FIRST KEYSTONE CORP
Form 10-Q
May 09, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10Q

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

For the quarterly period ended March 31, 2018

or

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

For the transition period from ________ to ________

Commission File Number: 2-88927

FIRST KEYSTONE CORPORATION
(Exact name of registrant as specified in its charter)

Pennsylvania **23-2249083**

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

111 West Front Street, Berwick, PA 18603
(Address of principal executive offices) (Zip Code)

Registrant's telephone number, including area code: (570) 752-3671

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 x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes x No ¨

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 definitions of "large accelerated filer," "accelerated filer," and "small reporting company" in Rule 12b-2 of the Exchange Act.

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

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

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

Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practical date:

Common Stock, $2 Par Value, 5,731,624 shares as of May 4, 2018

PART I - FINANCIAL INFORMATION

Item 1. Financial Statements

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(Dollars in thousands, except per share data)

	March 31, 2018	December 31, 2017
ASSETS		
Cash and due from banks	$8,973	$ 7,913
Interest-bearing deposits in other banks	1,328	826
Total cash and cash equivalents	10,301	8,739
Time deposits with other banks	1,482	1,482
Debt securities available-for-sale	342,093	348,586
Marketable equity securities	1,599	1,632
Restricted investment in bank stocks	5,445	4,058
Loans	573,244	559,397
Allowance for loan losses	(7,379)	(7,487)
Net loans	565,865	551,910
Premises and equipment, net	20,389	20,623
Accrued interest receivable	3,852	4,237
Cash surrender value of bank owned life insurance	22,497	22,354
Investments in low-income housing partnerships	2,371	2,626
Goodwill	19,133	19,133
Foreclosed assets held for resale	1,115	1,071
Deferred income taxes	2,138	936
Other assets	3,150	2,734
TOTAL ASSETS	$1,001,430	$ 990,121
LIABILITIES		
Deposits:		
Non-interest bearing	$131,282	$ 121,415
Interest bearing	617,564	656,731

Total deposits	748,846	778,146
Short-term borrowings	80,791	26,296
Long-term borrowings	55,000	65,000
Accrued interest payable	549	490
Other liabilities	3,816	3,470
TOTAL LIABILITIES	889,002	873,402
STOCKHOLDERS' EQUITY		
Preferred stock, par value $2.00 per share; authorized 1,000,000 shares as of March 31, 2018 and December 31, 2017; issued 0 as of March 31, 2018 and December 31, 2017		
Common stock, par value $2.00 per share; authorized 20,000,000 shares as of March 31, 2018 and December 31, 2017; issued 5,950,951 as of March 31, 2018 and December 31, 2017; outstanding 5,719,339 as of March 31, 2018 and December 31, 2017	11,902	11,902
Surplus	36,193	36,193
Retained earnings	73,013	72,507
Accumulated other comprehensive (loss) income	(2,971)	1,826
Treasury stock, at cost, 231,612 shares as of March 31, 2018 and December 31, 2017	(5,709)	(5,709)
TOTAL STOCKHOLDERS' EQUITY	112,428	116,719
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$1,001,430	$ 990,121

See accompanying notes to consolidated financial statements.

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FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF INCOME

FOR THE THREE MONTHS ENDED MARCH 31, 2018 AND 2017

(Unaudited)

(Dollars in thousands, except per share data)

	2018	2017
Interest and fees on loans	$5,945	$5,512
Interest and dividend income on securities:		
Taxable	1,040	1,142
Tax-exempt	1,199	1,147
Dividends	11	11
Dividend income on restricted investment in bank stocks	68	77
Interest on interest-bearing deposits in other banks	8	8
Total interest income	8,271	7,897
INTEREST EXPENSE		
Interest on deposits	1,272	901
Interest on short-term borrowings	174	136
Interest on long-term borrowings	335	382
Total interest expense	1,781	1,419
Net interest income	6,490	6,478
Provision for loan losses	50	83
Net interest income after provision for loan losses	6,440	6,395
NON-INTEREST INCOME		
Trust department	235	238
Service charges and fees	457	436
Bank owned life insurance income	143	158
ATM fees and debit card income	357	327
Gains on sales of mortgage loans	29	36
Net securities (losses) gains	(17)	303
Other	55	40
Total non-interest income	1,259	1,538
NON-INTEREST EXPENSE		
Salaries and employee benefits	3,036	2,742
Occupancy, net	472	487
Furniture and equipment	140	139

Computer expense	253	246
Professional services	223	238
Pennsylvania shares tax	199	206
FDIC insurance	81	80
ATM and debit card fees	175	137
Data processing fees	267	227
Foreclosed assets held for resale expense	68	26
Advertising	81	78
Other	900	657
Total non-interest expense	5,895	5,263
Income before income tax expense	1,804	2,670
Income tax expense	27	384
NET INCOME	$1,777	$2,286
PER SHARE DATA		
Net income per share:		
Basic	$0.31	$0.40
Diluted	0.31	0.40
Dividends per share	0.27	0.27

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF COMPREHENSIVE (LOSS) INCOME

THREE MONTHS ENDED MARCH 31, 2018 AND 2017

(Unaudited)

(Dollars in thousands)

	2018	2017
Net Income	$1,777	$2,286
Other comprehensive income:		
Unrealized net holding (losses) gains on debt securities available-for-sale arising during the period, net of income taxes of $(1,199) and $534, respectively	(4,510)	1,035
Less reclassification adjustment for net gains included in net income, net of income taxes of $(3) and $(103), respectively (a) (b)	(13)	(200)
Total other comprehensive (loss) income	(4,523)	835
Total Comprehensive (Loss) Income	$(2,746)	$3,121

(a) Gross amounts are included in net securities (losses) gains on the Consolidated Statements of Income in non-interest income.

(b) Income tax amounts are included in income tax expense on the Consolidated Statements of Income.

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' EQUITY

THREE MONTHS ENDED MARCH 31, 2018 AND 2017

(Unaudited)

(Dollars in thousands, except per share data)

	Common Stock			Retained	Accumulated Other Comprehensive (Loss) Income	Treasury	Total Stockholders'
	Shares	Amount	Surplus	Earnings		Stock	Equity
Balance at January 1, 2018	5,950,951	$11,902	$36,193	$72,507	$ 1,826	$(5,709)	$ 116,719
Net Income				1,777			1,777
Other comprehensive loss, net of taxes					(4,523)		(4,523)
Impact of adoption of accounting standards[1]				274	(274)		—
Dividends - $0.27 per share				(1,545)			(1,545)
Balance at March 31, 2018	5,950,951	$11,902	$36,193	$73,013	$ (2,971)	$(5,709)	$ 112,428
Balance at January 1, 2017	5,904,563	$11,809	$35,047	$70,004	$ (1,419)	$(5,756)	$ 109,685
Net Income				2,286			2,286
Other comprehensive income, net of taxes					835		835
Issuance of common stock under dividend reinvestment plan	11,781	24	277				301
Dividends - $0.27 per share				(1,532)			(1,532)
Balance at March 31, 2017	5,916,344	$11,833	$35,324	$70,758	$ (584)	$(5,756)	$ 111,575

[1]Represents the impact of adopting Accounting Standard Update ("ASU") 2018-02 and ASU 2016-01. See Note 2 to the consolidated financial statements for more information.

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

FOR THE THREE MONTHS ENDED MARCH 31, 2018 AND 2017

(Unaudited)

(Dollars in thousands)

	2018	2017
OPERATING ACTIVITIES		
Net income	$1,777	$2,286
Adjustments to reconcile net income to net cash provided by operating activities:		
Provision for loan losses	50	83
Depreciation and amortization	267	283
Net premium amortization on securities	901	1,186
Gains on sales of mortgage loans	(29)	(36)
Proceeds from sales of mortgage loans originated for resale	1,794	1,216
Originations of mortgage loans originated for resale	(1,642)	(1,637)
Net securities losses (gains)	17	(303)
Losses on sales of foreclosed real estate held for resale, including write-downs	31	—
Decrease in accrued interest receivable	385	30
Earnings on investment in bank owned life insurance	(143)	(158)
Increase in other assets	(416)	(469)
Amortization of investment in real estate ventures	255	40
Increase in accrued interest payable	59	28
Increase (decrease) increase in other liabilities	36	(502)
NET CASH PROVIDED BY OPERATING ACTIVITIES	3,342	2,047
INVESTING ACTIVITIES		
Proceeds from sales of debt securities available-for-sale	14,038	24,491
Proceeds from maturities and redemptions of debt securities available-for-sale	4,999	4,601
Purchases of debt securities available-for-sale	(19,154)	(38,662)
Proceeds from maturities and redemptions of investment securities held-to-maturity	—	1
Net change in restricted investment in bank stocks	(1,387)	(465)
Net increase in loans	(14,197)	(2,123)
Purchases of premises and equipment	(35)	(26)
Purchase of investment in real estate venture	—	(167)
Proceeds from sales of foreclosed assets held for resale	15	152
NET CASH USED IN INVESTING ACTIVITIES	(15,721)	(12,198)
FINANCING ACTIVITIES		
Net (decrease) increase in deposits	(29,300)	6,604
Net increase in short-term borrowings	54,495	5,635

Repayment of long-term borrowings	(10,000)	(31)
Common stock issued	—	301
Dividends paid	(1,254)	(1,532)
NET CASH PROVIDED BY FINANCING ACTIVITIES	13,941	10,977
INCREASE IN CASH AND CASH EQUIVALENTS	1,562	826
CASH AND CASH EQUIVALENTS, BEGINNING	8,739	9,128
CASH AND CASH EQUIVALENTS, ENDING	$10,301	$9,954
SUPPLEMENTAL DISCLOSURE OF CASH FLOW INFORMATION		
Interest paid	$1,722	$1,391
Income taxes paid	—	650
SUPPLEMENTAL DISCLOSURE OF NON-CASH ACTIVITIES		
Purchased securities settling after quarter end	—	4,478
Loans transferred to foreclosed assets held for resale	90	15

See accompanying notes to consolidated financial statements.

FIRST KEYSTONE CORPORATION AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

NOTE 1 BASIS OF PRESENTATION AND ACCOUNTING POLICIES

The consolidated financial statements include the accounts of First Keystone Corporation (the "Corporation") and its wholly owned subsidiary, First Keystone Community Bank (the "Bank"). All significant intercompany accounts and transactions have been eliminated.

