ACNB CORP
Form 10-Q
April 27, 2018

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, DC 20549

FORM 10-Q

(Mark One)

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

Commission file number 1-35015

ACNB CORPORATION

(Exact name of Registrant as specified in its charter)

Pennsylvania (State or other jurisdiction of incorporation or organization)	**23-2233457** (I.R.S. Employer Identification No.)
16 Lincoln Square, Gettysburg, Pennsylvania (Address of principal executive offices)	**17325** (Zip Code)

Registrant s telephone number, including area code: **(717) 334-3161**

Title of each class	Name of each exchange on which registered
Common Stock, $2.50 par value per share	The NASDAQ Stock Market, LLC

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 o

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

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

Large accelerated filer o Accelerated filer x

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

Smaller reporting company o

Emerging growth company o

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. o

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

The number of shares of the Registrant s Common Stock outstanding on April 27, 2018, was 7,034,540.

PART I - FINANCIAL INFORMATION

ACNB CORPORATION

ITEM 1 - FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

Dollars in thousands, except per share data		March 31, 2018		March 31, 2017		December 31, 2017
ASSETS						
Cash and due from banks	**$**	**16,467**	$	14,406	$	19,304
Interest bearing deposits with banks		**43,730**		2,110		15,137
Total Cash and Cash Equivalents		**60,197**		16,516		34,441
Equity securities with readily determinable fair values		**1,760**				
Debt securities available for sale		**155,620**		137,099		159,051
Securities held to maturity, fair value $40,758; $53,661; $44,549		**41,378**		53,794		44,829
Loans held for sale		**474**		466		1,736
Loans, net of allowance for loan losses $13,417; $14,145; $13,976		**1,224,337**		938,331		1,230,194
Premises and equipment		**26,609**		18,129		26,774
Restricted investment in bank stocks		**4,802**		5,089		4,773
Investment in bank-owned life insurance		**45,692**		40,997		44,935
Investments in low-income housing partnerships		**2,330**		2,794		2,446
Goodwill		**19,580**		6,308		19,580
Intangible assets		**2,985**		608		2,569
Foreclosed assets held for resale		**630**		85		436
Other assets		**24,621**		21,509		23,668
Total Assets	**$**	**1,611,015**	$	1,241,725	$	1,595,432
LIABILITIES AND STOCKHOLDERS EQUITY						
LIABILITIES						
Deposits:						
Non-interest bearing	**$**	**290,333**	$	186,154	$	279,413
Interest bearing		**1,023,081**		804,340		1,019,079
Total Deposits		**1,313,414**		990,494		1,298,492
Short-term borrowings		**33,435**		27,968		36,908
Long-term borrowings		**95,316**		90,250		94,600
Other liabilities		**12,245**		11,171		11,466
Total Liabilities		**1,454,410**		1,119,883		1,441,466
STOCKHOLDERS EQUITY						
Preferred stock, $2.50 par value; 20,000,000 shares authorized; no shares outstanding						
		17,743		15,325		17,716

Common stock, $2.50 par value; 20,000,000 shares authorized; 7,097,140, 6,129,649 and 7,086,258 shares issued; 7,034,540, 6,067,049 and 7,023,658 shares outstanding			
Treasury stock, at cost (62,600 shares)	**(728)**	(728)	(728)
Additional paid-in capital	**38,070**	11,023	37,777
Retained earnings	**109,801**	101,979	106,293
Accumulated other comprehensive loss	**(8,281)**	(5,757)	(7,092)
Total Stockholders Equity	**156,605**	121,842	153,966
Total Liabilities and Stockholders Equity	**$ 1,611,015**	$ 1,241,725	$ 1,595,432

The accompanying notes are an integral part of the consolidated financial statements.

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

Dollars in thousands, except per share data	Three Months Ended March 31, 2018	2017
INTEREST AND DIVIDEND INCOME		
Loans, including fees	**$ 14,157**	$ 9,530
Securities:		
Taxable	**903**	800
Tax-exempt	**65**	150
Dividends	**78**	49
Other	**52**	4
Total Interest Income	**15,255**	10,533
INTEREST EXPENSE		
Deposits	**1,134**	635
Short-term borrowings	**16**	45
Long-term borrowings	**543**	387
Total Interest Expense	**1,693**	1,067
Net Interest Income	**13,562**	9,466
PROVISION FOR LOAN LOSSES	**250**	
Net Interest Income after Provision for Loan Losses	**13,312**	9,466
OTHER INCOME		
Service charges on deposit accounts	**816**	570
Income from fiduciary, investment management and brokerage activities	**571**	442
Earnings on investment in bank-owned life insurance	**257**	255
Gain on life insurance proceeds	**52**	
Net losses on equity securities	**(33)**	
Service charges on ATM and debit card transactions	**530**	358
Commissions from insurance sales	**1,201**	1,154
Other	**318**	303
Total Other Income	**3,712**	3,082
OTHER EXPENSES		
Salaries and employee benefits	**6,627**	5,748
Net occupancy	**779**	537
Equipment	**1,162**	783
Other tax	**206**	211
Professional services	**369**	239
Supplies and postage	**215**	169
Marketing and corporate relations	**103**	64
FDIC and regulatory	**184**	139
Merger related expenses		162
Intangible assets amortization	**184**	80
Foreclosed real estate expenses	**48**	30
Other operating	**1,109**	838

Total Other Expenses		**10,986**		9,000
Income before Income Taxes		**6,038**		3,548
PROVISION FOR INCOME TAXES		**1,125**		911
Net Income	**$**	**4,913**	$	2,637
PER SHARE DATA				
Basic earnings	**$**	**0.70**	$	0.43
Cash dividends declared	**$**	**0.20**	$	0.20

The accompanying notes are an integral part of the consolidated financial statements.

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME (UNAUDITED)

Dollars in thousands	Three Months Ended March 31, 2018	2017
NET INCOME	**$ 4,913**	$ 2,637
OTHER COMPREHENSIVE (LOSS) INCOME		
SECURITIES		
Unrealized (losses) gains arising during the period, net of income taxes of ($375) and $79, respectively	**(1,289)**	157
Reclassification adjustment for net gains included in net income, net of income taxes of $0 and $0, respectively (A) (C)		
PENSION		
Amortization of pension net loss, transition liability, and prior service cost, net of income taxes of $29 and $59, respectively (B) (C)	**100**	110
TOTAL OTHER COMPREHENSIVE (LOSS) INCOME	**(1,189)**	267
TOTAL COMPREHENSIVE INCOME	**$ 3,724**	$ 2,904

The accompanying notes are an integral part of the consolidated financial statements.

