FIDELITY D & D BANCORP INC
Form 10-Q
August 08, 2018
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended June 30, 2018

OR

[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE

SECURITIES EXCHANGE ACT OF 1934

For the transition period from ______________to______________________

Commission file number: 001-38229

FIDELITY D & D BANCORP, INC.

STATE OF INCORPORATION: IRS EMPLOYER IDENTIFICATION NO:

PENNSYLVANIA 23-3017653

Address of principal executive offices:

BLAKELY & DRINKER ST.

DUNMORE, PENNSYLVANIA 18512

TELEPHONE:

570-342-8281

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

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

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

Large accelerated filer [ ]	Accelerated filer [X]
Non-accelerated filer [ ]	Smaller reporting company [ ]
(Do not check if a smaller reporting company)	Emerging growth company [ ]

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

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

[ ] YES [X] NO

The number of outstanding shares of Common Stock of Fidelity D & D Bancorp, Inc. on July 31, 2018, the latest practicable date, was 3,752,005 shares.

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FIDELITY D & D BANCORP, INC.

Form 10-Q June 30, 2018

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PART I – Financial Information

Item 1: Financial Statements

Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Balance Sheets
(Unaudited)

(dollars in thousands)	June 30, 2018	December 31, 2017
Assets:		
Cash and due from banks	$ 15,903	$ 14,143
Interest-bearing deposits with financial institutions	2,069	1,682
Total cash and cash equivalents	17,972	15,825
Available-for-sale securities	164,403	157,385
Federal Home Loan Bank stock	3,490	2,832
Loans and leases, net (allowance for loan losses of $9,527 in 2018; $9,193 in 2017)	676,161	628,767
Loans held-for-sale (fair value $1,328 in 2018, $2,221 in 2017)	1,305	2,181
Foreclosed assets held-for-sale	539	973
Bank premises and equipment, net	16,189	16,576
Cash surrender value of bank owned life insurance	20,315	20,017
Accrued interest receivable	3,130	2,786
Goodwill	209	209
Other assets	18,888	16,086
Total assets	$ 922,601	$ 863,637
Liabilities:		
Deposits:		
Interest-bearing	$ 565,894	$ 551,515
Non-interest-bearing	212,364	178,631
Total deposits	778,258	730,146
Accrued interest payable and other liabilities	7,234	6,402
Short-term borrowings	29,553	18,502
FHLB advances	18,704	21,204
Total liabilities	833,749	776,254
Shareholders' equity:		
Preferred stock authorized 5,000,000 shares with no par value; none issued	-	-
Capital stock, no par value (10,000,000 shares authorized; shares issued and outstanding; 3,752,005 in 2018; and 3,734,478 in 2017)	29,016	28,361
Retained earnings	61,119	57,218
Accumulated other comprehensive (loss) income	(1,283)	1,804
Total shareholders' equity	88,852	87,383
Total liabilities and shareholders' equity	$ 922,601	$ 863,637

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Income

(Unaudited)	Three months ended		Six months ended	
(dollars in thousands except per share data)	June 30, 2018	June 30, 2017	June 30, 2018	June 30, 2017
Interest income:				
Loans and leases:				
Taxable	$ 7,029	$ 6,566	$ 13,728	$ 12,726
Nontaxable	221	217	433	427
Interest-bearing deposits with financial institutions	42	4	84	10
Restricted regulatory securities	38	37	78	56
Investment securities:				
U.S. government agency and corporations	803	658	1,578	1,277
States and political subdivisions (nontaxable)	396	367	766	713
Other securities	6	5	11	11
Total interest income	8,535	7,854	16,678	15,220
Interest expense:				
Deposits	886	643	1,690	1,229
Securities sold under repurchase agreements	3	5	10	12
Other short-term borrowings and other	57	80	64	137
FHLB advances	66	59	132	97
Total interest expense	1,012	787	1,896	1,475
Net interest income	7,523	7,067	14,782	13,745
Provision for loan losses	425	225	725	550
Net interest income after provision for loan losses	7,098	6,842	14,057	13,195
Other income:				
Service charges on deposit accounts	540	549	1,093	1,092
Interchange fees	506	425	975	825
Fees from trust fiduciary activities	326	308	727	503
Fees from financial services	195	119	372	265
Service charges on loans	136	176	307	396
Fees and other revenue	247	229	479	439
Earnings on bank-owned life insurance	146	157	298	264
Gain (loss) on sale or disposal of:				
Loans	168	168	354	452
Available-for-sale debt securities	-	-	6	-
Equity securities	107	-	44	-
Premises and equipment	-	-	(1)	-
Total other income	2,371	2,131	4,654	4,236
Other expenses:				
Salaries and employee benefits	3,420	3,239	6,787	6,324
Premises and equipment	929	912	1,897	1,897
Advertising and marketing	217	345	621	580