The accompanying unaudited consolidated financial statements have been prepared in accordance with U.S. generally accepted accounting principles ("U.S. GAAP") for interim financial information. Accordingly, they do not include all of the information and footnotes required by U.S. GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for fair presentation have been included. Operating results for the three month period ended March 31, 2018, are not necessarily indicative of the results for the year ending December 31, 2018. For further information, refer to the consolidated financial statements and notes thereto included in First Keystone Corporation's Annual Report on Form 10-K for the year ended December 31, 2017.

For comparative purposes, certain 2017 balances have been reclassified to conform to the 2018 presentation. Such reclassifications had no impact on net income.

The Corporation has evaluated events and transactions occurring subsequent to the consolidated balance sheet date of March 31, 2018 for items that should potentially be recognized or disclosed in these consolidated financial statements. The evaluation was conducted through the date these consolidated financial statements were issued.

NOTE 2 RECENT ACCOUNTING STANDARDS UPDATES ("ASU")

Recently adopted ASUs:

On January 1, 2018, the Corporation adopted ASU 2014-09, *Revenue from Contracts with Customers,* and all subsequent amendments to the ASU (collectively "ASC 606"), which (i) creates a single framework for recognizing revenue from contracts with customers that fall within its scope and (ii) revises when it is appropriate to recognize a gain (loss) from the transfer of nonfinancial assets, such as OREO. The majority of the Corporation's revenue comes from interest income, including loans and securities, which are outside the scope of ASC 606. The Corporation's services that fall within the scope of ASC 606 are presented within other income on the consolidated statements of income and are recognized as revenue as the Corporation satisfies its obligation to the customer. Services within the scope of ASC 606 include deposit related fees and service charges, interchange fees and surcharges, and income from wealth management activities. ASC 606 did not result in a change to the accounting for any in-scope revenue streams; as such, no cumulative effect adjustment was recorded.

On January 1, 2018, the Corporation adopted ASU 2016-01, *Financial Instruments-Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities,* which amended the guidance on the classification and measurement of financial instruments. Adoption of ASU 2016-01 resulted in: (1) separate classification of marketable equity securities previously included in investment securities available-for-sale on the consolidated balance sheets, (2) changes in the fair value of the equity securities being captured in the consolidated statements of income and (3) an increase in retained earnings and corresponding decrease in accumulated other comprehensive loss of $634,000 at January 1, 2018 for the after-tax impact of the change in accounting for the unrealized gain on the equity securities. Adoption of the standard also resulted in the use of an exit price to determine the fair value of financial instruments not measured at fair value in the consolidated balance sheets. For more information about fair value disclosures, refer to Note 8, "Fair Value Measurements".

In August 2016, the Financial Accounting Standards Board ("FASB") issued ASU 2016-15 – Statement of Cash Flows (topic 230): *Classification of Certain Cash Receipts and Cash Payments (a consensus of the Emerging Issues Task Force).* ASU No. 2016-15 addresses eight cash flow issues with specific guidance on how certain cash receipts and cash payments should be presented on the statement of cash flows. ASU No. 2016-15 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2017. Early adoption is permitted. The adoption of ASU No. 2016-15 had no material effect on the Corporation's cash flows.

In November 2016, the Financial Accounting Standards Board ("FASB") issued ASU No. 2016-18, *Statement of Cash flows-Restricted Cash (Topic 230)*. The amendments in this Update clarify the inclusion of restricted cash in the cash and cash equivalents beginning-of-period and end-of period reconciliation on the consolidated statement of cash flows. For public business entities that are SEC filers, such as the Corporation, the amendments in this Update are effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The implementation of this ASU in 2018 had no material effect on the Corporation's consolidated financial position or results of operations.

In March 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-07, *Compensation - Retirement Benefits (Topic 715)*: Improving the Presentation of Net Periodic Pension Cost and Net Periodic Postretirement Benefit Cost. The amendments apply to all entities that offer employees defined benefit pension plans, other postretirement benefit plans, or other types of benefits accounted for under Topic 715, Compensation — Retirement Benefits. The amendments 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 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. The amendments also allow only the service cost component to be eligible for capitalization when applicable (e.g., as a cost of internally manufactured inventory or a self-constructed asset). The ASU is effective for public business entities for annual periods beginning after December 15, 2017, including interim periods within those annual periods. Early adoption is permitted as of the beginning of an annual period for which financial statements (interim or annual) have not been issued or made available for issuance. The adoption of this update had no material impact on the Corporation's consolidated financial position or results of operations.

In February 2018, the Financial Accounting Standards Board ("FASB") issued ASU 2018-02, *Income Statement – Reporting Comprehensive Income (Topic 220): Reclassification of Certain Tax Effects from Accumulated Other Comprehensive Income ("AOCI").* This ASU provides financial statement preparers with an option to reclassify stranded tax effects within AOCI to retained earnings in each period in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act (or portion thereof) are recorded. Effective for all organizations for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted. Organizations should apply the proposed amendments either in the period of adoption or retrospectively to each period (or periods) in which the effect of the change in the U.S. federal corporate income tax rate in the Tax Cuts and Jobs Act is recognized. The Corporation elected to early adopt this standard update, effective January 1, 2018. Adoption resulted in a reclassification between retained earnings and accumulated other comprehensive loss of $360,000 at January 1, 2018, which is included in the consolidated statements of changes in

stockholders' equity.

Pending ASUs:

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. ASU No. 2016-02 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. For public business entities, ASU No. 2016-02 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2018. Early adoption is permitted. The Corporation is currently assessing the effect that ASU No. 2016-02 will have on its results of operations, financial position and cash flows as it applies to the Corporation's three leased properties.

In June 2016, the FASB issued ASU No. 2016-13, *Financial Instruments-Credit Losses (Topic 326):* Measurement of Credit Losses on Financial Instruments. ASU No. 2016-13 requires financial assets measured at amortized cost to 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 measurement of expected credit losses is based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. ASU No. 2016-13 is effective for annual periods and interim periods within those annual periods beginning after December 15, 2019. Early adoption is permitted for annual and interim periods beginning after December 15, 2018. While the Corporation is currently evaluating the provisions of ASU 2016-13 to determine the potential impact of the new standard will have on the Corporation's Consolidated Financial Statements, it has taken steps to prepare for the implementation when it becomes effective, such as: forming an internal committee, gathering pertinent data, consulting with outside professionals, and begun evaluating its current IT systems.

In January 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-04, *Intangibles – Goodwill and Other (Topic 350)*: Simplifying the Test for Goodwill Impairment. The ASU simplifies the subsequent measurement of goodwill by eliminating Step 2 from the goodwill impairment test. Instead, under the amendments, an entity should perform its annual, or interim, goodwill impairment test by comparing the fair value with its carrying amount. Additionally, an entity should consider income tax effects from any tax deductible goodwill on the carrying amount when measuring the goodwill impairment loss, if applicable. The update also eliminated the requirements for zero or negative carrying amount to perform a qualitative assessment and, if it fails that qualitative test, to perform Step 2 of the goodwill impairment test. The amendments are effective for public business entities for its annual or any interim goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The adoption of this update is not expected to have a material impact on the Corporation's consolidated financial position or results of operations.

In March 2017, the Financial Accounting Standards Board ("FASB") issued ASU 2017-08, *Receivables- Nonrefundable Fees and Other Costs (Subtopic 310-20)*: Premium Amortization on Purchased Callable Debt Securities. The ASU shortens 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. The amendments are effective for public business entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. If an entity early adopts in an interim period, any adjustments should be reflected as of the beginning of the fiscal year that includes that interim period. The amendments should be applied on a modified retrospective basis, with a cumulative-effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Corporation is currently assessing the impact that this guidance will have on its consolidated financial statements and related disclosures.

NOTE 3 — SECURITIES

The Corporation classifies its securities as either "Held-to-Maturity" or "Available-for-Sale" at the time of purchase. Securities are accounted for on a trade date basis. Debt securities are classified as Held-to-Maturity when the Corporation has the ability and positive intent to hold the securities to maturity. Securities classified as Held-to-Maturity are carried at cost adjusted for amortization of premium and accretion of discount to maturity.

Debt securities not classified as Held-to-Maturity are included in the Available-for-Sale category and are carried at fair value. The amount of any unrealized gain or loss, net of the effect of deferred income taxes, is reported as accumulated other comprehensive income (loss) in the Consolidated Balance Sheets and Consolidated Statements of Changes in Stockholders' Equity. Management's decision to sell Available-for-Sale securities is based on changes in economic conditions, controlling the sources and applications of funds, terms, availability of and yield of alternative investments, interest rate risk and the need for liquidity.

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Beginning January 1, 2018, upon adoption of ASU 2016-01, equity securities with readily determinable fair values are stated at fair value with realized and unrealized gains and losses reported in income. For periods prior to January 1, 2018, equity securities were classified as available-for-sale and stated at fair value with unrealized gains and losses reported as a separate component of AOCI, net of tax. Equity securities without readily determinable fair values are recorded at cost less impairment, if any.

The cost of debt securities classified as Held-to-Maturity or Available-for-Sale is adjusted for amortization of premiums and accretion of discounts to expected maturity. Such amortization and accretion, as well as interest and dividends, are included in interest and dividend income from investment securities. Realized gains and losses are included in net securities gains and losses. The cost of securities sold, redeemed or matured is based on the specific identification method.

The amortized cost, related estimated fair value, and unrealized gains and losses for debt securities classified as "Available-For-Sale" were as follows at March 31, 2018 and December 31, 2017:

(Dollars in thousands)

	Debt Securities Available-for-Sale			
	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
March 31, 2018:				
U.S. Treasury securities	$2,823	$ —	$ (4)	$2,819
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	83,540	161	(1,715)	81,986
Other	21,341	80	(488)	20,933
Obligations of state and political subdivisions	203,561	1,803	(2,436)	202,928
Asset backed securities	5,025	—	—	5,025
Corporate debt securities	29,564	—	(1,162)	28,402
Total	$345,854	$ 2,044	$ (5,805)	$342,093

(Dollars in thousands)

	Debt Securities Available-for-Sale			
	Amortized	Gross Unrealized	Gross Unrealized	Fair

	Cost	Gains	Losses	Value
December 31, 2017:				
U.S. Treasury securities	$—	$ —	$ —	$—
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed	82,825	210	(1,175)	81,860
Other	22,409	132	(308)	22,233
Obligations of state and political subdivisions	211,743	4,690	(911)	215,522
Asset backed securities	—	—	—	—
Corporate debt securities	29,645	90	(764)	28,971
Total	$346,622	$ 5,122	$ (3,158)	$348,586

Securities Available-for-Sale with an aggregate fair value of $251,462,000 at March 31, 2018 and $290,104,000 at December 31, 2017, were pledged to secure public funds, trust funds, securities sold under agreements to repurchase, debtor in possession funds and the Federal Discount Window aggregating $188,312,000 at March 31, 2018 and $224,659,000 at December 31, 2017.

