | Temporary reduction in payment amount | 0 to (70)% | (20)%            |
|  | 8,493      | Appraisal of collateral (1) | Appraisal adjustments (1)             | 0 to (20)% | (15)%            |
| Other real estate owned  | \$839      | Appraisal of collateral (1) | Appraisal adjustments (1)             | (20)%      | (20)%            |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The discounted cash flow valuation technique is utilized to determine the fair value of performing impaired loans, while non-performing impaired loans utilize the appraisal of collateral method.

The significant unobservable inputs used in the fair value measurement of the Company's impaired loans using the discounted cash flow valuation technique include temporary changes in payment amounts and the probability of default. Significant increases (decreases) in payment amounts would result in significantly higher (lower) fair value measurements. The probability of default is 0% for impaired loans using the discounted cash flow valuation technique because all defaulted impaired loans are valued using the appraisal of collateral valuation technique.

The significant unobservable input used in the fair value measurement of the Company's impaired loans using the appraisal of collateral valuation technique include appraisal adjustments, which are adjustments to appraisals by management for qualitative factors such as economic conditions and estimated liquidation expenses. The significant unobservable input used in the fair value measurement of the Company's other real estate owned are the same inputs used to value impaired loans using the appraisal of collateral valuation technique.

#### Note 11. Fair Value of Financial Instruments

The Company is required to disclose fair values for its financial instruments. Fair values are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Also, it is the Company's general practice and intention to hold most of its financial instruments to maturity and not to engage in trading or sales activities. Because no market exists for a significant

portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These fair values are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the fair values.

Fair values have been determined by the Company using historical data and an estimation methodology suitable for each category of financial instruments. The Company's fair values, methods, and assumptions are set forth below for the Company's other financial instruments.

Table of Contents

As certain assets and liabilities, such as deferred tax assets, premises and equipment, and many other operational elements of the Company, are not considered financial instruments but have value, this fair value of financial instruments would not represent the full market value of the Company.

The fair values of the Company's financial instruments are as follows at June 30, 2017 and December 31, 2016:

| (In Thousands)                | Carrying Value | Fair Value | Fair Value Measurements at June 30, 2017     |          |            |
|-------------------------------|----------------|------------|--|----------|------------|
|                               |                |            | Level I                                      | Level II | Level III  |
| <b>Financial assets:</b>      |                |            |  |          |            |
| Cash and cash equivalents     | \$38,202       | \$38,202   | \$ 38,202                                    | \$ —     | \$ —       |
| <b>Investment securities:</b> |                |            |  |          |            |
| Available for sale            | 138,504        | 138,504    | 11,755                                       | 126,749  | —          |
| Trading                       | 213            | 213        | 213  | —        | —          |
| Loans held for sale           | 1,683          | 1,683      | 1,683  | —        | —          |
| Loans, net                    | 1,125,976      | 1,169,901  | —  | —        | 1,169,901  |
| Bank-owned life insurance     | 27,670         | 27,670     | 27,670                                       | —        | —          |
| Accrued interest receivable   | 3,641          | 3,641      | 3,641  | —        | —          |
| <b>Financial liabilities:</b> |                |            |  |          |            |
| Interest-bearing deposits     | \$851,056      | \$856,563  | \$ 651,773                                   | \$ —     | \$ 204,790 |
| Noninterest-bearing deposits  | 300,054        | 300,054    | 300,054                                      | —        | —          |
| Short-term borrowings         | 15,737         | 15,737     | 15,737                                       | —        | —          |
| Long-term borrowings          | 75,998         | 76,123     | —  | —        | 76,123     |
| Accrued interest payable      | 414            | 414        | 414  | —        | —          |
| (In Thousands)                | Carrying Value | Fair Value | Fair Value Measurements at December 31, 2016 |          |            |
|                               |                |            | Level I                                      | Level II | Level III  |
| <b>Financial assets:</b>      |                |            |  |          |            |
| Cash and cash equivalents     | \$43,671       | \$43,671   | \$ 43,671                                    | \$ —     | \$ —       |
| <b>Investment securities:</b> |                |            |  |          |            |
| Available for sale            | 133,492        | 133,492    | 12,018                                       | 121,474  | —          |
| Trading                       | 58             | 58         | 58   | —        | —          |
| Loans held for sale           | 1,953          | 1,953      | 1,953  | —        | —          |
| Loans, net                    | 1,080,785      | 1,088,122  | —  | —        | 1,088,122  |
| Bank-owned life insurance     | 27,332         | 27,332     | 27,332                                       | —        | —          |
| Accrued interest receivable   | 3,672          | 3,672      | 3,672  | —        | —          |
| <b>Financial liabilities:</b> |                |            |  |          |            |
| Interest-bearing deposits     | \$791,937      | \$789,401  | \$ 571,768                                   | \$ —     | \$ 217,633 |
| Noninterest-bearing deposits  | 303,277        | 303,277    | 303,277                                      | —        | —          |
| Short-term borrowings         | 13,241         | 13,241     | 13,241                                       | —        | —          |
| Long-term borrowings          | 85,998         | 86,353     | —  | —        | 86,353     |
| Accrued interest payable      | 455            | 455        | 455  | —        | —          |

Cash and Cash Equivalents, Loans Held for Sale, Accrued Interest Receivable, Short-term Borrowings, and Accrued Interest Payable:

The fair value is equal to the carrying value.

Investment Securities:

The fair value of investment securities available for sale and trading is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities. Regulatory stocks' fair value is equal to the carrying value.



Table of Contents

Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, financial, and agricultural, commercial real estate, residential real estate, construction real estate, and installment loans to individuals. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discounted rates are judgmentally determined using available market information and specific borrower information.

Bank-Owned Life Insurance:

The fair value is equal to the cash surrender value of the life insurance policies.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows.

The fair value estimates above do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

Long Term Borrowings:

The fair value of long term borrowings is based on the discounted value of contractual cash flows.

Commitments to Extend Credit, Standby Letters of Credit, and Financial Guarantees Written:

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items. The contractual amounts of unfunded commitments and letters of credit are presented in Note 9 (Off Balance Sheet Risk).

Note 12. Stock Options

In 2014, the Company adopted the 2014 Equity Incentive Plan designed to help the Company attract, retain, and motivate employees and non-employee directors. Incentive stock options, non-qualified stock options, and restricted stock may be granted as part of the plan.

On August 27, 2015, the Company issued 38,750 stock options with a strike price of \$42.03 to employees that have a five year vesting period and expire ten years from the grant date. On March 24, 2017, the Company issued 70,000 stock options in total, to a group of employees, that have a strike price of \$44.21. The options granted in 2017 all expire ten years from the grant date however, of the 70,000 grants awarded, 46,250 of the options have a three year vesting period while the remaining 23,750 options vest in five years.

Stock Options Granted

| Date            | Shares | Forfeited | Outstanding | Strike Price | Vesting Period | Expiration |
|-----------------|--------|-----------|-------------|--------------|----------------|------------|
| March 24, 2017  | 46,250 | —         | 46,250      | \$44.21      | 3 years        | 10 years   |
| March 24, 2017  | 23,750 | —         | 23,750      | 44.21        | 5 years        | 10 years   |
| August 27, 2015 | 38,750 | (12,250 ) | 26,500      | 42.03        | 5 years        | 10 years   |

Table of Contents

A summary of stock option activity is presented below:

|                                | June 30, 2017 |  | June 30, 2016 |  |
|--------------------------------|---------------|--|---------------|--|
|                                | Shares        | Weighted<br>Average<br>Exercise<br>Price | Shares        | Weighted<br>Average<br>Exercise<br>Price |
| Outstanding, beginning of year | 26,500        | \$ 42.03                                 | 34,750        | \$ 42.03                                 |
| Granted                        | 70,000        | 44.21                                    | —             | —  |
| Exercised                      | —             | —  | —             | —  |
| Forfeited                      | —             | —  | (3,750 )      | 42.03                                    |
| Expired                        | —             | —  | —             | —  |
| Outstanding, end of year       | 96,500        | \$ 43.61                                 | 31,000        | \$ 42.03                                 |
| Exercisable, end of year       | —             | \$ —                                     | —             | \$ —                                     |

The estimated fair value of options, including the effect of estimated forfeitures, is recognized as expense on a straightline basis over the options' vesting periods while ensuring that the cumulative amount of compensation cost recognized at least equals the value of the vested portion of the award at that date. The Company determines the fair value of options granted using the Black-Scholes option-pricing model. The risk-free interest rate is based on the United States Treasury bond with a similar term to the expected life of the options at the grant date. Expected volatility was estimated based on the adjusted historic volatility of the Company's shares. The expected life was estimated to equal the contractual life of the options. The dividend yield rate was based upon recent historical dividends paid on shares.