(A) Gross amounts are included in net gains on sales or calls of securities on the Consolidated Statements of Income in total other income.

(B) Gross amounts are included in the computation of net periodic benefit cost and are included in salaries and employee benefits on the Consolidated Statements of Income in total other expenses.

(C) Income tax amounts are included in the provision for income taxes on the Consolidated Statements of Income.

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY (UNAUDITED)

Three Months Ended March 31, 2018 and 2017

Dollars in thousands	Common Stock	Treasury Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss	Total Stockholders Equity
BALANCE JANUARY 1, 2017	$ 15,317	$ (728)	$ 10,941	$ 100,555	$ (6,024)	$ 120,061
Net income				2,637		2,637
Other comprehensive income, net of taxes					267	267
Common stock shares issued (2,911 shares)	8		23			31
Restricted stock compensation expense			59			59
Cash dividends declared				(1,213)		(1,213)
BALANCE MARCH 31, 2017	$ 15,325	$ (728)	$ 11,023	$ 101,979	$ (5,757)	$ 121,842
BALANCE JANUARY 1, 2018	**$ 17,716**	**$ (728)**	**$ 37,777**	**$ 106,293**	**$ (7,092)**	**$ 153,966**
Net income				**4,913**		**4,913**
Other comprehensive loss, net of taxes					**(1,189)**	**(1,189)**
Common stock shares issued (4,138 shares)	**10**		**111**			**121**
Restricted stock grants (6,744 shares)	**17**		**(4)**			**13**
Restricted stock compensation expense			**186**			**186**
Cash dividends declared				**(1,405)**		**(1,405)**
BALANCE MARCH 31, 2018	**$ 17,743**	**$ (728)**	**$ 38,070**	**$ 109,801**	**$ (8,281)**	**$ 156,605**

The accompanying notes are an integral part of the consolidated financial statements.

ACNB CORPORATION

CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

Dollars in thousands	Three Months Ended March 31, 2018		2017	
CASH FLOWS FROM OPERATING ACTIVITIES				
Net income	$	**4,913**	$	2,637
Adjustments to reconcile net income to net cash provided by operating activities:				
Gain on sales of loans originated for sale		**(138)**		(133)
Gain on sales of foreclosed assets held for resale, including writedowns		**(9)**		(3)
Earnings on investment in bank-owned life insurance		**(257)**		(255)
Loss on equity securities		**33**		
Restricted stock compensation expense		**186**		59
Depreciation and amortization		**706**		470
Provision for loan losses		**250**		
Net amortization of investment securities premiums		**120**		139
Increase in accrued interest receivable		**(588)**		(120)
Increase in accrued interest payable		**175**		48
Mortgage loans originated for sale		**(6,186)**		(6,798)
Proceeds from sales of loans originated for sale		**7,586**		8,235
Increase in other assets		**(98)**		(1,622)
Decrease in deferred tax expense		**195**		151
Increase in other liabilities		**733**		1,494
Net Cash Provided by Operating Activities		**7,621**		4,302
CASH FLOWS FROM INVESTING ACTIVITIES				
Proceeds from maturities of investment securities held to maturity		**3,449**		1,748
Proceeds from maturities of investment securities available for sale		**3,842**		6,014
Purchase of investment securities available for sale		**(3,986)**		
Purchase of restricted investment in bank stocks		**(29)**		(740)
Net decrease (increase) in loans		**5,372**		(44,615)
Purchase of bank-owned life insurance		**(500)**		
Insurance book- acquisition		**(600)**		
Capital expenditures		**(357)**		(367)
Proceeds from sales of foreclosed real estate		**50**		174
Net Cash Provided by (Used in) Investing Activities		**7,241**		(37,786)
CASH FLOWS FROM FINANCING ACTIVITIES				
Net increase in demand deposits		**10,920**		5,561
Net increase in time certificates of deposits and interest bearing deposits		**4,002**		17,312
Net decrease in short-term borrowings		**(3,473)**		(6,622)
Proceeds from long-term borrowings		**8,716**		16,000
Repayments on long-term borrowings		**(8,000)**		
Dividends paid		**(1,405)**		(1,213)
Common stock issued		**134**		31
Net Cash Provided by Financing Activities		**10,894**		31,069
Net Increase (Decrease) in Cash and Cash Equivalents		**25,756**		(2,415)
CASH AND CASH EQUIVALENTS BEGINNING		**34,441**		18,931
CASH AND CASH EQUIVALENTS ENDING	$	**60,197**	$	16,516
Supplemental disclosures of cash flow information				
Interest paid	$	**1,518**	$	1,019
Income taxes paid	$	**500**	$	750
Loans transferred to foreclosed assets held for resale and other foreclosed transactions	$	**235**	$	

The accompanying notes are an integral part of the consolidated financial statements.

ACNB CORPORATION

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. Basis of Presentation and Nature of Operations

ACNB Corporation (the Corporation or ACNB), headquartered in Gettysburg, Pennsylvania, provides banking, insurance, and financial services to businesses and consumers through its wholly-owned subsidiaries, ACNB Bank (Bank) and Russell Insurance Group, Inc. (RIG). The Bank engages in full-service commercial and consumer banking and wealth management services, including trust and retail brokerage, through twenty-two community banking office locations in Adams, Cumberland, Franklin and York Counties, Pennsylvania. There is also a loan production office situated in York County, Pennsylvania.

On July 1, 2017, ACNB completed its acquisition of New Windsor Bancorp, Inc. (New Windsor) of Taneytown, Maryland. At the effective time of the acquisition, New Windsor merged with and into a wholly-owned subsidiary of ACNB, immediately followed by the merger of New Windsor State Bank (NWSB) with and into ACNB Bank. ACNB Bank now operates in the Maryland market as NWSB Bank, A Division of ACNB Bank and serves this marketplace with banking and wealth management services via a network of seven community banking offices located in Carroll County, Maryland.

RIG is a full-service insurance agency based in Westminster, Maryland, with a second location in Germantown, Maryland. The agency offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients.

The Corporation s primary source of revenue is interest income on loans and investment securities and fee income on its products and services. Expenses consist of interest expense on deposits and borrowed funds, provisions for loan losses, and other operating expenses.

The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (US GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. In the opinion of management, the accompanying unaudited consolidated financial statements contain all adjustments necessary to present fairly ACNB Corporation s financial position and the results of operations, comprehensive income, changes in stockholders equity, and cash flows. All such adjustments are of a normal recurring nature.