The amortized cost, estimated fair value and weighted average yield of debt securities, by contractual maturity, are shown below at March 31, 2018. Expected maturities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

(Dollars in thousands)

	March 31, 2018 **Debt Securities Available-For-Sale**				
	U.S. Treasury Securities	U.S. Government Corporations & Agencies **Obligations**[1]	Obligations of State & Political **Subdivisions**[2]	Asset Backed Securities	Corporate Debt Securities
Within 1 Year:					
Amortized cost	$—	$	$ 2,343	$ —	$ 529
Fair value	—		2,356	—	529
Weighted average yield	—		3.29 %	—	2.66 %
1 - 5 Years:					
Amortized cost	2,823	16,907	25,009	—	12,429
Fair value	2,819	16,389	24,865	—	12,211
Weighted average yield	2.21 %	2.03 %	2.72 %	—	2.77 %
5 - 10 Years:					
Amortized cost		31,064	67,301	5,025	16,606
Fair value		29,800	66,716	5,025	15,662
Weighted average yield		2.09 %	3.23 %	4.32 %	2.75 %
After 10 Years:					
Amortized cost		56,910	108,908	—	—
Fair value		56,730	108,991	—	—
Weighted average yield		2.56 %	3.75 %	—	—
Total:					
Amortized cost	$2,823	$ 104,881	$ 203,561	$ 5,025	$ 29,564
Fair value	2,819	102,919	202,928	5,025	28,402
Weighted average yield	2.21 %	2.34 %	3.45 %	4.32 %	2.76 %

[1]Mortgage-backed securities are allocated for maturity reporting at their original maturity date.

[2]Average yields on tax-exempt obligations of state and political subdivisions have been computed on a tax-equivalent basis using a 21% tax rate.

There were no aggregate securities with a single issuer (excluding the U.S. Government and U.S. Government Agencies and Corporations) which exceeded ten percent of consolidated stockholders' equity at March 31, 2018. The quality rating of the obligations of state and political subdivisions are generally investment grade, as rated by Moody's, Standard and Poor's or Fitch. The typical exceptions are local issues which are not rated, but are secured by the full faith and credit obligations of the communities that issued these securities.

Proceeds from sales of investments in Available-for-Sale debt securities for the first quarter of 2018 and 2017 were $14,038,000 and $24,491,000, respectively. Gross gains realized on these sales were $50,000 and $341,000, respectively. Gross losses realized on these sales were $34,000 and $38,000, respectively. There were no impairment losses realized on Available-for-Sale debt securities during the first quarter of 2018 or 2017.

At March 31, 2018 and December 31, 2017, the Corporation had $1,599,000 and $1,632,000, respectively, in equity securities recorded at fair value. Prior to January 1, 2018, equity securities were stated at fair value with unrealized gains and losses reported as a separate component of AOCI, net of tax. At December 31, 2017, net unrealized gains net of tax of $634,000 had been recognized in AOCI. On January 1, 2018, these unrealized gains and losses were reclassified out of AOCI and into retained earnings with subsequent changes in fair value being recognized in net income. The following is a summary of unrealized and realized gains and losses recognized in net income on equity securities during the three months ended March 31, 2018:

(Dollars in thousands)

	Three months ended March 31, 2018
Net gains and (losses) recognized during the period on equity securities	$ (33)
Less: Net gains and (losses) recognized during the period on equity securities sold during the period	—
Unrealized gains and (losses) recognized during the reporting period on equity securities still held at the reporting date	$ (33)

There were no proceeds from sales of investments in Held-to-Maturity debt securities during the first quarter of 2018 or 2017. Therefore, there were no gains or losses realized during these periods.

Management evaluates securities for other-than-temporary impairment ("OTTI") at least on a quarterly basis, and more frequently when economic or market conditions warrant such an evaluation. Securities classified as Available-for-Sale or Held-to-Maturity are generally evaluated for OTTI under FASB ASC 320, *Investments - Debt and Equity Securities*. In determining OTTI under the FASB ASC 320 model, management considers many factors, including (1) the length of time and the extent to which the fair value has been less than cost, (2) the financial condition and near-term prospects of the issuer, (3) whether the market decline was affected by macroeconomic conditions, and (4) whether the entity has the intent to sell the debt security or more likely than not will be required to sell the debt security before its anticipated recovery. The assessment of whether an other-than-temporary decline exists involves a high degree of subjectivity and judgment and is based on the information available to management at a point in time.

When other-than-temporary impairment occurs on debt securities, the amount of the other-than-temporary impairment recognized in earnings depends on whether an entity intends to sell the security or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss. If an entity intends to sell or more likely than not will be required to sell the security before recovery of its amortized cost basis less any current-period credit loss, the other-than-temporary impairment shall be recognized in earnings equal to the entire difference between the investment's amortized cost basis and its fair value at the balance sheet date. If an entity does not intend to sell the security and it is not more likely than not that the entity will be required to sell the security before recovery of its amortized cost basis less any current-period loss, the other-than-temporary impairment shall be separated into the amount representing the credit loss and the amount related to all other factors. The amount of the total other-than-temporary impairment related to the credit loss is determined based on the present value of cash flows expected to be collected, and the realized loss is recognized as impairment charges on securities on the Consolidated Statements of Income. The amount of the total other-than-temporary impairment related to the other factors shall be recognized in other comprehensive income (loss), net of applicable taxes. The previous amortized cost basis less the other-than-temporary impairment recognized in earnings becomes the new amortized cost basis of the investment.

The Corporation and its investment advisors monitor the entire portfolio monthly with particular attention given to securities in a continuous loss position of at least ten percent for over twelve months. Based on the factors described above, management did not consider any securities to be other-than-temporarily impaired at March 31, 2018 or December 31, 2017.

In accordance with disclosures required by FASB ASC 320-10-50, *Investments – Debt and Equity Securities*, the summary below shows the gross unrealized losses and fair value of the Corporation's debt securities. Totals are aggregated by investment category where individual securities have been in a continuous loss position for less than 12 months or 12 months or more as of March 31, 2018 and December 31, 2017:

March 31, 2018

(Dollars in thousands)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized **Loss**	Fair Value	Unrealized **Loss**	Fair Value	Unrealized **Loss**
Debt Securities Available-for-Sale:						
U.S. Treasury securities	$ 2,819	$ (4)	$	$	$ 2,819	$ (4)
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	31,668	(489)	34,194	(1,226)	65,862	(1,715)
Other	2,823	(10)	7,006	(478)	9,829	(488)
Obligations of state and political subdivisions	84,238	(1,142)	26,264	(1,294)	110,502	(2,436)
Corporate debt securities	6,832	(87)	19,570	(1,075)	26,402	(1,162)
	$ 128,380	$ (1,732)	$ 87,034	$ (4,073)	$ 215,414	$ (5,805)

December 31, 2017

(Dollars in thousands)

	Less Than 12 Months		12 Months or More		Total	
	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss	Fair Value	Unrealized Loss
Debt Securities Available-for-Sale:						
U.S. Treasury securities	$ —	$ —	$ —	$ —	$ —	$ —
Obligations of U.S. Government Corporations and Agencies:						
Mortgage-backed	30,555	(300)	33,943	(875)	64,498	(1,175)
Other	2,905	(4)	7,179	(304)	10,084	(308)
	36,149	(329)	22,566	(582)	58,715	(911)

Obligations of state and political subdivisions						
Corporate debt securities	6,746	(24)	15,174	(740)	21,920	(764)
	$ 76,355	$ (657)	$ 78,862	$ (2,501)	$ 155,217	$ (3,158)

The Corporation invests in various forms of agency debt including mortgage-backed securities and callable debt. The mortgage-backed securities are issued by FHLMC ("Federal Home Loan Mortgage Corporation"), FNMA ("Federal National Mortgage Association") or GNMA ("Government National Mortgage Association"). The municipal securities consist of general obligations and revenue bonds. The fair market value of the above securities is influenced by market interest rates, prepayment speeds on mortgage securities, bid-offer spreads in the market place and credit premiums for various types of agency debt. These factors change continuously and therefore the market value of these securities may be higher or lower than the Corporation's carrying value at any measurement date. Management does not believe any of their 100 debt securities with a less than one year unrealized loss position, or any of their 58 debt securities with a one year or greater unrealized loss position as of March 31, 2018, represent an other-than-temporary impairment, as the unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

NOTE 4 — LOANS AND ALLOWANCE FOR LOAN LOSSES

Loans

Net loans are stated at their outstanding recorded investment, net of deferred fees and costs, unearned income and the allowance for loan losses. Interest on loans is recognized as income over the term of each loan, generally, by the accrual method. Loan origination fees and certain direct loan origination costs have been deferred with the net amount amortized using the straight line method or the interest method over the contractual life of the related loans as an interest yield adjustment.

Residential mortgage loans held for sale are carried at the lower of cost or market on an aggregate basis determined by independent pricing from appropriate federal or state agency investors. These loans are sold without recourse. Loans held for sale amounted to $708,000 and $834,000 at March 31, 2018 and December 31, 2017, respectively.

The loans receivable portfolio is segmented into commercial, residential and consumer loans. Commercial loans consist of the following classes: Commercial and Industrial and Commercial Real Estate.

Commercial and Industrial Lending

The Corporation originates commercial and industrial loans primarily to businesses located in its primary market area and surrounding areas. These loans are used for various business purposes, which include short-term loans and lines of credit to finance machinery and equipment, inventory and accounts receivable. Generally, the maximum term for loans extended on machinery and equipment is based on the projected useful life of such machinery and equipment. Most business lines of credit are written on demand and are reviewed annually.