Professional services	480	528	882	926
Data processing and communication	368	280	722	583
Automated transaction processing	193	184	378	358
Office supplies and postage	104	107	208	230
FDIC assessment	65	68	133	133
PA shares tax	195	47	236	211
Loan collection	28	47	51	107
Other real estate owned	5	109	65	146
Other	158	185	390	353
Total other expenses	6,162	6,051	12,370	11,848
Income before income taxes	3,307	2,922	6,341	5,583
Provision for income taxes	539	739	1,045	1,420
Net income	$ 2,768	$ 2,183	$ 5,296	$ 4,163
Per share data (1):				
Net income - basic	$ 0.74	$ 0.59	$ 1.41	$ 1.12
Net income - diluted	$ 0.73	$ 0.59	$ 1.40	$ 1.12
Dividends	$ 0.24	$ 0.21	$ 0.48	$ 0.41

See notes to unaudited consolidated financial statements

(1) On August 15, 2017, the Company declared a three-for-two stock split effected in the form of a 50% stock dividend. Per share data for the three and six months ended June 30, 2017 has been restated for the effects thereof.

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Fidelity D & D Bancorp, Inc. and Subsidiary

Consolidated Statements of Comprehensive Income (Unaudited) (dollars in thousands)	Three months ended June 30, 2018	2017	Six months ended June 30, 2018	2017
Net income	$ 2,768	$ 2,183	$ 5,296	$ 4,163
Other comprehensive (loss) income, before tax:				
Unrealized holding (loss) gain on available-for-sale debt securities	(892)	687	(3,369)	714
Reclassification adjustment for net gains realized in income	-	-	(6)	-
Net unrealized (loss) gain	(892)	687	(3,375)	714
Tax effect	188	(234)	709	(243)
Unrealized (loss) gain, net of tax	(704)	453	(2,666)	471
Other comprehensive (loss) income, net of tax	(704)	453	(2,666)	471
Total comprehensive income, net of tax	$ 2,064	$ 2,636	$ 2,630	$ 4,634

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Changes in Shareholders' Equity
For the six months ended June 30, 2018 and 2017
(Unaudited)

(dollars in thousands)	Capital stock Shares	Amount	Retained earnings	Accumulated other comprehensive income (loss)	Total
Balance, December 31, 2016	2,453,805	$ 27,155	$ 52,095	$ 1,381	$ 80,631
Net income			4,163		4,163
Other comprehensive income				471	471
Issuance of common stock through Employee Stock Purchase Plan	4,085	126			126
Issuance of common stock through Dividend Reinvestment Plan	2,478	90			90
Issuance of common stock from vested restricted share grants through stock compensation plans	9,657				
Issuance of common stock through exercise of stock options	519	15			15
Stock-based compensation expense		179			179
Cash dividends declared			(1,539)		(1,539)
Balance, June 30, 2017	2,470,544	$ 27,565	$ 54,719	$ 1,852	$ 84,136
Balance, December 31, 2017	3,734,478	$ 28,361	$ 57,218	$ 1,804	$ 87,383
Net income			5,296		5,296
Other comprehensive loss				(2,666)	(2,666)
Effect of adopting ASU 2016-01			421	(421)	-
Issuance of common stock through Employee Stock Purchase Plan	6,783	149			149
Issuance of common stock from vested restricted share grants through stock compensation plans	9,994				
Issuance of common stock through exercise of stock options	750	14			14
Stock-based compensation expense		492			492
Cash dividends declared			(1,816)		(1,816)
Balance, June 30, 2018	3,752,005	$ 29,016	$ 61,119	$ (1,283)	$ 88,852

See notes to unaudited consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows

(Unaudited)	Six months ended June 30,	
(dollars in thousands)	2018	2017
Cash flows from operating activities:		
Net income	$ 5,296	$ 4,163
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation, amortization and accretion	1,504	1,528
Provision for loan losses	725	550
Deferred income tax expense	511	585
Stock-based compensation expense	432	288
Excess tax benefit from exercise of stock options	4	1
Proceeds from sale of loans held-for-sale	16,452	20,700
Originations of loans held-for-sale	(15,134)	(17,279)
Earnings from bank-owned life insurance	(298)	(264)
Net gain from sales of loans	(354)	(452)
Net gain from sales of investment securities	(50)	-
Net loss from sale and write-down of foreclosed assets held-for-sale	13	75
Net loss from disposal of equipment	1	-
Change in:		
Accrued interest receivable	(344)	(456)
Other assets	(2,104)	(3,542)
Accrued interest payable and other liabilities	892	938
Net cash provided by operating activities	7,546	6,835
Cash flows from investing activities:		
Available-for-sale securities:		
Proceeds from sales	11,425	-
Proceeds from maturities, calls and principal pay-downs	10,397	8,285
Purchases	(32,734)	(31,487)
Increase in FHLB stock	(658)	(1,423)
Net increase in loans and leases	(49,115)	(39,785)
Purchase of life insurance policies	-	(8,000)
Purchases of bank premises and equipment	(821)	(472)
Net cash acquired in acquisition of bank branch	-	11,817
Proceeds from sale of bank premises and equipment	-	6
Proceeds from sale of foreclosed assets held-for-sale	1,097	463
Net cash used in investing activities	(60,409)	(60,596)
Cash flows from financing activities:		
Net increase (decrease) in deposits	48,112	(9,832)