Compensation expense for stock options is recognized using the fair value when the stock options are granted and is amortized over the options' vesting period. Compensation expense, with a corresponding increase in contributed surplus, related to stock options was \$8,000 and \$13,000 for the three and six month periods ended June 30, 2017 compared to \$5,000 and \$11,000 for the same periods of 2016. As of June 30, 2017, no stock options were exercisable and the weighted average years to expiration were 9.3 years. The fair value of options granted during the three and six month periods ending June 30, 2017 was approximately zero and \$1,702,000 respectively or zero and \$24.32 per award. Total unrecognized compensation cost for non-vested shares, \$116,000, will be recognized over their weighted average remaining vesting period of 4.7 years.

#### Note 13. Reclassification of Comparative Amounts

Certain comparative amounts for the prior period have been reclassified to conform to current period presentations. Such reclassifications had no effect on net income or shareholders' equity.

#### CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report contains certain "forward-looking statements" including statements concerning plans, objectives, future events or performance and assumptions and other statements which are other than statements of historical fact. The Company cautions readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement made by or on behalf of the Company herein:

(i) the effect of changes in laws and regulations, including federal and state banking laws and regulations, with which the Company must comply, and the associated costs of compliance with such laws and regulations either currently or

in the future as applicable; (ii) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies as well as by the Financial Accounting Standards Board, or of changes in the Company's organization, compensation and benefit plans; (iii) the effect on the Company's competitive position within its market area of the increasing consolidation within the banking and financial services industries, including the increased competition from larger regional and out-of-state banking organizations as well as non-bank providers of various financial services; (iv) the effect of changes in interest rates; (v) the effect of changes in the business cycle and downturns in the local, regional or national economies; and (vi) the Risk Factors identified in Item 1A of the Company's Annual Report on Form 10-K for the year ended December 31, 2016 and in other filings made by the Company under the Securities Exchange Act of 1934.

You should not put undue reliance on any forward-looking statements. These statements speak only as of the date of this Quarterly Report on Form 10-Q, even if subsequently made available by the Company on its website or otherwise. The Company undertakes no obligation to update or revise these statements to reflect events or circumstances occurring after the date of this Quarterly Report on Form 10-Q.

Table of Contents

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

## EARNINGS SUMMARY

## Comparison of the Three and Six Months Ended June 30, 2017 and 2016

## Summary Results

Net income for the three months ended June 30, 2017 was \$3,086,000 compared to \$3,390,000 for the same period of 2016 as after-tax securities gains decreased \$333,000 (from a gain of \$325,000 to a loss of \$8,000). Basic and diluted earnings per share for the three months ended June 30, 2017 and 2016 were \$0.65 and \$0.72, respectively. Return on average assets and return on average equity were 0.88% and 8.79% for the three months ended June 30, 2017 compared to 1.00% and 9.77% for the corresponding period of 2016. Net income from core operations ("operating earnings") was \$3,094,000 for the three months ended June 30, 2017 compared to \$3,065,000 for the same period of 2016. Basic and diluted operating earnings per share for the three months ended June 30, 2017 were \$0.66 compared to \$0.65 basic and diluted for the corresponding period of 2016. Impacting the level of operating earnings were several factors including the continued shift of earning assets from the investment portfolio to the loan portfolio as the balance sheet is actively managed to reduce market risk and interest rate risk in a rising rate environment. In addition, the effective tax rate has increased due to the conclusion of the ten year tax credit generation period of several low income elderly housing projects in our market footprint in which the company participates.

Net income for the six months ended June 30, 2017 was \$5,772,000 compared to \$6,468,000 for the same period of 2016 as after-tax securities gains decreased \$515,000 (from a gain of \$638,000 to a gain of \$123,000). Basic and diluted earnings per share for the six months ended June 30, 2017 and 2016 were \$1.22 and \$1.37, respectively. Return on average assets and return on average equity were 0.83% and 8.24% for the six months ended June 30, 2017 compared to 0.97% and 9.36% for the corresponding period of 2016. Net income from core operations ("operating earnings") decreased to \$5,649,000 for the six months ended June 30, 2017 compared to \$5,830,000 for the same period of 2016. Basic and diluted operating earnings per share for the six months ended June 30, 2017 were \$1.20 compared to \$1.23 basic and diluted for the corresponding period of 2016.

Management uses the non-GAAP measure of net income from core operations, or operating earnings, in its analysis of the Company's performance. This measure, as used by the Company, adjusts net income by excluding significant gains or losses that are unusual in nature. Because certain of these items and their impact on the Company's performance are difficult to predict, management believes the presentation of financial measures excluding the impact of such items provides useful supplemental information in evaluating the operating results of the Company's core businesses. For purposes of this Quarterly Report on Form 10-Q, net income from core operations, or operating earnings, means net income adjusted to exclude after-tax net securities gains or losses and bank-owned life insurance gains on death benefit. These disclosures should not be viewed as a substitute for net income determined in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

## Reconciliation of GAAP and Non-GAAP Financial Measures

| (Dollars in Thousands, Except Per Share Data)   | Three Months        |         | Six Months          |         |
|---|---------------------|---------|---------------------|---------|
|   | Ended June 30, 2017 | 2016    | Ended June 30, 2017 | 2016    |
| GAAP net income                                 | \$3,086             | \$3,390 | \$5,772             | \$6,468 |
| Less: net securities (losses) gains, net of tax | (8 )                | 325     | 123                 | 638     |
| Non-GAAP operating earnings                     | \$3,094             | \$3,065 | \$5,649             | \$5,830 |

|   | Three Months |       | Six Months |       |
|---|--------------|-------|------------|-------|
|   | Ended June   |       | Ended June |       |
|   | 30,          | 30,   | 30,        | 30,   |
|   | 2017         | 2016  | 2017       | 2016  |
| Return on average assets (ROA)                  | 0.88%        | 1.00% | 0.83%      | 0.97% |
| Less: net securities (losses) gains, net of tax | — %          | 0.09% | 0.01%      | 0.10% |
| Non-GAAP operating ROA                          | 0.88%        | 0.91% | 0.82%      | 0.87% |

Table of Contents

|   | Three Months<br>Ended June 30,       |        | Six Months<br>Ended June<br>30, |        |
|---|--------------------------------------|--------|---------------------------------|--------|
|   | 2017                                 | 2016   | 2017                            | 2016   |
| Return on average equity (ROE)                  | 8.79 %                               | 9.77%  | 8.24 %                          | 9.36 % |
| Less: net securities (losses) gains, net of tax | (0.03)%                              | 0.94%  | 0.18 %                          | 0.92 % |
| Non-GAAP operating ROE                          | 8.82 %                               | 8.83 % | 8.06 %                          | 8.44 % |
|   | Three<br>Months<br>Ended June<br>30, |        | Six Months<br>Ended June<br>30, |        |
|   | 2017                                 | 2016   | 2017                            | 2016   |
| Basic earnings per share (EPS)                  | \$0.65                               | \$0.72 | \$1.22                          | \$1.37 |
| Less: net securities (losses) gains, net of tax | (0.01 )                              | 0.07   | 0.02                            | 0.14   |
| Non-GAAP basic operating EPS                    | \$0.66                               | \$0.65 | \$1.20                          | \$1.23 |
|   | Three<br>Months<br>Ended June<br>30, |        | Six Months<br>Ended June<br>30, |        |
|   | 2017                                 | 2016   | 2017                            | 2016   |
| Dilutive EPS                                    | \$0.65                               | \$0.72 | \$1.22                          | \$1.37 |
| Less: net securities (losses) gains, net of tax | (0.01 )                              | 0.07   | 0.02                            | 0.14   |
| Non-GAAP dilutive operating EPS                 | \$0.66                               | \$0.65 | \$1.20                          | \$1.23 |

## Interest and Dividend Income

Interest and dividend income for the three months ended June 30, 2017 increased to \$12,209,000 compared to \$11,669,000 for the same period of 2016. Loan portfolio income increased due to the impact of portfolio growth, primarily in home equity products. The loan portfolio income increase was offset by a decrease in investment portfolio interest due to a decline in the average taxable equivalent yield of 14 bp as the duration in the investment portfolio continues to be shortened in order to reduce interest rate and market risk in the future. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. To offset the revenue impact of the declining asset yields, a focus has been placed on increasing earning assets by adding quality short and intermediate term loans such as home equity loans, even though these new earning assets are at lower yields than legacy assets.

During the six months ended June 30, 2017, interest and dividend income was \$23,891,000, an increase of \$496,000 over the same period of 2016. Interest income on the loan portfolio increased as the growth in the portfolio was countered by a 8 bp decline in average yield. The investment portfolio interest income decreased as the portfolio size was decreased in order to reduce interest rate and market risk, while the yield on the investment portfolio declined 38 bp.

