DIMECO, INC.

HONESDALE, PENNSYLVANIA

AUDIT REPORT

DECEMBER 31, 2018

DIMECO, INC.
AUDITED CONSOLIDATED FINANCIAL STATEMENTS
DECEMBER 31, 2018

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SNODGRASS
CERTIFIED PUBLIC ACCOUNTANTS & CONSULTANTS

INDEPENDENT AUDITOR'S REPORT

Board of Directors and Shareholders
Dimeco, Inc.
Honesdale, Pennsylvania

Report on the Financial Statements

We have audited the accompanying consolidated financial statements of Dimeco, Inc. and subsidiary, which comprise the consolidated balance sheets as of December 31, 2018 and 2017; the related consolidated statements of income, comprehensive income, changes in stockholders' equity, and cash flows for each of the three years in the period ended December 31, 2018; and the related notes to the consolidated financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with accounting principles generally accepted in the United States of America; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

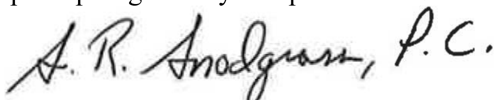
Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Dimeco, Inc. and subsidiary as of December 31, 2018 and 2017, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2018, in accordance with accounting principles generally accepted in the United States of America.



Cranberry Township, Pennsylvania
March 13, 2019

S.R. Snodgrass, P.C. • 2009 Mackenzie Way, Suite 340 • Cranberry Township, Pennsylvania 16066 • Phone: 724-934-0344 • Fax: 724-934-0345

CONSOLIDATED BALANCE SHEET

(in thousands, except shares and per share data)	December 31, 2018	December 31, 2017
Assets		
Cash and due from banks	$ 6,609	$ 6,987
Interest-bearing deposits in other banks	5,543	1,100
Total cash and cash equivalents	12,152	8,087
Investment securities available for sale	116,947	91,739
Equity securities	218	487
Mortgage loans held for sale	-	356
Loans, net of unearned income	523,289	510,334
Less allowance for loan losses	8,125	7,582
Net loans	515,164	502,752
Premises and equipment	9,563	10,101
Accrued interest receivable	2,218	2,035
Bank-owned life insurance	17,568	15,976
Other real estate owned	5,067	5,807
Other assets	15,798	18,133
TOTAL ASSETS	$ 694,695	$ 655,473
Liabilities		
Deposits:		
Noninterest-bearing	$ 93,963	$ 87,954
Interest-bearing	438,420	410,278
Total deposits	532,383	498,232
Short-term borrowings	20,355	32,544
Other borrowed funds	53,721	42,326
Accrued interest payable	456	288
Other liabilities	8,250	7,578
TOTAL LIABILITIES	615,165	580,968
Stockholders' Equity		
Common stock, $.50 par value; 5,000,000 shares authorized; 2,547,150 and 2,534,825 shares issued in 2018 and 2017; 2,487,390 and 2,475,065 shares outstanding in 2018 and 2017, respectively	1,274	1,267
Capital surplus	8,157	7,854
Retained earnings	71,820	66,466
Accumulated other comprehensive (loss) income	(127)	512
Treasury stock, at cost (59,760 shares)	(1,594)	(1,594)
TOTAL STOCKHOLDERS' EQUITY	79,530	74,505
TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY	$ 694,695	$ 655,473

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

CONSOLIDATED STATEMENT OF INCOME

(in thousands, except per share data)	Year Ended December 31, 2018	2017	2016
Interest Income			
Interest and fees on loans	$ 26,138	$ 24,989	$ 23,388
Investment securities:			
Taxable	1,638	952	1,012
Exempt from federal income tax	953	1,112	1,259
Other	253	122	96
Total interest income	28,982	27,175	25,755
Interest Expense			
Deposits	2,604	2,007	2,018
Short-term borrowings	115	129	79
Other borrowed funds	1,115	810	653
Total interest expense	3,834	2,946	2,750
Net Interest Income	25,148	24,229	23,005
Provision for loan losses	500	700	1,000
Net Interest Income After Provision for Loan Losses	24,648	23,529	22,005
Noninterest Income			
Service charges on deposit accounts	906	832	722
Mortgage loans held for sale gains, net	228	358	520
Investment securities gains (losses), net	19	159	(173)
Equity security gains, net	27	-	-
Brokerage commissions	1,293	1,210	1,104
Earnings on bank-owned life insurance	429	545	546
Debit card interchange fees	1,078	929	775
Other income	440	492	718
Total noninterest income	4,420	4,525	4,212
Noninterest Expense			
Salaries and employee benefits	10,645	10,305	9,692
Occupancy expense, net	1,729	1,661	1,645
Professional fees	1,100	973	1,057
Data processing expense	1,417	1,283	1,117
Communication expense	493	478	409
Other real estate expense	1,279	1,050	761
Other expense	3,665	3,409	3,455
Total noninterest expense	20,328	19,159	18,136
Income before income taxes	8,740	8,895	8,081
Income taxes	747	3,488	1,731
NET INCOME	$ 7,993	$ 5,407	$ 6,350
Earnings Per Share:			
Basic	$ 3.22	$ 2.19	$ 2.57
Diluted	$ 3.19	$ 2.17	$ 2.56

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

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME

(in thousands)	Year Ended December 31, 2018	2017	2016
Net income	$ 7,993	$ 5,407	$ 6,350
Other comprehensive income (loss):			
Unrealized (loss) gain on available for sale securities	(555)	234	(1,159)
Tax effect	118	(80)	394
	(437)	154	(765)
Investment securities (gains) losses, net	(19)	(159)	173
Tax effect	4	54	(58)
	(15)	(105)	115
Other comprehensive income (loss)	(452)	49	(650)
Comprehensive income	$ 7,541	$ 5,456	$ 5,700

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

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS' EQUITY

(in thousands, except shares and per share data)	Common Stock	Capital Surplus	Retained Earnings	Accumulated Other Comprehensive (Loss) Income	Treasury Stock	Total Stockholders' Equity
Balance, December 31, 2015	$ 842	$ 7,543	$ 60,301	$ 1,029	$ (1,560)	$ 68,155
Net income			6,350			6,350
Other comprehensive loss				(650)		(650)
Stock compensation expense		87				87
Purchase of treasury stock (1,350 shares)					(34)	(34)
Exercise of stock options (1,020 shares)	1	24				25
Employee stock purchase plan (1,434 shares)		37				37
Cash dividends ($1.01 per share)			(2,500)			(2,500)
Balance, December 31, 2016	843	7,691	64,151	379	(1,594)	71,470
Net income			5,407			5,407
Reclassification of certain income tax effects due to decrease in federal corporate income tax rate			(84)	84		-
Other comprehensive income				49		49
Exercise of stock options (3,800 shares)	2	104				106
Employee stock purchase plan (1,560 shares)		53				53
Employee stock bonus (195 shares)		6				6
Stock split	422		(422)			-
Cash dividends ($1.05 per share)			(2,586)			(2,586)
Balance, December 31, 2017	1,267	7,854	66,466	512	(1,594)	74,505
Net income			7,993			7,993
Reclassification due to FASB ASU 2016-01			187	(187)		-
Other comprehensive loss				(452)		(452)
Exercise of stock options (10,475 shares)	6	239				245
Employee stock purchase plan (1,850 shares)	1	64				65
Cash dividends ($1.14 per share)			(2,826)			(2,826)
Balance, December 31, 2018	$ 1,274	$ 8,157	$ 71,820	$ (127)	$ (1,594)	$ 79,530

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

CONSOLIDATED STATEMENT OF CASH FLOWS

(in thousands)	2018	2017	2016
	Year Ended December 31,		
Operating Activities			
Net income	$ 7,993	$ 5,407	$ 6,350
Adjustments to reconcile net income to net cash provided by operating activities:			
Provision for loan losses	500	700	1,000
Depreciation and amortization	800	773	782
Amortization of premium and discount on investment securities, net	870	1,196	1,274
Accretion of net deferred loan origination fees	(182)	(181)	(273)
Investment securities (gains) losses, net	(19)	(159)	173
Equity securities gains, net	(27)	-	-
Origination of loans held for sale	(9,661)	(14,741)	(14,651)
Proceeds from sale of loans	10,245	14,743	15,171
Mortgage loans held for sale gains, net	(228)	(358)	(520)
Impairment of other real estate owned	886	644	299
(Gain) loss on the sale of other real estate owned	(92)	24	(32)
Increase in accrued interest receivable	(183)	(93)	(137)
Increase (decrease) in accrued interest payable	168	28	(14)
Deferred federal income taxes	(344)	1,582	(252)
Earnings on bank-owned life insurance	(429)	(545)	(546)
Stock compensation expense	-	-	87
Increase (decrease) in prepaid federal income taxes	370	(477)	743
Other, net	1,104	1,277	954
Net cash provided by operating activities	11,771	9,820	10,408
Investing Activities			
Investment securities available for sale:			
Proceeds from sales or calls	18,544	9,357	17,192
Proceeds from maturities or paydown	47,016	40,354	48,535
Purchases	(89,993)	(49,645)	(68,561)
Proceeds from sales of equity securities	274	-	-
Redemption of Federal Home Loan Bank stock	2,692	2,432	2,645
Purchase of Federal Home Loan Bank stock	(2,916)	(3,676)	(2,720)
Net increase in loans	(14,513)	(17,931)	(24,745)
Investment in limited partnership	(1)	(2,010)	(459)
Purchase of bank-owned life insurance	(1,201)	-	-
Proceeds from sale of other real estate owned	1,617	1,139	885
Purchase of premises and equipment	(119)	(1,492)	(426)
Net cash used for investing activities	(38,600)	(21,472)	(27,654)
Financing Activities			
Net increase (decrease) in deposits	34,151	(9,819)	18,975
(Decrease) increase in short-term borrowings	(12,189)	929	1,590
Proceeds from other borrowed funds	15,929	28,914	7,100
Repayment of other borrowed funds	(4,534)	(9,940)	(4,066)
Proceeds from exercise of stock options	245	106	25
Proceeds from employee stock purchase plan	65	53	37
Purchase of treasury stock	-	-	(34)
Cash dividends paid	(2,773)	(2,519)	(2,500)
Net cash provided by financing activities	30,894	7,724	21,127
Increase (decrease) in cash and cash equivalents	4,065	(3,928)	3,881
Cash and cash equivalents at beginning of year	8,087	12,015	8,134
Cash and cash equivalents at end of year	$ 12,152	$ 8,087	$ 12,015

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

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the significant accounting and reporting policies applied in the presentation of the accompanying financial statements follows:

Nature of Operations and Basis of Presentation

Dimeco, Inc. (the "Company") is a Pennsylvania company organized as the holding company of The Dime Bank (the "Bank"). The Bank is a state-chartered bank and operates from seven locations in northeastern Pennsylvania. The Company and its subsidiary derive substantially all of their income from banking and bank-related services that include interest earnings on residential real estate, commercial mortgage, commercial and consumer financing as well as interest earnings on investment securities. The Company, through its subsidiary, provides deposit services including checking, savings and certificate of deposit accounts and investment services. The Company is supervised by the Federal Reserve Board, while the Bank is subject to regulation and supervision by the Federal Deposit Insurance Corporation ("FDIC") and the Pennsylvania Department of Banking.

