EVANS BANCORP INC
Form 10-Q
May 02, 2019
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United States

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

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

For quarterly period ended March 31, 2019

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

For the transition period from to ______

Commission file number 001-35021

EVANS BANCORP, INC.

(Exact name of registrant as specified in its charter)

New York	16-1332767
(State or other jurisdiction of	(I.R.S. Employer
incorporation or organization)	Identification No.)

One Grimsby Drive, Hamburg, NY 14075

(Address of principal executive offices) (Zip Code)

(716) 926-2000

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed

since last report)

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

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

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

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

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

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Securities registered pursuant to Section 12(b) of the Act:

Title of each class	Trading Symbol(s)	Name of each exchange on which registered
Common Stock, $0.50 par value	EVBN	NYSE American

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date: Common Stock, $.50 par value, 4,883,467 shares as of April 30, 2019.

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EVANS BANCORP, INC. AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION
ITEM 1 - FINANCIAL STATEMENTS

EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED BALANCE SHEETS
MARCH 31, 2019 AND DECEMBER 31, 2018
(in thousands, except share and per share amounts)

	March 31, 2019	December 31, 2018
ASSETS		
Cash and due from banks	$ 12,434	$ 13,997
Interest-bearing deposits at banks	56,082	25,918
Securities:		
Available for sale, at fair value (amortized cost: $140,240 at March 31, 2019; $135,274 at December 31, 2018)	138,831	132,104
Held to maturity, at amortized cost (fair value: $1,903 at March 31, 2019; $1,674 at December 31, 2018)	1,900	1,685
Federal Home Loan Bank common stock, at cost	1,474	1,474
Federal Reserve Bank common stock, at cost	1,939	1,929
Loans, net of allowance for loan losses of $15,207 at March 31, 2019 and $14,784 at December 31, 2018	1,170,222	1,141,146
Properties and equipment, net of accumulated depreciation of $19,713 at March 31, 2019 and $19,416 at December 31, 2018	10,583	10,485
Goodwill and intangible assets	12,880	12,992
Bank-owned life insurance	28,922	28,403
Operating lease right-of-use asset (see Note 1)	4,142	-
Other assets	16,772	18,074
TOTAL ASSETS	$ 1,456,181	$ 1,388,207
LIABILITIES AND STOCKHOLDERS' EQUITY		
LIABILITIES		
Deposits:		
Demand	$ 242,156	$ 231,902
NOW	122,204	110,450
Savings	618,471	571,479
Time	292,892	301,227

Total deposits	1,275,723	1,215,058
Securities sold under agreement to repurchase	2,482	3,142
Other borrowings	10,000	10,000
Operating lease liability (see Note 1)	4,594	-
Other liabilities	17,617	17,031
Junior subordinated debentures	11,330	11,330
Total liabilities	1,321,746	1,256,561
STOCKHOLDERS' EQUITY:		
Common stock, $.50 par value, 10,000,000 shares authorized; 4,860,316 and 4,852,868 shares issued at March 31, 2019 and December 31, 2018, respectively, and 4,860,316 and 4,852,868 outstanding at March 31, 2019 and December 31, 2018, respectively	2,432	2,429
Capital surplus	61,448	61,225
Retained earnings	74,538	73,345
Accumulated other comprehensive loss, net of tax	(3,983)	(5,353)
Total stockholders' equity	134,435	131,646
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 1,456,181	$ 1,388,207

See Notes to Unaudited Consolidated Financial Statements

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF INCOME
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(in thousands, except share and per share amounts)