Interest and dividend income composition for the three and six months ended June 30, 2017 and 2016 was as follows:

|                      | Three Months Ended |         |               |         |        |        |
|----------------------|--------------------|---------|---------------|---------|--------|--------|
|                      | June 30, 2017      |         | June 30, 2016 |         | Change |        |
| (In Thousands)       | Amount             | % Total | Amount        | % Total | Amount | %      |
| Loans including fees | \$11,109           | 90.99 % | \$10,466      | 89.69 % | \$643  | 6.14 % |

Investment securities:

|                                    |          |         |          |         |       |         |
|------------------------------------|----------|---------|----------|---------|-------|---------|
| Taxable                            | 570      | 4.66    | 601      | 5.15    | (31 ) | (5.16 ) |
| Tax-exempt                         | 323      | 2.65    | 398      | 3.41    | (75 ) | (18.84) |
| Dividend and other interest income | 207      | 1.70    | 204      | 1.75    | 3     | 1.47    |
| Total interest and dividend income | \$12,209 | 100.00% | \$11,669 | 100.00% | \$540 | 4.63 %  |

34

---



Table of Contents

| (In Thousands)                     | Six Months Ended |         |               |         |        |         |
|------------------------------------|------------------|---------|---------------|---------|--------|---------|
|                                    | June 30, 2017    |         | June 30, 2016 |         | Change |         |
|                                    | Amount           | % Total | Amount        | % Total | Amount | %       |
| Loans including fees               | \$21,736         | 90.98 % | \$20,821      | 89.00 % | \$915  | 4.39 %  |
| Investment securities:             |                  |         |               |         |        |         |
| Taxable                            | 1,112            | 4.65    | 1,223         | 5.23    | (111 ) | (9.08 ) |
| Tax-exempt                         | 621              | 2.60    | 874           | 3.74    | (253 ) | (28.95) |
| Dividend and other interest income | 422              | 1.77    | 477           | 2.03    | (55 )  | (11.53) |
| Total interest and dividend income | \$23,891         | 100.00% | \$23,395      | 100.00% | \$496  | 2.12 %  |
| Interest Expense                   |                  |         |               |         |        |         |

Interest expense for the three months ended June 30, 2017 increased \$4,000 to \$1,385,000 compared to \$1,381,000 for the same period of 2016. The increase in interest expense is the result of growth within the deposit portfolio and the lengthening of the time deposit portfolio as part of a strategy to build balance sheet protection in a rising rate environment, offset by a decrease in short and long-term borrowing utilization.

Interest expense for the six months ended June 30, 2017 decreased slightly from the same period of 2016. The reasons noted for the three month period comparison also apply to the six month period.

Interest expense composition for the three and six months ended June 30, 2017 and 2016 was as follows:

| (In Thousands)         | Three Months Ended |         |               |         |        |          |
|------------------------|--------------------|---------|---------------|---------|--------|----------|
|                        | June 30, 2017      |         | June 30, 2016 |         | Change |          |
|                        | Amount             | % Total | Amount        | % Total | Amount | %        |
| Deposits               | \$1,008            | 72.78 % | \$881         | 63.79 % | \$127  | 14.42 %  |
| Short-term borrowings  | 4                  | 0.29    | 8             | 0.58    | (4 )   | (50.00)  |
| Long-term borrowings   | 373                | 26.93   | 492           | 35.63   | (119 ) | (24.19)  |
| Total interest expense | \$1,385            | 100.00% | \$1,381       | 100.00% | \$4    | 0.29 %   |
| (In Thousands)         | Six Months Ended   |         |               |         |        |          |
|                        | June 30, 2017      |         | June 30, 2016 |         | Change |          |
|                        | Amount             | % Total | Amount        | % Total | Amount | %        |
| Deposits               | \$1,910            | 69.94 % | \$1,716       | 62.79 % | \$194  | 11.31 %  |
| Short-term borrowings  | 8                  | 0.29    | 34            | 1.24    | (26 )  | (76.47)  |
| Long-term borrowings   | 813                | 29.77   | 983           | 35.97   | (170 ) | (17.29)  |
| Total interest expense | \$2,731            | 100.00% | \$2,733       | 100.00% | \$(2 ) | (0.07 )% |

**Net Interest Margin**

The net interest margin ("NIM") for the three months ended June 30, 2017 was 3.44% compared to 3.42% for the corresponding period of 2016. The impact of the decreasing investment portfolio balance was offset by 7.36% growth in the balance of the average loan portfolio from June 30, 2016 to June 30, 2017. The primary funding for the loan growth was an increase in core deposits. These deposits represent a lower cost funding source than time deposits and comprise 82.11% of total deposits at June 30, 2017 compared to 79.65% at June 30, 2016. Limiting the positive impact on the net interest margin caused by the growth in core deposits was the lengthening of the time deposit portfolio.

The NIM for the six months ended June 30, 2017 was 3.42% compared to 3.49% for the same period of 2016. The impact of the decreasing investment portfolio balance was partially offset by growth in the balance of the average loan portfolio from June 30, 2016 to June 30, 2017. The rate on interest-bearing liabilities decreased slightly as the usage

of borrowed funds declined.

35

---

Table of Contents

The following is a schedule of average balances and associated yields for the three and six months ended June 30, 2017 and 2016:

| (In Thousands)                               | AVERAGE BALANCES AND INTEREST RATES |          |              |   |                                  |          |              |   |
|--|-------------------------------------|----------|--------------|---|----------------------------------|----------|--------------|---|
|  | Three Months Ended June 30, 2017    |          |              |   | Three Months Ended June 30, 2016 |          |              |   |
|  | Average Balance<br>(1)              | Interest | Average Rate |   | Average Balance<br>(1)           | Interest | Average Rate |   |
| <b>Assets:</b>                               |                                     |          |              |   |                                  |          |              |   |
| Tax-exempt loans (3)                         | \$41,685                            | \$405    | 3.89         | % | \$46,281                         | \$445    | 3.87         | % |
| All other loans                              | 1,082,165                           | 10,842   | 4.02         | % | 1,000,541                        | 10,172   | 4.09         | % |
| Total loans (2)                              | 1,123,850                           | 11,247   | 4.01         | % | 1,046,822                        | 10,617   | 4.08         | % |
| Taxable securities                           | 83,895                              | 680      | 3.24         | % | 94,049                           | 734      | 3.12         | % |
| Tax-exempt securities (3)                    | 52,850                              | 489      | 3.70         | % | 56,348                           | 603      | 4.28         | % |
| Total securities                             | 136,745                             | 1,169    | 3.42         | % | 150,397                          | 1,337    | 3.56         | % |
| Interest-bearing deposits                    | 36,662                              | 96       | 1.05         | % | 54,309                           | 71       | 0.53         | % |
| Total interest-earning assets                | 1,297,257                           | 12,512   | 3.87         | % | 1,251,528                        | 12,025   | 3.86         | % |
| Other assets                                 | 100,356                             |          |              |   | 100,241                          |          |              |   |
| Total assets                                 | \$1,397,613                         |          |              |   | \$1,351,769                      |          |              |   |
| <b>Liabilities and shareholders' equity:</b> |                                     |          |              |   |                                  |          |              |   |
| Savings                                      | \$158,413                           | 15       | 0.04         | % | \$153,151                        | 14       | 0.04         | % |
| Super Now deposits                           | 202,692                             | 131      | 0.26         | % | 198,048                          | 125      | 0.25         | % |
| Money market deposits                        | 288,035                             | 255      | 0.36         | % | 239,754                          | 161      | 0.27         | % |
| Time deposits                                | 205,418                             | 607      | 1.19         | % | 221,376                          | 581      | 1.06         | % |
| Total interest-bearing deposits              | 854,558                             | 1,008    | 0.47         | % | 812,329                          | 881      | 0.44         | % |
| Short-term borrowings                        | 10,579                              | 4        | 0.15         | % | 16,710                           | 8        | 0.19         | % |
| Long-term borrowings                         | 75,998                              | 373      | 1.95         | % | 91,025                           | 492      | 2.14         | % |
| Total borrowings                             | 86,577                              | 377      | 1.73         | % | 107,735                          | 500      | 1.84         | % |
| Total interest-bearing liabilities           | 941,135                             | 1,385    | 0.59         | % | 920,064                          | 1,381    | 0.60         | % |
| Demand deposits                              | 300,311                             |          |              |   | 276,748                          |          |              |   |
| Other liabilities                            | 15,801                              |          |              |   | 16,151                           |          |              |   |
| Shareholders' equity                         | 140,366                             |          |              |   | 138,806                          |          |              |   |
| Total liabilities and shareholders' equity   | \$1,397,613                         |          |              |   | \$1,351,769                      |          |              |   |
| Interest rate spread                         |                                     |          | 3.28         | % |                                  |          | 3.26         | % |
| Net interest income/margin                   |                                     | \$11,127 | 3.44         | % |                                  | \$10,644 | 3.42         | % |

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Non-accrual loans have been included with loans for the purpose of analyzing net interest earnings.

3. Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.

36

---

Table of Contents

| (In Thousands)                               | AVERAGE BALANCES AND INTEREST RATES |          |              |   |                                |          |              |   |
|--|-------------------------------------|----------|--------------|---|--------------------------------|----------|--------------|---|
|  | Six Months Ended June 30, 2017      |          |              |   | Six Months Ended June 30, 2016 |          |              |   |
|  | Average Balance<br>(1)              | Interest | Average Rate |   | Average Balance<br>(1)         | Interest | Average Rate |   |
| <b>Assets:</b>                               |                                     |          |              |   |                                |          |              |   |
| Tax-exempt loans (3)                         | \$41,959                            | \$821    | 3.95         | % | \$50,700                       | \$980    | 3.89         | % |
| All other loans                              | 1,069,896                           | 21,194   | 3.99         | % | 994,034                        | 20,174   | 4.08         | % |
| Total loans (2)                              | 1,111,855                           | 22,015   | 3.99         | % | 1,044,734                      | 21,154   | 4.07         | % |
| Taxable securities                           | 86,591                              | 1,365    | 3.15         | % | 96,541                         | 1,618    | 3.35         | % |
| Tax-exempt securities                        | 49,779                              | 941      | 3.78         | % | 59,860                         | 1,324    | 4.42         | % |
| Total securities                             | 136,370                             | 2,306    | 3.38         | % | 156,401                        | 2,942    | 3.76         | % |
| Interest-bearing deposits                    | 34,924                              | 169      | 0.98         | % | 33,501                         | 82       | 0.49         | % |
| Total interest-earning assets                | 1,283,149                           | 24,490   | 3.85         | % | 1,234,636                      | 24,178   | 3.94         | % |
| Other assets                                 | 99,934                              |          |              |   | 98,276                         |          |              |   |
| Total assets                                 | \$1,383,083                         |          |              |   | \$1,332,912                    |          |              |   |
| <b>Liabilities and shareholders' equity:</b> |                                     |          |              |   |                                |          |              |   |
| Savings                                      | \$157,423                           | 30       | 0.04         | % | \$151,004                      | 29       | 0.04         | % |
| Super Now deposits                           | 196,032                             | 237      | 0.24         | % | 193,098                        | 249      | 0.26         | % |
| Money market deposits                        | 275,529                             | 446      | 0.33         | % | 229,497                        | 301      | 0.26         | % |
| Time deposits                                | 207,722                             | 1,197    | 1.16         | % | 220,965                        | 1,137    | 1.03         | % |
| Total interest-bearing deposits              | 836,706                             | 1,910    | 0.46         | % | 794,564                        | 1,716    | 0.43         | % |
| Short-term borrowings                        | 10,962                              | 8        | 0.15         | % | 22,560                         | 34       | 0.30         | % |
| Long-term borrowings                         | 79,258                              | 813      | 2.04         | % | 91,025                         | 983      | 2.14         | % |
| Total borrowings                             | 90,220                              | 821      | 1.81         | % | 113,585                        | 1,017    | 1.77         | % |
| Total interest-bearing liabilities           | 926,926                             | 2,731    | 0.59         | % | 908,149                        | 2,733    | 0.60         | % |
| Demand deposits                              | 300,207                             |          |              |   | 270,900                        |          |              |   |
| Other liabilities                            | 15,770                              |          |              |   | 15,703                         |          |              |   |
| Shareholders' equity                         | 140,180                             |          |              |   | 138,160                        |          |              |   |
| Total liabilities and shareholders' equity   | \$1,383,083                         |          |              |   | \$1,332,912                    |          |              |   |
| Interest rate spread                         |                                     |          | 3.26         | % |                                |          | 3.34         | % |
| Net interest income/margin                   |                                     | \$21,759 | 3.42         | % |                                | \$21,445 | 3.49         | % |

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2017 and 2016.

| (In Thousands) | Three Months           |      | Six Months             |      |
|----------------|------------------------|------|------------------------|------|
|                | Ended June 30,<br>2017 | 2016 | Ended June 30,<br>2017 | 2016 |
|                |                        |      |                        |      |

Edgar Filing: PENNS WOODS BANCORP INC - Form 10-Q

|  |          |          |          |          |
|--|----------|----------|----------|----------|
| Total interest income                          | \$12,209 | \$11,669 | \$23,891 | \$23,395 |
| Total interest expense                         | 1,385    | 1,381    | 2,731    | 2,733    |
| Net interest income                            | 10,824   | 10,288   | 21,160   | 20,662   |
| Tax equivalent adjustment                      | 303      | 356      | 599      | 783      |
| Net interest income (fully taxable equivalent) | \$11,127 | \$10,644 | \$21,759 | \$21,445 |

37

---

Table of Contents

The following table sets forth the respective impact that both volume and rate changes have had on net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2017 and 2016:

| (In Thousands)                     | Three Months Ended June 30, 2017 vs. 2016 |       |          | Six Months Ended June 30, 2017 vs. 2016 |           |           |
|------------------------------------|---|-------|----------|---|-----------|-----------|
|                                    | Volume                                    | Rate  | Net      | Volume                                  | Rate      | Net       |
| Interest income:                   |   |       |          |   |           |           |
| Tax-exempt loans                   | \$ (50 )                                  | \$ 10 | \$ (40 ) | \$ (173 )                               | \$ 14     | \$ (159 ) |
| All other loans                    | 686                                       | (16 ) | 670      | 1,480                                   | (460 )    | 1,020     |
| Taxable investment securities      | (97 )                                     | 43    | (54 )    | (160 )                                  | (93 )     | (253 )    |
| Tax-exempt investment securities   | (42 )                                     | (72 ) | (114 )   | (207 )                                  | (176 )    | (383 )    |
| Interest bearing deposits          | (34 )                                     | 59    | 25       | 3                                       | 84        | 87        |
| Total interest-earning assets      | 463                                       | 24    | 487      | 943                                     | (631 )    | 312       |
| Interest expense:                  |   |       |          |   |           |           |
| Savings deposits                   | 2   | (1 )  | 1        | 2                                       | (1 )      | 1         |
| Super Now deposits                 | 3   | 3     | 6        | 7                                       | (19 )     | (12 )     |
| Money market deposits              | 62  | 32    | 94       | 106                                     | 39        | 145       |
| Time deposits                      | (13 )                                     | 39    | 26       | (23 )                                   | 83        | 60        |
| Short-term borrowings              | (1 )                                      | (3 )  | (4 )     | (4 )                                    | (22 )     | (26 )     |
| Long-term borrowings               | (24 )                                     | (95 ) | (119 )   | (40 )                                   | (130 )    | (170 )    |
| Total interest-bearing liabilities | 29  | (25 ) | 4        | 48                                      | (50 )     | (2 )      |
| Change in net interest income      | \$ 434                                    | \$ 49 | \$ 483   | \$ 895                                  | \$ (581 ) | \$ 314    |

## Provision for Loan Losses

The provision for loan losses is based upon management's quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Banks. Management remains committed to an aggressive program of problem loan identification and resolution.

The allowance for loan losses is determined by applying loss factors to outstanding loans by type, excluding loans for which a specific allowance has been determined. Loss factors are based on management's consideration of the nature of the portfolio segments, changes in mix and volume of the loan portfolio, and historical loan loss experience. In addition, management considers industry standards and trends with respect to non-performing loans and its knowledge and experience with specific lending segments.

Although management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate at June 30, 2017, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, increased unemployment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets, charge-offs, loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Banks' loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

When determining the appropriate allowance level, management has attributed the allowance for loan losses to various portfolio segments; however, the allowance is available for the entire portfolio as needed.

The allowance for loan losses increased from \$12,896,000 at December 31, 2016 to \$13,109,000 at June 30, 2017. The increase in the allowance for loan losses was driven by growth in the loan portfolio. Limiting the increase in the allowance for loan losses was net charge-offs during the six months ended June 30, 2017 of \$332,000. The majority of the loans charged-off had a specific allowance within the allowance for losses. At June 30, 2017 and December 31, 2016, the allowance for loan losses to total loans was 1.15% and 1.18%, respectively.