The consolidated financial statements of the Company include its wholly owned subsidiary, the Bank. All inter-company items have been eliminated in preparing the consolidated financial statements. The investment in subsidiary on the parent company financial statements is carried at the parent company's equity in the underlying net assets of the Bank. Wealth management assets held by the Bank in fiduciary or agency capacities for its customers are not included in the accompanying Consolidated Balance Sheet, since such items are not assets of the Bank or the Company. In accordance with industry practice, wealth management fees are recorded on a cash basis and approximate the fees that would have been recognized on the accrual basis.

The consolidated financial statements have been prepared in conformity with U.S. GAAP. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the consolidated balance sheet date and revenues and expenses for the period. Actual results could differ significantly from those estimates.

Investment Securities

Investment securities are classified at the time of purchase, based on management's intention and ability, as securities available for sale. Debt securities have been classified as available for sale to serve principally as a source of liquidity. Unrealized holding gains and losses for available for sale securities are reported as a separate component of stockholders' equity, net of tax, until realized. Realized securities gains and losses are computed using the specific identification method and included in noninterest income. Amortization of premium and discounts for U.S. government agencies, obligations of states and political subdivisions and corporate securities use the constant yield method. Amortization of premium and discounts for collateralized mortgage obligations is a two-step proration method. This method uses a proration component and the calculated final amortization/accretion date. Mortgage-backed securities and Small Business Administration ("SBA") securities also use a two-step proration method that has a proration component and a three-month historical constant pre-payment rate ("CPR") and periodic discounted cash flow yield. The SBA securities are included in the U.S. government agency category. Interest and dividends on investment securities are recognized as income when earned.

Securities are periodically reviewed for other than temporary impairment based upon a number of factors. Those factors include, but are not limited to, the length of time and extent to which the fair value has been less than cost, the financial condition of the underlying issuer, the ability of the issuer to meet contractual obligations, the likelihood of the security's ability to recover any decline in its fair value and whether management intends to sell and their belief that they will not be required to sell these securities before recovery of their cost basis, which may be at maturity. A decline in value that is considered to be other than temporary is recorded as a loss within noninterest income in the Consolidated Statement of Income.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Equity Securities

Equity securities are held at fair value. Holding gains and losses are recorded in income. Dividends on equity securities are recognized as income when earned.

Restricted Stock

Common stock of the Federal Home Loan Bank of Pittsburgh ("FHLB") and the Atlantic Community Bankers Bank ("ACBB") represents ownership in institutions that are wholly owned by other financial institutions. These securities are accounted for at cost and are classified with other assets.

The Bank is a member of FHLB and as such, is required to maintain a minimum investment in stock of FHLB that varies with the level of advances outstanding with FHLB. The stock is bought from and sold to FHLB based upon its $100 par value. The stock does not have a readily determinable fair value and as such is classified as restricted stock, carried at cost and evaluated for impairment by management. The stock's value is determined by the ultimate recoverability of the par value rather than by recognizing temporary declines. The determination of whether the par value will ultimately be recovered is influenced by criteria such as the following: (a) the significance of the decline in net assets of FHLB as compared to the capital stock amount and the length of time this situation has persisted; (b) commitments by FHLB to make payments required by law or regulation and the level of such payments in relation to the operating performance; (c) the impact of legislative and regulatory changes on the customer base of FHLB and; (d) the liquidity position of FHLB.

Management evaluated the stock of both ACBB and FHLB and concluded that the stock was not impaired for the periods presented herein. This evaluation took into consideration regulatory capital ratios and liquidity. In addition, new shares of ACBB and FHLB stock continue to exchange hands at the $250 and $100 par value, respectively.

Mortgage Loans Held for Sale

In general, fixed rate residential mortgage loans originated by the Bank that qualify for sale in the secondary market are held for sale and are carried at the aggregate lower of cost or fair value. Such loans sold are generally serviced by the Bank.

Transfers of Financial Assets

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

Loans

Loans are stated at the principal amount outstanding, net of any unearned income, deferred loan fees and the allowance for loan losses. Interest on consumer loans is credited to operations over the term of each loan using a method which results in a level yield or the simple interest method. Interest income on mortgage loans is accrued on the amortized balance. Interest income on other loans is accrued on the principal amount outstanding. Loan fees which represent an adjustment to interest yield are deferred and amortized over the life of the loan. Loans on which the accrual of interest has been discontinued are designated as nonaccrual loans. Accrual of interest on loans is generally discontinued when it is determined that a reasonable doubt exists as to the collectability of additional interest. When a loan is placed on nonaccrual status, unpaid interest is charged against income. Payments received on nonaccrual loans are either applied to principal or reported as interest income according to management's judgment as to the collectability of principal. Loans are returned to accrual status when past due principal and interest is collected and the collection of principal is probable.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Allowance for Loan Losses

The allowance for loan losses represents the amount which management estimates is adequate to provide for probable losses inherent in its loan portfolio as of the balance sheet date. The allowance method is used in providing for loan losses. Accordingly, all loan losses are charged to the allowance and all recoveries are credited to it. The allowance for loan losses is established through a provision for loan losses charged to operations. The provision for loan losses is based on management's periodic evaluation of individual loans, economic factors, past loan loss experience, changes in the composition and volume of the portfolio and other relevant factors. The estimates used in determining the adequacy of the allowance for loan losses, including the amounts and timing of future cash flows expected on impaired loans, are particularly susceptible to changes in the near term.

Historical loss percentages for each risk category are calculated and used as the basis for calculating allowance allocations. Certain qualitative factors are then added to the historical allocation percentage to get the adjusted factor to be applied to non-classified loans. The following qualitative factors are analyzed:

- Levels of and trends in delinquencies
- Trends in volume and terms
- Changes in lending policies and procedures
- Changes in collateral value
- Changes in adverse classification levels
- Quality of the loan review function
- Economic trends
- Concentrations of credit
- Experience, depth and ability of management
- Other factors affecting the collectability of the loans

The Company analyzes its loan portfolio each quarter to determine the appropriateness of its allowance for loan losses.

In situations where, for economic or legal reasons related to a borrower's financial difficulties, management may grant a concession for other than an insignificant period of time to the borrower that would not otherwise be considered, the related loan is classified as a troubled debt restructuring ("TDR"). Management strives to identify borrowers in financial difficulty early and work with them to modify to more affordable terms before their loan reaches nonaccrual status. These modified terms may include rate reductions, principal forgiveness, payment forbearance and other actions intended to minimize the economic loss and to avoid foreclosure or repossession of the collateral. In cases where borrowers are granted new terms that provide for a reduction of either interest or principal, management measures any impairment on the restructuring and charges down the principal balance as determined in the analysis. This process is completed for all types of loans. It is then further analyzed to determine if the loan should be classified as impaired.

Impaired loans are primarily commercial and commercial real estate loan relationships for which it is probable that the Company will not be able to collect all amounts due according to the contractual terms of the loan agreement. These types of loans which are 90 days past due are evaluated in the analysis for loan impairment. The Company individually evaluates such loans for impairment and does not aggregate loans by major risk classifications. The definition of "impaired loans" is not the same as the definition of "nonaccrual loans," although the two categories overlap. The Company may choose to place a loan on nonaccrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired if the loan is not a commercial or commercial real estate loan. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of impaired loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loans. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

<u>Allowance for Loan Losses</u> (continued)

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively unless included in an impaired loan relationship. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all of the circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record and the amount of shortfall in relation to the principal and interest owed. Residential mortgages and consumer loans are generally evaluated to determine a fair value of the collateral when 90 days past due and then are fully or partially charged down to reflect that fair value unless the loan is well secured and in the process of collection.

Premises and Equipment

Land is carried at cost. Premises and equipment are stated at cost less accumulated depreciation. Depreciation is principally computed on the straight-line method over the estimated useful lives of the related assets, which range from 3 to 20 years for furniture and equipment and 5 to 31 years for office buildings and improvements. Leasehold improvements are amortized over the shorter of their estimated useful lives or their respective lease terms, which range from 5 to 20 years. Expenditures for maintenance and repairs are charged against income as incurred. Costs of major additions and improvements are capitalized.

Bank-Owned Life Insurance ("BOLI")

The Company owns insurance on the lives of a certain group of key employees. The policies were purchased to help offset the increase in the costs of various fringe benefit plans including healthcare. The cash surrender value of these policies is included as an asset on the Consolidated Balance Sheet, and any increases in cash surrender value are recorded as noninterest income on the Consolidated Statement of Income. In the event of the death of an insured individual under these policies, the Company would receive a death benefit which would be recorded as noninterest income.

Other Real Estate Owned

Real estate acquired by foreclosure is classified on the Consolidated Balance Sheet at its fair value minus estimated costs of sale. Prior to foreclosure, the value of the underlying collateral is written down by a charge to the allowance for loan losses, if necessary. Any subsequent write-downs are charged against operating expenses. Operating expenses of such properties, net of related income and losses on their disposition, are included as other real estate owned expense.

Income Taxes

The Company and the Bank file a consolidated federal income tax return. Deferred tax assets or liabilities are computed based on the difference between the financial statement and the income tax basis of assets and liabilities using the enacted marginal tax rates. Deferred income tax expenses or benefits are based on the changes in the deferred tax asset or liability from period to period.

Earnings Per Share

The Company provides dual presentation of basic and diluted earnings per share. Basic earnings per share are calculated utilizing net income as reported as the numerator and average shares outstanding as the denominator. The computation of diluted earnings per share differs in that the dilutive effects of any options and non-vested restricted stock grants are adjusted for in the denominator.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock Based Compensation

The Company accounts for stock-based compensation issued to employees, and where appropriate non-employees, at fair value. Under fair value provisions, stock-based compensation cost is measured at the grant date based on the fair value of the award and is recognized as expense over the appropriate vesting period using the straight-line method. The amount of stock-based compensation recognized at any date must at least equal the portion of the grant date fair value of the award that is vested at that date and as a result it may be necessary to recognize the expense using a ratable method. Determining the fair value of stock-based awards at the date of grant requires judgment, including estimating the expected term of the stock options and the expected volatility of the Company's stock. In addition, judgment is required in estimating the amount of stock-based awards that are expected to be forfeited.

Mortgage Servicing Rights ("MSRs")

The Company has agreements for the express purpose of selling loans in the secondary market. The Company maintains servicing rights for most of these loans. MSRs are carried at the lower of cost or fair value. Originated MSRs are recorded by allocating total costs incurred between the loan and servicing rights based on their relative fair values. MSRs are amortized in proportion to the estimated servicing income over the estimated life of the servicing portfolio. MSRs are a component of other assets on the Consolidated Balance Sheet.