The accounting policies followed by the Corporation are set forth in Note A to the Corporation s consolidated financial statements in the 2017 ACNB Corporation Annual Report on Form 10-K, filed with the SEC on March 9, 2018. It is suggested that the consolidated financial statements contained herein be read in conjunction with the consolidated financial statements and notes included in the Corporation s Annual Report on Form 10-K. The results of operations for the three month period ended March 31, 2018, are not necessarily indicative of the results to be expected for the full year.

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, that 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 statement of income and are recognized as revenue as the Corporation satisfies its obligation to the customer. Services within the scope of ASC 606 include service charges on deposit accounts, service charges on ATM and debit card transactions, income from fiduciary investment management and brokerage activities and commission from insurance sales. 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. Upon adoption of ASU 2016-01, the Corporation recognized the equity securities fair value change in net income. Previously the fair value changes were recognized, net of tax, in other comprehensive income (loss). The adoption of this ASU did not have a material effect on the Corporation s consolidated financial condition or results of operations.

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

2. Acquisition of New Windsor Bancorp, Inc.

On July 1, 2017, ACNB completed its acquisition of New Windsor Bancorp Inc. (New Windsor) of Taneytown, Maryland. New Windsor was a locally owned and managed institution with seven locations in north central Maryland that complemented, enhanced and expanded ACNB s physical presence in north central Maryland. ACNB transacted the acquisition to enhance its competitive strategic position, potential prospective business opportunities, operations, management, prospective financial condition, future earnings and business prospects. Specifically, ACNB believes that the acquisition will enhance its business opportunities in Northern Maryland due to the combined company having a greater market share, market presence and the ability to offer more diverse (i.e. Trust Services) and more profitable products, as well as a broader based and geographically diversified branch system to enhance deposit collection and potentially improve funding costs. The fair value of total assets acquired as a result of the acquisition totaled $319.8 million, loans totaled $263.5 million and deposits totaled $293.3 million. Goodwill recorded in the acquisition was $13.3 million. In accordance with the terms of the Reorganization Agreement, dated November 21, 2016, as amended, New Windsor shareholders received, in aggregate, $4.5 million in cash and 938,360 shares or approximately 13% of the post transaction outstanding shares of the Corporation s common stock. The transaction was valued at $33.3 million based on the Corporation s June 30, 2017 closing price of $30.50 as quoted on NASDAQ. The results of the combined entity s operations are included in the Corporation s Consolidated Financial Statements from the date of acquisition.

The acquisition of New Windsor is being accounted for as a business combination using the acquisition method of accounting and, accordingly, assets acquired, liabilities assumed, and consideration paid were recorded at estimated fair values on the acquisition date.

The following table summarizes the consideration paid for New Windsor and the fair value of assets acquired and liabilities assumed as of the acquisition date:

Purchase Price Consideration in Common Stock

New Windsor shares outstanding		1,003,703
Shares paid cash consideration		150,555
Cash consideration (per New Windsor share)	$	30.00
Cash portion of purchase price	$	4,519,995
New Windsor shares outstanding		1,003,703
Shares paid stock consideration		853,148
Exchange ratio		1.10
Total ACNB shares issued		938,360
ACNB s share price for purposes of calculation	$	30.50
Equity portion of purchase price	$	28,619,980
Cost of shares owned by buyer	$	150,000
Total consideration paid	$	33,289,975

Allocation of Purchase Price

	In thousands		
Total Purchase Price		$	33,290
Fair Value of Assets Acquired			
Cash and cash equivalents	10,964		
Investment securities	21,624		
Loans held for sale	1,463		
Loans	263,450		
Restricted stock	486		
Premises and equipment	8,624		
Core deposit intangible asset	2,418		
Other assets	10,792		
Total assets	319,821		
Fair Value of Liabilities Assumed			
Non-interest bearing deposits	80,006		
Interest bearing deposits	213,327		
Subordinated debt	4,688		
Other liabilities	1,782		
Total liabilities	299,803		
Net Assets Acquired			20,018
Goodwill Recorded in Acquisition		$	13,272

Pursuant to the accounting requirements, the Corporation assigned a fair value to the assets acquired and liabilities assumed of New Windsor. ASC 820 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Goodwill and core deposit intangibles are allocated to the banking business segment.

Fair values of the major categories of assets acquired and liabilities assumed were determined as follows:

Investment securities available-for-sale

The estimated fair values of the investment securities available for sale, primarily comprised of U.S. Government agency mortgage-backed securities, U.S. government agencies and municipal bonds, were determined using Level 2 inputs in the fair value hierarchy. The fair values were determined using independent pricing services. The Corporation s independent pricing service utilized matrix pricing, which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific security but rather relying on the security s relationship to other benchmark quoted prices. Management reviewed the data and assumptions used in pricing the securities.

Loans

Acquired loans (impaired and non-impaired) are initially recorded at their acquisition-date fair values using Level 3 inputs. Fair values are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, expected life time losses, environmental factors, collateral values, discount rates, expected payments and expected prepayments. Specifically, the Corporation has prepared three separate loan fair value adjustments that it believed a market participant might employ in estimating the entire fair value adjustment necessary under ASC 820-10 for the acquired loan portfolio. The three-separate fair valuation methodology employed are: 1) an interest rate loan fair value adjustment, 2) a general credit fair value adjustment, and 3) a specific credit fair value adjustment for purchased credit impaired loans subject to ASC 310-30 procedures. The acquired loans were recorded at fair value at the acquisition date without carryover of New Windsor s previously established allowance for loan losses. The fair value of the financial assets acquired included loans receivable with a gross amortized cost basis of $272,646,000. The table below illustrates the fair value adjustments made to the amortized cost basis in order to present a fair value of the loans acquired. The credit adjustment on purchased credit impaired loans is derived in accordance with ASC 310-30 and represents the portion of the loan balances that has been deemed uncollectible based on the Corporation s expectations of future cash flows for each respective loan.

In thousands		
Gross amortized cost basis at July 1, 2017	$	272,646
Interest rate fair value adjustment on pools of homogeneous loans		(731)
Credit fair value adjustment on pools of homogeneous loans		(4,501)
Credit fair value adjustment on purchased credit impaired loans		(3,964)
Fair value of acquired loans at July 1, 2017	$	263,450

For loans acquired without evidence of credit quality deterioration, ACNB prepared the interest rate loan fair value and credit fair value adjustments. Loans were grouped into homogeneous pools by characteristics such as loan type, term, collateral and rate. Market rates for similar loans were obtained from various internal and external data sources and reviewed by management for reasonableness. The average of these rates was used as the fair value interest rate a market participant would utilize. A present value approach was utilized to calculate the interest rate fair value discount of $731,000.