	Three Months Ended March 31, 2019	2018
INTEREST INCOME		
Loans	$ 14,362	$ 12,363
Interest-bearing deposits at banks	249	10
Securities:		
Taxable	801	797
Non-taxable	130	196
Total interest income	15,542	13,366
INTEREST EXPENSE		
Deposits	2,843	1,498
Other borrowings	45	298
Junior subordinated debentures	146	118
Total interest expense	3,034	1,914
NET INTEREST INCOME	12,508	11,452
PROVISION FOR LOAN LOSSES	538	767
NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES	11,970	10,685
NON-INTEREST INCOME		
Deposit service charges	533	509
Insurance service and fees	2,442	1,965
Gain on loans sold	26	-
Bank-owned life insurance	159	171
Interchange fee income	421	492
Other	614	649
Total non-interest income	4,195	3,786
NON-INTEREST EXPENSE		
Salaries and employee benefits	7,160	6,627
Occupancy	836	758
Advertising and public relations	167	124
Professional services	745	653
Technology and communications	893	764
Amortization of intangibles	112	28
FDIC insurance	207	232
Other	1,104	985
Total non-interest expense	11,224	10,171
INCOME BEFORE INCOME TAXES	4,941	4,300

INCOME TAX PROVISION	1,221	981
NET INCOME	$ 3,720	$ 3,319
Net income per common share-basic	$ 0.77	$ 0.69
Net income per common share-diluted	$ 0.75	$ 0.68
Cash dividends per common share	$ 0.52	$ 0.46
Weighted average number of common shares outstanding	4,855,815	4,787,846
Weighted average number of diluted shares outstanding	4,932,451	4,912,289

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED STATEMENTS OF CONSOLIDATED COMPREHENSIVE INCOME
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(in thousands)

	Three Months Ended March 31,	
	2019	2018
NET INCOME	$ 3,720	$ 3,319
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX:		
Unrealized gain/(loss) on available-for-sale securities	1,303	(1,360)
Defined benefit pension plans:		
Amortization of prior service cost	6	6
Amortization of actuarial loss	61	36
Total	67	42
OTHER COMPREHENSIVE INCOME (LOSS), NET OF TAX	1,370	(1,318)
COMPREHENSIVE INCOME	$ 5,090	$ 2,001

See Notes to Unaudited Consolidated Financial Statements

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(in thousands, except share and per share amounts)

	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive Loss	Total
Balance, December 31, 2017	$ 2,394	$ 59,444	$ 59,921	$ (3,417)	$ 118,342
Cumulative-effect adjustment due to change in accounting principle			1,496		1,496
Net Income			3,319		3,319
Other comprehensive income				(1,318)	(1,318)
Cash dividends ($0.46 per common share)			(2,202)		(2,202)
Stock compensation expense		186			186
Reissued 1,057 restricted shares		-			-
Issued 16,368 restricted shares	8	(8)			-
Issued 3,404 shares in stock option exercises	2	48			50
Balance, March 31, 2018	$ 2,404	$ 59,670	$ 62,534	$ (4,735)	$ 119,873
Balance, December 31, 2018	$ 2,429	$ 61,225	$ 73,345	$ (5,353)	$ 131,646
Net Income			3,720		3,720
Other comprehensive income				1,370	1,370
Cash dividends ($0.52 per common share)			(2,527)		(2,527)
Stock compensation expense		201			201
Reissued 500 restricted shares					-
Issued 4,934 restricted shares, net of forfeitures	2	(2)			-
Issued 2,514 shares in stock option exercises	1	24			25
Balance, March 31, 2019	$ 2,432	$ 61,448	$ 74,538	$ (3,983)	$ 134,435

See Notes to Unaudited Consolidated Financial Statements

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(in thousands)