Comprehensive Income

The Company is required to present comprehensive income in a full set of general-purpose financial statements for all periods presented. Other comprehensive income is composed of unrealized holding gains (losses) on the available for sale securities portfolio.

Cash Flows

The Company has defined cash and cash equivalents as cash and due from banks and interest-bearing deposits in other banks that have original maturities of 90 days or less.

Amounts paid for interest and income taxes and noncash activities are as follows (in thousands):

	2018	2017	2016
Cash paid during the year for:			
Interest	$ 3,665	$ 2,918	$ 2,764
Income taxes	$ 721	$ 2,443	$ 1,251
Noncash investing activities:			
Transfer of loans to other real estate owned	$ 1,783	$ 1,456	$ 1,066
Loans to facilitate the sale of other real estate owned	$ 39	$ -	$ 780
Changes in unrealized holding gains and losses on available for sale securities	$ (574)	$ 75	$ (986)
Securities sold not settled	$ -	$ 2,205	$ -

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recent Accounting Pronouncements

In May 2014, the FASB issued ASU 2014-09*, Revenue from Contracts with Customers (a new revenue recognition standard*). The Update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this Update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. Effective January 1, 2018 the Company has elected to apply the standard utilizing the modified retrospective approach with a cumulative effect of adoption for the impact from uncompleted contracts at the date of adoption. The adoption of this guidance did not result in a change to the accounting for any of the in-scope revenue streams; as such, no cumulative effect adjustments were recorded. Management determined that the primary sources of revenue emanating from interest and dividend income on loans and securities along with noninterest revenue resulting from investment security gains, loan servicing, gains on the sale of loans, commitment fees, fees from financial guarantees, certain credit cards fees, and income on bank-owned life insurance are not within the scope of ASC 606. As a result, no changes were made during the period related to these sources of revenue, which cumulatively comprise 89 percent of the total revenue of the Company. Services within the scope of ASC 606 include income from fiduciary activities, brokerage fees, service charges on deposit accounts, other service income, ATM fees, interchange fees, and gain on sale of OREO, net. For these accounts, fees are related to specific customer transactions are attributable to specific performance obligations of the Bank where the revenue is recognized at a defined point in time, completion of the requested service/transaction.

In January 2016, the FASB issued ASU 2016-01, *Financial Instruments – Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities*. This Update applies to all entities that hold financial assets or owe financial liabilities and is intended to provide more useful information on the recognition, measurement, presentation, and disclosure of financial instruments. Among other things, this Update (a) requires equity investments (except those accounted for under the equity method of accounting or those that result in consolidation of the investee) to be measured at fair value with changes in fair value recognized in net income; (b) simplifies the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment; (c) eliminates the requirement to disclose the fair value of financial instruments measured at amortized cost for entities that are not public business entities; (d) eliminates the requirement for public business entities to disclose the method(s) and significant assumptions used to estimate the fair value that is required to be disclosed for financial instruments measured at amortized cost on the balance sheet; (e) requires public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes; (f) requires separate presentation of financial assets and financial liabilities by measurement category and form of financial asset (that is, securities or loans and receivables) on the balance sheet or the accompanying notes to the financial statements; and (g) clarifies that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities in combination with the entity's other deferred tax assets. Effective January 1, 2018, the Company made a one-time cumulative effect reclassification adjustment from accumulated other comprehensive income to retained earnings of $187 thousand. Gains and losses on equity securities are recorded through the Consolidated Statement of Income and are included in Note 3. Also, effects of this standard are included in Note 18 where the methods used to calculate the fair value of financial instruments were based on exit pricing assumptions at December 31, 2018.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recent Accounting Pronouncements (continued)

In February 2016, the FASB issued ASU 2016-02, *Leases (Topic 842)*. The standard requires lessees to recognize the assets and liabilities that arise from leases on the balance sheet. A lessee should recognize in the statement of financial position a liability to make lease payments (the lease liability) and a right-of-use asset representing its right to use the underlying asset for the lease term. A short-term lease is defined as one in which (a) the lease term is 12 months or less and (b) there is not an option to purchase the underlying asset that the lessee is reasonably certain to exercise. For short-term leases, lessees may elect to recognize lease payments over the lease term on a straight-line basis. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those years. The amendments should be applied at the beginning of the earliest period presented using a modified retrospective approach with earlier application permitted as of the beginning of an interim or annual reporting period. This Update will have a less than 1% effect on the Consolidated Balance Sheet.

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

In August 2017, the FASB issued ASU 2017-12, *Derivatives and Hedging (Topic 850)*, the objective of which is to improve the financial reporting of hedging relationships to better portray the economic results of an entity's risk management activities in its financial statements. In addition, the amendments in this Update make certain targeted improvements to simplify the application and disclosure of the hedge accounting guidance in current general accepted accounting principles. For public business entities, the amendments in this Update are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2019, and interim periods beginning after December 15, 2020. Early application is permitted in any period after issuance. For cash flow and net investment hedges existing at the date of adoption, an entity should apply a cumulative-effect adjustment related to eliminating the separate measurement of ineffectiveness to accumulated other comprehensive income with a corresponding adjustment to the opening balance of retained earnings as of the beginning of the fiscal year that an entity adopts the amendments in this Update. The amended presentation and disclosure guidance is required only prospectively. This Update is not expected to have a significant impact on the Company's financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recent Accounting Pronouncements (continued)

In July 2018, the FASB issued ASU 2018-09, *Codification Improvements*, represents changes to clarify, correct errors in, or make minor improvements to the Codification. The amendments make the Codification easier to understand and easier to apply by eliminating inconsistencies and providing clarifications. The transition and effective date guidance is based on the facts and circumstances of each amendment. Some of the amendments do not require transition guidance and will be effective upon issuance of this ASU. However, many of the amendments in this ASU do have transition guidance with effective dates for annual periods beginning after December 15, 2018, for public business entities. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In July 2018, the FASB issued ASU 2018-10, *Codification Improvements to Topic 842, Leases*, represents changes to clarify, correct errors in, or make minor improvements to the Codification. The amendments in this ASU affect the amendments in ASU 2016-02, which are not yet effective, but for which early adoption upon issuance is permitted. For entities that early adopted Topic 842, the amendments are effective upon issuance of this ASU, and the transition requirements are the same as those in Topic 842. For entities that have not adopted Topic 842, the effective date and transition requirements will be the same as the effective date and transition requirements in Topic 842. This Update is not expected to have a significant impact on the Company's financial statements.

In July 2018, the FASB issued ASU 2018-11, *Leases (Topic 842): Targeted Improvements*. This Update provides another transition method which allows entities to initially apply ASC 842 at the adoption date and recognize a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. Entities that elect this approach should report comparative periods in accordance with ASC 840, *Leases*. In addition, this Update provides a practical expedient under which lessors may elect, by class of underlying assets, to not separate nonlease components from the associated lease component, similar to the expedient provided for lessees. However, the lessor practical expedient is limited to circumstances in which the nonlease component or components otherwise would be accounted for under the new revenue guidance and both (a) the timing and pattern of transfer are the same for the nonlease component(s) and associated lease component and (b) the lease component, if accounted for separately, would be classified as an operating lease. If the nonlease component or components associated with the lease component are the predominant component of the combined component, an entity should account for the combined component in accordance with ASC 606, *Revenue from Contracts with Customers*. Otherwise, the entity should account for the combined component as an operating lease in accordance with ASC 842. If a lessor elects the practical expedient, certain disclosures are required. This Update is effective for public business entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years, with early adoption permitted. This Update is not expected to have a significant impact on the Company's financial statements.

In August 2018, the FASB issued ASU 2018-13, *Fair Value Measurement (Topic 820): Disclosure Framework – Changes the Disclosure Requirements for Fair Value Measurements*. The Update removes the requirement to disclose the amount of and reasons for transfers between Level I and Level II of the fair value hierarchy; the policy for timing of transfers between levels; and the valuation processes for Level III fair value measurements. The Update requires disclosure of changes in unrealized gains and losses for the period included in other comprehensive income (loss) for recurring Level III fair value measurements held at the end of the reporting period and the range and weighted average of significant unobservable inputs used to develop Level III fair value measurements. This Update is effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019. This Update is not expected to have a significant impact on the Company's financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Recent Accounting Pronouncements (continued)

In August 2018, the FASB issued ASU 2018-15, *Intangibles – Goodwill and Other – Internal-Use Software (Subtopic 350-40).* This Update addresses customers' accounting for implementation costs incurred in a cloud computing arrangement that is a service contract and also adds certain disclosure requirements related to implementation costs incurred for internal-use software and cloud computing arrangements. The amendment aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with the requirements for capitalizing implementation costs incurred to develop or obtain internal-use software (and hosting arrangements that include an internal-use software license). This Update is effective for public business entities for fiscal years beginning after December 15, 2019, and interim periods within those fiscal years, with early adoption permitted. For all other entities, the amendments are effective for fiscal years beginning after December 15, 2020, and interim periods within fiscal years beginning after December 15, 2021. The amendments in this Update can be applied either retrospectively or prospectively to all implementation costs incurred after the date of adoption. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In October 2018, the FASB issued ASU 2018-16*, Derivatives and Hedging (Topic 815)*. The amendments in this Update permit use of the Overnight Index Swap (OIS) rate based on the Secured Overnight Financing Rate (SOFR) as a U.S. benchmark interest rate for hedge accounting purposes under Topic 815, in addition to the interest rates on direct Treasury obligations of the U.S. government, the London Interbank Offered Rate (LIBOR) swap rate, the OIS rate based on the Fed Funds Effective Rate, and the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Rate. For entities that have not already adopted Update 2017-12, the amendments in this Update are required to be adopted concurrently with the amendments in Update 2017-12. For public business entities that already have adopted the amendments in Update 2017-12, the amendments are effective for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted in any interim period upon issuance of this Update if an entity already has adopted Update 2017-12. This Update is not expected to have a significant impact on the Company's financial statements.

In November 2018, the FASB issued ASU 2018-19, *Codification Improvements to Topic 326, Financial Instruments - Credit Losses,* which amended the effective date of ASU 2016-13 for entities other than public business entities (PBEs), by requiring non-PBEs to adopt the standard for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years. Therefore, the revised effective dates of ASU 2016-13 for PBEs that are SEC filers will be fiscal years beginning after December 15, 2019, including interim periods within those years, PBEs other than SEC filers will be for fiscal years beginning after December 15, 2020, including interim periods within those years, and all other entities (non-PBEs) will be for fiscal years beginning after December 15, 2021, including interim periods within those years. The ASU also clarifies that receivables arising from operating leases are not within the scope of Subtopic 326-20. Rather, impairment of receivables arising from operating leases should be accounted for in accordance with Topic 842, *Leases*. The effective date and transition requirements for ASU 2018-19 are the same as those in ASU 2016-13, as amended by ASU 2018-19. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In December 2018, the FASB issued ASU 2018-20, *Leases (Topic 842),* which addressed implementation questions arising from stakeholders in regard to ASU 2016-02, *Leases*. Specifically addressed in this Update were issues related to 1) sales taxes and other similar taxes collected from lessees, 2) certain lessor costs, and 3) recognition of variable payments for contracts with lease and nonlease components. The amendments in this Update affect the amendments in Update 2016-02, which are not yet effective but can be early adopted. The effective date and transition requirements for the amendments in this Update are the same as the effective date and transition requirements in Update 2016-02 (for example, January 1, 2019, for calendar-year-end public business entities). This Update is not expected to have a significant impact on the Company's financial statements.