Table of Contents

The provision for loan losses totaled \$215,000 and \$258,000 for the three months ended June 30, 2017 and 2016 and \$545,000 and \$608,000 for the six months ended June 30 2017 and 2016, respectively. The amount of the provision for loan losses was primarily the result of loan growth offset by minimal net charge-offs.

Nonperforming loans increased to \$12,498,000 at June 30, 2017 from \$11,626,000 at June 30, 2016. The majority of nonperforming loans are centered on loans that are either in a secured position and have sureties with a strong underlying financial position or have a specific allocation for any impairment recorded within the allowance for loan losses. The ratio of nonperforming loans to total loans was 1.10% and 1.10% at June 30, 2017 and 2016, respectively, and the ratio of the allowance for loan losses to nonperforming loans was 104.89% and 107.66% at June 30, 2017 and 2016, respectively. Internal loan review and analysis coupled with loan growth dictated a provision for loan losses of \$545,000 for the six months ended June 30, 2017.

The following is a table showing total nonperforming loans as of:

| (In Thousands)     | Total Nonperforming Loans |                |           |
|--------------------|---------------------------|----------------|-----------|
|                    | 90 Days Past Due          | Non-Delinquent | Total     |
| June 30, 2017      | \$ 1,329                  | \$ 11,169      | \$ 12,498 |
| March 31, 2017     | 141                       | 10,730         | 10,871    |
| December 31, 2016  | 870                       | 10,756         | 11,626    |
| September 30, 2016 | 114                       | 11,416         | 11,530    |
| June 30, 2016      | 512                       | 11,114         | 11,626    |

## Non-interest Income

Total non-interest income for the three months ended June 30, 2017 compared to the same period in 2016 decreased \$415,000 to \$2,763,000. Excluding net securities gains, non-interest income for the three months ended June 30, 2017 increased \$89,000 compared to the same period in 2016. The decrease in gain on sale of loans was driven by a shift in product mix. The changes in insurance and brokerage commissions is due to a change in the product mix of consumer purchases. The increase in other non-interest income was driven by an increase in debit card income.

Total non-interest income for the six months ended June 30, 2017 compared to the same period in 2016 decreased \$761,000. Excluding net securities gains, non-interest income increased \$19,000 compared the 2016 period. The reasons noted for the three month period comparison also apply to the six month period.

Non-interest income composition for the three and six months ended June 30, 2017 and 2016 was as follows:

| (In Thousands)                                    | Three Months Ended |          |               |          |         |           |
|---|--------------------|----------|---------------|----------|---------|-----------|
|   | June 30, 2017      |          | June 30, 2016 |          | Change  |           |
|   | Amount             | % Total  | Amount        | % Total  | Amount  | %         |
| Service charges                                   | \$559              | 20.23 %  | \$561         | 17.65 %  | \$(2 )  | (0.36 )%  |
| Net securities (losses) gains, available for sale | (12 )              | (0.43 )  | 486           | 15.29    | (498 )  | (102.47)  |
| Net securities gains, trading                     | —                  | —        | 6             | 0.19     | (6 )    | (100.00)  |
| Bank-owned life insurance                         | 161                | 5.83     | 161           | 5.07     | —       | —         |
| Gain on sale of loans                             | 503                | 18.20    | 566           | 17.81    | (63 )   | (11.13 )  |
| Insurance commissions                             | 99                 | 3.58     | 200           | 6.29     | (101 )  | (50.50 )  |
| Brokerage commissions                             | 361                | 13.07    | 272           | 8.56     | 89      | 32.72     |
| Debit Card Fees                                   | 501                | 18.13    | 433           | 13.62    | 68      | 15.70     |
| Other   | 591                | 21.39    | 493           | 15.52    | 98      | 19.88     |
| Total non-interest income                         | \$2,763            | 100.00 % | \$3,178       | 100.00 % | \$(415) | (13.06 )% |



Table of Contents

| (In Thousands)                                    | Six Months Ended |          |               |          |         |          |
|---|------------------|----------|---------------|----------|---------|----------|
|   | June 30, 2017    |          | June 30, 2016 |          | Change  |          |
|   | Amount           | % Total  | Amount        | % Total  | Amount  | %        |
| Service charges                                   | \$1,087          | 20.08 %  | \$1,093       | 17.70 %  | \$(6 )  | (0.55 )% |
| Net securities (losses) gains, available for sale | 185              | 3.42     | 921           | 14.91    | (736 )  | (79.91)  |
| Net securities gains, trading                     | 2                | 0.04     | 46            | 0.74     | (44 )   | (95.65)  |
| Bank-owned life insurance                         | 333              | 6.15     | 345           | 5.59     | (12 )   | (3.48 )  |
| Gain on sale of loans                             | 861              | 15.90    | 1,033         | 16.73    | (172 )  | (16.65)  |
| Insurance commissions                             | 290              | 5.36     | 405           | 6.56     | (115 )  | (28.40)  |
| Brokerage commissions                             | 692              | 12.78    | 527           | 8.53     | 165     | 31.31    |
| Debit Card Fees                                   | 935              | 17.27    | 964           | 15.61    | (29 )   | (3.01 )  |
| Other   | 1,029            | 19.00    | 841           | 13.63    | 188     | 22.35    |
| Total non-interest income                         | \$5,414          | 100.00 % | \$6,175       | 100.00 % | \$(761) | (12.32)% |

## Non-interest Expense

Total non-interest expense increased \$397,000 for the three months ended June 30, 2017 compared to the same period of 2016. The increase in salaries and employee benefits is primarily attributable to routine wage increases. Amortization of investment in limited partnerships decreased as several of the partnerships have reached the end of their tax credit generating life and have been fully amortized. Occupancy expense increased due to various maintenance projects to refresh facilities. Other non-interest expenses increased primarily due to legal expenses.

Total non-interest expense for the six months ended June 30, 2017 compared to the same period in 2016 increased \$321,000. The reasons noted for the three month period comparison also apply to the six month period.

Non-interest expense composition for the three and six months ended June 30, 2017 and 2016 was as follows:

| (In Thousands)  | Three Months Ended |          |               |          |        |         |
|---|--------------------|----------|---------------|----------|--------|---------|
|   | June 30, 2017      |          | June 30, 2016 |          | Change |         |
|   | Amount             | % Total  | Amount        | % Total  | Amount | %       |
| Salaries and employee benefits                          | \$4,608            | 50.84 %  | \$4,346       | 50.15 %  | \$262  | 6.03 %  |
| Occupancy   | 614                | 6.77     | 545           | 6.29     | 69     | 12.66   |
| Furniture and equipment                                 | 664                | 7.33     | 679           | 7.84     | (15 )  | (2.21 ) |
| Software amortization                                   | 242                | 2.67     | 272           | 3.14     | (30 )  | (11.03) |
| Pennsylvania shares tax                                 | 230                | 2.54     | 220           | 2.54     | 10     | 4.55    |
| Professional fees                                       | 550                | 6.07     | 436           | 5.03     | 114    | 26.15   |
| Federal Deposit Insurance Corporation deposit insurance | 150                | 1.66     | 236           | 2.72     | (86 )  | (36.44) |
| Debit card expenses                                     | 151                | 1.67     | 159           | 1.83     | (8 )   | (5.03 ) |
| Marketing   | 204                | 2.25     | 185           | 2.13     | 19     | 10.27   |
| Intangible amortization                                 | 86                 | 0.95     | 100           | 1.15     | (14 )  | (14.00) |
| Other   | 1,564              | 17.25    | 1,488         | 17.18    | 76     | 5.11    |
| Total non-interest expense                              | \$9,063            | 100.00 % | \$8,666       | 100.00 % | \$397  | 4.58 %  |

Table of Contents

| (In Thousands)  | Six Months Ended |         |               |         |        |         |
|---|------------------|---------|---------------|---------|--------|---------|
|   | June 30, 2017    |         | June 30, 2016 |         | Change |         |
|   | Amount           | % Total | Amount        | % Total | Amount | %       |
| Salaries and employee benefits                          | \$9,378          | 51.95 % | \$8,926       | 50.35 % | \$452  | 5.06 %  |
| Occupancy   | 1,252            | 6.94    | 1,086         | 6.13    | 166    | 15.29   |
| Furniture and equipment                                 | 1,313            | 7.28    | 1,380         | 7.78    | (67 )  | (4.86 ) |
| Software amortization                                   | 515              | 2.85    | 629           | 3.55    | (114 ) | (18.12) |
| Pennsylvania shares tax                                 | 468              | 2.59    | 478           | 2.70    | (10 )  | (2.09 ) |
| Professional fees                                       | 987              | 5.47    | 777           | 4.38    | 210    | 27.03   |
| Federal Deposit Insurance Corporation deposit insurance | 320              | 1.77    | 468           | 2.64    | (148 ) | (31.62) |
| Debit card expenses                                     | 310              | 1.72    | 286           | 1.61    | 24     | 8.39    |
| Marketing   | 375              | 2.08    | 395           | 2.23    | (20 )  | (5.06 ) |
| Intangible amortization                                 | 176              | 0.98    | 187           | 1.05    | (11 )  | (5.88 ) |
| Other   | 2,954            | 16.37   | 3,115         | 17.58   | (161 ) | (5.17 ) |
| Total non-interest expense                              | \$18,048         | 100.00% | \$17,727      | 100.00% | \$321  | 1.81 %  |