Additionally for loans acquired without credit deterioration, a credit fair value adjustment was calculated using a two-part credit fair value analysis: 1) expected lifetime credit migration losses; and 2) estimated fair value adjustment for certain qualitative factors. The expected lifetime losses were calculated using historical losses observed at the Bank, NWSB and peer banks. ACNB also estimated an environmental factor to apply to each loan type. The environmental factor represents potential discount which may arise due to general credit and economic factors. A credit fair value discount of $4.5 million was determined. Both the interest rate and credit fair value adjustments relate to loans acquired without evidence of credit quality deterioration will be substantially recognized as interest income on a level yield amortization method over the expected life of the loans.

The following table presents the acquired purchased credit impaired loans receivable at the Acquisition Date:

In thousands		
Contractual principal and interest at acquisition	$	13,439
Nonaccretable difference		(5,651)
Expected cash flows at acquisition		7,788
Accretable yield		(1,458)
Fair value of purchased impaired loans	$	6,330

Premises and Equipment

The Corporation acquired seven branches from New Windsor. The fair value of New Windsor s premises, including land, buildings, and improvements, was determined based upon independent third-party appraisals and other data in the market in which the premises are located. The Corporation prepared an internal analysis to compare the lease contract obligations to comparable market rental rates. The Corporation believed that the leased contract rates were in a reasonable range of market rental rates and concluded that no fair market value adjustment related to leasehold interest was necessary.

Core Deposit Intangible

The fair value of the core deposit intangible was determined based on a discounted cash flow analysis using a discount rate commensurate with market participants. To calculate cash flows, deposit account servicing costs (net of deposit fee income) and interest expense on deposits were compared to the cost of alternative funding sources available through national brokered CD offering rates. The projected cash flows were developed using projected deposit attrition rates. The core deposit intangible will be amortized over ten years using the sum-of-years digits method.

Time Deposits

The fair value adjustment for time deposits represents a discount from the value of the contractual repayments of fixed-maturity deposits using prevailing market interest rates for similar-term time deposits. The time deposit discount of approximately $847,500 is being amortized into income on a level yield amortization method over the contractual life of the deposits.

Long-term Borrowings

The Corporation assumed a trust preferred subordinated debt in connection with the acquisition. The fair value of the trust preferred subordinated debt was determined based upon an estimated fair value from an independent brokerage firm. The trust preferred capital note was valued at a discount of $312,500, which is being amortized into income on a level yield amortization method based upon the assumed market rate, and the term of the trust preferred subordinated debt instrument.

3. Earnings Per Share and Restricted Stock Plan

The Corporation has a simple capital structure. Basic earnings per share of common stock is computed based on 7,025,593 and 6,064,656 weighted average shares of common stock outstanding for the three months ended March 31, 2018 and 2017, respectively. All outstanding unvested restricted stock awards that contain rights to nonforfeitable dividends are considered participating securities for this calculation.

The Corporation has a restricted stock plan available to selected officers and employees of the Bank to advance the best interest of the Corporation and its shareholders. The plan provides those persons who have responsibility for its growth with additional incentive by allowing them to acquire ownership in the Corporation and, thereby, encouraging them to contribute to the success of the Corporation. Plan expense is recognized over the vesting period of the stock issued under the plan. As of March 31, 2018, 26,045 shares were issued under this plan, of which 13,235 were fully vested, 6,249 vested during the quarter, and the remaining 6,560 will vest over the next two years. $186,000 and $59,000 of compensation expenses related to the grants were recognized during the three months ended March 31, 2018 and 2017, respectively.

4. Retirement Benefits

The components of net periodic benefit expense related to the non-contributory, defined benefit pension plan for the three month periods ended March 31 were as follows:

In thousands	**Three Months Ended March 31, 2018**	**2017**
Service cost	**$ 215**	$ 210
Interest cost	**274**	284
Expected return on plan assets	**(692)**	(630)
Amortization of net loss	**128**	169
Net Periodic Benefit Expense	**$ (75)**	$ 33

The Corporation previously disclosed in its consolidated financial statements for the year ended December 31, 2017, that it had not yet determined the amount the Bank planned on contributing to the defined benefit plan in 2018. As of March 31, 2018, this contribution amount had still not been determined. Effective April 1, 2012, no inactive or former participant in the plan is eligible to again participate in the plan, and no employee hired after March 31, 2012, is eligible to participate in the plan. As of the last annual census, ACNB Bank had a combined 353 active, vested, terminated and retired persons in the plan.

5. Guarantees

The Corporation does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by the Corporation to guarantee the performance of a customer to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to customers. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had $4,621,000 in standby letters of credit as of March 31,

2018. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding guarantees. The current amount of the liability, as of March 31, 2018, for guarantees under standby letters of credit issued is not material.

6. Accumulated Other Comprehensive Loss

The components of accumulated other comprehensive loss, net of taxes, are as follows:

In thousands	Unrealized Losses on Securities	Pension Liability	Accumulated Other Comprehensive Loss
BALANCE MARCH 31, 2018	**$ (2,246)**	**$ (6,035)**	**$ (8,281)**
BALANCE DECEMBER 31, 2017	$ (957)	$ (6,135)	$ (7,092)
BALANCE MARCH 31, 2017	$ (109)	$ (5,648)	$ (5,757)

7. Segment Reporting

The Corporation has two reporting segments, the Bank and RIG. RIG is managed separately from the banking segment, which includes the Bank and related financial services that the Corporation offers through its banking subsidiary. RIG offers a broad range of property and casualty, life, and health insurance to both commercial and individual clients.

Segment information for the three month periods ended March 31, 2018 and 2017, is as follows:

In thousands	Banking	Insurance	Total
2018			
Net interest income and other income from external customers	**$ 16,074**	**$ 1,200**	**$ 17,274**
Income before income taxes	**5,818**	**220**	**6,038**
Total assets	**1,601,028**	**9,987**	**1,611,015**
Capital expenditures	**357**		**357**
2017			
Net interest income and other income from external customers	$ 11,394	$ 1,154	$ 12,548
Income before income taxes	3,438	110	3,548
Total assets	1,232,035	9,690	1,241,725
Capital expenditures	367		367

Customer renewal lists are amortized over their estimated useful lives which range from eight to thirteen years. Core deposit intangible assets are primarily amortized over 10 years using accelerated methods. Goodwill is not amortized, but rather is analyzed annually for impairment. If certain events occur which might indicate goodwill has been impaired, the goodwill is tested for impairment when such events occur. Tax amortization of goodwill and the intangible assets is deductible for tax purposes. Tax amortization of the goodwill associated with the New Windsor acquisition is not deductible for federal income tax purposes.