NOTE 1 - SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Stock Split

On August 11, 2017, the Company effected in the form of a stock dividend, a three for two stock split of its common stock to shareholders of record on July 28, 2017. All share and earnings per share information have been retroactively adjusted to reflect the stock split and incremental par value of the newly issued shares was recorded with the offset to additional paid-in-capital. Shareholders received cash in lieu of fractional shares except those shareholders participating in the Dividend Reinvestment and Stock Purchase Plan.

Reclassification of Comparative Amounts

Certain comparative amounts for prior years have been reclassified to conform to current year presentations. The reclassified amounts did not affect net income or stockholders' equity.

NOTE 2 - EARNINGS PER SHARE

There are no convertible securities that would affect the numerator in calculating basic and diluted earnings per share; therefore, net income as presented on the Consolidated Statement of Income will be used as the numerator. The following table sets forth the composition of the weighted-average common shares (denominator) used in the basic and diluted earnings per share computation.

	2018	2017	2016
Weighted-average common shares issued	2,538,547	2,530,638	2,527,278
Average treasury stock shares	(59,760)	(59,760)	(59,620)
Average unearned nonvested shares	-	-	(1,252)
Weighted-average common shares and common stock equivalents used to calculate basic earnings per share	2,478,787	2,470,878	2,466,406
Additional common stock equivalents (stock options) used to calculate diluted earnings per share	28,468	25,645	11,743
Weighted-average common shares and common stock equivalents used to calculate diluted earnings per share	2,507,255	2,496,523	2,478,149

There were no shares that were considered anti-dilutive for the years ended December 31, 2018, 2017, and 2016.

NOTE 3 - INVESTMENT AND EQUITY SECURITIES

The amortized costs and fair value of investment securities at December 31 are summarized as follows (in thousands):

2018	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
AVAILABLE FOR SALE				
U.S. government agencies	$ 10,526	$ 35	$ (183)	$ 10,378
Mortgage-backed securities of government-sponsored entities	18,208	169	(72)	18,305
Collateralized mortgage obligations of government-sponsored entities	45,883	326	(390)	45,819
Obligations of states and political subdivisions:				
Taxable	1,531	-	(13)	1,518
Tax-exempt	33,463	242	(253)	33,452
Corporate securities	4,000	1	(24)	3,977
Commercial paper	3,497	1	-	3,498
Total	$ 117,108	$ 774	$ (935)	$ 116,947

2017	Amortized Cost	Gross Unrealized Gains	Gross Unrealized Losses	Fair Value
AVAILABLE FOR SALE				
U.S. government agencies	$ 10,641	$ 61	$ (86)	$ 10,616
Mortgage-backed securities of government-sponsored entities	13,434	143	(65)	13,512
Collateralized mortgage obligations of government-sponsored entities	18,377	47	(213)	18,211
Obligations of states and political subdivisions:				
Taxable	504	-	(18)	486
Tax-exempt	42,868	639	(100)	43,407
Corporate securities	3,502	11	(6)	3,507
Commercial paper	2,000	-	-	2,000
Total	$ 91,326	$ 901	$ (488)	$ 91,739

NOTE 3 - INVESTMENT AND EQUITY SECURITIES (continued)

The following table shows the Company's fair value and gross unrealized losses, aggregated by investment category and length of time that the individual securities have been in a continuous unrealized loss position, at December 31 (in thousands):

	2018					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government agencies	$ 1,035	$ (12)	$ 5,821	$ (171)	$ 6,856	$ (183)
Mortgage-backed securities of government-sponsored entities	1,660	(20)	3,201	(52)	4,861	(72)
Collateralized mortgage obligations of government-sponsored entities	4,963	(18)	15,502	(372)	20,465	(390)
Obligations of states and political subdivisions:						
Taxable	-	-	491	(13)	491	(13)
Tax-exempt	7,758	(65)	9,727	(188)	17,485	(253)
Corporate securities	3,476	(23)	499	(1)	3,975	(24)
Total	$ 18,892	$ (138)	$ 35,241	$ (797)	$ 54,133	$ (935)

	2017					
	Less than Twelve Months		Twelve Months or Greater		Total	
	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses	Fair Value	Gross Unrealized Losses
U.S. government agencies	$ 5,311	$ (50)	$ 1,836	$ (36)	$ 7,147	$ (86)
Mortgage-backed securities of government-sponsored entities	1,853	(18)	2,745	(47)	4,598	(65)
Collateralized mortgage obligations of government-sponsored entities	12,146	(115)	3,834	(98)	15,980	(213)
Obligations of states and political subdivisions:						
Taxable	-	-	486	(18)	486	(18)
Tax-exempt	9,784	(59)	1,934	(41)	11,718	(100)
Corporate securities	999	(3)	497	(3)	1,496	(6)
Total debt securities	$ 30,093	$ (245)	$ 11,332	$ (243)	$ 41,425	$ (488)

The Company reviews its position quarterly and has asserted that at December 31, 2018 and 2017, the declines outlined in the previous tables represent temporary declines and the Company does not intend to sell and does not believe they will be required to sell these securities before recovery of their cost basis, which may be at maturity. There were 95 and 70 positions that were temporarily impaired at December 31, 2018 and 2017, respectively. The Company has concluded that the unrealized losses disclosed above are not other than temporary, but are the result of interest rate changes, sector credit ratings changes or company-specific ratings changes that are not expected to result in the non-collection of principal and interest.

NOTE 3 – INVESTMENT AND EQUITY SECURITIES (continued)

The amortized cost and fair values of debt securities at December 31, 2018, by contractual maturity, are shown below. Expected maturities of mortgage-backed securities will differ from contractual maturities because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties (in thousands):

	Amortized Cost	Fair Value
Due in one year or less	$ 17,920	$ 17,936
Due after one year through five years	52,628	52,593
Due after five years through ten years	37,815	37,626
Due after ten years	8,745	8,792
Total debt securities	$ 117,108	$ 116,947

The following table is a summary of proceeds received, gross gains, and gross losses realized on the sale, call and mergers of investment securities (in thousands):

	2018	2017	2016
Proceeds	$ 18,544	$ 9,357	$ 17,192
Gross gains	$ 53	$ 255	$ 50
Gross losses	$ (34)	$ (96)	$ (223)

Investment securities that were pledged to secure deposits, short-term borrowings and for other purposes as required by law as of December 31 are as follows (in thousands):

	2018	2017
Amortized cost	$ 82,206	$ 77,439
Fair value	$ 81,635	$ 77,854

Equity Securities

At December 31, 2017, the Company had $487 thousand 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 accumulated other comprehensive income, net of tax. At December 31, 2017, net unrealized gains of $187 thousand were recognized in accumulated other comprehensive income. On January 1, 2018, these unrealized gains and losses were reclassified out of accumulated other comprehensive income and into retained earnings with subsequent changes in fair value being recognized in equity securities gains (losses). The following summary of unrealized and realized gains and losses recognized in net income on equity securities as of December 31, 2018 are as follows (in thousands):

	2018
Net realized gains	$ 136
Net unrealized losses	(109)
Net gains	$ 27

NOTE 4 - LOANS

Major classifications of loans at December 31 are as follows (in thousands):

	2018	2017
Commercial	$ 101,187	$ 93,902
Construction and development	27,378	30,139
Commercial real estate	273,610	272,089
Consumer	8,904	7,663
Residential real estate	112,210	106,541
Total	$ 523,289	$ 510,334

Total loans were net of unearned income of $1.4 million and $1.5 million at December 31, 2018 and 2017, respectively.

Real estate loans serviced for others which are not included in the Consolidated Balance Sheet totaled $96 million, at December 31, 2018 and 2017. Commercial loans serviced for others which are not included in the Consolidated Balance Sheet totaled $1.2 million and $681 thousand at December 31, 2018 and 2017, respectively.

In the normal course of business, loans are extended to officers and directors, their families and corporations in which they are beneficially interested as stockholders, officers, or directors. A summary of loan activity for those officers and directors with aggregate loan balances in excess of $60,000 for the year ended December 31, 2018, is as follows (in thousands):

December 31, 2017	Additions	Amounts Collected	December 31, 2018
$ 17,760	$ 3,447	$ 3,386	$ 17,821

The Company's primary business activity is with customers located within its local trade area. Generally, the Company grants commercial, residential and consumer loans. The Company also selectively funds and purchases commercial and residential loans outside of its local trade area provided such loans meet the Company's credit policy guidelines. At December 31, 2018 and 2017, the Company had approximately $134 million and $131 million, respectively, of outstanding loans to summer camps and recreational facilities in the northeastern United States. Although the Company has a diversified loan portfolio at December 31, 2018 and 2017, loans outstanding to individuals and businesses are dependent upon the local economic conditions in its immediate trade area.

NOTE 5- CUSTOMER DERIVATES/INTEREST RATE SWAPS/FLOORS

In 2018, the Company entered into an interest rate swap to hedge the interest rate risk related to a fixed rate commercial loan. Under the commercial loan agreement, the Company entered into a variable rate loan agreement with a customer in addition to a hedging agreement, which serves to effectively convert the customer's variable rate into a fixed rate. The Company then entered into a corresponding interest rate swap agreement with a swap counterparty in order to economically hedge its exposure to the customer hedging agreement. The interest rate swap with the swap counterparty and the hedging agreement with the customer are not designated as hedges under FASB ASC 815. The customer hedging agreement meets the definition of a derivative contract (ASC 815-10-83) that must be bifurcated (ASC 815-15-25-1) and accounted for as a standalone derivative. The market value of both the interest rate swap and the customer hedging agreement are carried on the balance sheet at their underlying market values. Changes in the underlying market values of the interest rate swap and the customer hedging agreement are recorded in current earnings. As the interest rate swap and the customer hedging agreement are structured to offset each other, changes to the underlying market values of these instruments do not result in an impact to earnings; however, there may be fair value adjustments related to credit quality variations between counterparties, which may impact earnings as required by FASB ASC 820. There was no effect on earnings in any periods presented. At December 31, 2018, based upon the swap contract values, a U.S. Government-sponsored mortgage-backed security was pledged for collateral with the third-party financial institution with a fair value $458 thousand.