	Three Months Ended March 31, 2019	2018
OPERATING ACTIVITIES:		
Interest received	$ 15,323	$ 13,392
Fees received	4,424	3,395
Interest paid	(2,999)	(1,871)
Cash paid to employees and vendors	(12,685)	(11,122)
Income taxes paid	-	(8)
Proceeds from sale of loans held for resale	2,071	-
Originations of loans held for resale	(2,045)	-
Net cash provided by operating activities	4,089	3,786
INVESTING ACTIVITIES:		
Available for sales securities:		
Purchases	(10,568)	(47,853)
Proceeds from maturities, calls, and payments	5,523	33,127
Held to maturity securities:		
Purchases	(224)	-
Proceeds from maturities, calls, and payments	10	610
Cash paid for bank-owned life insurance	(360)	-
Proceeds from bank-owned life insurance claims	-	675
Additions to properties and equipment	(426)	(162)
Purchase of tax credit investment	(19)	(129)
Net increase in loans	(29,454)	(48,445)
Net cash used in investing activities	(35,518)	(62,177)
FINANCING ACTIVITIES:		
Repayments of short-term borrowings, net	(660)	(25,755)
Net increase in deposits	60,665	83,204
Issuance of common stock	25	50
Net cash provided by financing activities	60,030	57,499
Net increase (decrease) in cash and cash equivalents	28,601	(892)
CASH AND CASH EQUIVALENTS:		
Beginning of period	39,915	21,330

End of period	$ 68,516	$ 20,438

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EVANS BANCORP, INC. AND SUBSIDIARIES
UNAUDITED CONSOLIDATED STATEMENTS OF CASH FLOWS
THREE MONTHS ENDED MARCH 31, 2019 AND 2018
(in thousands)

	Three Months Ended March 31,	
	2019	2018
RECONCILIATION OF NET INCOME TO NET CASH PROVIDED BY OPERATING ACTIVITIES:		
Net income	$ 3,720	$ 3,319
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	505	446
Deferred tax expense	12	144
Provision for loan losses	538	767
Loss on tax credit investment	148	-
Refundable state historic tax credit received (accrued)	17	-
Gain on loans sold	(26)	-
Change in fair value of equity securities	-	(147)
Stock compensation expense	201	186
Proceeds from sale of loans held for resale	2,071	-
Originations of loans held for resale	(2,045)	-
Changes in assets and liabilities affecting cash flow:		
Other assets	(4,528)	(1,060)
Other liabilities	3,476	131
NET CASH PROVIDED BY OPERATING ACTIVITIES	$ 4,089	$ 3,786

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EVANS BANCORP, INC. AND SUBSIDIARIES

NOTES TO UNAUDITED CONSOLIDATED FINANCIAL STATEMENTS

THREE MONTHS ENDED MARCH 31, 2019 AND 2018

1. ORGANIZATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The accounting and reporting policies followed by Evans Bancorp, Inc. (the "Company"), a financial holding company, and its two direct, wholly-owned subsidiaries: (i) Evans Bank, National Association (the "Bank"), and the Bank's subsidiaries, Evans National Leasing, Inc. ("ENL"), and Evans National Holding Corp. ("ENHC"); and (ii) Evans National Financial Services, LLC ("ENFS"), and ENFS's subsidiary, The Evans Agency, LLC ("TEA"), and TEA's subsidiaries, Frontier Claims Services, Inc. ("FCS") and ENB Associates Inc. ("ENBA"), in the preparation of the accompanying interim unaudited consolidated financial statements conform with U.S. generally accepted accounting principles ("GAAP") and with general practice within the industries in which it operates. Except as the context otherwise requires, the Company and its direct and indirect subsidiaries are collectively referred to in this report as the "Company."

The results of operations for the three month period ended March 31, 2019 are not necessarily indicative of the results to be expected for the full year. The accompanying unaudited consolidated financial statements should be read in conjunction with the Audited Consolidated Financial Statements and the Notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2018 ("10-K"). The Company's significant accounting policies are disclosed in Note 1 to the 10-K.

The Financial Accounting Standards Board ("FASB") establishes changes to U.S. GAAP in the form of accounting standards updates ("ASUs") to the FASB Accounting Standards Codification. The Company considers the applicability and impact of all ASUs when they are issued by FASB. ASUs listed below were adopted by the Company during its current fiscal year. ASUs not listed below did not have a material impact on the Company's consolidated financial position, results of operations, cash flows or disclosures.