8. **Securities**

Debt securities that management has the positive intent and ability to hold to maturity are classified as held to maturity and recorded at amortized cost. Securities not classified as held to maturity or trading are classified as available for sale and recorded at fair value, with unrealized gains and losses excluded from earnings and reported, net of tax, in other comprehensive income (loss). As of January 1, 2018, equity securities with readily determined fair values are recorded at fair value with changes in fair value recognized in net income. Prior to 2018, fair value changes were reported, net of tax, in other comprehensive income (loss).

Purchase premiums and discounts are recognized in interest income using the interest method over the terms of the securities. Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary are reflected in earnings as realized losses. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the security, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) if management does not expect to recover the entire amortized cost basis. In assessing potential other-than-temporary impairment for equity securities, consideration is given to management s intention and ability to hold the securities until recovery of unrealized losses. Gains and losses on the sale of securities are recorded on the trade date and are determined using the specific identification method.

Amortized cost and fair value of securities at March 31, 2018, and December 31, 2017, were as follows:

In thousands	**Amortized Cost**	**Gross Unrealized Gains**	**Gross Unrealized Losses**	**Fair Value**
SECURITIES AVAILABLE FOR SALE				
MARCH 31, 2018				
U.S. Government and agencies	**$ 108,790**	**$ 2**	**$ 2,841**	**$ 105,951**
Mortgage-backed securities, residential	**32,338**	**267**	**433**	**32,172**
State and municipal	**12,497**	**81**	**71**	**12,507**
Corporate bonds	**5,000**		**10**	**4,990**
	$ 158,625	**$ 350**	**$ 3,355**	**$ 155,620**
DECEMBER 31, 2017				
U.S. Government and agencies	$ 105,899	$ 2	$ 1,818	$ 104,083
Mortgage-backed securities, residential	34,473	461	101	34,833
State and municipal	13,227	109	42	13,294
Corporate bonds	5,000	57		5,057
CRA mutual fund	1,044		9	1,035
Stock in other banks	647	102		749
	$ 160,290	$ 731	$ 1,970	$ 159,051
SECURITIES HELD TO MATURITY				
MARCH 31, 2018				
U.S. Government and agencies	**$ 17,000**	**$**	**$ 132**	**$ 16,868**
Mortgage-backed securities, residential	**24,378**	**2**	**490**	**23,890**
	$ 41,378	**$ 2**	**$ 622**	**$ 40,758**
DECEMBER 31, 2017				
U.S. Government and agencies	$ 19,000	$ 2	$ 99	$ 18,903
Mortgage-backed securities, residential	25,829	55	238	25,646
	$ 44,829	$ 57	$ 337	$ 44,549

The Corporation adopted ASU 2016-01, *Financial Instruments Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* effective January 1, 2018. The required fair value disclosures are as follows:

In thousands	Fair Value	Unrealized Gains	Unrealized Losses	Fair Value
MARCH 31, 2018				
Equity securities with a readily determinable fair value	**$ 1,793**	**$ 7**	**$ 40**	**$ 1,760**

The following table shows the Corporation s investments gross unrealized losses and fair value, aggregated by investment category and length of time that individual securities have been in a continuous unrealized loss position, at March 31, 2018, and December 31, 2017:

	Less than 12 Months		12 Months or More		Total	
In thousands	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses	Fair Value	Unrealized Losses
SECURITIES AVAILABLE FOR SALE						
MARCH 31, 2018						
U.S. Government and agencies	**$ 39,388**	**$ 817**	**$ 62,553**	**$ 2,024**	**$ 101,941**	**$ 2,841**
Mortgage-backed securities, residential	**18,712**	**342**	**2,675**	**91**	**21,387**	**433**
State and municipal	**1,725**	**11**	**1,921**	**60**	**3,646**	**71**
Corporate bond	**4,990**	**10**			**4,990**	**10**
	$ 64,815	**$ 1,180**	**$ 67,149**	**$ 2,175**	**$ 131,964**	**$ 3,355**
DECEMBER 31, 2017						
U.S. Government and agencies	$ 42,775	$ 445	$ 58,279	$ 1,373	$ 101,054	$ 1,818
Mortgage-backed securities, residential	7,228	56	2,845	45	10,073	101
State and municipal	1,042	8	1,950	34	2,992	42
CRA Mutual Fund			1,035	9	1,035	9
	$ 51,045	$ 509	$ 64,109	$ 1,461	$ 115,154	$ 1,970
SECURITIES HELD TO MATURITY						
MARCH 31, 2018						
U.S. Government and agencies	**$ 6,969**	**$ 31**	**$ 9,899**	**$ 101**	**$ 16,868**	**$ 132**
Mortgage-backed securities, residential	**12,856**	**139**	**10,491**	**351**	**23,347**	**490**
	$ 19,825	**$ 170**	**$ 20,390**	**$ 452**	**$ 40,215**	**$ 622**
DECEMBER 31, 2017						
U.S. Government and agencies	$ 4,985	$ 15	$ 10,916	$ 84	$ 15,901	$ 99
Mortgage-backed securities, residential	4,946	29	11,070	209	16,016	238
	$ 9,931	$ 44	$ 21,986	$ 293	$ 31,917	$ 337

All mortgage-backed security investments are government sponsored enterprise (GSE) pass-through instruments issued by the Federal National Mortgage Association (FNMA), Government National Mortgage Association (GNMA) or Federal Home Loan Mortgage Corporation (FHLMC), which guarantee the timely payment of principal on these investments.

At March 31, 2018, sixty-five available for sale U.S. Government and agency securities had unrealized losses that individually did not exceed 6% of amortized cost. Thirty-five of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At March 31, 2018, thirty-five available for sale residential mortgage-backed securities had unrealized losses that individually did not exceed 8% of amortized cost. Three of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At March 31, 2018, thirteen available for sale state and municipal securities had unrealized losses that individually did not exceed 9% of amortized cost. Eight of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At March 31, 2018, the Corporate bond had an unrealized loss that did not exceed 1% of amortized cost. This security has not been in a continuous loss position for 12 months or more. This unrealized loss relates principally to changes in interest rates subsequent to the acquisition of the specific security.

At March 31, 2018, ten held to maturity U.S. Government and agency securities had unrealized losses that individually did not exceed 2% of amortized cost. Six of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

At March 31, 2018, thirty-three held to maturity residential mortgage-backed securities had unrealized losses that individually did not exceed 4% of amortized cost. Thirteen of these securities have been in a continuous loss position for 12 months or more. These unrealized losses relate principally to changes in interest rates subsequent to the acquisition of the specific securities.