NOTE 5- CUSTOMER DERIVATES/INTEREST RATE SWAPS/FLOORS (continued)

As of December 31, summary information regarding these derivatives is presented below (in thousands):

Customer interest rate swap	Notional Amount		Interest Rate Paid	Interest Rate Received	Fair Value	
	2018	2017			2018	2017
Maturing in 2028	$ 2,989	$ -	1 month Libor plus margin	Fixed	$ (189)	$ -
Total	$ 2,989	$ -			$ (189)	$ -
Third party interest rate swap						
Maturing in 2028	$ 2,989	$ -	Fixed	1 month Libor plus margin	$ 189	$ -
	$ 2,989	$ -			$ 189	$ -

The following table presents the fair values of derivative instruments in the balance sheet as of December 31 (in thousands):

Interest rate derivatives	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
2018	Other assets	$ 189	Other liabilities	$ 189
2017	Other assets	$ -	Other liabilities	$ -

NOTE 6 –ALLOWANCE FOR LOAN LOSSES

The total allowance reflects management's estimate of loan losses inherent in the loan portfolio at the balance sheet date. The Company considers the allowance for loan losses adequate to cover loan losses inherent in the loan portfolio. The following tables present by portfolio segment, the allowance for loan losses for the year ended December 31 (in thousands):

	2018						
	Commercial	Construction & Development	Commercial Real Estate	Consumer	Residential Real Estate	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 2,525	$ 226	$ 2,838	$ 91	$ 1,362	$ 540	$ 7,582
Charge-offs	(35)	(90)	(67)	(145)	(228)	-	(565)
Recoveries	99	-	425	36	48	-	608
Provision	349	79	(485)	126	140	291	500
Ending balance	$ 2,938	$ 215	$ 2,711	$ 108	$ 1,322	$ 831	$ 8,125
Ending allowance balance:							
Loans individually evaluated for impairment	$ 336	$ -	$ 180	$ 5	$ 301	$ -	$ 822
Loans collectively evaluated for impairment	2,602	215	2,531	103	1,021	831	7,303
Total	$ 2,938	$ 215	$ 2,711	$ 108	$ 1,322	$ 831	$ 8,125
Ending loan balance:							
Loans individually evaluated for impairment	$ 1,316	$ -	$ 7,516	$ 5	$ 1,813	$ -	$ 10,650
Loans collectively evaluated for impairment	99,871	27,378	266,094	8,899	110,397	-	512,639
Total	$ 101,187	$ 27,378	$ 273,610	$ 8,904	$ 112,210	$ -	$ 523,289

In 2018, the allowance for loan losses increased for commercial loans despite net recoveries because of growth in this loan category along with an extension of the historical look-back period from three to fours years, which increased the applicable percentage rate.

The allowances for loan losses related to residential real estate loans decreased due to increasing the look back period to four years from three years in addition to a decrease in average charge-offs in 2018.

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

	2017						
	Commercial	Construction & Development	Commercial Real Estate	Consumer	Residential Real Estate	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 3,284	$ 137	$ 3,080	$ 73	$ 1,249	$ 710	$ 8,533
Charge-offs	(1,013)	-	(457)	(150)	(319)	-	(1,939)
Recoveries	5	5	152	26	100	-	288
Provision	249	84	63	142	332	(170)	700
Ending balance	$ 2,525	$ 226	$ 2,838	$ 91	$ 1,362	$ 540	$ 7,582
Ending allowance balance:							
Loans individually evaluated for impairment	$ 462	$ -	$ 183	$ 5	$ 318	$ -	$ 968
Loans collectively evaluated for impairment	2,063	226	2,655	86	1,044	540	6,614
Total	$ 2,525	$ 226	$ 2,838	$ 91	$ 1,362	$ 540	$ 7,582
Ending loan balance:							
Loans individually evaluated for impairment	$ 1,696	$ -	$ 10,176	$ 5	$ 1,575	$ -	$ 13,452
Loans collectively evaluated for impairment	92,206	30,139	261,913	7,658	104,966	-	496,882
Total	$ 93,902	$ 30,139	$ 272,089	$ 7,663	$ 106,541	$ -	$ 510,334

The allowance for loan losses in 2017 related to commercial loans declined due to charge-offs during the year of several loans that were individually evaluated for impairment.

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

	2016						
	Commercial	Construction & Development	Commercial Real Estate	Consumer	Residential Real Estate	Unallocated	Total
Allowance for loan losses:							
Beginning balance	$ 3,193	$ 63	$ 3,544	$ 115	$ 1,235	$ 127	$ 8,277
Charge-offs	(166)	-	(925)	(38)	(53)		(1,182)
Recoveries	33	2	261	39	103		438
Provision	224	72	200	(43)	(36)	583	1,000
Ending balance	$ 3,284	$ 137	$ 3,080	$ 73	$ 1,249	$ 710	$ 8,533
Ending allowance balance:							
Loans individually evaluated for impairment	$ 1,347	$ -	$ 412	$ -	$ 345	$ -	$ 2,104
Loans collectively evaluated for impairment	1,937	137	2,668	73	904	710	6,429
Total	$ 3,284	$ 137	$ 3,080	$ 73	$ 1,249	$ 710	$ 8,533
Ending loan balance:							
Loans individually evaluated for impairment	$ 2,695	$ -	$ 10,875	$ -	$ 1,764	$ -	$ 15,334
Loans collectively evaluated for impairment	86,420	27,405	254,616	8,103	103,451	-	479,995
Total	$ 89,115	$ 27,405	$ 265,491	$ 8,103	$ 105,215	$ -	$ 495,329

Credit Quality Information

The following tables represent credit exposures by assigned grades for the years ended December 31, 2018 and 2017. The grading analysis estimates the capability of the borrower to repay the contractual obligations of the loan agreements as scheduled or at all. The Company's internal credit risk grading system is based on experiences with similarly graded loans.

The Company's internally assigned grades are as follows:

Pass – loans which are protected by the current net worth and paying capacity of the obligor or by the value of the underlying collateral.

Special Mention – loans where a potential weakness or risk exists, which could cause a more serious problem if not corrected.

Substandard – loans that have a well-defined weakness based on objective evidence and are characterized by the distinct possibility that the Bank will sustain some loss if the deficiencies are not corrected.

Doubtful – loans classified as doubtful have all the weaknesses inherent in a substandard asset. In addition, these weaknesses make collection or liquidation in full highly questionable and improbable, based on existing circumstances.

Loss – loans classified as a loss are considered uncollectable, or of such value that continuance as an asset is not warranted.

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

<u>Credit Quality Information</u> (continued)

Loans are graded by either independent loan review or internal review. Internally reviewed loans were assigned a risk weighting by the loan officer and approved by the loan committee but have not undergone a formal loan review by an independent party. These loans are typically smaller dollar balances that have not experienced delinquency issues. Balances are net of unearned income and include overdrafts, loan settlement and loan unposted, as of December 31 (in thousands):

	2018					
	Commercial	Construction & Development	Commercial Real Estate	Consumer	Residential Real Estate	Total
Pass	$ 94,518	$ 23,605	$ 248,774	$ 8,901	$ 107,859	$ 483,657
Special Mention	5,381	126	11,824	3	2,406	19,740
Substandard	1,288	3,647	13,012	-	1,945	19,892
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	$ 101,187	$ 27,378	$ 273,610	$ 8,904	$ 112,210	$ 523,289

	2017					
	Commercial	Construction & Development	Commercial Real Estate	Consumer	Residential Real Estate	Total
Pass	$ 87,100	$ 26,059	$ 246,180	$ 7,660	$ 102,796	$ 469,795
Special Mention	5,267	-	9,751	3	1,152	16,173
Substandard	1,535	4,080	16,158	-	2,593	24,366
Doubtful	-	-	-	-	-	-
Loss	-	-	-	-	-	-
Total	$ 93,902	$ 30,139	$ 272,089	$ 7,663	$ 106,541	$ 510,334

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

Age Analysis of Past Due Loans by Class

The following is a table which includes an aging analysis of the recorded investment of past due loans as of December 31 including loans which are in nonaccrual status (in thousands):

2018	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial	$ 131	$ 72	$ 425	$ 628	$ 100,559	$ 101,187	$ -
Construction and development	-	-	-	-	27,378	27,378	-
Commercial real estate	169	114	1,276	1,559	272,051	273,610	-
Consumer	33	-	-	33	8,871	8,904	-
Residential real estate	257	756	522	1,535	110,675	112,210	-
Total	$ 590	$ 942	$ 2,223	$ 3,755	$ 519,534	$ 523,289	$ -

2017	30-59 Days Past Due	60-89 Days Past Due	90 Days Or Greater	Total Past Due	Current	Total Loans	Recorded Investment > 90 Days and Accruing
Commercial	$ 90	$ -	$ 621	$ 711	$ 93,191	$ 93,902	$ -
Construction and development	-	-	-	-	30,139	30,139	-
Commercial real estate	647	118	1,975	2,740	269,349	272,089	-
Consumer	29	11	-	40	7,623	7,663	-
Residential real estate	257	157	862	1,276	105,265	106,541	-
Total	$ 1,023	$ 286	$ 3,458	$ 4,767	$ 505,567	$ 510,334	$ -

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

Impaired Loans

Management considers commercial loans and commercial real estate loans which are 90 days or more past due as impaired, and if warranted, includes the entire customer relationship in that status. These loans are analyzed to determine if it is probable that all amounts will not be collected according to the contractual terms of the loan agreement. If management determines that the value of the impaired loan is less than the recorded investment in the loan (net of previous charge-offs, deferred loan fees or costs and unamortized premium or discount), impairment is recognized through an allowance estimate or a charge-off to the allowance.

The following tables include the recorded investment and unpaid principal balances for impaired loans with the associated allowance amount, if applicable, as of December 31 (in thousands):

	2018				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 611	$ 611	$ -	$ 697	$ 15
Commercial real estate	6,934	7,335	-	7,172	212
Residential real estate	1,293	1,293	-	1,323	34
With an allowance recorded:					
Commercial	705	705	336	730	54
Commercial real estate	582	582	180	584	30
Residential real estate	520	520	301	526	28
Consumer	5	5	5	5	1
Total	$ 10,650	$ 11,051	$ 822	$ 11,037	$ 374

	2017				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 870	$ 870	$ -	$ 1,024	$ 14
Commercial real estate	9,591	10,039	-	10,311	308
Residential real estate	1,043	1,043	-	1,115	18
With an allowance recorded:					
Commercial	826	826	462	1,084	57
Commercial real estate	585	585	183	586	26
Residential real estate	532	532	318	499	25
Consumer	5	5	5	5	-
Total	$ 13,452	$ 13,900	$ 968	$ 14,624	$ 448

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

Impaired Loans (continued)

	2016				
	Recorded Investment	Unpaid Principal Balance	Related Allowance	Average Recorded Investment	Interest Income Recognized
With no related allowance recorded:					
Commercial	$ 291	$ 291	$ -	$ 277	$ 14
Commercial real estate	9,541	10,038	-	9,266	282
Residential real estate	966	966	-	1,072	19
With an allowance recorded:					
Commercial	2,404	2,404	1,347	2,509	57
Commercial real estate	1,334	1,334	412	935	26
Residential real estate	798	798	345	482	21
Total	$ 15,334	$ 15,831	$ 2,104	$ 14,541	$ 419

Nonaccrual Loans

The following are the loans, presented by class, on nonaccrual status as of December 31 (in thousands):

	2018	2017
Commercial	$ 651	$ 688
Construction and development	-	9
Commercial real estate	2,066	3,051
Consumer	2	-
Residential real estate	1,376	1,743
Total	$ 4,095	$ 5,491

Residential real estate loans in process of foreclosure were $467 and $579 for the years ended December 31, 2018 and 2017, respectively.