Net increase in short-term borrowings	11,051	30,232
Proceeds from issuance of FHLB advances	-	23,704
Repayment of FHLB advances	(2,500)	-
Proceeds from employee stock purchase plan participants	149	126
Exercise of stock options	14	15
Dividends paid, net of dividends reinvested	(1,816)	(1,450)
Net cash provided by financing activities	55,010	42,795
Net increase (decrease) in cash and cash equivalents	2,147	(10,966)
Cash and cash equivalents, beginning	15,825	25,843
Cash and cash equivalents, ending	$ 17,972	$ 14,877

See notes to consolidated financial statements

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Fidelity D & D Bancorp, Inc. and Subsidiary
Consolidated Statements of Cash Flows (continued)

(Unaudited)	Six months ended June 30,	
(dollars in thousands)	2018	2017
Supplemental Disclosures of Cash Flow Information		
Cash payments for:		
Interest	$ 1,838	$ 1,319
Income tax	-	900
Supplemental Disclosures of Non-cash Investing Activities:		
Net change in unrealized gains on available-for-sale securities	(3,375)	714
Transfers from loans to foreclosed assets held-for-sale	676	202
Transfers from loans to loans held-for-sale	320	2,318
Acquisition of West Scranton Branch from Wayne Bank		
Non-cash assets acquired:		
Loans		$ 1,574
Bank premises and equipment		264
Goodwill		209
Accrued interest receivable and other assets		4
Total non-cash assets acquired		$ 2,051
Liabilities assumed:		
Deposits		$ 13,809
Accrued interest payable and other liabilities		59
Total liabilities assumed		$ 13,868

See notes to unaudited consolidated financial statements

FIDELITY D & D BANCORP, INC.

Notes to Consolidated Financial Statements

(Unaudited)

1. Nature of operations and critical accounting policies

Nature of operations

Fidelity Deposit and Discount Bank (the Bank) is a commercial bank chartered under the law of the Commonwealth of Pennsylvania and a wholly-owned subsidiary of Fidelity D & D Bancorp, Inc. (collectively, the Company). Having commenced operations in 1903, the Bank is committed to provide superior customer service, while offering a full range of banking products and financial and trust services to both our consumer and commercial customers from our main office located in Dunmore and other branches located throughout Lackawanna and Luzerne Counties.

Principles of consolidation

The accompanying unaudited consolidated financial statements of the Company and the Bank have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP) for interim financial information and with the instructions to this Form 10-Q and Rule 8-03 of Regulation S-X. Accordingly, they do not include all of the information and footnote disclosures required by GAAP for complete financial statements. In the opinion of management, all normal recurring adjustments necessary for a fair presentation of the financial condition and results of operations for the periods have been included. All significant inter-company balances and transactions have been eliminated in consolidation.

For additional information and disclosures required under GAAP, refer to the Company's Annual Report on Form 10-K for the year ended December 31, 2017.

Management is responsible for the fairness, integrity and objectivity of the unaudited financial statements included in this report. Management prepared the unaudited financial statements in accordance with GAAP. In meeting its responsibility for the financial statements, management depends on the Company's accounting systems and related internal controls. These systems and controls are designed to provide reasonable but not absolute assurance that the financial records accurately reflect the transactions of the Company, the Company's assets are safeguarded and that the financial statements present fairly the financial condition and results of operations of the Company.

In the opinion of management, the consolidated balance sheets as of June 30, 2018 and December 31, 2017 and the related consolidated statements of income and consolidated statements of comprehensive income for the three and six months ended June 30, 2018 and 2017, and consolidated statements of changes in shareholders' equity and consolidated statements of cash flows for the six months ended June 30, 2018 and 2017 present fairly the financial condition and results of operations of the Company. All material adjustments required for a fair presentation have been made. These adjustments are of a normal recurring nature. Certain reclassifications have been made to the 2017 financial statements to conform to the 2018 presentation.