## Provision for Income Taxes

Income taxes increased \$71,000 and \$175,000 for the three and six months ended June 30, 2017 compared to the same periods of 2016. The primary cause of the increase in tax expense for the three and six months ended June 30, 2017 compared to 2016 is the impact of a reduction of tax-exempt interest income within the investment portfolio as the portfolio was strategically reduced and a reduction in the amount of federal tax credits recognized from low income elderly housing partnerships. Excluding the impact of securities gains and losses, the effective tax rate for the three and six months ended June 30, 2017 was 28.40% and 27.52% compared to 24.32% and 22.63% for the same periods of 2016. The Company currently is in a deferred tax asset position. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

## ASSET/LIABILITY MANAGEMENT

## Cash and Cash Equivalents

Cash and cash equivalents decreased \$5,469,000 from \$43,671,000 at December 31, 2016 to \$38,202,000 at June 30, 2017 primarily as a result of the following activities during the six months ended June 30, 2017.

## Loans Held for Sale

Activity regarding loans held for sale resulted in sales proceeds trailing loan originations, less \$861,000 in realized gains, by \$270,000 for the six months ended June 30, 2017.

## Loans

Gross loans increased \$45,404,000 since December 31, 2016 due primarily to an increase in installment loans to individuals. The growth in installment loans was driven by automobile indirect lending.

Table of Contents

The allocation of the loan portfolio, by category, as of June 30, 2017 and December 31, 2016 is presented below:

| (In Thousands)                          | June 30, 2017 |          | December 31, 2016 |          | Change    |          |
|---|---------------|----------|-------------------|----------|-----------|----------|
|   | Amount        | % Total  | Amount            | % Total  | Amount    | %        |
| Commercial, financial, and agricultural | \$ 148,294    | 13.02 %  | \$ 146,110        | 13.36 %  | \$ 2,184  | 1.49 %   |
| Real estate mortgage:                   |               |          |                   |          |           |          |
| Residential                             | 570,696       | 50.11    | 564,740           | 51.63    | 5,956     | 1.05 %   |
| Commercial                              | 317,718       | 27.89    | 306,182           | 27.99    | 11,536    | 3.77 %   |
| Construction                            | 34,105        | 2.99     | 34,650            | 3.17     | (545 )    | (1.57 )% |
| Installment loans to individuals        | 69,523        | 6.10     | 43,256            | 3.96     | 26,267    | 60.72 %  |
| Net deferred loan fees and discounts    | (1,251 )      | (0.11 )  | (1,257 )          | (0.11 )  | 6         | (0.48 )% |
| Gross loans                             | \$ 1,139,085  | 100.00 % | \$ 1,093,681      | 100.00 % | \$ 45,404 | 4.15 %   |

The following table shows the amount of accrual and non-accrual TDRs at June 30, 2017 and December 31, 2016:

| (In Thousands)                          | June 30, 2017 |             |          | December 31, 2016 |             |          |
|---|---------------|-------------|----------|-------------------|-------------|----------|
|   | Accrual       | Non-accrual | Total    | Accrual           | Non-accrual | Total    |
| Commercial, financial, and agricultural | \$ 38         | \$ 124      | \$ 162   | \$ 109            | \$ 132      | \$ 241   |
| Real estate mortgage:                   |               |             |          |                   |             |          |
| Residential                             | 1,290         | 449         | 1,739    | 1,491             | 541         | 2,032    |
| Commercial                              | 4,196         | 2,305       | 6,501    | 4,723             | 2,184       | 6,907    |
|   | \$ 5,524      | \$ 2,878    | \$ 8,402 | \$ 6,323          | \$ 2,857    | \$ 9,180 |

## Investments

The fair value of the investment securities portfolio at June 30, 2017 increased \$5,167,000 since December 31, 2016 while the amortized cost of the portfolio increased \$4,231,000. The portfolio continues to be actively managed in order to reduce interest rate and market risk. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. The proceeds of the bond sales are being deployed into loans and intermediate term corporate bonds and short and intermediate term municipal bonds. The strategy to sell a portion of the long-term bond portfolio does negatively impact current earnings, but this action plays a key role in our long-term asset liability management strategy as the balance sheet is shortened in anticipation of a steadily rising rate environment. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 86% of the debt securities portfolio on an amortized cost basis is currently rated A or higher by either S&P or Moody's.

The Company considers various factors, which include examples from applicable accounting guidance, when analyzing the available for sale portfolio for possible other than temporary impairment. The Company primarily considers the following factors in its analysis: length of time and severity of the fair value being less than carrying value; reduction of dividend paid (equities); continued payment of dividend/interest, credit rating, and financial condition of an issuer; intent and ability to hold until anticipated recovery (which may be maturity); and general outlook for the economy, specific industry, and entity in question.

The bond portion of the portfolio review is conducted with emphases on several factors. Continued payment of principal and interest is given primary importance with credit rating and financial condition of the issuer following as the next most important. Credit ratings were reviewed with the ratings of the bonds being satisfactory. Bonds that were not currently rated were discussed with a third party and/or underwent an internal financial review. The

Company also monitors whether each of the investments incurred a decline in fair value from carrying value of at least 20% for twelve consecutive months or a similar decline of at least 50% for three consecutive months. Each bond is reviewed to determine whether it is a general obligation bond, which is backed by the credit and taxing power of the issuing jurisdiction, or revenue bond, which is only payable from specified revenues. Based on the review undertaken by the Company, the Company determined that the decline in value of the various bond holdings were temporary and were the result of the general market downturns and interest rate/yield curve changes, not credit issues. The fact that almost all of such bonds are general obligation bonds further solidified the Company's determination that the decline in the value of these bond holdings is temporary.

Table of Contents

The fair value of the equity portfolio continues to fluctuate as the economic turbulence continues to impact stock pricing. The amortized cost of the available for sale equity securities portfolio has decreased \$115,000 to \$11,118,000 at June 30, 2017 from \$11,233,000 at December 31, 2016 while the fair value decreased \$263,000 over the same time period.

The equity portion of the portfolio is reviewed for possible other than temporary impairment in a similar manner to the bond portfolio with greater emphasis placed on the length of time the fair value has been less than the carrying value and financial sector outlook. The Company also reviews dividend payment activities. The starting point for the equity analysis is the length and severity of a market price decline. The Company monitors two primary measures: 20% decline in fair value from carrying value for twelve consecutive months and 50% decline for three consecutive months.

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at June 30, 2017 follows:

| (In Thousands)                 | A- to AAA      |            | B- to BBB+     |            | Not Rated      |            | Total          |            |
|--------------------------------|----------------|------------|----------------|------------|----------------|------------|----------------|------------|
|                                | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Available for sale (AFS):      |                |            |                |            |                |            |                |            |
| Mortgage-backed securities     | \$4,649        | \$4,626    | \$—            | \$—        | \$—            | \$—        | \$4,649        | \$4,626    |
| State and political securities | 66,229         | 67,087     | —              | —          | 2,862          | 2,880      | 69,091         | 69,967     |
| Other debt securities          | 39,091         | 38,360     | 13,524         | 12,820     | 1,056          | 976        | 53,671         | 52,156     |
| Total debt securities AFS      | \$109,969      | \$110,073  | \$13,524       | \$12,820   | \$3,918        | \$3,856    | \$127,411      | \$126,749  |

## Financing Activities

## Deposits

Total deposits increased \$55,896,000 from December 31, 2016 to June 30, 2017. The growth was led by an increase in money market and NOW deposit accounts from December 31, 2016 to June 30, 2017 of \$42,019,000 and \$25,264,000, respectively. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios. While deposit gathering efforts have centered on core deposits, the lengthening of the time deposit portfolio is moving forward as part of the strategy to build balance sheet protection in a rising rate environment. The increase in deposits is the result of our focus on building relationships, not by offering market leading rates.