On January 1, 2019, the Company adopted ASU 2016-02 Leases and all subsequent amendments (collectively, "ASU 2016-02"). The objective of this ASU is to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements to meet that objective. The main difference between previous GAAP and this ASU is the recognition of lease assets and lease liabilities by lessees for those leases classified as operating leases under previous GAAP. Under this new guidance, a lessee should recognize in the statement of financial position a liability to make lease payments and a right-of-use ("ROU") asset representing its right to use the underlying asset for the lease term. The recognition, measurement, and presentation of expenses and cash flows arising from a lease by a lessee have not significantly changed from previous GAAP.

ASU 2016-02 required a modified retrospective transition approach, applying the new standard to all leases existing at the date of initial application. The Company elected to use the effective date, January 1, 2019, as our date of initial application. Consequently, financial information will not be updated and the disclosures required under the new standard will not be provided for dates and periods before January 1, 2019. In addition, the Company elected the package of practical expedients permitted under the transition guidance within the new standard, which among other things, allowed us to carry forward the historical lease classification.

Under ASU 2016-02, leases are classified as finance or operating, with the classification affecting the pattern and classification of expense recognition in the income statement. The Company's leases, consisting of property leases for certain of our bank branches and insurance agency offices, are classified as operating leases. Operating lease ROU assets and liabilities are recognized at commencement date based on the present value of lease payments over the lease term. As these leases do not provide an implicit rate, we use our incremental borrowing rate in determining the present value of lease payments. Our lease terms include options to extend or terminate the lease when it is reasonably certain that we will exercise that option. Leases with an initial term of 12 months or less are not recorded on the balance sheet. Lease expense for lease payments is recognized on a straight-line basis over the lease term.

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ASU 2016-02 had a material impact on the Company's consolidated balance sheets, but did not have an impact on the consolidated statements of income or the consolidated statements of cash flows. The most significant impacts upon adoption on January 1, 2019 were the recognition of $4.3 million of ROU assets and $4.7 million of lease liabilities, including $0.4 million of liabilities that were reported in other liabilities in the Company's December 31, 2018 consolidated balance sheet. ROU assets and lease liability were $4.1 million and $4.6 million, respectively, at March 31, 2019. Operating lease expenses during the three months ended March 31, 2019 were $178 thousand and are included in other non-interest expense on the consolidated statement of income. Cash paid for amounts included in the measurement of lease liabilities during the three months ended March 31, 2019 was $184 thousand and is included in cash flows from operating activities on the consolidated statement of cash flows. The weighted average discount rate related to the Company's leases was 3.5% as of March 31, 2019. The weighted average remaining lease term related to the Company's leases was 9.0 years as of March 31, 2019. Future minimum lease payments under non-cancellable leases as of March 31, 2019 were as follows:

	Year Ending December 31,
2019 (excluding the three months ended March 31, 2019)	552
2020	749
2021	682
2022	694
2023	589
Thereafter	2,092
Total future minimum lease payments	5,358
Less imputed interest	764
Total	4,594

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2. SECURITIES

The amortized cost of securities and their approximate fair value at March 31, 2019 and December 31, 2018 were as follows:

	March 31, 2019 (in thousands)			
	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 39,160	$ 139	$ (309)	$ 38,990
States and political subdivisions	20,212	143	(14)	20,341
Total debt securities	$ 59,372	$ 282	$ (323)	$ 59,331
Mortgage-backed securities:				
FNMA	$ 27,135	$ 29	$ (332)	$ 26,832
FHLMC	16,181	20	(192)	16,009
GNMA	1,608	9	(23)	1,594
SBA	8,991	3	(146)	8,848
CMO	26,953	15	(751)	26,217
Total mortgage-backed securities	$ 80,868	$ 76	$ (1,444)	$ 79,500
Total securities designated as available for sale	$ 140,240	$ 358	$ (1,767)	$ 138,831
Held to Maturity:				
Debt securities				
States and political subdivisions	$ 1,900	$ 16	$ (13)	$ 1,903
Total securities designated as held to maturity	$ 1,900	$ 16	$ (13)	$ 1,903