In analyzing the issuer s financial condition, management considers industry analysts reports, financial performance, and projected target prices of investment analysts within a one-year time frame. Based on the above information, management has determined that none of these investments are other-than-temporarily impaired.

The fair values of securities available for sale (carried at fair value) and held to maturity (carried at amortized cost) are determined by obtaining quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2) which is a mathematical technique used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities but rather by relying on the security s relationship to other benchmark quoted prices. The Corporation uses independent service providers to provide matrix pricing.

Management routinely sells securities from its available for sale portfolio in an effort to manage and allocate the portfolio. At March 31, 2018, management had not identified any securities with an unrealized loss that it intends to sell or will be required to sell. In estimating other-than-temporary impairment losses on debt securities, management considers (1) whether management intends to sell the security, or (2) if it is more likely than not that management will be required to sell the security before recovery, or (3) if management does not expect to recover the entire amortized cost basis. In assessing potential other-than-temporary impairment for equity securities, consideration is given to management s intention and ability to hold the securities until recovery of unrealized losses.

Amortized cost and fair value at March 31, 2018, by contractual maturity, where applicable, are shown below. Expected maturities will differ from contractual maturities because issuers may have the right to call or prepay with or without penalties.

In thousands	Available for Sale Amortized Cost	Available for Sale Fair Value	Held to Maturity Amortized Cost	Held to Maturity Fair Value
1 year or less	$ 8,002	$ 7,981	$ 10,000	$ 9,954
Over 1 year through 5 years	107,334	104,738	7,000	6,914
Over 5 years through 10 years	10,881	10,660		
Over 10 years	70	69		
Mortgage-backed securities, residential	32,338	32,172	24,378	23,890
	$ 158,625	$ 155,620	$ 41,378	$ 40,758

The Corporation did not sell any securities available for sale during the first quarter of 2018 or 2017.

At March 31, 2018, and December 31, 2017, securities with a carrying value of $149,780,000 and $157,601,000, respectively, were pledged as collateral as required by law on public and trust deposits, repurchase agreements, and for other purposes.

9. Loans

The Corporation grants commercial, residential, and consumer loans to customers. A substantial portion of the loan portfolio is represented by mortgage loans throughout southcentral Pennsylvania and northern Maryland. The ability of the Corporation s debtors to honor their contracts is dependent upon the real estate values and general economic conditions in this area.

Loans that management has the intent and ability to hold for the foreseeable future or until maturity or pay-off generally are reported at their outstanding unpaid principal balances adjusted for charge-offs, the allowance for loan losses, and any deferred fees or costs on originated loans. Interest income is accrued on the unpaid principal balance. Loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the related loan yield using the interest method.

The loans receivable portfolio is segmented into commercial, residential mortgage, home equity lines of credit, and consumer loans. Commercial loans consist of the following classes: commercial and industrial, commercial real estate, and commercial real estate construction.

The accrual of interest on residential mortgage and commercial loans is discontinued at the time the loan is 90 days past due unless the credit is well-secured and in process of collection. Consumer loans (consisting of home equity lines of credit and consumer loan classes) are typically charged off no later than 120 days past due. Past due status is based on the contractual terms of the loan. In all cases, loans are placed on nonaccrual or charged off at an earlier date if collection of principal or interest is considered doubtful.

All interest accrued, but not collected, for loans that are placed on nonaccrual or charged off is reversed against interest income. The interest on these loans is accounted for on the cash-basis or cost-recovery method, until qualifying for return to accrual status. Loans are returned to accrual status when all the principal and interest amounts contractually due are brought current and future payments are reasonably assured.

Allowance for Credit Losses

The allowance for credit losses consists of the allowance for loan losses and the reserve for unfunded lending commitments. The allowance for loan losses (the allowance) is established as losses are estimated to occur through a provision for loan losses charged to earnings. Loan losses are charged against the allowance when management believes the uncollectibility of a loan balance is confirmed. Subsequent recoveries, if any, are credited to the allowance. The reserve for unfunded lending commitments represents management s estimate of losses inherent in its unfunded loan commitments and is recorded in other liabilities on the consolidated statement of condition. The amount of the reserve for unfunded lending commitments is not material to the consolidated financial statements.

The allowance for loan losses is evaluated on a regular basis by management and is based upon management s periodic review of the collectibility of the loans in light of historical experience, the nature and volume of the loan portfolio, adverse situations that may affect the borrower s ability to repay, estimated value of any underlying collateral, and prevailing economic conditions. This evaluation is inherently subjective as it requires estimates that are susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as either doubtful, substandard, or special mention. For such loans that are also classified as impaired, an allowance is established when the discounted cash flows (or collateral value or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class including commercial loans not considered impaired, as well as smaller balance homogeneous loans, such as residential real estate, home equity, and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for the previous twelve quarters for each of these categories of loans, adjusted for qualitative risk factors. These qualitative risk factors include:

- lending policies and procedures, including underwriting standards and collection, charge-off and recovery practices;
- national, regional and local economic and business conditions, as well as the condition of various market segments, including the impact on the value of underlying collateral for collateral dependent loans;
- the nature and volume of the portfolio and terms of loans;
- the experience, ability and depth of lending management and staff;
- the volume and severity of past due, classified and nonaccrual loans, as well as other loan modifications; and,
- the existence and effect of any concentrations of credit and changes in the level of such concentrations.

Each factor is assigned a value to reflect improving, stable or declining conditions based on management s best judgment using relevant information available at the time of the evaluation. Adjustments to the factors are supported through documentation of changes in conditions in a narrative accompanying the allowance for loan loss calculation.

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. It covers risks that are inherently difficult to quantify including, but not limited to, collateral risk, information risk, and historical charge-off risk.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal and/or interest when due according to the contractual terms of the loan agreement. Factors considered by management in determining impairment include payment status, collateral value, and the probability of collecting scheduled principal and/or 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. Impairment is measured on a loan by loan basis for commercial and commercial construction loans by either the present value of expected future cash flows discounted at the loan s effective interest rate, the loan s obtainable market price, or the fair value of the collateral if the loan is collateral dependent.

A specific allocation within the allowance for loan losses is established for an impaired loan if its carrying value exceeds its estimated fair value. The estimated fair values of the Corporation s impaired loans are measured based on the estimated fair value of the loan s collateral or the discounted cash flows method.