Deposit balances and their changes for the periods being discussed follow:

| (In Thousands)        | June 30, 2017 |          | December 31, 2016 |          | Change     |          |
|-----------------------|---------------|----------|-------------------|----------|------------|----------|
|                       | Amount        | % Total  | Amount            | % Total  | Amount     | %        |
| Demand deposits       | \$300,054     | 26.07 %  | \$303,277         | 27.69 %  | \$(3,223 ) | (1.06 )% |
| NOW accounts          | 199,917       | 17.37    | 174,653           | 15.95    | 25,264     | 14.47    |
| Money market deposits | 287,140       | 24.94    | 245,121           | 22.38    | 42,019     | 17.14    |
| Savings deposits      | 158,101       | 13.73    | 153,788           | 14.04    | 4,313      | 2.80     |
| Time deposits         | 205,898       | 17.89    | 218,375           | 19.94    | (12,477 )  | (5.71 )  |
| Total deposits        | \$1,151,110   | 100.00 % | \$1,095,214       | 100.00 % | \$55,896   | 5.10 %   |





Table of Contents

## Borrowed Funds

Total borrowed funds decreased 7.56% or \$7,504,000 to \$91,735,000 at June 30, 2017 compared to \$99,239,000 at December 31, 2016. The reduction in long-term borrowings was the result of a maturity. Growth in deposits and a reduction in the size of the investment portfolio allowed for a decrease in the utilization of borrowings.

| (In Thousands)                                | June 30, 2017 |          | December 31, 2016 |          | Change    |          |
|---|---------------|----------|-------------------|----------|-----------|----------|
|   | Amount        | % Total  | Amount            | % Total  | Amount    | %        |
| Short-term borrowings:                        |               |          |                   |          |           |          |
| FHLB repurchase agreements                    | \$5,300       | 5.78 %   | \$—               | — %      | \$5,300   | — %      |
| Securities sold under agreement to repurchase | 10,437        | 11.37    | 13,241            | 13.34    | (2,804 )  | (21.18)  |
| Total short-term borrowings                   | 15,737        | 17.15    | 13,241            | 13.34    | 2,496     | 18.85    |
| Long-term borrowings:                         |               |          |                   |          |           |          |
| Long-term FHLB borrowings                     | 75,625        | 82.44    | 85,625            | 86.28    | (10,000 ) | (11.68)  |
| Long-term capital lease                       | 373           | 0.41     | 373               | 0.38     | —         | —        |
| Total long-term borrowings                    | 75,998        | 82.85    | 85,998            | 86.66    | (10,000 ) | (11.63)  |
| Total borrowed funds                          | \$91,735      | 100.00 % | \$99,239          | 100.00 % | \$(7,504) | (7.56 )% |

The decline in securities sold under agreement to repurchase is due to the phasing out of a product the bank offers.

## Capital

The adequacy of the Company's capital is reviewed on an ongoing basis with reference to the size, composition, and quality of the Company's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings.

Bank holding companies are required to comply with the Federal Reserve Board's risk-based capital guidelines. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets. Specifically, each is required to maintain certain minimum dollar amounts and ratios of common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital. In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvements Act (FDICIA) established five capital categories ranging from "well capitalized" to "critically undercapitalized." To be classified as "well capitalized", common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital ratios must be at least 6.5%, 8%, 10%, and 5%, respectively.



Table of Contents

The Company's capital ratios as of June 30, 2017 and December 31, 2016 were as follows:

| (In Thousands)  | June 30, 2017 |          | December 31, 2016 |          |
|---|---------------|----------|-------------------|----------|
|   | Amount        | Ratio    | Amount            | Ratio    |
| Common Equity Tier I Capital (to Risk-weighted Assets)            |               |          |                   |          |
| Actual  | \$125,318     | 12.015 % | \$125,804         | 12.620 % |
| For Capital Adequacy Purposes                                     | 46,936        | 4.500    | 44,849            | 4.500    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 59,973        | 5.750    | 51,078            | 5.125    |
| To Be Well Capitalized  | 67,796        | 6.500    | 64,782            | 6.500    |
| Total Capital (to Risk-weighted Assets)                           |               |          |                   |          |
| Actual  | \$127,690     | 12.243 % | \$133,393         | 13.380 % |
| For Capital Adequacy Purposes                                     | 83,437        | 8.000    | 79,732            | 8.000    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 96,474        | 9.250    | 85,961            | 8.625    |
| To Be Well Capitalized  | 104,296       | 10.000   | 99,665            | 10.000   |
| Tier I Capital (to Risk-weighted Assets)                          |               |          |                   |          |
| Actual  | \$125,318     | 12.015 % | \$125,804         | 12.620 % |
| For Capital Adequacy Purposes                                     | 62,581        | 6.000    | 59,799            | 6.000    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 75,618        | 7.250    | 66,028            | 6.625    |
| To Be Well Capitalized  | 83,441        | 8.000    | 79,732            | 8.000    |
| Tier I Capital (to Average Assets)                                |               |          |                   |          |
| Actual  | \$125,318     | 8.963 %  | \$125,804         | 9.432 %  |
| For Capital Adequacy Purposes                                     | 55,927        | 4.000    | 53,352            | 4.000    |
| To Be Well Capitalized  | 69,909        | 5.000    | 66,691            | 5.000    |

Jersey Shore State Bank's capital ratios as of June 30, 2017 and December 31, 2016 were as follows:

| (In Thousands)  | June 30, 2017 |          | December 31, 2016 |          |
|---|---------------|----------|-------------------|----------|
|   | Amount        | Ratio    | Amount            | Ratio    |
| Common Equity Tier I Capital (to Risk-weighted Assets)            |               |          |                   |          |
| Actual  | \$87,751      | 10.753 % | \$86,397          | 11.136 % |
| For Capital Adequacy Purposes                                     | 36,723        | 4.500    | 34,914            | 4.500    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 46,923        | 5.750    | 39,763            | 5.125    |
| To Be Well Capitalized  | 53,044        | 6.500    | 50,431            | 6.500    |
| Total Capital (to Risk-weighted Assets)                           |               |          |                   |          |
| Actual  | \$88,374      | 10.829 % | \$90,992          | 11.728 % |
| For Capital Adequacy Purposes                                     | 65,287        | 8.000    | 62,069            | 8.000    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 75,488        | 9.250    | 66,918            | 8.625    |
| To Be Well Capitalized  | 81,609        | 10.000   | 77,587            | 10.000   |
| Tier I Capital (to Risk-weighted Assets)                          |               |          |                   |          |
| Actual  | \$87,751      | 10.753 % | \$86,397          | 11.136 % |
| For Capital Adequacy Purposes                                     | 48,964        | 6.000    | 46,552            | 6.000    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 59,164        | 7.250    | 51,401            | 6.625    |
| To Be Well Capitalized  | 65,285        | 8.000    | 62,069            | 8.000    |
| Tier I Capital (to Average Assets)                                |               |          |                   |          |
| Actual  | \$87,751      | 8.631 %  | \$86,397          | 8.894 %  |
| For Capital Adequacy Purposes                                     | 40,668        | 4.000    | 38,856            | 4.000    |
| To Be Well Capitalized  | 50,835        | 5.000    | 48,570            | 5.000    |



Table of Contents

Luzerne Bank's capital ratios as of June 30, 2017 and December 31, 2016 were as follows:

| (In Thousands)  | June 30, 2017 |          | December 31, 2016 |          |
|---|---------------|----------|-------------------|----------|
|   | Amount        | Ratio    | Amount            | Ratio    |
| Common Equity Tier I Capital (to Risk-weighted Assets)            |               |          |                   |          |
| Actual  | \$31,280      | 9.986 %  | \$31,102          | 10.165 % |
| For Capital Adequacy Purposes                                     | 14,096        | 4.500    | 13,769            | 4.500    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 18,011        | 5.750    | 15,682            | 5.125    |
| To Be Well Capitalized  | 20,361        | 6.500    | 19,889            | 6.500    |
| Total Capital (to Risk-weighted Assets)                           |               |          |                   |          |
| Actual  | \$32,741      | 10.453 % | \$33,589          | 10.977 % |
| For Capital Adequacy Purposes                                     | 25,058        | 8.000    | 24,479            | 8.000    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 28,973        | 9.250    | 26,391            | 8.625    |
| To Be Well Capitalized  | 31,322        | 10.000   | 30,599            | 10.000   |
| Tier I Capital (to Risk-weighted Assets)                          |               |          |                   |          |
| Actual  | \$31,280      | 9.986 %  | \$31,102          | 10.165 % |
| For Capital Adequacy Purposes                                     | 18,794        | 6.000    | 18,359            | 6.000    |
| Minimum To Maintain Capital Conservation Buffer At Reporting Date | 22,710        | 7.250    | 20,272            | 6.625    |
| To Be Well Capitalized  | 25,059        | 8.000    | 24,479            | 8.000    |
| Tier I Capital (to Average Assets)                                |               |          |                   |          |
| Actual  | \$31,280      | 8.610 %  | \$31,102          | 8.535 %  |
| For Capital Adequacy Purposes                                     | 14,532        | 4.000    | 14,576            | 4.000    |
| To Be Well Capitalized  | 18,165        | 5.000    | 18,220            | 5.000    |

In July 2013, the federal bank regulatory agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. The July 2013 final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered "well capitalized") and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered "well capitalized"); the total capital ratio remains at 8.0% under the new rules (10.0% to be considered "well capitalized"). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements were effective beginning on January 1, 2015. The capital contribution buffer requirements phase in over a three-year period beginning January 1, 2016. The Company and the Banks will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Banks.