December 31, 2018
(in thousands)

	Amortized Cost	Unrealized Gains	Losses	Fair Value
Available for Sale:				
Debt securities:				
U.S. government agencies	$ 34,597	$ 2	$ (671)	$ 33,928
States and political subdivisions	22,168	69	(64)	22,173
Total debt securities	$ 56,765	$ 71	$ (735)	$ 56,101
Mortgage-backed securities:				
FNMA	$ 27,747	$ 21	$ (729)	$ 27,039
FHLMC	14,645	11	(431)	14,225
GNMA	1,660	6	(36)	1,630
SBA	9,432	-	(299)	9,133
CMO	25,025	6	(1,055)	23,976
Total mortgage-backed securities	$ 78,509	$ 44	$ (2,550)	$ 76,003
Total securities designated as available for sale	$ 135,274	$ 115	$ (3,285)	$ 132,104
Held to Maturity:				
Debt securities				
States and political subdivisions	$ 1,685	$ 11	$ (22)	$ 1,674
Total securities designated as held to maturity	$ 1,685	$ 11	$ (22)	$ 1,674

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Available for sale securities with a total fair value of $117 million and $94 million at March 31, 2019 and December 31, 2018, respectively, were pledged as collateral to secure public deposits and for other purposes required or permitted by law.

The scheduled maturities of debt and mortgage-backed securities at March 31, 2019 and December 31, 2018 are summarized below. All maturity amounts are contractual maturities. Actual maturities may differ from contractual maturities because certain issuers have the right to call or prepay obligations with or without call premiums.

	March 31, 2019		December 31, 2018	
	Amortized cost	Estimated fair value	Amortized cost	Estimated fair value
	(in thousands)		(in thousands)	
Debt securities available for sale:				
Due in one year or less	$ 3,344	$ 3,347	$ 5,074	$ 5,075
Due after one year through five years	21,794	21,782	22,637	22,448
Due after five years through ten years	34,050	34,016	28,870	28,391
Due after ten years	184	186	184	187
	59,372	59,331	56,765	56,101
Mortgage-backed securities available for sale	80,868	79,500	78,509	76,003
Total	$ 140,240	$ 138,831	$ 135,274	$ 132,104
Debt securities held to maturity:				
Due in one year or less	$ 733	$ 734	$ 693	$ 693
Due after one year through five years	991	999	811	811
Due after five years through ten years	88	85	93	89
Due after ten years	88	85	88	81
Total	$ 1,900	$ 1,903	$ 1,685	$ 1,674

Contractual maturities of the Company's mortgage-backed securities generally exceed ten years; however, the effective lives may be significantly shorter due to prepayments of the underlying loans and due to the nature of these securities.

Information regarding unrealized losses within the Company's available for sale securities at March 31, 2019 and December 31, 2018 is summarized below. The securities are primarily U.S. government-guaranteed agency securities or municipal securities.

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	March 31, 2019					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ -	$ -	$ 24,697	$ (309)	$ 24,697	$ (309)
States and political subdivisions	402	(1)	3,545	(13)	3,947	(14)
Total debt securities	$ 402	$ (1)	$ 28,242	$ (322)	$ 28,644	$ (323)
Mortgage-backed securities:						
FNMA	$ -	$ -	$ 22,217	$ (332)	$ 22,217	$ (332)
FHLMC	-	-	13,558	(192)	13,558	(192)
GNMA	201	(1)	769	(22)	970	(23)
SBA	-	-	7,113	(146)	7,113	(146)
CMO	-	-	22,795	(751)	22,795	(751)
Total mortgage-backed securities	$ 201	$ (1)	$ 66,452	$ (1,443)	$ 66,653	$ (1,444)
Held to Maturity:						
Debt securities:						
States and political subdivisions	$ -	$ -	$ 558	$ (13)	$ 558	$ (13)
Total temporarily impaired securities	$ 603	$ (2)	$ 95,252	$ (1,778)	$ 95,855	$ (1,780)