On August 15, 2017, the Company declared a three-for-two stock split effected in the form of a 50% stock dividend on its common stock outstanding to shareholders as of September 18, 2017 and distributed on September 28, 2017. All share and per share information included in the accompanying consolidated financial statements and footnotes has been retroactively adjusted to reflect this stock split.

In preparing these consolidated financial statements, the Company evaluated the events and transactions that occurred after June 30, 2018 through the date these consolidated financial statements were issued.

This Quarterly Report on Form 10-Q should be read in conjunction with the Company's audited financial statements for the year ended December 31, 2017, and the notes included therein, included within the Company's Annual Report filed on Form 10-K.

Critical accounting policies

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported periods. Actual results could differ from those estimates.

A material estimate that is particularly susceptible to significant change relates to the determination of the allowance for loan losses. Management believes that the allowance for loan losses at June 30, 2018 is adequate and reasonable. Given the subjective nature of identifying and estimating loan losses, it is likely that well-informed individuals could make different assumptions and could, therefore, calculate a materially different allowance amount. While management uses available information to recognize losses on loans, changes in economic conditions may necessitate revisions in the future. In addition, various regulatory agencies, as an integral part of their examination process, periodically review the Company's allowance for loan losses. Such agencies may require the Company to recognize adjustments to the allowance based on their judgment of information available to them at the time of their examination.

Another material estimate is the calculation of fair values of the Company's investment securities. Fair values of investment securities are determined by pricing provided by a third-party vendor, who is a provider of financial market data, analytics and related services to financial institutions. Based on experience, management is aware that estimated fair values of investment securities tend to vary among valuation services. Accordingly, when selling investment securities, price quotes may be obtained from more than one source. All of the Company's debt securities are classified as available-for-sale (AFS). AFS debt securities are carried at fair value on the consolidated balance sheets, with unrealized gains and losses, net of income tax, reported separately within shareholders' equity as a component of accumulated other comprehensive income (AOCI).

The fair value of residential mortgage loans, classified as held-for-sale (HFS), is obtained from the Federal National Mortgage Association (FNMA) or the Federal Home Loan Bank (FHLB). Generally, the market to which the Company sells residential mortgages it originates for sale is restricted and price quotes from other sources are not typically obtained. On occasion, the Company may transfer loans from the loan portfolio to loans HFS. Under these circumstances, pricing may be obtained from other entities and the residential mortgage loans are transferred at the lower of cost or market value and simultaneously sold. For other loans transferred to HFS, pricing may be obtained from other entities or modeled and the other loans are transferred at the lower of cost or market value and then sold. As of June 30, 2018 and December 31, 2017, loans classified as HFS consisted of residential mortgage loans.

Financing of automobiles, provided to customers under lease arrangements of varying terms, are accounted for as direct finance leases. Interest income on automobile direct finance leasing is determined using the interest method to arrive at a level effective yield over the life of the lease.

Foreclosed assets held-for-sale includes other real estate acquired through foreclosure (ORE) and may, from time-to-time, include repossessed assets such as automobiles. ORE is carried at the lower of cost (principal balance at date of foreclosure) or fair value less estimated cost to sell. Any write-downs at the date of foreclosure are charged to the allowance for loan losses. Expenses incurred to maintain ORE properties, subsequent write downs to the asset's fair value, any rental income received and gains or losses on disposal are included as components of other real estate owned expense in the consolidated statements of income.

Goodwill is recorded on the consolidated balance sheets as the excess of liabilities assumed over identifiable assets acquired on the acquisition date. Goodwill is recorded at its net carrying value which represents estimated fair value. The goodwill is deductible for tax purposes over a 15 year period.

The Company holds separate supplemental executive retirement (SERP) agreements for certain officers and an amount is credited to each participant's SERP account monthly while they are actively employed by the bank until retirement. A deferred tax asset is provided for the non-deductible SERP expense. The Company also entered into separate split dollar life insurance arrangements with three executives providing post-retirement benefits and accrues monthly expense for this benefit. The split dollar life insurance expense is not deductible for tax purposes. Monthly expenses for the SERP and post-retirement split dollar life benefit are recorded as components of salaries and employee benefit expense on the consolidated statements of income.

For purposes of the consolidated statements of cash flows, cash and cash equivalents includes cash on hand, amounts due from banks and interest-bearing deposits with financial institutions. Expenditures for construction in process, a component of other assets in the consolidated balance sheets, are included in acquisition of premises and equipment.

Revenue Recognition

As of January 1, 2018, the Company adopted ASU 2014-09, Revenue from Contracts with Customers (Topic 606) and all subsequent ASUs that modified Topic 606. The Company has elected to use the modified retrospective approach

with prior period financial statements unadjusted and presented with historical revenue recognition methods. The implementation of the new standard had no material impact on the measurement or recognition of revenue; as such, a cumulative effect adjustment to opening retained earnings was not deemed necessary.