Commercial and industrial loans are generally secured with short-term assets; however, in many cases, additional collateral such as real estate is provided as additional security for the loan. Loan-to-value maximum thresholds have been established by the Corporation and are specific to the type of collateral. Collateral values may be determined using invoices, inventory reports, accounts receivable aging reports, business financial statements, collateral appraisals, etc. Commercial and industrial loans are typically secured by personal guarantees of the borrower.

In underwriting commercial and industrial loans, an analysis is performed to evaluate the borrower's character and capacity to repay the loan, the adequacy of the borrower's capital and collateral, as well as the conditions affecting the borrower. Evaluation of the borrower's past, present and future cash flows is also an important aspect of the Corporation's analysis of the borrower’s ability to repay.

Commercial and industrial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions. Commercial and industrial loans are typically made on the basis of the borrower’s ability to make repayment from cash flows from the borrower’s primary business activities. As a result, the availability of funds for the repayment of commercial and industrial loans is dependent on the success of the business itself, which in turn, is likely to be dependent upon the general economic environment.

Commercial Real Estate Lending

The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation’s commercial real estate portfolio is secured primarily by commercial retail space, commercial office buildings, residential housing and hotels. Generally, commercial real estate loans have terms that do not exceed twenty years, have loan-to-value ratios of up to eighty percent of the value of the collateral property, and are typically secured by personal guarantees of the borrowers.

In underwriting these loans, the Corporation performs a thorough analysis of the financial condition of the borrower, the borrower’s credit history, and the reliability and predictability of the cash flow generated by the property securing the loan. The value of the property is determined by either independent appraisers or internal evaluations by Bank officers.

Commercial real estate loans generally present a higher level of risk than residential real estate secured loans. Repayment of loans secured by commercial real estate is typically dependent upon the successful operation of the related real estate project and/or the effect of the general economic conditions on income producing properties.

Residential Real Estate Lending (Including Home Equity)

The Corporation's residential real estate portfolio is comprised of one-to-four family residential mortgage loan originations, home equity term loans and home equity lines of credit. These loans are generated by the Corporation's marketing efforts, its present customers, walk-in customers and referrals. These loans originate primarily within or with customers from the Corporation's market area.

The Corporation's one-to-four family residential mortgage originations are secured primarily by properties located in its primary market area and surrounding areas. The Corporation offers fixed-rate mortgage loans with terms up to a maximum of thirty years for both permanent structures and those under construction. Loans with terms of thirty years are normally held for sale and sold without recourse; most of the residential mortgages held in the Corporation's residential real estate portfolio have maximum terms of twenty years. Generally, the majority of the Corporation's residential mortgage loans originate with a loan-to-value of eighty percent or less, or those with primary mortgage insurance at ninety-five percent or less. Home equity term loans are secured by the borrower's primary residence and typically have a maximum loan-to-value of eighty percent and a maximum term of fifteen years. In general, home equity lines of credit are secured by the borrower's primary residence with a maximum loan-to-value of eighty percent and a maximum term of twenty years.

In underwriting one-to-four family residential mortgage loans, the Corporation evaluates the borrower's ability to make monthly payments, the borrower's repayment history and the value of the property securing the loan. The ability and willingness to repay is determined by the borrower's employment history, current financial conditions and credit background. A majority of the properties securing residential real estate loans made by the Corporation are appraised by independent appraisers. The Corporation generally requires mortgage loan borrowers to obtain an attorney's title opinion or title insurance and fire and property insurance, including flood insurance, if applicable.

Residential mortgage loans, home equity term loans and home equity lines of credit generally present a lower level of risk than consumer loans because they are secured by the borrower's primary residence. Risk is increased when the Corporation is in a subordinate position, especially to another lender, for the loan collateral.

Consumer Lending

The Corporation offers a variety of secured and unsecured consumer loans, including vehicle loans, stock loans and loans secured by financial institution deposits. These loans originate primarily within or with customers from the market area.

Consumer loan terms vary according to the type and value of collateral and creditworthiness of the borrower. In underwriting personal loans, a thorough analysis is performed regarding the borrower’s willingness and financial ability to repay the loan as agreed. The ability to repay is determined by the borrower’s employment history, current financial condition and credit background.

Consumer loans may entail greater credit risk than residential real estate loans, particularly in the case of personal loans which are unsecured or are secured by rapidly depreciable assets, such as automobiles or recreational equipment. In such cases, repossessed collateral for a defaulted personal loan may not provide an adequate source of repayment of the outstanding loan balance as a result of the greater likelihood of damage, loss or depreciation. In addition, personal loan collections are dependent on the borrower’s continuing financial stability and therefore, are more likely to be affected by adverse personal circumstances. Furthermore, the application of various federal and state laws, including bankruptcy and insolvency laws, may limit the amount which can be recovered on such loans.

Delinquent Loans

Generally, a loan is considered to be past-due when scheduled loan payments are in arrears 10 days or more. Delinquent notices are generated automatically when a loan is 10 or 15 days past-due, depending on loan type. Collection efforts continue on past-due loans that have not been brought current, when it is believed that some chance exists for improvement in the status of the loan. Past-due loans are continually evaluated with the determination for charge-off being made when no reasonable chance remains that the status of the loan can be improved.

Commercial and Industrial and Commercial Real Estate loans are charged off in whole or in part when they become sufficiently delinquent based upon the terms of the underlying loan contract and when a collateral deficiency exists. Because all or part of the contractual cash flows are not expected to be collected, the loan is considered to be impaired, and the Bank estimates the impairment based on its analysis of the cash flows or collateral estimated at fair value less cost to sell.

Residential Real Estate and Consumer loans are charged off when they become sufficiently delinquent based upon the terms of the underlying loan contract and when the value of the underlying collateral is not sufficient to support the loan balance and a loss is expected. At that time, the amount of estimated collateral deficiency, if any, is charged off for loans secured by collateral, and all other loans are charged off in full. Loans with collateral are charged down to the estimated fair value of the collateral less cost to sell.

Loans in which the borrower is in bankruptcy are considered on a case by case basis and are either charged off or reaffirmed by the borrower.

Generally, a loan is classified as non-accrual and the accrual of interest on such a loan is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan may currently be performing. A loan may remain on accrual status if it is well secured (or supported by a strong guarantee) and in the process of collection. When a loan is placed on non-accrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against interest income. Certain non-accrual loans may continue to perform; that is, payments are still being received. Generally, the payments are applied to principal. These loans remain under constant scrutiny, and if performance continues, interest income may be recorded on a cash basis based on management's judgment as to collectability of principal.

Allowance for Loan Losses

The allowance for loan losses is established through provisions for loan losses charged against income. Loans deemed to be uncollectible are charged against the allowance for loan losses and subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level estimated by management to be adequate to absorb potential loan losses. Management’s periodic evaluation of the adequacy of the allowance for loan losses is based on the Corporation’s past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower’s ability to repay (including the timing of future payments), the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions, and other relevant factors. This evaluation is inherently subjective as it requires material estimates including the amounts and timing of future cash flows expected to be received on impaired loans that may be susceptible to significant change.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are individually classified as impaired. Select loans are not aggregated for collective impairment evaluation, as such;

all loans are subject to individual impairment evaluation should the facts and circumstances pertinent to a particular loan suggest that such evaluation is necessary. Factors considered by management in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record, and the amount of the shortfall in relation to the principal and interest owed. If a loan is impaired, a portion of the allowance may be allocated so that the loan is reported, net, at the present value of estimated future cash flows using the loan's existing rate or at the fair value of collateral if repayment is expected solely from collateral. Troubled debt restructurings are separately identified for impairment disclosures and are measured at the present value of estimated future cash flows using the loan's effective rate at inception. If a troubled debt restructuring is considered to be a collateral dependent loan, the loans may be reported, net, at the fair value of the collateral. For troubled debt restructurings that subsequently default, the Corporation determines the amount of reserve in accordance with the accounting policy for the allowance for loan losses.

The general component covers all other loans not identified as impaired and is based on historical losses and qualitative factors. The historical loss component of the allowance is determined by losses recognized by portfolio segment over a time period that management has determined represents the current credit cycle. Qualitative factors impacting each portfolio segment may include: delinquency trends, loan volume trends, Bank policy changes, management processes and oversight, economic trends (including change in consumer and business disposable incomes, unemployment and under-employment levels, and other conditions), concentrations by industry or product, internal and external loan review processes, collateral value and market conditions, and external factors including regulatory issues and competition.

The unallocated component of the allowance is maintained to cover uncertainties that could affect management's estimate of probable losses. The unallocated component of the allowance reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the portfolio.

A reserve for unfunded lending commitments is provided for possible credit losses on off-balance sheet credit exposures. The reserve for unfunded lending commitments represents management's estimate of losses inherent in its unfunded loan commitments and, if necessary, is recorded in other liabilities on the Consolidated Balance Sheets. As of March 31, 2018 and December 31, 2017, the amount of the reserve for unfunded lending commitments was $170,000 and $116,000, respectively.

The Corporation is subject to periodic examination by its federal and state examiners, and may be required by such regulators to recognize additions to the allowance for loan losses based on their assessment of credit information available to them at the time of their examinations.

A loan is considered impaired when, based on current information and events, it is probable that the Bank will be unable to collect all amounts due according to the contractual terms of the original loan agreement. Under current accounting standards, the allowance for loan losses related to impaired loans is based on discounted cash flows using the loan's effective interest rate at inception or the fair value of the collateral for certain collateral dependent loans.

The restructuring of a loan is considered a "troubled debt restructuring" if both the following conditions are met: (i) the borrower is experiencing financial difficulties, and (ii) the Bank has granted a concession. The most common concessions granted include one or more modifications to the terms of the debt, such as (a) a reduction in the interest rate for the remaining life of the debt, (b) an extension of the maturity date at an interest rate lower than the current market rate for new debt with similar risk, (c) a temporary period of interest-only payments, and (d) a reduction in the contractual payment amount for either a short period or remaining term of the loan. A less common concession is the forgiveness of a portion of the principal.

The determination of whether a borrower is experiencing financial difficulties takes into account not only the current financial condition of the borrower, but also the potential financial condition of the borrower were a concession not granted. Similarly, the determination of whether a concession has been granted is very subjective in nature. For example, simply extending the term of a loan at its original interest rate or even at a higher interest rate could be interpreted as a concession unless the borrower could readily obtain similar credit terms from a different lender.