It is the policy of the Corporation to order an updated valuation on all real estate secured loans when the loan becomes 90 days past due and there has not been an updated valuation completed within the previous 12 months. In addition, the Corporation orders third-party valuations on all impaired real estate collateralized loans within 30 days of the loan being classified as impaired. Until the valuations are completed, the Corporation utilizes the most recent independent third-party real estate valuation to estimate the need for a specific allocation to be assigned to the loan. These existing valuations are discounted downward to account for such things as the age of the existing collateral valuation, change in the condition of the real estate, change in local market and economic conditions, and other specific factors involving the collateral. Once the updated valuation is completed, the collateral value is updated accordingly.

For commercial and industrial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower s financial statements, inventory reports, accounts receivable aging reports, equipment appraisals, or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets.

The Corporation actively monitors the values of collateral as well as the age of the valuation of impaired loans. Management believes that the Corporation s market area is not as volatile as other areas throughout the United States, therefore valuations are ordered at least every 18 months, or more frequently if management believes that there is an indication that the fair value has declined.

For impaired loans secured by collateral other than real estate, the Corporation considers the net book value of the collateral, as recorded in the most recent financial statements of the borrower, and determines fair value based on estimates made by management.

Large groups of smaller balance homogeneous loans are collectively evaluated for impairment. Accordingly, the Corporation does not separately identify individual consumer and residential loans for impairment disclosures, unless such loans are the subject of a troubled debt restructure.

Loans whose terms are modified are classified as troubled debt restructured loans if the Corporation grants such borrowers concessions that it would not otherwise consider and it is deemed that those borrowers are experiencing financial difficulty. Concessions granted under a troubled debt restructuring generally involve a temporary reduction in interest rate, a below market interest rate given the risk associated with the loan, or an extension of a loan s stated maturity date. Nonaccrual troubled debt restructurings may be restored to accrual status if principal and interest payments, under the modified terms, are current for a sustained period of time and, based on a well-documented credit evaluation of the borrower s financial condition, there is reasonable assurance of repayment. Loans classified as troubled debt restructurings are generally designated as impaired.

The allowance calculation methodology includes further segregation of loan classes into credit quality rating categories. The borrower s overall financial condition, repayment sources, guarantors, and value of collateral, if appropriate, are generally evaluated annually for commercial loans or when credit deficiencies arise, such as delinquent loan payments.

Credit quality risk ratings include regulatory classifications of special mention, substandard, doubtful, and loss. Loans classified special mention have potential weaknesses that deserve management s close attention. If uncorrected, the potential weaknesses may result in deterioration of the repayment prospects. Loans classified substandard have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They include loans that are inadequately protected by the current sound net worth and paying capacity of the obligor or of the collateral pledged, if any. Loans classified doubtful have all the weaknesses inherent in loans classified substandard with the added characteristic that collection or liquidation in full, on the basis of current conditions and facts, is highly improbable. Loans classified as a loss are considered uncollectible and are charged to the allowance for loan losses. Loans not classified are rated pass.

In addition, federal and state regulatory agencies, as an integral part of their examination process, periodically review the Corporation s allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to management. Based on management s comprehensive analysis of the loan portfolio and economic conditions, management believes the current level of the allowance for loan losses is adequate.

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 purchases, 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 may be renewed 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 values 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, collateral appraisals, etc.

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.

Commercial loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions.

Commercial Real Estate Lending The Corporation engages in commercial real estate lending in its primary market area and surrounding areas. The Corporation s commercial loan portfolio is secured primarily by commercial retail space, office buildings, and hotels. Generally, commercial real estate loans have terms that do not exceed 20 years, have loan-to-value ratios of up to 80% of the appraised value of the 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. Appraisals on properties securing commercial real estate loans originated by the Corporation are performed by independent appraisers.

Commercial real estate loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions and the complexities involved in valuing the underlying collateral.

Commercial Real Estate Construction Lending The Corporation engages in commercial real estate construction lending in its primary market area and surrounding areas. The Corporation s commercial real estate construction lending consists of commercial and residential site development loans, as well as commercial building construction and residential housing construction loans.

The Corporation s commercial real estate construction loans are generally secured with the subject property. Terms of construction loans depend on the specifics of the project, such as estimated absorption rates, estimated time to complete, etc.

In underwriting commercial real estate construction 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 project using feasibility studies, market data, etc. Appraisals on properties securing commercial real estate construction loans originated by the Corporation are performed by independent appraisers.

Commercial real estate construction loans generally present a higher level of risk than other types of loans due primarily to the effect of general economic conditions and the uncertainties surrounding total construction costs.

Residential Mortgage Lending One-to-four family residential mortgage loan originations, including home equity closed-end loans, are generated by the Corporation s marketing efforts, its present customers, walk-in customers, and referrals. These loans originate primarily within the Corporation s market area or with customers primarily from the market area.

The Corporation offers fixed-rate and adjustable-rate mortgage loans with terms up to a maximum of 30 years for both permanent structures and those under construction. 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 majority of the Corporation s residential mortgage loans originate with a loan-to-value of 80% or less. Loans in excess of 80% are required to have private mortgage insurance.

In underwriting one-to-four family residential real estate loans, the Corporation evaluates both the borrower s financial ability to repay the loan as agreed and the value of the property securing the loan. Properties securing real estate loans made by the Corporation are appraised by independent appraisers. The Corporation generally requires borrowers to obtain an attorney s title opinion or title insurance, as well as fire and property insurance (including flood insurance, if necessary) in an amount not less than the amount of the loan. The Corporation has not engaged in subprime residential mortgage originations.

Residential mortgage loans present a moderate level of risk due primarily to general economic conditions, as well as a continued weak housing market.

Home Equity Lines of Credit Lending The Corporation originates home equity lines of credit primarily within the Corporation s market area or with customers primarily from the market area. Home equity lines of credit are generated by the Corporation s marketing efforts, its present customers, walk-in customers, and referrals.

Home equity lines of credit are secured by the borrower s primary residence with a maximum loan-to-value of 90% and a maximum term of 20 years. In underwriting home equity lines of credit, the Corporation evaluates both the value of the property securing the loan and the borrower s 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.

Home equity lines of credit generally present a moderate level of risk due primarily to general economic conditions, as well as a continued weak housing market.

Junior liens inherently have more credit risk by virtue of the fact that another financial institution may have a higher security position in the case of foreclosure liquidation of collateral to extinguish the debt. Generally, foreclosure actions could become more prevalent if the real estate market continues to be weak and property values deteriorate.

Consumer Lending The Corporation offers a variety of secured and unsecured consumer loans, including those for vehicles and mobile homes and loans secured by savings deposits. These loans originate primarily within the Corporation s market area or with customers primarily from the market area.