The majority of the Company's revenues are generated through interest earned on securities and loans, which is explicitly excluded from the scope of the guidance. In addition, certain non-interest income streams such as fees associated with mortgage servicing rights, loan service charges, life insurance earnings, rental income and gains/losses on the sale of loans and securities are not in the scope of the new guidance. The main types of contracts with customers that are in the scope of the new guidance are:

- Service charges on deposit accounts – Deposit service charges represent fees charged by the Company for the performance obligation of providing services to a customer's deposit account. The transaction price for deposit services includes both fixed and variable amounts based on the Company's fee schedules. Revenue is recognized and payment is received either at a point in time for transactional fees or on a monthly basis for non-transactional fees.
- Interchange fees – Interchange fees represent fees charged by the Company for customers using debit cards. The contract is between the Company and the processor and the performance obligation is the ability of customers to use debit cards to make purchases at a point in time. The transaction price is a percentage of debit card usage and the processor pays the Company and revenue is recorded throughout the month as the performance obligations are being met.

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- Fees from trust fiduciary activities – Trust fees represent fees charged by the Company for the management, custody and/or administration of trusts. These are mostly monthly fees based on the market value of assets in the trust account at the prior month end. Payment is generally received a few weeks after month end through a direct charge to customers' accounts. Estate fees are recognized and charged as the Company reaches each of six different stages of the estate administration process.
- Fees from financial services – Financial service fees represent fees charged by the Company for the performance obligation of providing various services for an investment account. Revenue is recognized twice monthly for fees on sales transactions and on a monthly basis for advisory fees and quarterly for trail fees.
- Gain/loss on ORE sales – Gain/loss on the sale of ORE is recognized at the closing date when the sales proceeds are received. In seller-financed ORE transactions, the contract is made subject to our normal underwriting standards and pricing. The Company does not have any obligation or right to repurchase any sales of ORE.

Contract balances

A contract asset balance occurs when an entity performs a service for a customer before the customer pays consideration (resulting in a contract receivable) or before the payment is due (resulting in a contract asset). A contract liability balance is an entity's obligation to transfer a service to a customer for which the entity already received payment (or payment is due) from the customer. The Company's non-interest income streams are largely based on transactional activity, or standard month-end revenue accruals such as asset management fees based on month-end market values. Consideration is often received immediately or shortly after the Company satisfies its performance obligation and revenue is recognized. The Company typically does not enter into long-term revenue contracts with customers, and therefore, does not experience significant contract balances. As of June 30, 2018 and December 31, 2017, the Company did not have any significant contract balances.

Remaining performance obligations

The Company's performance obligations have an original expected duration of less than one year and follow the relevant guidance for recognizing revenue over time. There is no variable consideration subject to constraint that is not included in information about transaction price.

Contract acquisition costs

In connection with the adoption of Topic 606, an entity is required to capitalize and subsequently amortize into expense, certain incremental costs of obtaining a contract if these costs are expected to be recovered. The incremental costs of obtaining a contract are those costs that an entity incurs to obtain a contract with a customer that it would not have incurred if the contract had not been obtained (for example, sales commission). The Company utilizes the practical expedient which allows entities to immediately expense contract acquisition costs when the asset that would have resulted from capitalizing these costs would have been amortized in one year or less. Upon adoption of Topic 606, the Company did not capitalize any contract acquisition costs.

2. New accounting pronouncements

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standard Update (ASU) 2016-13, Financial Instruments – Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments. The amendments in this update require financial assets measured at amortized cost basis to be presented at the net amount expected to be collected, through an allowance for credit losses that is deducted from the amortized cost basis. Previously, when credit losses were measured under GAAP, an entity only considered past events and current conditions when measuring the incurred loss. The amendments in this update broaden the information that an entity must consider in developing its expected credit loss estimate for assets measured either collectively or individually. The measurement of expected credit losses is based on relevant information about past events, including

historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amount. An entity must use judgement in determining the relevant information and estimation methods that are appropriate under the circumstances. The amendments in this update also require that credit losses on available-for-sale debt securities be presented as an allowance for credit losses rather than a writedown. The amendments in this update are effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2019 for public companies. Early adoption is permitted beginning after December 15, 2018, including interim periods within those fiscal years. An entity will apply the amendments in this update through a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption (modified-retrospective approach). Upon adoption, the change in this accounting guidance could result in an increase in the Company's allowance for loan losses and require the Company to record loan losses more rapidly. The Company is currently evaluating the impact of ASU 2016-13 on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers, which supersedes nearly all existing revenue recognition guidance under U.S. GAAP. The core principle of ASU 2014-09 is to recognize revenues when promised goods or services are transferred to customers in an amount that reflects the consideration to which an entity expects to be entitled for those goods or services. ASU 2014-09 defines a five step process to achieve this core principle and, in doing so, more judgment and estimates may be required within the revenue recognition process than are required under existing U.S. GAAP: identify the contract(s) with a customer; identify the performance obligations in the contract; determine the transaction price; allocate the

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transaction price to the performance obligations in the contract; recognize revenue when (or as) the entity satisfies a performance obligation.