Loans modified in a troubled debt restructuring are considered impaired and may or may not be placed on non-accrual status until the Bank determines the future collection of principal and interest is reasonably assured, which generally

requires that the borrower demonstrates a period of performance according to the restructured terms of six months.

The Bank utilizes a risk grading matrix as a tool for managing credit risk in the loan portfolio and assigns an asset quality rating (risk grade) to all Commercial and Industrial, Commercial Real Estate, Residential Real Estate and Consumer borrowings. An asset quality rating is assigned using the guidance provided in the Bank's loan policy. Primary responsibility for assigning the asset quality rating rests with the lender. The asset quality rating is validated periodically by both an internal and external loan review process.

The commercial loan grading system focuses on a borrower's financial strength and performance, experience and depth of management, primary and secondary sources of repayment, the nature of the business and the outlook for the particular industry. Primary emphasis is placed on financial condition and trends. The grade also reflects current economic and industry conditions; as well as other variables such as liquidity, cash flow, revenue/earnings trends, management strengths or weaknesses, quality of financial information, and credit history.

The loan grading system for Residential Real Estate and Consumer loans focuses on the borrower's credit score and credit history, debt-to-income ratio and income sources, collateral position and loan-to-value ratio, as well as other variables such as current economic conditions, and individual strengths and weaknesses.

Risk grade characteristics are as follows:

Risk Grade 1 – MINIMAL RISK through Risk Grade 6 – MANAGEMENT ATTENTION (Pass Grade Categories)

Risk is evaluated via examination of several attributes including but not limited to financial trends, strengths and weaknesses, likelihood of repayment when considering both cash flow and collateral, sources of repayment, leverage position, management expertise, and repayment history.

At the low-risk end of the rating scale, a risk grade of 1 – Minimal Risk is the grade reserved for loans with exceptional credit fundamentals and virtually no risk of default or loss. Loan grades then progress through escalating ratings of 2 through 6 based upon risk. Risk Grade 2 – Modest Risk are loans with sufficient cash flows; Risk Grade 3 – Average Risk are loans with key balance sheet ratios slightly above the borrower's peers; Risk Grade 4 – Acceptable Risk are loans with key balance sheet ratios usually near the borrower's peers, but one or more ratios may be higher; and Risk Grade 5 – Marginally Acceptable are loans with strained cash flow, increasing leverage and/or weakening markets. Risk Grade 6 – Management Attention are loans with weaknesses resulting from declining performance trends and the borrower's cash flows may be temporarily strained. Loans in this category are performing according to terms, but present some type of potential concern.

Risk Grade 7 – SPECIAL MENTION (Non-Pass Category)

Generally, these loans are currently protected, but are "potentially weak." They constitute an undue and unwarranted credit risk but not to the point of justifying a classification of substandard.

Assets in this category are protected but have potential weakness which may, if not checked or corrected, weaken the asset or inadequately protect the Bank's credit position at some future date. No loss of principal or interest is envisioned; however, they constitute an undue credit risk that may be minor but is unwarranted in light of the circumstances surrounding a specific asset. Risk is increasing beyond that at which the loan originally would have been granted. Historically, cash flows are inconsistent; financial trends show some deterioration. Liquidity and leverage are above industry averages. Financial information could be incomplete or inadequate. A Special Mention asset has potential weaknesses that deserve management's close attention.

Risk Grade 8 – SUBSTANDARD (Non-Pass Category)

Generally, these assets are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have "well-defined" weaknesses that jeopardize the full liquidation of the debt.

These loans are characterized by the distinct possibility that the Bank will sustain some loss if the aggregate amount of substandard assets is not fully covered by the liquidation of the collateral used as security. Substandard loans have a high probability of payment default and require more intensive supervision by Bank management.

Risk Grade 9 – DOUBTFUL (Non-Pass Category)

Generally, loans graded doubtful have all the weaknesses inherent in a substandard loan with the added factor that the weaknesses are pronounced to a point whereby the basis of current information, conditions, and values, collection or liquidation in full is deemed to be highly improbable. The possibility of loss is extremely high, but because of certain important and reasonably specific pending factors that may work to strengthen the asset, its classification is deferred until, for example, a proposed merger, acquisition, liquidation procedure, capital injection, perfection of liens on additional collateral and/or refinancing plan is completed. Loans are graded doubtful if they contain weaknesses so serious that collection or liquidation in full is questionable.

The following table presents the classes of the loan portfolio summarized by risk rating as of March 31, 2018 and December 31, 2017:

(Dollars in thousands)

	Commercial and Industrial		Commercial Real Estate	
	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
Grade:				
1-6 Pass	$105,794	$ 97,832	$276,671	$ 276,682
7 Special Mention	10	10	9,892	1,514
8 Substandard	1,221	1,334	11,759	12,210
9 Doubtful	—	—	—	
Add (deduct): Unearned discount and	—	—	—	
Net deferred loan fees and costs	150	161	613	564
Total loans	$107,175	$ 99,337	$298,935	$ 290,970

	Residential Real Estate Including Home Equity		Consumer Loans	
	March 31, 2018	December 31, 2017	March 31, 2018	December 31, 2017
Grade:				
1-6 Pass	$160,215	$ 161,405	$5,302	$ 5,997
7 Special Mention	123	124	50	52
8 Substandard	1,385	1,444	23	24
9 Doubtful	—	—	—	
Add (deduct): Unearned discount and	(1)	(1)	—	—
Net deferred loan fees and costs	(49)	(47)	86	92
Total loans	$161,673	$ 162,925	$5,461	$ 6,165

	Total Loans	
	March 31, 2018	December 31, 2017
Grade:		
1-6 Pass	$547,982	$ 541,916
7 Special Mention	10,075	1,700
8 Substandard	14,388	15,012

9 Doubtful	—	—
Add (deduct): Unearned discount and	(1)	(1)
Net deferred loan fees and costs	800	770
Total loans	$573,244	$ 559,397

Commercial and Industrial and Commercial Real Estate include loans categorized as tax-free in the amounts of $42,128,000 and $2,278,000 at March 31, 2018 and $40,926,000 and $2,315,000 at December 31, 2017. Loans held for sale amounted to $708,000 at March 31, 2018 and $834,000 at December 31, 2017.

The activity in the allowance for loan losses, by loan class, is summarized below for the periods indicated.

(Dollars in thousands)

	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the three month period ended March 31, 2018:						
Allowance for Loan Losses:						
Beginning balance	$ 949	$ 4,067	$ 1,656	$ 111	$ 704	$ 7,487
Charge-offs	—	(117)	(29)	(13)	—	(159)
Recoveries	1	—	—	—	—	1
Provision	67	578	45	(3)	(637)	50
Ending Balance	$ 1,017	$ 4,528	$ 1,672	$ 95	$ 67	$ 7,379
Ending balance: individually evaluated for impairment	$	$ 625	$ 20	$	$	$ 645
Ending balance: collectively evaluated for impairment	$ 1,017	$ 3,903	$ 1,652	$ 95	$ 67	$ 6,734
Loans Receivable:						
Ending Balance	$ 107,175	$ 298,935	$ 161,673	$ 5,461	$	$ 573,244
Ending balance: individually evaluated for impairment	$ 1,188	$ 11,611	$ 994	$	$	$ 13,793
Ending balance: collectively evaluated for impairment	$ 105,987	$ 287,324	$ 160,679	$ 5,461	$	$ 559,451

(Dollars in thousands)

	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the three month period ended March 31, 2017:						
Allowance for Loan Losses:						
Beginning balance	$ 836	$ 4,421	$ 1,777	$ 95	$ 228	$ 7,357
Charge-offs	—	(9)	(19)	(22)	—	(50)
Recoveries	67	—	—	4	—	71
Provision	(28)	45	(9)	18	57	83
Ending Balance	$ 875	$ 4,457	$ 1,749	$ 95	$ 285	$ 7,461

Ending balance: individually evaluated for impairment	$	$ 241	$ 19	$	$	$ 260
Ending balance: collectively evaluated for impairment	$ 875	$ 4,216	$ 1,730	$ 95	$ 285	$ 7,201
Loans Receivable:						
Ending Balance	$ 89,336	$ 262,651	$ 166,982	$ 6,020	$	$ 524,989
Ending balance: individually evaluated for impairment	$ 1,250	$ 13,062	$ 1,169	$	$	$ 15,481
Ending balance: collectively evaluated for impairment	$ 88,086	$ 249,589	$ 165,813	$ 6,020	$	$ 509,508

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(Dollars in thousands)

	Commercial and Industrial	Commercial Real Estate	Residential Real Estate	Consumer	Unallocated	Total
As of and for the year ended December 31, 2017						
Allowance for Loan Losses:						
Beginning balance	$ 836	$ 4,421	$ 1,777	$ 95	$ 228	$ 7,357
Charge-offs	—	(189)	(62)	(82)	—	(333)
Recoveries	74	103	9	10	—	196
Provision	39	(268)	(68)	88	476	267
Ending Balance	$ 949	$ 4,067	$ 1,656	$ 111	$ 704	$ 7,487
Ending balance: individually evaluated for impairment	$ —	$ 305	$ 22	$ —	$ —	$ 327
Ending balance: collectively evaluated for impairment	$ 949	$ 3,762	$ 1,634	$ 111	$ 704	$ 7,160
Loans Receivable:						
Ending Balance	$ 99,337	$ 290,970	$ 162,925	$ 6,165	$ —	$ 559,397
Ending balance: individually evaluated for impairment	$ 1,203	$ 11,673	$ 1,050	$ —	$ —	$ 13,926
Ending balance: collectively evaluated for impairment	$ 98,134	$ 279,297	$ 161,875	$ 6,165	$ —	$ 545,471

Of the $1,115,000 in foreclosed assets held for resale at March 31, 2018, $209,000 was represented by residential real estate, $50,000 was represented by land, and $856,000 was represented by commercial real estate. Of the $1,071,000 in foreclosed assets held for resale at December 31, 2017, $15,000 was represented by residential real estate, $50,000 was represented by land, and $1,006,000 was represented by commercial real estate. At March 31, 2018 and December 31, 2017, all foreclosed assets were held as the result of obtaining physical possession. Consumer mortgage loans secured by residential real estate for which the Bank has entered into formal foreclosure proceedings but for which physical possession of the property has yet to be obtained amounted to $516,000 at March 31, 2018 and $485,000 at December 31, 2017. These balances were not included in foreclosed assets held for resale at March 31, 2018 or December 31, 2017.