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

Troubled Debt Restructurings

Loan modifications that are considered troubled debt restructurings completed during the year are as follows (dollars in thousands):

	2017		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial real estate	2	$ 855	$ 763
Residential real estate	1	89	89
Total	3	$ 944	$ 852

	2016		
	Number of Contracts	Pre-Modification Outstanding Recorded Investment	Post-Modification Outstanding Recorded Investment
Commercial	1	$ 19	$ 19
Commercial real estate	1	1,044	549
Residential real estate	1	44	44
Total	3	$ 1,107	$ 612

In 2018, the Bank did not approve any new trouble restructured debt.

No additional interest was recognized in 2017 because the loans were accruing interest the entire year without a change in rate. No additional interest income would have been recognized in 2016 because the loans were in nonaccrual status before and after the restructuring.

In 2017, the bank restructured two loans for one customer in order to lower the payment amount but not the final maturity. One of these loans is a commercial loan and the other is a residential junior lien loan used for commercial purposes. There was no change to the original interest rates or any decrease in the interest receivable or principal balance of the loans. Another commercial loan was transferred to troubled debt restructured status after the customer declared Chapter 11 in United States Bankruptcy Court. The collateral that supported this loan was sold, a charge-off was recorded with the remaining loan balance guaranteed by the borrowers at the same interest rate as the original loan and with extension of the final maturity by three months.

NOTE 6 –ALLOWANCE FOR LOAN LOSSES (continued)

Troubled Debt Restructurings (continued)

In 2016, the Bank consolidated a commercial loan and a consumer loan as one restructured commercial loan in order to improve the bank's collateral position and facilitate payment ability for the borrower. The interest rate on the new loan was .88% lower than the average rate of the initial loans and extended the maturity date by 3.4 years. The commercial real estate loan was restructured in accordance with the borrower's Chapter 11 Plan of Reorganization, as approved by the United States Bankruptcy Court allowing for a decline of .75% in the interest rate and extending the maturity by 5.5 years. The residential mortgage was restructured in accordance with the Bank's policy to avoid unnecessary foreclosure in residential properties, extending the maturity by 2.75 years.

Of the loans restructured in 2017 and 2016, there was no default on the terms.

When a loan is classified as a troubled debt restructuring, we evaluate it for impairment and, if necessary, include that valuation in the allowance for loan losses.

NOTE 7 - PREMISES AND EQUIPMENT

A summary by asset classification at December 31 is as follows (in thousands):

	2018	2017
Land	$ 1,641	$ 1,641
Premises and improvements	12,589	12,623
Furniture and equipment	4,784	4,661
Leasehold improvements	2,617	2,606
Total, at cost	21,631	21,531
Less accumulated depreciation	12,068	11,430
Net premises and equipment	$ 9,563	$ 10,101

Depreciation and amortization expense was $656, $628, and $640 thousand, in 2018, 2017, and 2016, respectively.

NOTE 8 - DEPOSITS

Deposits at December 31 are summarized as follows (in thousands):

	2018	2017
Demand - noninterest-bearing	$ 93,963	$ 87,954
Demand - interest-bearing	89,524	82,311
Money market	77,468	74,901
Savings	92,041	88,983
Time deposits of $250,000 or more	58,106	52,392
Other time deposits	121,281	111,691
Total	$ 532,383	$ 498,232

Included in the deposit accounts are deposits of one customer relationship totaling $33.8 million and $35.6 million at December 31, 2018 and 2017, respectively.

The following table summarizes the maturity distribution of time deposits at December 31, 2018 (in thousands):

2019	$ 129,214
2020	31,035
2021	10,951
2022	5,486
2023	2,701
Total	$ 179,387

Brokered deposits totaled $23.7 million and $13 million for the years ended December 31, 2018 and 2017, respectively.

NOTE 9 - SHORT-TERM BORROWINGS

Short-term borrowings consist of borrowings from correspondent banks and securities sold under agreements to repurchase. Average amounts outstanding during the year represent daily average balances and average interest rates represent interest expense divided by the related average balance.

The outstanding balances and related information for short-term borrowings at December 31 are summarized as follows (in thousands):

	2018		2017	
	Amount	Rate	Amount	Rate
Balance at year-end	$ 20,355	.21%	$ 32,544	.59%
Average balance outstanding during the year	$ 31,049	.37%	$ 36,457	.35%
Maximum amount outstanding at any month-end	$ 39,164		$ 42,590	

The balance of securities sold under agreements to repurchase was $20 million at December 31, 2018 and $23 million at December 31, 2017. Pledged as collateral for those liabilities were investment securities with amortized costs of $23 million and $25 million and fair values of $24 million and $27 million, respectively, at December 31, 2018 and 2017.

FHLB borrowings are subject to annual renewal, incur no service charges and are secured by a blanket security agreement on certain investment securities, qualifying loans and the Bank's investment in FHLB stock. At December 31, 2018, the Bank's remaining borrowing capacity with FHLB was approximately $183 million. The Bank has unsecured lines of credit with correspondent banks in the amount of $22 million. In addition, the Bank has the ability to borrow overnight at the Federal Reserve Bank of Philadelphia ("Fed") discount window based on the level of collateral pledged. At December 31, 2018, the balance available was approximately $3.8 million.

NOTE 10 - OTHER BORROWED FUNDS

Other borrowed funds consist of FHLB fixed rate advances at December 31 as follows (in thousands):

Description	Maturity Range From	Maturity Range To	Weighted-Average Rate	Stated Interest Rate Range From	Stated Interest Rate Range To	2018	2017
Fixed rate	03/14/19	03/27/23	2.34%	1.60%	3.01%	$ 17,827	$ 12,327
Fixed rate amortizing	04/17/19	12/28/33	2.80%	1.66%	4.91%	35,894	29,999
Total						$ 53,721	$ 42,326

The following table represents maturities/repayments and weighted average rates of the remaining FHLB advances (in thousands):

Year Ending December 31,	Maturities/ Repayments	Weighted-Average Rate
2019	$ 5,848	2.53%
2020	7,431	2.57%
2021	12,850	2.64%
2022	8,035	2.65%
2023	3,817	2.86%
2024 and beyond	15,740	2.91%
Total	$ 53,721	2.63%

NOTE 11 - DIVIDEND REINVESTMENT AND STOCK PURCHASE PLAN

The Company maintains a Dividend Reinvestment and Stock Purchase Plan (the "DRP Plan"). Participation is available to all common stockholders. The DRP Plan provides each participant with a simple and convenient method of purchasing additional common shares without payment of any brokerage commission or other service fees.

A participant in the DRP Plan may elect to reinvest dividends on all or part of his or her shares to acquire additional common stock. Participants may also make cash contributions for the purchase of additional shares of common stock. A participant may withdraw from the DRP Plan at any time. The following table represents the number of shares purchased by stockholders through the DRP Plan:

	2018	2017	2016
Shares purchased through dividend reinvestment	17,406	19,413	24,144
Shares purchased through cash contributions	1,850	1,696	914
Total shares	19,256	21,109	25,058

The Company offers an Employee Stock Purchase Plan that allows eligible employees the opportunity through payroll deductions to purchase shares of the Company stock at a discounted rate with no additional fees. Employees purchased 1,850 shares in 2018, 1,560 shares in 2017 and 1,434 shares in 2016 under this program.

NOTE 12 - EMPLOYEE BENEFITS

Retirement Plan

The Bank maintains a section 401(k) employee savings and investment plan for substantially all employees and officers of the Bank. The Bank's contribution to the plan is based on 100 percent matching of voluntary contributions up to 3 percent and 50 percent matching on the next 2 percent of individual compensation. Additionally, the Bank may contribute a discretionary amount each year. For each of the years of 2018, 2017, and 2016, the Board of Directors authorized an additional 3 percent, 2 percent, and 2 percent, respectively, of each eligible employee's compensation. Employee contributions are vested at all times, and Bank contributions are fully vested after five years. Contributions for 2018, 2017, and 2016 to this plan amounted to $468, $376, and $362 thousand, respectively.

Supplemental Retirement Plan

The Bank maintains a Salary Continuation Plan for certain officers of the Bank to provide guaranteed consecutive postretirement payments totaling a predetermined amount over a ten or fifteen-year period. Expenses for the years ended December 31, 2018, 2017, and 2016 amounted to $417, $398, and $380 thousand, respectively, and are included as a component of salaries and employee benefits.

Stock Compensation Plans

The Company maintains an Equity Incentive Plan (the "Plan"). A total of 187,500 shares of either authorized and unissued shares or authorized shares issued by and subsequently reacquired by the Company are issuable under the Plan. The Plan terminates on the day preceding the tenth anniversary of the date of shareholder ratification. These awards may be made as incentive stock options, non-qualified stock options or restricted stock grants. Restrictions placed on awards are: 1) a maximum of 25%, or 46,875, of the shares may be issued to directors and 2) up to 25%, or 46,875, of the shares in the Plan may be awarded as restricted stock. Awards are granted at no less than the fair value of the Company's common stock on the date of grant.

There were no options or restricted stock granted in 2018 or 2017.

The Board of Directors granted compensation to officers and directors from the Plan as follows:

	Exercise price	Options granted	Options forfeited	Options exercised	Vested options outstanding
Stock options:					
Incentive	$ 23.33	79,350	5,625	18,650	55,075
Non-qualified	$ 23.33	32,400	4,050	10,325	18,025
Remaining shares available in Plan at December 31, 2018					50,445

Stock options and restricted stock granted to directors vested over two years. Stock options and restricted stock granted to officers vested over five years. All stock options expire ten years after the grant. The weighted average period over which these expenses were recognized was approximately five years for employees and two years for directors.

The Company expenses the fair value of all share-based compensation over the requisite service periods. The fair value of both stock options and restricted stock are expensed on a straight-line basis. The Company classifies share-based compensation for employees within "salaries and employee benefits" and for directors within "other expense" on the Consolidated Statement of Income. Additionally, the Company reports the expense associated with the grants as an adjustment to operating cash flows.

NOTE 12 - EMPLOYEE BENEFITS (continued)

Stock Compensation Plans (continued)

As of December 31, the following was expensed as compensation expense relating to share-based compensation (in thousands):

	2018	2017	2016
Stock options	$ -	$ -	$ 17
Restricted stock	$ -	$ -	$ 70

As of December 31, the following tax benefit was recognized (in thousands):

2018	2017	2016
$ -	$ -	$ 35

As of December 31, 2018, 2017 and 2016, there was no unrecognized compensation related to the plan.