	December 31, 2018					
	Less than 12 months		12 months or longer		Total	
	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
	(in thousands)					
Available for Sale:						
Debt securities:						
U.S. government agencies	$ 9,931	$ (49)	$ 21,144	$ (622)	$ 31,075	$ (671)
States and political subdivisions	5,218	(15)	6,893	(49)	12,111	(64)
Total debt securities	$ 15,149	$ (64)	$ 28,037	$ (671)	$ 43,186	$ (735)
Mortgage-backed securities:						

FNMA	$ 2,637	$ (21)	$ 23,667	$ (708)	$ 26,304	$ (729)
FHLMC	1,895	(25)	11,899	(406)	13,794	(431)
GNMA	-	-	926	(36)	926	(36)
SBA	-	-	9,133	(299)	9,133	(299)
CMO	-	-	23,127	(1,055)	23,127	(1,055)
Total mortgage-backed securities	$ 4,532	$ (46)	$ 68,752	$ (2,504)	$ 73,284	$ (2,550)
Held to Maturity:						
Debt securities:						
States and political subdivisions	$ 156	$ -	$ 722	$ (22)	$ 878	$ (22)
Total temporarily impaired securities	$ 19,837	$ (110)	$ 97,511	$ (3,197)	$ 117,348	$ (3,307)

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Management has assessed the securities available for sale in an unrealized loss position at March 31, 2019 and December 31, 2018 and determined the decline in fair value below amortized cost to be temporary. In making this determination, management considered the period of time the securities were in a loss position, the percentage decline in comparison to the securities' amortized cost, and the financial condition of the issuer (primarily government or government-sponsored enterprises). In addition, management does not intend to sell these securities and it is not more likely than not that the Company will be required to sell these securities before recovery of their amortized cost. Management believes the decline in fair value is primarily related to market interest rate fluctuations and not to the credit deterioration of the individual issuers.

The Company has not recorded any other-than-temporary impairment ("OTTI") charges as of March 31, 2019 and did not record any OTTI charges during 2018. The credit worthiness of the Company's securities portfolio is largely reliant on the ability of U.S. government sponsored agencies such as Federal Home Loan Bank ("FHLB"), Federal National Mortgage Association ("FNMA"), Government National Mortgage Association ("GNMA"), and Federal Home Loan Mortgage Corporation ("FHLMC"), and municipalities throughout New York State to meet their obligations. In addition, dysfunctional markets could materially alter the liquidity, interest rate, and pricing risk of the portfolio. The stable past performance is not a guarantee for similar performance of the Company's securities portfolio in future periods.

3. FAIR VALUE MEASUREMENT

Fair value is defined in ASC Topic 820 "Fair Value Measurement" as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

There are three levels of inputs to fair value measurement:

Level 1 inputs are quoted prices for identical instruments in active markets;
Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly; and
Level 3 inputs are unobservable inputs.

Observable market data should be used when available.

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A RECURRING BASIS

The following table presents, for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a recurring basis as of March 31, 2019 and December 31, 2018, respectively:

(in thousands)	Level 1	Level 2	Level 3	Fair Value
March 31, 2019				
Securities available-for-sale:				
US government agencies	$ -	$ 38,990	$ -	$ 38,990
States and political subdivisions	-	20,341	-	20,341
Mortgage-backed securities	-	79,500	-	79,500
Mortgage servicing rights	-	-	587	587
December 31, 2018				
Securities available-for-sale:				
US government agencies	$ -	$ 33,928	$ -	$ 33,928
States and political subdivisions	-	22,173	-	22,173
Mortgage-backed securities	-	76,003	-	76,003
Mortgage servicing rights	-	-	609	609

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Securities available for sale