From time to time, the Bank may agree to modify the contractual terms of a borrower’s loan. In cases where the modifications represent a concession to a borrower experiencing financial difficulty, the modification is considered a troubled debt restructuring (“TDR”).

The outstanding recorded investment of TDRs as of March 31, 2018 and December 31, 2017 was $9,063,000 and $9,109,000, respectively. The decrease in TDRs at March 31, 2018 as compared to December 31, 2017 is attributable to principal payments, paydowns, and charge-offs made on existing TDRs net against smaller loans modified as TDRs during the three months ended March 31, 2018. There were no unfunded commitments on TDRs at March 31, 2018 and December 31, 2017.

During the three months ended March 31, 2018, three loans with a combined post modification balance of $164,000 were modified as TDRs as compared to the same period in 2017, when two loans with a combined post modification balance of $110,000 were classified as TDRs. The loan modifications for the three months ended March 31, 2018 consisted of one term modification and two payment modifications. The loan modifications for the three months ended March 31 2017 consisted of two payment modifications.

The following table presents the outstanding recorded investment of TDRs at the dates indicated:

(Dollars in thousands)

	March 31, 2018	December 31, 2017
Non-accrual TDRs	$ 160	$ 273
Accruing TDRs	8,903	8,836
Total	$ 9,063	$ 9,109

At March 31, 2018, eight Commercial Real Estate loans classified as TDRs with a combined recorded investment of $573,000, one Commercial and Industrial loan classified as a TDR with a recorded investment of $10,000 and one Residential Real Estate loan classified as a TDR with a recorded investment of $60,000 were not in compliance with the terms of their restructure, compared to March 31, 2017 when seven Commercial Real Estate loans classified as TDRs with a combined recorded investment of $642,000 and one Commercial and Industrial loan classified as a TDR with a recorded investment of $13,000 were not in compliance with the terms of their restructure.

During the three months ended March 31, 2018 and March 31, 2017, no loans that were modified as TDRs within the preceding twelve months had experienced payment defaults

The following table presents information regarding the loan modifications categorized as TDRs during the three months ended March 31, 2018 and March 31, 2017.

(Dollars in thousands)

	Three Months Ended March 31, 2018			
		Pre-Modification	**Post-Modification**	
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	—	$ —	$ —	$ —
Commercial Real Estate	3	152	164	160
Total	3	$ 152	$ 164	$ 160

(Dollars in thousands)

	Three Months Ended March 31, 2017			
		Pre-Modification	**Post-Modification**	
	Number of Contracts	Outstanding Recorded Investment	Outstanding Recorded Investment	Recorded Investment
Commercial and Industrial	1	$ 38	$ 38	$ 38
Commercial Real Estate	1	72	72	72
Total	2	$ 110	$ 110	$ 110

The following table provides detail regarding the types of loan modifications made for loans categorized as TDRs during the three months ended March 31, 2018 and March 31, 2017 with the total number of each type of modification performed.

	Three Months Ended March 31, 2018				Three Months Ended March 31, 2017			
	Rate Modification	Term Modification	Payment Modification	Number Modified	Rate Modification	Term Modification	Payment Modification	Number Modified
Commercial and Industrial	—	—	—	—		—	1	1
Commercial Real Estate	—	1	2	3		—	1	1
Total	—	1	2	3		—	2	2

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The recorded investment, unpaid principal balance, and the related allowance of the Corporation's impaired loans are summarized below for the periods ended March 31, 2018 and December 31, 2017.

(Dollars in thousands)

	March 31, 2018			December 31, 2017		
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Recorded Investment	Unpaid Principal Balance	Related Allowance
With no related allowance recorded:						
Commercial and Industrial	$1,188	$1,188	$ —	$1,203	$1,203	$ —
Commercial Real Estate	9,284	11,574	—	9,199	11,383	—
Residential Real Estate	866	1,012	—	878	1,024	—
With an allowance recorded:						
Commercial and Industrial	—	—	—	—	—	—
Commercial Real Estate	2,327	3,742	625	2,474	3,889	305
Residential Real Estate	128	128	20	172	172	22
Total	$13,793	$17,644	$ 645	$13,926	$17,671	$ 327
Total consists of:						
Commercial and Industrial	$1,188	$1,188	$ —	$1,203	$1,203	$ —
Commercial Real Estate	$11,611	$15,316	$ 625	$11,673	$15,272	$ 305
Residential Real Estate	$994	$1,140	$ 20	$1,050	$1,196	$ 22

At March 31, 2018 and December 31, 2017, $9,063,000 and $9,109,000 of loans classified as TDRs were included in impaired loans with a total allocated allowance of $0 and $2,000, respectively. The recorded investment represents the loan balance reflected on the Consolidated Balance Sheets net of any charge-offs. The unpaid balance is equal to the gross amount due on the loan.

The average recorded investment and interest income recognized for the Corporation's impaired loans are summarized below for the three months ended March 31, 2018 and 2017.

(Dollars in thousands)

	For the Three Months Ended March 31, 2018		For the Three Months Ended March 31, 2017	
	Average Recorded Investment	Interest Income Recognized	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:				
Commercial and Industrial	$ 1,196	$ 4	$ 833	$ 12
Commercial Real Estate	9,307	101	11,960	127
Residential Real Estate	873	1	632	1
With an allowance recorded:				
Commercial and Industrial	—	—	—	—
Commercial Real Estate	2,327	—	985	
Residential Real Estate	128	—	424	
Total	$ 13,831	$ 106	$ 14,834	$ 140
Total consists of:				
Commercial and Industrial	$ 1,196	$ 4	$ 833	$ 12
Commercial Real Estate	$ 11,634	$ 101	$ 12,945	$ 127
Residential Real Estate	$ 1,001	$ 1	$ 1,056	$ 1

Of the $106,000 and $140,000 in interest income recognized on impaired loans for the three months ended March 31, 2018 and 2017, respectively, $0 and $17,000 in interest income was recognized with respect to non-accrual loans.

Total non-performing assets (which includes loans receivable on non-accrual status, foreclosed assets held for resale and loans past-due 90 days or more and still accruing interest) as of March 31, 2018 and December 31, 2017 were as follows:

(Dollars in thousands)

	March 31, 2018	December 31, 2017
Commercial and Industrial	$ 787	$ 798
Commercial Real Estate	3,168	3,302
Residential Real Estate	935	990
Total non-accrual loans	4,890	5,090
Foreclosed assets held for resale	1,115	1,071
Loans past-due 90 days or more and still accruing interest	18	70
Total non-performing assets	$ 6,023	$ 6,231

The following tables present the classes of the loan portfolio summarized by past-due status at March 31, 2018 and December 31, 2017:

(Dollars in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total Loans	90 Days Or Greater Past Due and Still Accruing Interest
March 31, 2018:							
Commercial and Industrial	$ 10	$ 34	$ —	$ 44	$107,131	$107,175	$ —
Commercial Real Estate	592	921	2,555	4,068	294,867	298,935	—
Residential Real Estate	1,646	635	534	2,815	158,858	161,673	18
Consumer	1	3	—	4	5,457	5,461	—
Total	$ 2,249	$ 1,593	$ 3,089	$ 6,931	$566,313	$573,244	$ 18

(Dollars in thousands)

	30-59 Days Past Due	60-89 Days Past Due	90 Days or Greater Past Due	Total Past Due	Current	Total Loans	90 Days Or Greater Past Due and Still Accruing Interest
December 31, 2017:							
Commercial and Industrial	$ 68	$ 42	$ —	$ 110	$99,227	$99,337	$ —
Commercial Real Estate	603	201	2,606	3,410	287,560	290,970	50
Residential Real Estate	1,952	484	584	3,020	159,905	162,925	20
Consumer	21	2	—	23	6,142	6,165	—
Total	$ 2,644	$ 729	$ 3,190	$ 6,563	$552,834	$559,397	$ 70

At March 31, 2018, commitments to lend additional funds with respect to impaired loans consisted of one irrevocable letter of credit totaling $1,249,000 that was associated with a loan to a developer of a residential sub-division compared to December 31, 2017 when commitments to lend additional funds with respect to impaired loans consisted of one irrevocable letter of credit in the amount of $1,249,000 associated with a loan to a developer of a residential sub-division and two irrevocable letters of credit totaling $19,000 that were associated with a loan to non-profit community recreation facility.

NOTE 5 — BORROWINGS

Short-Term Borrowings

Short-term borrowings include federal funds purchased, securities sold under agreements to repurchase, the Federal Discount Window, and Federal Home Loan Bank ("FHLB") advances, which generally represent overnight or less than 30-day borrowings.

Securities Sold Under Agreements to Repurchase ("Repurchase Agreements")

The Corporation enters into agreements under which it sells securities subject to an obligation to repurchase the same or similar securities. Under these arrangements, the Corporation may transfer legal control over the assets but still retain effective control through an agreement that both entitles and obligates the Corporation to repurchase the assets.

As a result, these repurchase agreements are accounted for as collateralized financing agreements (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability on the Corporation's Consolidated Balance Sheets, while the securities underlying the repurchase agreements remain in the respective investment securities asset accounts. In other words, there is not offsetting or netting of the investment securities assets with the repurchase agreement liabilities. In addition, as the Corporation does not enter into reverse repurchase agreements, there is no such offsetting to be done with the repurchase agreements.

The right of setoff for a repurchase agreement resembles a secured borrowing, whereby the collateral would be used to settle the fair value of the repurchase agreement should the Corporation be in default (e.g., fails to make an interest payment to the counterparty). The collateral is held by a correspondent bank in the counterparty's custodial account. The counterparty has the right to sell or repledge the investment securities.

The following table presents the short-term borrowings subject to an enforceable master netting arrangement or repurchase agreements as of March 31, 2018 and December 31, 2017.