A summary of the Company's stock award activity for the year ended December 31 is as follows:

	2018	Weighted-Average Exercise Price
Stock options:		
Outstanding, beginning of year	83,575	$ 23.33
Granted	-	-
Exercised	(10,475)	23.33
Forfeited	-	-
Expired	-	-
Outstanding, end of year	73,100	$ 23.33
Exercisable at year-end	73,100	

The following table summarizes characteristics of stock options outstanding at December 31, 2018:

	Outstanding			Exercisable	
Exercise Price	Shares	Average Remaining Life	Average Exercise Price	Shares	Average Exercise Price
$ 23.33	73,100	2.73	$ 23.33	73,100	$ 23.33
Total	73,100		Total	73,100	

NOTE 12 - EMPLOYEE BENEFITS (continued)

Stock Compensation Plans (continued)

On February 23, 2017, the Company adopted an employee stock bonus plan. Stock is issued at no cost to certain employees. Expense associated with this plan is included in salaries and employee benefits. There were no expenses related to the plan year ended December 31, 2018. Expense for the year ended December 31, 2017 was $7 thousand. A total of 750 shares of common stock are reserved under the plan. There were no shares issued in 2018 with 555 available to be issued as of December 31,2018.

	2018	2017
Available shares to be issued	555	-
Granted	-	750
Shares issued	-	195
Remaining shares	555	555

NOTE 13 - INCOME TAXES

Income tax expense at December 31 consists of the following (in thousands):

	2018	2017	2016
Currently payable-federal	$ 995	$ 1,825	$ 1,957
Currently payable-state	96	81	26
Deferred taxes	(344)	186	(252)
Change in corporate tax rate	-	1,396	-
Total provision	$ 747	$ 3,488	$ 1,731

The components of the net deferred tax assets and liabilities at December 31 are as follows (in thousands):

	2018	2017
Deferred tax assets:		
Allowance for loan losses	$ 1,706	$ 1,592
Salary continuation plan	718	631
Nonaccrual loans	156	189
Stock options and grants	11	11
Allowance for impairment of other real estate owned	526	421
Accrued compensation	76	72
Intangible asset	1	6
Unrealized loss on investment securities	34	-
Other than temporary impairment	8	13
Total	3,236	2,935
Deferred tax liabilities:		
Premises and equipment	273	312
Deferred loan origination fees, net	70	61
Prepaid contribution	52	36
Partnership investment	71	131
Unrealized gain on nonmonetary exchange	-	3
Unrealized gain on investment securities	-	136
Total	466	679
Net deferred tax assets	$ 2,770	$ 2,256

NOTE 13 - INCOME TAXES (continued)

No valuation allowance was established at December 31, 2018 and 2017, in view of the Company's ability to carryback taxes paid in previous years and certain tax strategies and anticipated future taxable income as evidenced by the Company's earnings potential.

A reconciliation between the expected statutory income tax rate and the effective income tax rate follows (in thousands):

	2018		2017		2016	
	Amount	% of Pretax Income	Amount	% of Pretax Income	Amount	% of Pretax Income
Provision at statutory rate	$ 1,835	21.0 %	$ 3,024	34.0 %	$ 2,748	34.0 %
State tax, net of federal tax benefit	76	.9	73	.8	32	.4
Tax-exempt income	(286)	(3.3)	(476)	(5.4)	(507)	(6.3)
BOLI earnings	(82)	(.9)	(185)	(2.1)	(186)	(2.3)
Nondeductible interest	14	.1	19	.2	19	.2
Partnership investment tax credit	(731)	(8.4)	(459)	(5.1)	(459)	(5.6)
Stock options	(33)	(.4)	(17)	(.2)	-	-
Change in corporate tax rate	-	-	1,396	15.7	-	-
Other, net	(46)	(.5)	113	1.3	84	1.0
Effective income tax and rate	$ 747	8.5 %	$ 3,488	39.2 %	$ 1,731	21.4 %

The Tax Cuts and Job Act, enacted on December 22, 2017, lowered the federal corporate tax rate from 35% to 21% effective January 1, 2018. As a result, the carrying value of net deferred tax assets was reduced which increased income tax expense by $1,396 thousand in 2017.

The Company prescribes a recognition threshold and a measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. Benefits from tax positions should be recognized in the financial statements only when it is more likely than not that the tax position will be sustained upon examination by the appropriate taxing authority that would have full knowledge of all relevant information. A tax position that meets the more-likely-than-not recognition threshold is measured at the largest amount of benefit that is greater than 50 percent likely of being realized upon ultimate settlement. Tax positions that previously failed to meet the more-likely-than-not recognition threshold should be recognized in the first subsequent financial reporting period in which that threshold is met. Previously recognized tax positions that no longer meet the more-likely-than-not recognition threshold should be derecognized in the first subsequent financial reporting period in which that threshold is no longer met.

There is currently no liability for uncertain tax positions and no known unrecognized tax benefits. The Company recognizes, when applicable, interest and penalties related to unrecognized tax benefits in the provision for income taxes in the Consolidated Statement of Income. The Company's federal and state income tax returns for taxable years through 2014 have been closed for purposes of examination by the Internal Revenue Service and the Pennsylvania Department of Revenue.

NOTE 14 - COMMITMENTS AND CONTINGENT LIABILITIES

Commitments

In the normal course of business, there are outstanding commitments and contingent liabilities such as commitments to extend credit, financial guarantees and letters of credit that are not reflected in the accompanying Consolidated Financial Statements. The Company does not anticipate any losses as a result of these transactions. These instruments involve, to varying degrees, elements of credit and interest rate risk in excess of the amount recognized in the Consolidated Balance Sheet. The contractual or notional amounts of those instruments reflect the extent of involvement the Company has in the particular classes of financial instruments.

Financial instruments whose contractual amounts represent credit risk at December 31 are as follows (in thousands):

	2018	2017
Commitments to extend credit	$ 71,466	$ 65,989
Standby letters of credit	$ 11,034	$ 10,838

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 and may require payment of a fee. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future cash requirements.

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

On September 28, 2016, the Company entered into an Agreement of Limited Partnership which generates low income housing credits for use in future periods. The agreement states the Bank will acquire a 33.33% interest in the partnership at a cost of $2,500. The final installment of this investment of $30 thousand will be paid in 2019.

At December 31, 2018, the minimum rental commitments for all non-cancelable leases are as follows (in thousands):

2019	$ 250
2020	226
2021	140
2022	83
2023	-
2024 and thereafter	-
Total	$ 699

Rental expense amounted to $260, $257, and $253 thousand for the years ended December 31, 2018, 2017, and 2016, respectively.

Contingent Liabilities

The Company and its subsidiary are involved in various legal actions from the normal course of business activities. Management believes the liability, if any, arising from such actions will not have a material adverse effect on the Company's financial position.

NOTE 15 - REGULATORY RESTRICTIONS

Cash and Due From Banks

The Bank is required to maintain reserved funds in cash or on deposit with Fed. The required reserve at December 31, 2018 and 2017 was $460 thousand and $452 thousand, respectively.

Dividends

The Pennsylvania Banking Code restricts the availability of capital funds for payment of dividends by all state-chartered banks to the surplus of the Bank. Accordingly, at December 31, 2018, the balance in the capital surplus account totaling approximately $1.8 million is unavailable for dividends.

NOTE 16 - REGULATORY CAPITAL REQUIREMENTS

Federal regulations require the Company and the bank to maintain minimum amounts of capital. Specifically, each is required to maintain certain minimum dollar amounts of ratios of Common Equity Tier 1, Total, and Tier 1 Capital to Risk-Weighted Assets and of Tier 1 Capital to Average Assets.

In addition to the capital requirements, the Federal Deposit Insurance Corporation Insurance Act ("FDICIA") established five capital categories ranging from "well capitalized" to "critically undercapitalized." Should any institution fail to meet the requirements to be considered "adequately capitalized," it would become subject to a series of increasingly restrictive regulatory actions.

As of December 31, 2018, and 2017, the FDIC categorized the bank as well capitalized under the regulatory framework for prompt corrective action. To be classified as a well capitalized financial institution, Common Equity Tier 1 Risk-Based, Tier 1 Risked-Based, Total Risk-Based, and Tier 1 Leverage Capital ratios must be at least 6.5%, 8%, 10%, and 5%, respectively.

The Company's capital position does not differ significantly from the bank's capital position. The Company's actual capital ratios (using the definitions from the prompt corrective action rules) are presented in the following tables, which shows the Company met all regulatory capital requirements.

NOTE 16 - REGULATORY CAPITAL REQUIREMENTS (continued)

At December 31, 2018 and 2017, the Company's capital levels were as follows (in thousands):

	2018			2017		
		Amount	Ratio		Amount	Ratio
Total Capital (to Risk-Weighted Assets)						
Actual	$	86,968	14.78%	$	81,142	14.09%
For capital adequacy purposes	$	47,078	8.00%	$	46,056	8.00%
To be well capitalized	$	58,835	10.00%	$	57,569	10.00%
Tier I Capital (to Risk-Weighted Assets)						
Actual	$	79,604	13.53%	$	73,941	12.84%
For capital adequacy purposes	$	35,301	6.00%	$	46,056	6.00%
To be well capitalized	$	47,068	8.00%	$	57,569	8.00%
Tier I Capital (to Average Assets)						
Actual	$	79,604	12.03%	$	73,941	11.42%
For capital adequacy purposes	$	26,468	4.00%	$	25,894	4.00%
To be well capitalized	$	33,085	5.00%	$	32,368	5.00%
Common Equity Tier 1 (to Risk-Weighted Assets)						
Actual	$	79,604	13.53%	$	73,941	12.84%
For capital adequacy purposes	$	26,476	4.50%	$	25,906	4.50%
To be well capitalized	$	38,243	6.50%	$	37,420	6.50%

NOTE 17 – FAIR VALUE MEASUREMENTS

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value. The three broad levels defined by the Company are as follows:

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

Level II: Pricing inputs are other than quoted prices in active markets, which are either directly or indirectly observable as of the reported date. The nature of these assets and liabilities include items for which quoted prices are available but traded less frequently, and items that are fair valued using other financial instruments, the parameters of which can be directly observed.

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

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

The following is a description of the valuation methodologies the Company uses for financial instruments recorded at fair value on either a recurring or nonrecurring basis:

Securities Available for Sale

Securities available for sale consists of debt securities. These securities are recorded at fair value on a recurring basis. At December 31, all of these securities used valuation methodologies involving market-based or market derived information, collectively Level I and Level II measurements, to measure fair value.

Equity securities are recorded at fair value on a recurring basis. At December 31, these securities used valuation methodologies involving market-based information as Level 1 measurements to measure fair value.

The Company closely monitors market conditions involving assets that have become less actively traded. If the fair value measurement is based upon recent observable market activity of such assets or comparable assets (other than forced or distressed transactions) that occur in sufficient volume, and do not require significant adjustment using unobservable inputs, those assets are classified as Level I or Level II; if not, they are classified as Level III. Making this assessment requires significant judgment.

The Company uses prices from independent pricing services and, to a lesser extent, indicative (non-binding) quotes from independent brokers to measure securities.