#### Liquidity; Interest Rate Sensitivity and Market Risk

The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

The following liquidity measures are monitored for compliance and were within the limits cited at June 30, 2017:

1. Net Loans to Total Assets, 85% maximum
2. Net Loans to Total Deposits, 100% maximum
3. Cumulative 90 day Maturity GAP %, +/- 20% maximum
4. Cumulative 1 Year Maturity GAP %, +/- 25% maximum

Fundamental objectives of the Company's asset/liability management process are to maintain adequate liquidity while minimizing interest rate risk. The maintenance of adequate liquidity provides the Company with the ability to meet its financial obligations to depositors, loan customers, and shareholders. Additionally, it provides funds for normal operating expenditures and business

Table of Contents

opportunities as they arise. The objective of interest rate sensitivity management is to increase net interest income by managing interest sensitive assets and liabilities in such a way that they can be repriced in response to changes in market interest rates.

The Banks, like other financial institutions, must have sufficient funds available to meet liquidity needs for deposit withdrawals, loan commitments and originations, and expenses. In order to control cash flow, the Banks estimate future cash flows from deposits, loan payments, and investment security payments. The primary sources of funds are deposits, principal and interest payments on loans and investment securities, FHLB borrowings, and brokered deposits. Management believes the Banks have adequate resources to meet their normal funding requirements.

Management monitors the Company's liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale and trading investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core funding to satisfy depositor, borrower, and creditor needs.

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential, as well as the current cost of borrowing funds. The Company has a total current maximum borrowing capacity at the FHLB of \$541,872,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$45,243,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$75,625,000 as of June 30, 2017.

Interest rate sensitivity, which is closely related to liquidity management, is a function of the repricing characteristics of the Company's portfolio of assets and liabilities. Asset/liability management strives to match maturities and rates between loan and investment security assets with the deposit liabilities and borrowings that fund them. Successful asset/liability management results in a balance sheet structure which can cope effectively with market rate fluctuations. The matching process by segments both assets and liabilities into future time periods (usually 12 months, or less) based upon when repricing can be effected. Repriceable assets are subtracted from repriceable liabilities, for a specific time period to determine the "gap", or difference. Once known, the gap is managed based on predictions about future market interest rates. Intentional mismatching, or gapping, can enhance net interest income if market rates move as predicted. However, if market rates behave in a manner contrary to predictions, net interest income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to determine the effects of interest rate movements on shareholders' equity and a simulation analysis to monitor the effects of interest rate changes on the Company's balance sheet.

The Company currently maintains a GAP position of being asset sensitive. The Company has strategically taken this position as it has decreased the duration of the earning asset portfolio by adding quality short and intermediate term loans such as home equity loans and the selling of long-term municipal bonds. Lengthening of the liability portfolio is being undertaken to build protection in a rising rate environment.

A market value at risk calculation is utilized to monitor the effects of interest rate changes on the Company's balance sheet and more specifically shareholders' equity. The Company does not manage the balance sheet structure in order to maintain compliance with this calculation. The calculation serves as a guideline with greater emphases placed on interest rate sensitivity. Changes to calculation results from period to period are reviewed as changes in results could be a signal of future events. As of the most recent analysis, the results of the market value at risk calculation were

within established guidelines due to the strategic direction being taken.



Table of Contents

## Interest Rate Sensitivity

In this analysis the Company examines the result of a 100, 200, 300, and 400 basis point change in market interest rates and the effect on net interest income. It is assumed that the change is instantaneous and that all rates move in a parallel manner. Assumptions are also made concerning prepayment speeds on mortgage loans and mortgage securities.

The following is a rate shock forecast for the twelve month period ending June 30, 2018 assuming a static balance sheet as of June 30, 2017.

| (In Thousands)             | Parallel Rate Shock in Basis Points |          |          |          |          |          |          |
|----------------------------|-------------------------------------|----------|----------|----------|----------|----------|----------|
|                            | -200                                | -100     | Static   | +100     | +200     | +300     | +400     |
| Net interest income        | \$40,325                            | \$43,129 | \$45,588 | \$47,519 | \$49,208 | \$50,677 | \$52,100 |
| Change from static         | (5,263 )                            | (2,459 ) | —        | 1,931    | 3,620    | 5,089    | 6,512    |
| Percent change from static | -11.54 %                            | -5.39 %  | —        | 4.24 %   | 7.94 %   | 11.16 %  | 14.28 %  |

The model utilized to create the report presented above makes various estimates at each level of interest rate change regarding cash flow from principal repayment on loans and mortgage-backed securities and/or call activity on investment securities. Actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change. In addition, the limits stated above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

## Inflation

The asset and liability structure of a financial institution is primarily monetary in nature. Therefore, interest rates rather than inflation have a more significant impact on the Company's performance. Interest rates are not always affected in the same direction or magnitude as prices of other goods and services, but are reflective of fiscal policy initiatives or economic factors which are not measured by a price index.

## Item 3. Quantitative and Qualitative Disclosures About Market Risk

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at both the level of the Company and the Banks. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's gap analysis or simulation analysis compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2016. Additional information and details are provided in the "Liquidity, Interest Rate Sensitivity, and Market Risk" section of "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Generally, management believes the Company is well positioned to respond in a timely manner when the market interest rate outlook changes.

## Item 4. Controls and Procedures

## Evaluation of Disclosure Controls and Procedures

An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2017.

#### Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2017, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

Table of Contents

## Part II. OTHER INFORMATION

## Item 1. Legal Proceedings

None.

## Item 1A. Risk Factors

There are no material changes to the risk factors set forth in Part I, Item 1A, "Risk Factors," of the Company's Annual Report on Form 10-K for the year ended December 31, 2016. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

The following table provides certain information with respect to the Company's repurchase of common stock during the quarter ended June 30, 2017.

| Period                              | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Units) Purchased | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|-------------------------------------|---|---|---|---|
| Month #1 (April 1 - April 30, 2017) | —   | \$ —  | —   | 390,144   |
| Month #2 (May 1 - May 31, 2017)     | 47,198                                      | 39.42   | 47,198  | 342,946   |
| Month #3 (June 1 - June 30, 2017)   | 500   | 39.90   | 500   | 342,446   |

On April 24, 2017, the Board of Directors extended the previously approved authorization to repurchase up to 482,000 shares, or approximately 10%, of the outstanding shares of the Company for an additional year to April 30, 2018. As of June 30, 2017 there have been 91,856 shares repurchased under this plan.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

Table of Contents

Item 6. Exhibits

- 3(i) Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Quarterly Report on Form 10-Q for the period ended March 31, 2012).
  - 3(ii) Bylaws of the Registrant (incorporated by reference to Exhibit 3(ii) of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011).
  - 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer.
  - 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer.
  - 32(i) Section 1350 Certification of Chief Executive Officer.
  - 32(ii) Section 1350 Certification of Chief Financial Officer.
- 101 Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2017 and December 31, 2016; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2017 and 2016; (iii) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2017 and 2016; (iv) the Consolidated Statement of Shareholders' Equity for the six months ended June 30, 2017 and 2016; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2017 and 2016; and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.

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.

PENNS WOODS BANCORP, INC.  
(Registrant)

Date: August 8, 2017 /s/ Richard A. Grafmyre  
Richard A. Grafmyre, President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 8, 2017 /s/ Brian L. Knepp  
Brian L. Knepp, Senior Vice President and Chief Financial Officer  
(Principal Financial Officer and Principal Accounting  
Officer)

Table of Contents

EXHIBIT INDEX

- Exhibit 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer
- Exhibit 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer
- Exhibit 32(i) Section 1350 Certification of Chief Executive Officer
- Exhibit 32(ii) Section 1350 Certification of Chief Financial Officer
- Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2017 and December 31, 2016; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2017 and 2016; (iii) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2017 and 2016; (iv) the Consolidated Statement of Shareholders' Equity for the six months ended June 30, 2017 and 2016; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2017 and 2016; and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.
- Exhibit 101