(Dollars in thousands)

	Gross Amounts of Recognized Liabilities	**Gross Amounts Offset in the Consolidated Balance Sheet**	**Net Amounts of Liabilities Presented in the Consolidated Balance Sheet**	**Financial Instruments**	**Cash Collateral Pledge**	**Net Amount**
March 31, 2018						
Repurchase agreements (a)	$ 14,714	$	$ 14,714	$ (14,714)	$	$
December 31, 2017						
Repurchase agreements (a)	$ 22,844	$	$ 22,844	$ (22,844)	$	$

(a) As of March 31, 2018 and December 31, 2017, the fair value of securities pledged in connection with repurchase agreements was $24,020,000 and $26,023,000, respectively.

The following table presents the remaining contractual maturity of the master netting arrangement or repurchase agreements as of March 31, 2018:

(Dollars in thousands)

	Remaining Contractual Maturity of the Agreements				
	Overnight and Continuous	Up to 30 days	30 -90 Days	Greater than 90 Days	Total
March 31, 2018:					
Repurchase agreements and repurchase-to-maturity transactions:					
U.S. Treasury and/or agency securities	$ 14,714	$	$	$	$ 14,714
Total	$ 14,714	$	$	$	$ 14,714

Long-Term Borrowings

Long-term borrowings are comprised of advances from FHLB. Under terms of a blanket agreement, collateral for the FHLB loans is certain qualifying assets of the Corporation’s banking subsidiary. The principal assets are real estate mortgages and certain investment securities.

NOTE 6 — COMMITMENTS AND CONTINGENCIES

In the normal course of business, there are various pending legal actions and proceedings that are not reflected in the consolidated financial statements. Management does not believe the outcome of these actions and proceedings will have a material effect on the consolidated financial position or results of operations of the Corporation.

NOTE 7 — FINANCIAL INSTRUMENTS WITH OFF-BALANCE SHEET RISK AND CONCENTRATIONS OF CREDIT RISK

Financial Instruments with Off-Balance Sheet Risk

The Corporation 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 include commitments to extend credit and standby letters of credit. Those instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheets. The contract or notional amounts of those instruments reflect the extent of involvement the Corporation has in particular classes of financial instruments. The Corporation does not engage in trading activities with respect to any of its financial instruments with off-balance sheet risk.

The Corporation’s exposure to credit loss in the event of non-performance by the other party to the financial instrument for commitments to extend credit and standby letters of credit is represented by the contractual notional amount of those instruments.

The Corporation uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments.

The Corporation may require collateral or other security to support financial instruments with off-balance sheet credit risk.

The contract or notional amounts at March 31, 2018 and December 31, 2017, were as follows:

(Dollars in thousands)

	March 31, 2018	December 31, 2017
Financial instruments whose contract amounts represent credit risk:		
Commitments to extend credit	$ 119,274	$ 90,373
Financial standby letters of credit	$ 430	$ 450
Performance standby letters of credit	$ 2,952	$ 2,901

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

Standby letters of credit are conditional commitments issued by the Corporation to guarantee payment to a third party when a customer either fails to repay an obligation or fails to perform some non-financial obligation. The credit risk involved in issuing letters of credit is essentially the same as that involved in extending loan facilities to customers. The Corporation may hold collateral (similar to the items held as collateral for commitments to extend credit) to support standby letters of credit for which collateral is deemed necessary.

Financial Instruments with Concentrations of Credit Risk

The Corporation originates primarily commercial and residential real estate loans to customers in northeastern Pennsylvania. The ability of the majority of the Corporation's customers to honor their contractual loan obligations is dependent on the economy and real estate market in this area. At March 31, 2018, the Corporation had $460,608,000 in loans secured by real estate, which represented 80.4% of total loans. The real estate loan portfolio is largely secured by lessors of residential buildings and dwellings, lessors of non-residential buildings, and lessors of hotels/motels. As of March 31, 2018 and December 31, 2017, management is of the opinion that there were no concentrations exceeding 10% of total loans with regard to loans to borrowers who were engaged in similar activities that were similarly impacted by economic or other conditions.

As all financial instruments are subject to some level of credit risk, the Corporation requires collateral and/or guarantees for all loans. Collateral may include, but is not limited to property, plant, and equipment, commercial and/or residential real estate property, land, and pledge of securities. In the event of a borrower's default, the collateral supporting the loan may be seized in order to recoup losses associated with the loan. The Corporation also establishes an allowance for loan losses that constitutes the amount available to absorb losses within the loan portfolio that may exist due to deficiencies in collateral values.

NOTE 8 — FAIR VALUE MEASUREMENTS

Fair value measurement and disclosure guidance defines fair value as the price that would be received to sell the asset or transfer the liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date under current market conditions. This guidance provides additional information on determining when the volume and level of activity for the asset or liability has significantly decreased. The guidance also includes information on identifying circumstances when a transaction may not be considered orderly.

Fair value measurement and disclosure guidance provides a list of factors that a reporting entity should evaluate to determine whether there has been a significant decrease in the volume and level of activity for the asset or liability in relation to normal market activity for the asset or liability. When the reporting entity concludes there has been a significant decrease in the volume and level of activity for the asset or liability, further analysis of the information from that market is needed and significant adjustments to the related prices may be necessary to estimate fair value in accordance with the fair value measurement and disclosure guidance.

This guidance clarifies that when there has been a significant decrease in the volume and level of activity for the asset or liability, some transactions may not be orderly. In those situations, the entity must evaluate the weight of the

evidence to determine whether the transaction is orderly. The guidance provides a list of circumstances that may indicate that a transaction is not orderly. A transaction price that is not associated with an orderly transaction is given little, if any, weight when estimating fair value.

Fair value is 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. Inputs to valuation techniques refer to the assumptions that market participants would use in pricing the asset or liability. Inputs may be observable, meaning those that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from independent sources, or unobservable, meaning those that reflect the reporting entity's own belief about the assumptions market participants would use in pricing the asset or liability based upon the best information available in the circumstances. Fair value measurement and disclosure guidance establishes a fair value hierarchy for valuation inputs that gives the highest priority to quoted prices in active markets for identical assets or liabilities and the lowest priority to unobservable inputs. The fair value hierarchy is as follows:

Level 1 Inputs: Unadjusted quoted prices in active markets that are accessible at the measurement date for identical, unrestricted assets or liabilities;

Level 2 Inputs: Quoted prices in markets that are not active, or inputs that are observable either directly or indirectly, for substantially the full term of the asset or liability;

Level 3 Inputs: Prices or valuation techniques that require inputs that are both significant to the fair value measurement and unobservable (i.e., supported by little or no market activity).

A description of the valuation methodologies used for instruments measured at fair value, as well as the general classification of such instruments pursuant to the valuation hierarchy, is set forth as follows.

Financial Assets Measured at Fair Value on a Recurring Basis

At March 31, 2018 and December 31, 2017, securities measured at fair value on a recurring basis and the valuation methods used are as follows:

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
March 31, 2018				
Debt Securities Available-for-Sale:				
U.S. Treasury securities	$	$2,819	$	$2,819
Obligations of U.S. Government Corporations and Agencies:				
Mortgage-backed		81,986	—	81,986
Other		20,933	—	20,933
Obligations of state and political subdivisions		202,928	—	202,928
Asset backed securities	—	5,025	—	5,025
Corporate debt securities		28,402		28,402
Total debt securities available-for-sale	—	342,093	—	342,093
Marketable equity securities	1,599	—		1,599
Total recurring fair value measurements	$1,599	$342,093	$	$343,692

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
December 31, 2017				
Debt Securities Available-for-Sale:				
U.S. Treasury securities	$—	$—	$ —	$—
Obligations of U.S. Government Corporations and Agencies:				
Mortgaged-backed	—	81,860	—	81,860
Other	—	22,233	—	22,233
Obligations of state and political subdivisions	—	215,522	—	215,522
Asset backed securities	—	—	—	—
Corporate debt securities	—	28,971	—	28,971

Total debt securities available-for-sale	—	348,586	—	348,586
Marketable equity securities	1,632	—	—	1,632
Total recurring fair value measurements	$ 1,632	$ 348,586	$ —	$ 350,218

The estimated fair values of equity securities classified as Level 1 are derived from quoted market prices in active markets; these assets consist mainly of stocks held in other banks. The estimated fair values of all debt securities classified as Level 2 are obtained from nationally-recognized third-party pricing agencies. The estimated fair values are derived primarily from cash flow models, which include assumptions for interest rates, credit losses, and prepayment speeds. The significant inputs utilized in the cash flow models are based on market data obtained from sources independent of the Corporation (observable inputs), and are therefore classified as Level 2 within the fair value hierarchy. The Corporation does not have any Level 3 inputs for securities. There were no transfers between Level 1 and Level 2 during 2018 or 2017.

Financial Assets Measured at Fair Value on a Nonrecurring Basis

At March 31, 2018 and December 31, 2017, impaired loans measured at fair value on a nonrecurring basis and the valuation methods used are as follows:

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at March 31, 2018				
Impaired loans:				
Commercial Real Estate	$	$	$ 4,903	$ 4,903
Residential Real Estate			212	212
Total impaired loans	$	$	$ 5,115	$ 5,115

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(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2017				
Impaired loans:				
Commercial Real Estate	$ —	$ —	$ 5,498	$ 5,498
Residential Real Estate	—	—	254	254
Total impaired loans	$ —	$ —	$ 5,752	$ 5,752

The Bank's impaired loan valuation procedure for any loans greater than $250,000 requires an appraisal to be obtained and reviewed annually at year end. A quarterly collateral evaluation is performed which may include a site visit, property pictures and discussions with realtors and other similar business professionals to ascertain current values. For impaired loans less than $250,000 upon classification and annually at year end, the Bank completes a Certificate of Inspection, which includes an onsite inspection, insured values, tax assessed values, recent sales comparisons and a review of the previous evaluations. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. The fair value consists of the impaired loan balances less the valuation allowance and/or charge-offs. There were no transfers between valuation levels in 2018 and 2017.