Consumer loan terms vary according to the type and value of collateral and the creditworthiness of the borrower. In underwriting consumer loans, a thorough analysis of the borrower s financial ability to repay the loan as agreed is performed. 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 mortgage loans or home equity lines of credit, particularly in the case of consumer loans which are unsecured or are secured by rapidly depreciable assets such as automobiles or recreational equipment. In such cases, any repossessed collateral for a defaulted consumer 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, consumer loan collections are dependent on the borrower s continuing financial stability, and thus 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.

Acquired Loans

Acquired loans (impaired and non-impaired) are initially recorded at their acquisition-date fair values using Level 3 inputs. Fair values are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, expected lifetime losses, environmental factors, collateral values, discount rates, expected payments and expected prepayments. Specifically, the Corporation has prepared three separate loan fair value adjustments that it believed a market participant might employ in estimating the entire fair value adjustment necessary under ASC 820-10 for the acquired loan portfolio. The three-separate fair valuation methodology employed are: 1) an interest rate loan fair value adjustment, 2) a general credit fair value adjustment, and 3) a specific credit fair value adjustment for purchased credit impaired loans subject to ASC 310-30 procedures.

The carryover of allowance for loan losses related to acquired loans is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. The allowance for loan losses on acquired loans reflects only those losses incurred after acquisition and represents the present value of cash flows expected at acquisition that is no longer expected to be collected. Acquired loans are marked to fair value on the date of acquisition. In conjunction with the quarterly evaluation of the adequacy of the allowance for loan losses, the

Corporation performs an analysis on acquired loans to determine whether or not there has been subsequent deterioration in relation to those loans. If deterioration has occurred, the Corporation will include these loans in the calculation of the allowance for loan losses after the initial valuation, and provide accordingly.

Upon acquisition, in accordance with US GAAP, the Corporation has individually determined whether each acquired loan is within the scope of ASC 310-30. The Corporation s senior lending management reviewed the accounting seller s loan portfolio on a loan by loan basis to determine if any loans met the two-part definition of an impaired loan as defined by ASC 310-30: 1) Credit deterioration on the loan from its inception until the acquisition date, and 2) It is probable that not all of the contractual cash flows will be collected on the loan.

Acquired ASC 310-20 loans, which are loans that did not meet the criteria above, were pooled into groups of similar loans based on various factors including borrower type, loan purpose, and collateral type. For these pools, the Corporation used certain loan information, including outstanding principal balance, estimated expected losses, weighted average maturity, weighted average margin, and weighted average interest rate along with estimated prepayment rates, expected lifetime losses, environment factors to estimate the expected cash flow for each loan pool. With regards to ASC 310-30 loans, for external disclosure purposes, the aggregate contractual cash flows less the aggregate expected cash flows resulted in a credit related non-accretable yield amount. The aggregate expected cash flows less the acquisition date fair value resulted in an accretable yield amount. The accretable yield reflects the contractual cash flows management expects to collect above the loan s acquisition date fair value and will be recognized over the life of the loan on a level-yield basis as a component of interest income.

Over the life of the acquired ASC 310-30 loan, the Corporation continue to estimate cash flows expected to be collected. Decreases in expected cash flows, other than from prepayments or rate adjustments, are recognized as impairments through a charge to the provision for credit losses resulting in an increase in the allowance for credit losses. Subsequent improvements in cash flows result in first, reversal of existing valuation allowances recognized subsequent to acquisition, if any, and next, an increase in the amount of accretable yield to be subsequently recognized on a prospective basis over the loan s remaining life.

Acquired ASC 310-30 loans that met the criteria for non-accrual of interest prior to acquisition are considered performing upon acquisition, regardless of whether the customer is contractually delinquent, if we can reasonably estimate the timing and amount of expected cash flows on such loans. Accordingly, we do not consider acquired contractually delinquent loans to be non-accruing and continue to recognize interest income on these loans using the accretion model.

The following table presents the classes of the loan portfolio summarized by the aggregate pass rating and the classified ratings of special mention, substandard, and doubtful within the Corporation s internal risk rating system as of March 31, 2018, and December 31, 2017:

In thousands	Pass	Special Mention	Substandard	Doubtful	Total
MARCH 31, 2018					
Originated Loans					
Commercial and industrial	$ 152,154	$ 3,249	$ 1,259	$	$ 156,662
Commercial real estate	342,702	20,020	8,202		370,924
Commercial real estate construction	14,449	785	250		15,484
Residential mortgage	367,120	3,245	101		370,466
Home equity lines of credit	81,845	449			82,294
Consumer	14,267				14,267
Total Originated Loans	972,537	27,748	9,812		1,010,097
Acquired Loans					
Commercial and industrial	5,599	199	3		5,801
Commercial real estate	122,270	12,459	4,094		138,823
Commercial real estate construction	5,207	382			5,589
Residential mortgage	47,856	2,421	3,201		53,478
Home equity lines of credit	21,525	288	385		22,198
Consumer	1,412	356			1,768
Total Acquired Loans	203,869	16,105	7,683		227,657
Total Loans					
Commercial and industrial	157,753	3,448	1,262		162,463
Commercial real estate	464,972	32,479	12,296		509,747
Commercial real estate construction	19,656	1,167	250		21,073
Residential mortgage	414,976	5,666	3,302		423,944
Home equity lines of credit	103,370	737	385		104,492
Consumer	15,679	356			16,035
Total Loans	$ 1,176,406	$ 43,853	$ 17,495	$	$ 1,237,754

In thousands	Pass	Special Mention	Substandard	Doubtful	Total
DECEMBER 31, 2017					
Originated Loans					
Commercial and industrial	$ 154,177	$ 3,466	$ 1,812	$	$ 159,455
Commercial real estate	325,002	17,666	9,277		351,945
Commercial real estate construction	27,413	767	250		28,430
Residential mortgage	363,195	3,251	478		366,924
Home equity lines of credit	81,976	360			82,336
Consumer	14,454				14,454
Total Originated Loans	966,217	25,510	11,817		1,003,544
Acquired Loans					
Commercial and industrial	6,120	244	10		6,374
Commercial real estate	124,852	12,734	3,228		140,814
Commercial real estate construction	6,742	388			7,130
Residential mortgage	52,959	2,762	3,248		58,969
Home equity lines of credit	24,990	88	378		25,456
Consumer	1,525	358			1,883
Total Acquired Loans	217,188	16,574	6,864		240,626
Total Loans					
Commercial and industrial	160,297	3,710	1,822		165,829
Commercial real estate	449,854	30,400			