The Company adopted this guidance on January 1, 2018 using the modified retrospective approach. The adoption of ASU 2014-09 did not materially change the method in which the Company recognizes revenue. As a result, the Company changed the process for recognizing revenue for estate fees within fees from trust fiduciary services. The Company concluded the cumulative adjustment to retained earnings for estates in process was immaterial and the income was recognized during the first quarter of 2018. See "Revenue Recognition" in footnote 1 for more information.

In January 2016, the FASB issued ASU 2016-01 related to Financial Instruments - Overall (Subtopic 825-10) Recognition and Measurement of Financial Assets and Financial Liabilities. The update applies to all entities that hold financial assets or owe financial liabilities. The amendments in this update make targeted improvements to U.S. GAAP as follows:

- Require equity investments to be measured at fair value with changes in fair value recognized in net income;
- Simplify the impairment assessment of equity investments without readily determinable fair values by requiring a qualitative assessment to identify impairment;
- Require public business entities to use the exit price notion when measuring fair value of financial instruments for disclosure purposes;
- Require separate presentation of financial assets and financial liabilities by measurement category and form of financial asset;
- Clarify that an entity should evaluate the need for a valuation allowance on a deferred tax asset related to available-for-sale securities.

The Company adopted this guidance on January 1, 2018. The adoption did not have a material impact on the consolidated financial statements. As a result of this guidance, the Company reclassified $0.4 million in net unrealized gains on equity securities from accumulated other comprehensive income to retained earnings on January 1, 2018 and the Company measured the fair value of its loan portfolio using the exit price notion. See "Fair Value Measurements" in footnote 8 for more information about the fair value measurement of the loan portfolio.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) to increase transparency and comparability among organizations by recognizing lease assets and lease liabilities on the balance sheet and disclosing key information about leasing arrangements. ASU 2016-02 requires the recognition of a right-of-use asset and related lease liability by lessees for leases classified as operating leases under GAAP. The Company is expected to make an election to exclude leases less than 12 months from the provisions of this ASU. The amendments in this update are effective for the Company for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. Early adoption of the amendments in this update is permitted. A modified retroactive approach must be applied for leases existing at, or entered into after, the beginning of the earliest comparative period. The Company has several lease agreements, such as branch locations, which are currently considered operating leases, and therefore not recognized on the Company's consolidated balance sheets. Therefore, the adoption of ASU 2016-02 is expected to impact the Company's consolidated balance sheets, along with our regulatory capital ratios. Upon adoption, this change in accounting guidance could also potentially impact debt covenant agreements with our customers. The Company is currently evaluating the amount of the impact of ASU 2016-02 on its consolidated financial statements.

In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, Leases and ASU 2018-11, Leases (Topic 842) Targeted Improvements to clarify how to apply certain aspects of ASU 2016-02 and to simplify adoption and reduce costs. ASU 2018-11 allows companies the option to apply the provisions of the new lease standard prospectively as of the effective date, without adjusting comparative periods, and recognizes a cumulative-effect adjustment to the opening balance of retained earnings in the period of adoption. The Company

anticipates using this additional transition method. The amendments in this update are effective upon adoption of Topic 842.

In August 2016, the FASB released ASU 2016-15, Statement of Cash Flows (Topic 230) to clarify the presentation of certain cash receipts and payments on the statement of cash flows. The update addressed eight specific cash flow issues with the objective of reducing the existing diversity in practice. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2017, and interim periods within those fiscal years. Early adoption is permitted, including adoption in an interim period. The amendments in this update should be applied using a retrospective transition method to each period presented. The Company adopted ASU 2016-15 on January 1, 2018 and it did not have a significant impact on the Company's consolidated financial statements.

In January 2017, the FASB issued ASU 2017-04, Intangibles-Goodwill and Other (Topic 350) to simplify the test for goodwill impairment. To simplify the subsequent measurement of goodwill, the FASB eliminated Step 2 from the goodwill impairment test. Under the amendments in this update, an entity should perform its annual goodwill impairment test by comparing the fair value of a reporting unit with its carrying amount. An entity should recognize an impairment charge for the amount by which the carrying amount exceeds the reporting units fair value; however, the loss recognized should not exceed the total amount of goodwill allocated to that reporting unit. An entity should apply the amendments in his update on a prospective basis. The amendments in this update are effective for the Company for its annual goodwill impairment tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company adopted this standard in 2017 and it did not have an impact on its consolidated financial statements. The Company did not have any

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goodwill prior to adoption of this update.