Nonfinancial Assets Measured at Fair Value on a Nonrecurring Basis

At March 31, 2018 and December 31, 2017, foreclosed assets held for resale measured at fair value on a nonrecurring basis and the valuation methods used are as follows:

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at March 31, 2018				
Foreclosed assets held for resale:				
Commercial Real Estate	$	$	$ 856	$ 856
Residential Real Estate	—	—	209	209
Total foreclosed assets held for resale	$	$	$ 1,065	$ 1,065

(Dollars in thousands)

	Level 1	Level 2	Level 3	Total
Assets at December 31, 2017				
Other foreclosed assets held for resale:				
Commercial Real Estate	$ —	$ —	$ 81	$ 81
Residential Real Estate	—	—	13	13
Total foreclosed assets held for resale	$ —	$ —	$ 94	$ 94

The Bank's foreclosed asset valuation procedure requires an appraisal, which considers the sales prices of similar properties in the proximate vicinity, to be completed periodically with the exception of those cases which the Bank has obtained a sales agreement. These assets are included as Level 3 fair values, based upon the lowest level that is significant to the fair value measurements. There were no transfers between valuation levels in 2018 and 2017.

The following table presents additional quantitative information about assets measured at fair value on a nonrecurring basis and for which the Bank has utilized Level 3 inputs to determine the fair value:

(Dollars in thousands)

	Quantitative Information about Level 3 Fair Value Measurements				
	Fair Value Estimate	Valuation Technique	Unobservable Input	Range	Weighted Average
March 31, 2018					
Impaired loans	$2,018	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(17%) – (67%)	(21%)
Impaired loans	$3,097	Discounted cash flow	Discount rate	(7%) – (7%)	(7%)
Foreclosed assets held for resale	$1,065	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(2%) – (35%)	(7%)
December 31, 2017					
Impaired loans	$2,495	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(7%) – (65%)	(15%)
Impaired loans	$3,257	Discounted cash flow	Discount rate	(7%) – (8%)	(7%)
Foreclosed assets held for sale	$94	Appraisal of collateral[1,3]	Appraisal adjustments[2]	(35%) – (37%)	(36%)

[1]Fair value is generally determined through independent appraisals of the underlying collateral, as defined by Bank regulators.

[2]Appraisals may be adjusted downward by management for qualitative factors such as economic conditions and estimated liquidation expenses. The typical range of appraisal adjustments are presented as a percent of the appraisal value.

[3]Includes qualitative adjustments by management and estimated liquidation expenses.

Fair Value of Financial Instruments

(Dollars in thousands)

	Carrying	Fair Value Measurements at March 31, 2018			
	Amount	Level 1	Level 2	Level 3	Total

FINANCIAL ASSETS:					
Cash and due from banks	$8,973	$8,973	$	$	$8,973
Interest-bearing deposits in other banks	1,328	—	1,328	—	1,328
Time deposits with other banks	1,482	—	1,482	—	1,482
Debt securities available-for-sale	342,093	—	342,093	—	342,093
Marketable equity securities	1,599	1,599	—	—	1,599
Restricted investment in bank stocks	5,445	—	5,445	—	5,445
Net loans	565,865	—	—	560,037	560,037
Mortgage servicing rights	363	—	—	363	363
Accrued interest receivable	3,852	—	3,852	—	3,852
FINANCIAL LIABILITIES:					
Core deposits	535,379	—	535,379	—	535,379
Time deposits	213,467	—	210,647	—	210,647
Short-term borrowings	80,791	—	80,791	—	80,791
Long-term borrowings	55,000	—	54,852	—	54,852
Accrued interest payable	549	—	549	—	549

OFF-BALANCE SHEET FINANCIAL INSTRUMENTS

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(Dollars in thousands)

	Carrying	Fair Value Measurements at December 31, 2017			
	Amount	Level 1	Level 2	Level 3	Total
FINANCIAL ASSETS:					
Cash and due from banks	$7,913	$ 7,913	$ —	$ —	$ 7,913
Interest-bearing deposits in other banks	826	—	826	—	826
Time deposits with other banks	1,482	—	1,482	—	1,482
Debt securities available-for-sale	348,586	—	348,586	—	348,586
Marketable equity securities	1,632	1,632	—	—	1,632
Restricted investment in bank stocks	4,058	—	4,058	—	4,058
Net loans	551,910	—	—	550,696	550,696
Mortgage servicing rights	379	—	—	379	379
Accrued interest receivable	4,237	—	4,237	—	4,237
FINANCIAL LIABILITIES:					
Core deposits	570,518	—	570,518	—	570,518
Time deposits	207,628	—	206,299	—	206,299
Short-term borrowings	26,296	—	26,296	—	26,296
Long-term borrowings	65,000	—	65,336	—	65,336
Accrued interest payable	490	—	490	—	490
OFF-BALANCE SHEET FINANCIAL INSTRUMENTS	—	—	—	—	—

NOTE 9 — REVENUE RECOGNITION

As disclosed in Note 2, as of January 1, 2018, the Corporation adopted ASU 2014-09 *Revenue from Contracts with Customers - Topic 606* and all subsequent ASUs that modified ASC 606. The Corporation has elected to apply the ASU and all related ASUs using the modified retrospective implementation method. The implementation of the guidance had no material impact on the measurement or recognition of revenue of prior periods, however, additional disclosures have been added in accordance with the ASU.

The main types of revenue contracts included in non-interest income within the consolidated statements of income are as follows:

Deposits related fees and service charges

Service charges and fees on deposits, which are included as liabilities in the consolidated balance sheets, consist of fees related to monthly fees for various retail and business checking accounts, automated teller machine ("ATM") fees (charged for withdrawals by our deposit customers from other bank ATMs) and insufficient funds fees ("NSF") (which are charged when customers overdraw their accounts beyond available funds). All deposit liabilities are considered to have one-day terms and therefore related fees are recognized in income at the time when the services are provided to the customers. The Corporation elected to adopt practical expedient related to incremental costs of obtaining deposit contracts. As such, any costs associated with acquiring the deposits, except for certificate of deposits ("CDs") with maturities in excess of one year, are recognized as an expense within the non-interest expense in the consolidated statements of income when incurred as the amortization period of the deposit liabilities that otherwise would have been recognized is one year or less.

Wealth/Asset/Trust Management Fees

Wealth management services are delivered to individuals, corporations and retirement funds located primarily within our geographic markets. The Trust Department of the Corporation conducts the wealth management operations, which provides a broad range of personal and corporate fiduciary services, including the administration of estates.

Assets held in a fiduciary capacity by the Trust Department are not assets of the Corporation and, therefore, are not included in our Consolidated Financial Statements. Wealth management fees, which are contractually agreed with each customer, are earned each month and recognized on a cash basis based on average fair value of the trust assets under management. The services provided under such a contract are considered a single performance obligation under ASC 606 because they embody a series of distinct goods or services that are substantially the same and have the same pattern of transfer to the customer. Wealth management fees charged by the Trust Department follow a tiered structure based on the type and size of the assets under management. Wealth management fees are included within non-interest income in the consolidated statements of income. As of March 31, 2018 and December 31, 2017, the fair value of trust assets under management was $114,498,000 and $111,130,000 respectively. The costs of acquiring asset management customers are incremental and recognized within the non-interest expense of the consolidated statements of income.

Interchange Fees and Surcharges

Interchange fees are related to the acceptance and settlement of debit card transactions, both point-of-sale and ATM, to cover operating costs and risks associated with the approval and settlement of the transactions. Interchange fees vary by type of transaction and each merchant sector. Net income recognized from interchange fees is included in non-interest income on the consolidated statements of income. A surcharge is assessed for use of the Corporation’s ATMs by non-customers. All interchange fees and surcharges are recognized as received on a daily basis for the prior business day’s transactions. All expenses related to the settlement of debit card transactions (both point-of-sale and ATM) are recognized on a monthly basis and included in non-interest expense on the consolidated statements of income.

NOTE 10 — EARNINGS PER SHARE

Basic earnings per share (“EPS”) is computed by dividing net income by the weighted average number of common shares outstanding for the period. Diluted EPS reflects the potential dilution that could occur if securities or other contracts to issue common stock were exercised or converted into common stock or resulted in the issuance of common stock that then shared in the earnings of the Corporation. Potential common shares that may be issued by the Corporation relate solely to outstanding stock options and are determined using the treasury stock method. The

following table sets forth the computation of basic and diluted earnings per share.

(In thousands, except earnings per share)

	Three Months Ended March 31,	
	2018	2017
Net income	$ 1,777	$ 2,286
Weighted-average common shares outstanding	5,719	5,672
Basic earnings per share	$ 0.31	$ 0.40
Weighted-average common shares outstanding	5,719	5,672
Common stock equivalents due to effect of stock options	—	2
Total weighted-average common shares and equivalents	5,719	5,674
Diluted earnings per share	$ 0.31	$ 0.40

Item 2. First Keystone Corporation Management's Discussion and Analysis of Financial Condition and Results of Operation

This quarterly report contains certain forward-looking statements, which are included pursuant to the "safeharbor" provisions of the Private Securities Litigation Reform Act of 1995, and reflect management's beliefs and expectations based on information currently available. These forward-looking statements are inherently subject to significant risks and uncertainties, including changes in general economic and financial market conditions, the Corporation's ability to effectively carry out its business plans and changes in regulatory or legislative requirements. Other factors that could cause or contribute to such differences are changes in competitive conditions, and pending or threatened litigation. Although management believes the expectations reflected in such forward-looking statements are reasonable, actual results may differ materially.

CRITICAL ACCOUNTING ESTIMATES

The Corporation has chosen accounting policies that it believes are appropriate to accurately and fairly report its operating results and financial position, and the Corporation applies those accounting policies in a consistent manner. The Significant Accounting Policies are summarized in Note 1 to the consolidated financial statements included in the 2017 Annual Report on Form 10-K. There have been no changes to the Critical Accounting Estimates since the Corporation filed its Annual Report on Form 10-K for the year ended December 31, 2017.

RESULTS OF OPERATIONS

Quarter ended March 31, 2018 compared to quarter ended March 31, 2017

First Keystone Corporation realized earnings for the first quarter of 2018 of $1,777,000, a decrease of $509,000, or 22.3% from the first quarter of 2017. The decrease in net income for the three months ended March 31, 2018 was primarily due to increases in salaries and employee benefits and interest expense on deposits and short-term borrowings, as well as a decrease in net investment securities gains.

On a per share basis, for the three months ended March 31, 2018, net income was $0.31 versus $0.40 for the same three month period of 2017. Cash dividends amounted to $0.27 per share for the three months ended March 31, 2018 and 2017.

NET INTEREST INCOME

The major source of operating income for the Corporation is net interest income, defined as interest income less interest ex