NOTE 17 – FAIR VALUE MEASUREMENTS (continued)

The following tables present the assets reported on the Consolidated Balance Sheet at their fair value as of December 31, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement (in thousands):

	2018			
	Level 1	Level II	Level III	Total
Assets:				
U.S. government agencies	$ -	$ 10,378	$ -	$ 10,378
Mortgage-backed securities of government-sponsored entities	-	18,305	-	18,305
Collateralized mortgage obligations of government-sponsored entities	-	45,819	-	45,819
Obligations of states and political subdivisions:				
Taxable	-	1,518	-	1,518
Tax-exempt	-	33,452	-	33,452
Corporate securities	-	3,977	-	3,977
Commercial paper	3,498	-		3,498
Total debt securities	3,498	113,449	-	116,947
Equity securities of financial institutions	218	-	-	218
Total	$ 3,716	$ 113,449	$ -	$ 117,165

	2017			
	Level 1	Level II	Level III	Total
Assets:				
U.S. government agencies	$ -	$ 10,616	$ -	$ 10,616
Mortgage-backed securities of government-sponsored entities	-	13,512	-	13,512
Collateralized mortgage obligations of government-sponsored entities	-	18,211	-	18,211
Obligations of states and political subdivisions:				
Taxable	-	486	-	486
Tax-exempt	-	43,407	-	43,407
Corporate securities	-	3,507	-	3,507
Commercial paper	2,000	-	-	2,000
Total debt securities	2,000	89,739	-	91,739
Equity securities of financial institutions	487	-	-	487
Total	$ 2,487	$ 89,739	$ -	$ 92,226

NOTE 17 – FAIR VALUE MEASUREMENTS (continued)

The following tables present the assets measured on a nonrecurring basis on the Consolidated Balance Sheet at their fair value as of December 31 by level within the fair value hierarchy. Other real estate fair value is determined by current appraisal less management estimate of market volatility or by a current market offering adjusted for volatility, both classified as Level III inputs. Impaired loans that are collateral dependent are written down to fair value through the establishment of specific reserves. Techniques used to value the collateral that secure the impaired loan include: quoted market prices for identical assets classified as Level I inputs; observable inputs, employed by certified appraisers, for similar assets classified as Level II inputs. In cases where valuation techniques included inputs that are unobservable and are based on estimates and assumptions developed by management based on the best information available under each circumstance, the asset valuation is classified as Level III inputs. Mortgage servicing rights fair value is estimated by discounting future cash flows using current market inputs at which loans with similar terms and qualities would be made to borrowers of similar credit quality. Where quoted market prices were available, primarily for certain residential mortgage loans, such market rates were utilized as estimates for fair value. Those valuations are as follows (in thousands):

	2018			
	Level 1	Level II	Level III	Total
Assets measured on a nonrecurring basis:				
Impaired loans	$ 59	$ -	$ 1,090	$ 1,149
Other real estate owned	$ -	$ -	$ 5,067	$ 5,067
Mortgage servicing rights	$ -	$ -	$ 684	$ 684

	2017			
	Level 1	Level II	Level III	Total
Assets measured on a nonrecurring basis:				
Impaired loans	$ -	$ 461	$ 1,081	$ 1,542
Other real estate owned	$ -	$ -	$ 5,807	$ 5,807
Mortgage servicing rights	$ -	$ -	$ 657	$ 657

NOTE 17 – FAIR VALUE MEASUREMENTS (continued)

The following tables provide information describing the valuation processes used to determine nonrecurring fair value measurements categorized within Level III of the fair value hierarchy as follows (in thousands):

2018

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	$ 1,090	Appraised values	Management discount for property type and recent market volatility	9.16% - 44.2% discount (31.3%)
Other real estate owned	$ 5,008	Appraised values/tax assessment	Management discount for property type and recent market volatility	0% - 30.12% discount (20.06%)
Mortgage servicing rights	$ 684	Discounted cash flows	Market rates	12%

2017

	Fair Value	Valuation Technique	Unobservable Input	Range (Weighted Average)
Impaired loans	$ 1,081	Appraised values	Management discount for property type and recent market volatility	7% - 44.2% discount (30.1%)
Other real estate owned	$ 4,867	Appraised values	Management discount for property type and recent market volatility	0% - 58.5% discount (24.08%)
	$940	Agreement to sell/letter of intent	Management discount for property type and recent market volatility	1.1% discount
Mortgage servicing rights	$ 657	Discounted cash flows	Market rates	12%

NOTE 18 - FAIR VALUE DISCLOSURE

The estimated fair values of the Company's financial instruments at December 31 are as follows (in thousands):

	2018				
	Carrying Value	Level I	Level II	Level III	Total Fair Value
Financial assets:					
Cash and cash equivalents	$ 12,152	$ 12,152	$ -	$ -	$ 12,152
Investment securities available for sale	$ 116,947	$ 3,498	$ 113,449	$ -	$ 116,947
Equity securities	$ 218	$ 218	$ -	$ -	$ 218
Loans held for sale					$ -
Net loans	$ 515,164	$ -	$ -	$ 501,074	$ 501,074
Accrued interest receivable	$ 2,218	$ 2,218	$ -	$ -	$ 2,218
Regulatory stock	$ 3,288	$ 3,288	$ -	$ -	$ 3,288
Fixed annuity	$ 1,944	$ 1,944	$ -	$ -	$ 1,944
Bank-owned life insurance	$ 17,568	$ 17,568	$ -	$ -	$ 17,568
Financial liabilities:					
Deposits	$ 532,383	$ 352,996	$ -	$ 177,809	$ 530,805
Short-term borrowings	$ 20,355	$ 20,355	$ -	$ -	$ 20,355
Other borrowed funds	$ 53,721	$ -	$ -	$ 53,936	$ 53,936
Accrued interest payable	$ 456	$ 456	$ -	$ -	$ 456

	2017				
	Carrying Value	Level I	Level II	Level III	Total Fair Value
Financial assets:					
Cash and cash equivalents	$ 8,087	$ 8,087	$ -	$ -	$ 8,087
Investment securities available for sale	$ 91,739	$ 2,000	$ 89,739	$ -	$ 91,739
Equity securities	$ 487	$ 487	$ -	$ -	$ 487
Net loans	$ 502,752	$ -	$ -	$ 498,717	$ 498,717
Accrued interest receivable	$ 2,035	$ 2,035	$ -	$ -	$ 2,035
Regulatory stock	$ 3,064	$ 3,064	$ -	$ -	$ 3,064
Fixed annuity	$ 1,887	$ 1,887	$ -	$ -	$ 1,887
Bank-owned life insurance	$ 15,976	$ 15,976	$ -	$ -	$ 15,976
Financial liabilities:					
Deposits	$ 498,232	$ 334,149	$ -	$ 162,727	$ 496,876
Short-term borrowings	$ 32,544	$ 32,544	$ -	$ -	$ 32,544
Other borrowed funds	$ 42,326	$ -	$ -	$ 42,823	$ 42,823
Accrued interest payable	$ 288	$ 288	$ -	$ -	$ 288

NOTE 18 - FAIR VALUE DISCLOSURE (continued)

Financial instruments are defined as cash, evidence of ownership interest in an entity, or a contract which creates an obligation or right to receive or deliver cash or another financial instrument from/to a second entity on potentially favorable or unfavorable terms.

Fair value is defined as the amount at which a financial instrument could be exchanged in a current transaction between willing parties other than in a forced or liquidation sale. If a quoted market price is available for a financial instrument, the estimated fair value would be calculated based upon the market price per trading unit of the instrument.

If no readily available market exists, the fair value estimates for financial instruments should be based upon management's judgment regarding current economic conditions, interest rate risk, expected cash flows, future estimated losses and other factors as determined through various option pricing formulas or simulation modeling.

As many of these assumptions result from judgments made by management based upon estimates that are inherently uncertain, the resulting estimated fair values may not be indicative of the amount realizable in the sale of a particular financial instrument. In addition, changes in assumptions on which the estimated fair values are based may have a significant impact on the resulting estimated fair values.

As certain assets such as deferred tax assets and premises and equipment are not considered financial instruments, the estimated fair value of financial instruments would not represent the full value of the Company.

NOTE 19 – ACCUMULATED OTHER COMPREHENSIVE INCOME

The following table presents the changes in accumulated other comprehensive income by component net of tax for the years ended December 31, 2018, 2017 and 2016 (in thousands):

	Unrealized (losses) gains on available for sale securities [1]
Balance as of December 31, 2015	$ 1,029
Other comprehensive loss before reclassification	(765)
Amount reclassified from accumulated other comprehensive income	115
Total other comprehensive loss	(650)
Balance as of December 31, 2016	$ 379
Other comprehensive gain before reclassification	154
Amount reclassified from accumulated other comprehensive loss	(105)
Reclassification of certain income tax effects due to decrease in federal corporate income tax rate	84
Total other comprehensive loss	49
Balance as of December 31, 2017	$ 512
Other comprehensive loss before reclassification	(467)
Amount reclassified from accumulated other comprehensive loss	15
Reclassification due to FASB ASU 2016-01	(187)
Total other comprehensive loss	(452)
Balance as of December 31, 2018	$ (127)

[1] All amounts are net of tax. Amounts in parentheses indicate debits.

NOTE 19 – ACCUMULATED OTHER COMPREHENSIVE INCOME (continued)

The following table presents amounts reclassified out of each component of other comprehensive income for the years ended December 31, 2018, 2017 and 2016 (in thousands):

	Amount reclassified from accumulated other comprehensive income [1]			Affected line item in the consolidated statement of income
	2018	2017	2016	
Unrealized gains (loss) on available for sale securities	$ 19	$ 159	$ (173)	Investment securities gains (loss), net
	(4)	(54)	58	Income taxes
	$ 15	$ 105	$ (115)	Net of taxes

[1] Amounts in parentheses indicate debits.

NOTE 20 – QUALIFIED AFFORDABLE HOUSING PROJECT INVESTMENTS

The Company invests in qualified affordable housing projects. At December 31, 2018 and 2017, the balance of the investment for qualified affordable housing projects was $4.7 million and $5.3 million. These balances are reflected in the other assets line on the consolidated balance sheet. The unfunded commitments related to the investments in qualified affordable housing projects totaled $30 thousand at December 31, 2018 and $31 thousand at December 31, 2017.

During the years ended December 31, 2018, 2017 and 2016, the Company recognized investment loss with respect to its investment in qualified affordable housing projects of $616 thousand, $383 thousand and $131 thousand, respectively, which was included within pretax income on the consolidated statement of income. Additionally, during the year ended December 31, 2018, the Company recognized tax credits and other benefits from its investment in affordable housing tax credits of $731 thousand and for years ended December 31, 2017 and 2016, $459 thousand.

NOTE 21 – SUBSEQUENT EVENTS

The Company assessed events occurring subsequent to December 31, 2018 through March 13, 2019, for potential recognition and disclosure in the consolidated financial statements. No other events have occurred that would require adjustment to or disclosure in the consolidated financial statements.