Fair values for securities are determined using independent pricing services and market-participating brokers. The Company's independent pricing service utilizes evaluated pricing models that vary by asset class and incorporate available trade, bid and other market information for structured securities, cash flow and, when available, loan performance data. Because many fixed income securities do not trade on a daily basis, the evaluated pricing applications apply information as applicable through processes, such as benchmarking of like securities, sector groupings, and matrix pricing, to prepare evaluations. In addition, model processes, such as the Option Adjusted Spread model, are used to assess interest rate impact and develop prepayment scenarios. The models and the process take into account market convention. For each asset class, a team of evaluators gathers information from market sources and integrates relevant credit information, perceived market movements and sector news into the evaluated pricing applications and models. The Company's service provider may occasionally determine that it does not have sufficient verifiable information to value a particular security. In these cases the Company will utilize valuations from another pricing service.

Management believes that it has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of securities to enable management to maintain an appropriate system of internal control. On a quarterly basis, the Company reviews changes in the market value of its security portfolio. Individual changes in valuations are reviewed for consistency with general interest rate movements and any known credit concerns for specific securities. Additionally, on an annual basis, the Company has its entire security portfolio priced by a second pricing service to determine consistency with another market evaluator. If, during the Company's review or when comparing with another servicer, a material difference between pricing evaluations were to exist, the Company would submit an inquiry to the service provider regarding the data used to value a particular security. If the Company determines it has market information that would support a different valuation than the initial evaluation it can submit a challenge for a change to that security's valuation.

Securities available for sale are classified as Level 2 in the fair value hierarchy as the valuation provided by the third-party provider uses observable market data.

Equity securities

At December 31, 2017 and through the first three months of 2018, the Company held equity securities in another financial institution. Since the ownership level was less than 5% of the outstanding shares of that financial institution, the investment was recorded on the Company's balance sheet at historical cost, under the cost method of accounting. On January 1, 2018, the Company adopted ASU 2016-01, requiring the Company to mark the investment to its fair value with a cumulative-effect adjustment to retained earnings.

The equity securities of the financial institution are classified as Level 3 in the fair value hierarchy because the primary inputs in measuring the fair value are unobservable to the public. The shares of the institution are not publicly traded on a major stock exchange, but rather through private sales between shareholders. Trading in the securities is fairly limited as the institution's total trading volume for the first three months of 2018 was approximately 1% of the outstanding common shares. The Company obtained the sales information from the institution to calculate the fair value of the equity securities as of the end of the reporting period. The fair value recorded in the Company's financial statements is based on observable prices obtained from the latest orderly transactions in the quarter.

Due to the adoption of ASU 2016-01 and the designation of the financial institution's equity securities as Level 3 on the fair value hierarchy, there was a transfer into Level 3 for the institution's equity securities during the first quarter of 2018. The Company sold its entire equity interest in this financial institution during the third quarter of 2018. The following table summarizes the changes in fair value for equity securities:

(in thousands)	Three months ended March 31, 2018
Equity securities - January 1	$ 580
Increase in recorded value due to adoption of ASU 2016-01 through beginning retained earnings	1,234
Fair value change included in earnings	147
Equity securities - March 31	$ 1,961

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Mortgage servicing rights

Mortgage servicing rights ("MSRs") do not trade in an active, open market with readily observable prices. Accordingly, the Company obtains the fair value of the MSRs using a third-party pricing provider. The provider determines the fair value by discounting projected net servicing cash flows of the remaining servicing portfolio. The valuation model used by the provider considers market loan prepayment predictions and other economic factors which management considers to be significant unobservable inputs. The fair value of MSRs is mostly affected by changes in mortgage interest rates since rate changes cause the loan prepayment acceleration factors to increase or decrease. Management has a sufficient understanding of the third party service's valuation models, assumptions and inputs used in determining the fair value of MSRs to enable management to maintain an appropriate system of internal control. MSRs are classified within Level 3 of the fair value hierarchy as the valuation is model driven and primarily based on unobservable inputs.