In March 2017, the FASB issued ASU 2017-08, Receivables-Nonrefundable Fees and Other Costs (Subtopic 310-20) Premium Amortization on Purchased Callable Debt Securities to amend the amortization period for certain purchased callable debt securities held at a premium. The amendments in this update shorten the amortization period for the premium to the earliest call date. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2018. Early adoption is permitted, including adoption in an interim period. An entity should apply the amendments in this update on a modified retrospective basis through a cumulative effect adjustment directly to retained earnings as of the beginning of the period of adoption. The Company adopted this standard in 2017 and it did not have an effect on its consolidated financial statements.

In February 2018, the FASB released ASU 2018-02, Income Statement – Reporting Comprehensive Income (Topic 220) to allow a reclassification from accumulated other comprehensive income to retained earnings for stranded tax effects resulting from the Tax Act. The amendments in this update also require certain disclosures about stranded tax effects. The guidance is effective for all entities for fiscal years beginning after December 15, 2018, and interim periods within those fiscal years. Early adoption is permitted for periods for which financial statements have not yet been issued or available for issuance, including in the period the Act was enacted. The Company elected to early adopt and reclassify the stranded income tax effects of the Act from accumulated other comprehensive income to retained earnings during the fourth quarter of 2017. The reclassification increased AOCI and decreased retained earnings by $0.3 million, with zero net effect on total shareholders' equity.

3. Accumulated other comprehensive income

The following tables illustrate the changes in accumulated other comprehensive income by component and the details about the components of accumulated other comprehensive income as of and for the periods indicated:

As of and for the six months ended June 30, 2018

(dollars in thousands)	Unrealized gains (losses) on available-for-sale debt securities
Beginning balance	$ 1,804
Other comprehensive loss before reclassifications, net of tax	(2,661)
Amounts reclassified from accumulated other comprehensive income, net of tax	(5)
Effect of adopting ASU 2016-01, net of tax*	(421)
Net current-period other comprehensive loss	(3,087)
Ending balance	$ (1,283)

*The Company adopted ASU 2016-01 on January 1, 2018. As a result, unrealized gains on equity securities were reclassified from accumulated other comprehensive income to retained earnings.

As of and for the three months ended June 30, 2018

Unrealized gains
(losses) on

(dollars in thousands)	available-for-sale debt securities
Beginning balance	$ (579)
Other comprehensive loss before reclassifications, net of tax	(704)
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	(704)
Ending balance	$ (1,283)

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As of and for the six months ended June 30, 2017

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities
Beginning balance	$ 1,381
Other comprehensive income before reclassifications, net of tax	471
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	471
Ending balance	$ 1,852

As of and for the three months ended June 30, 2017

(dollars in thousands)	Unrealized gains (losses) on available-for-sale securities
Beginning balance	$ 1,399
Other comprehensive income before reclassifications, net of tax	453
Amounts reclassified from accumulated other comprehensive income, net of tax	-
Net current-period other comprehensive income	453
Ending balance	$ 1,852

Details about accumulated other comprehensive income components (dollars in thousands)	Amount reclassified from accumulated other comprehensive income				Affected line item in the statement where net income is presented
	For the three months ended June 30,		For the six months ended June 30,		
	2018	2017	2018	2017	
Unrealized gains on AFS debt securities	$ -	$ -	$ 6	$ -	Gain on sale of investment securities
Income tax effect	-	-	(1)	-	Provision for income taxes

Total reclassifications for the period	$ -	$ -	$ 5	$ -	Net income

4. Investment securities

Agency – Government-sponsored enterprise (GSE) and MBS - GSE residential

Agency – GSE and MBS – GSE residential securities consist of short- to long-term notes issued by Federal Home Loan Mortgage Corporation (FHLMC), Federal National Mortgage Association (FNMA), Federal Home Loan Bank (FHLB) and Government National Mortgage Association (GNMA). These securities have interest rates that are fixed and adjustable, have varying short to long-term maturity dates and have contractual cash flows guaranteed by the U.S. government or agencies of the U.S. government.

Obligations of states and political subdivisions

The municipal securities are bank qualified or bank eligible, general obligation and revenue bonds rated as investment grade by various credit rating agencies and have fixed rates of interest with mid- to long-term maturities. Fair values of these securities are highly driven by interest rates. Management performs ongoing credit quality reviews on these issues.