The following table summarizes the changes in fair value for MSRs:

	Three months ended March 31,	
(in thousands)	2019	2018
Mortgage servicing rights - January 1	$ 609	$ 586
Losses/(gains) included in earnings	(40)	58
Additions from loan sales	18	-
Mortgage servicing rights - March 31	$ 587	$ 644

Quantitative information about the significant unobservable inputs used in the fair value measurement of MSRs at the respective dates is as follows:

	March 31, 2019	December 31, 2018
Servicing fees	0.25 %	0.25 %
Discount rate	9.00 %	9.00 %
Prepayment rate (CPR)	7.31 %	6.52 %

FINANCIAL INSTRUMENTS MEASURED AT FAIR VALUE ON A NONRECURRING BASIS

The Company is required, on a nonrecurring basis, to adjust the carrying value of certain assets or provide valuation allowances related to certain assets using fair value measurements. The following table presents for each of the fair-value hierarchy levels as defined in this footnote, those financial instruments which are measured at fair value on a nonrecurring basis at March 31, 2019 and December 31, 2018:

(in thousands)	Level 1	Level 2	Level 3	Fair Value
March 31, 2019				
Collateral dependent impaired loans	$ -	$ -	$ 21,221	$ 21,221
December 31, 2018				
Collateral dependent impaired loans	$ -	$ -	$ 20,590	$ 20,590

Collateral dependent impaired loans

The Company evaluates and values impaired loans at the time the loan is identified as impaired, and the fair values of such loans are estimated using Level 3 inputs in the fair value hierarchy. Each loan’s collateral has a unique appraisal and management’s discount of the value is based on factors unique to each impaired loan. The significant unobservable input in determining the fair value is management’s subjective discount on appraisals of the collateral securing the loan. Collateral may consist of real estate and/or business assets including equipment, inventory and/or accounts receivable and the value of these assets is determined based on appraisals by qualified licensed appraisers hired by the Company. Appraised and reported values may be discounted based on management's historical knowledge, changes in market conditions from the time of valuation, estimated costs to sell, and/or management's expertise and knowledge of the client and the client's business.

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The Company has an appraisal policy in which appraisals are obtained upon a commercial loan being downgraded on the Company's internal loan rating scale to a special mention or a substandard depending on the amount of the loan, the type of loan and the type of collateral. All impaired commercial loans are graded substandard or worse on the internal loan rating scale. For consumer loans, the Company obtains appraisals when a loan becomes 90 days past due or is determined to be impaired, whichever occurs first. Subsequent to the downgrade or reaching 90 days past due, if the loan remains outstanding and impaired for at least one year more, management may require another follow-up appraisal. Between receipts of updated appraisals, if necessary, management may perform an internal valuation based on any known changing conditions in the marketplace such as sales of similar properties, a change in the condition of the collateral, or feedback from local appraisers. Collateral dependent impaired loans had a gross value of $22.2 million, with an allowance for loan loss of $1.0 million, at March 31, 2019 compared with $21.7 million and $1.1 million, respectively, at December 31, 2018.

FAIR VALUE OF FINANCIAL INSTRUMENTS

The table below depicts the estimated fair values of the Company's financial instruments, including those that are not measured and reported at fair value on a recurring basis or nonrecurring basis.

	March 31, 2019		December 31, 2018	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
	(in thousands)		(in thousands)	
Financial assets:				
Level 1:				
Cash and cash equivalents	$ 68,516	$ 68,516	$ 39,915	$ 39,915
Level 2:				
Available for sale securities	138,831	138,831	132,104	132,104
FHLB and FRB stock	3,413	3,413	3,403	3,403
Level 3:				
Held to maturity securities	1,900	1,903	1,685	1,674
Loans, net	1,170,222	1,165,888	1,141,146	1,131,891

Mortgage servicing rights	587	587	609	609
Financial liabilities:				
Level 1:				
Demand deposits	$ 242,156	$ 242,156	$ 231,902	$ 231,902
NOW deposits	122,204	122,204	110,450	110,450
Savings deposits	618,471	618,471	571,479	571,479
Level 2:				
Securities sold under agreement to repurchase	2,482	2,482		