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The amortized cost and fair value of investment securities at June 30, 2018 and December 31, 2017 are summarized as follows:

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
June 30, 2018				
Available-for-sale debt securities:				
Agency - GSE	$ 5,918	$ 5	$ (46)	$ 5,877
Obligations of states and political subdivisions	45,233	1,336	(208)	46,361
MBS - GSE residential	114,877	231	(2,943)	112,165
Total available-for-sale debt securities	$ 166,028	$ 1,572	$ (3,197)	$ 164,403

(dollars in thousands)	Amortized cost	Gross unrealized gains	Gross unrealized losses	Fair value
December 31, 2017				
Available-for-sale securities:				
Agency - GSE	$ 9,120	$ 3	$ (24)	$ 9,099
Obligations of states and political subdivisions	42,300	2,036	(30)	44,306
MBS - GSE residential	103,386	519	(753)	103,152
Total debt securities	154,806	2,558	(807)	156,557
Equity securities - financial services	294	534	-	828
Total available-for-sale securities	$ 155,100	$ 3,092	$ (807)	$ 157,385

The Company adopted ASU 2016-01, Financial Instruments – Overall (Topic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities effective January 1, 2018. The Company sold all of its equity securities during the first half of 2018.

The amortized cost and fair value of debt securities at June 30, 2018 by contractual maturity are summarized below:

(dollars in thousands)	Amortized cost	Fair value
Available-for-sale securities:		

Debt securities:		
Due in one year or less	$ -	$ -
Due after one year through five years	2,816	2,880
Due after five years through ten years	8,523	8,547
Due after ten years	39,812	40,811
MBS - GSE residential	114,877	112,165
Total available-for-sale debt securities	$ 166,028	$ 164,403

Actual maturities will differ from contractual maturities because issuers and borrowers may have the right to call or repay obligations with or without call or prepayment penalty. Agency – GSE and municipal securities are included based on their original stated maturity. MBS – GSE residential, which are based on weighted-average lives and subject to monthly principal pay-downs, are listed in total. Most of the securities have fixed rates or have predetermined scheduled rate changes and many have call features that allow the issuer to call the security at par before its stated maturity without penalty.

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The following table presents the fair value and gross unrealized losses of debt securities aggregated by investment type, the length of time and the number of securities that have been in a continuous unrealized loss position as of June 30, 2018 and December 31, 2017:

	Less than 12 months		More than 12 months		Total	
(dollars in thousands)	Fair value	Unrealized losses	Fair value	Unrealized losses	Fair value	Unrealized losses
June 30, 2018						
Agency - GSE	$ 4,871	$ (46)	$ -	$ -	$ 4,871	$ (46)
Obligations of states and political subdivisions	9,864	(113)	2,038	(95)	11,902	(208)
MBS - GSE residential	78,856	(1,849)	26,912	(1,094)	105,768	(2,943)
Total	$ 93,591	$ (2,008)	$ 28,950	$ (1,189)	$ 122,541	$ (3,197)
Number of securities	73		21		94	
December 31, 2017						
Agency - GSE	$ 6,020	$ (14)	$ 1,008	$ (10)	$ 7,028	$ (24)
Obligations of states and political subdivisions	425	(1)	2,109	(29)	2,534	(30)
MBS - GSE residential	61,349	(437)	15,309	(316)	76,658	(753)
Total	$ 67,794	$ (452)	$ 18,426	$ (355)	$ 86,220	$ (807)
Number of securities	45		14		59	

The Company had ninety-four debt securities in an unrealized loss position at June 30, 2018, including five agency securities, sixty-seven mortgage-backed securities and twenty-two municipal securities. The severity of these unrealized losses based on their underlying cost basis was as follows at June 30, 2018: 0.94% for agencies; 2.71% for total MBS-GSE; and 1.72% for municipals. Of these securities, seventeen mortgage-backed securities and four municipal securities had been in an unrealized loss position in excess of 12 months. The changes in the prices on these securities in an unrealized loss position in excess of 12 months are the result of interest rate movement and management believes they are temporary in nature.

Management believes the cause of the unrealized losses is related to changes in interest rates, instability in the capital markets or the limited trading activity due to illiquid conditions in the debt market and is not directly related to credit quality. Quarterly, management conducts a formal review of investment securities for the presence of OTTI. The accounting guidance related to OTTI requires the Company to assess whether OTTI is present when the fair value of a debt security is less than its amortized cost as of the balance sheet date. Under those circumstances, OTTI is considered to have occurred if: (1) the entity has intent to sell the security; (2) more likely than not the entity will be required to sell the security before recovery of its amortized cost basis; or (3) the present value of expected cash flows is not sufficient to recover the entire amortized cost. The accounting guidance requires that credit-related OTTI be recognized in earnings while non-credit-related OTTI on securities not expected to be sold be recognized in other comprehensive income (OCI). Non-credit-related OTTI is based on other factors affecting market value, including illiquidity.

The Company's OTTI evaluation process also follows the guidance set forth in topics related to debt securities. The guidance set forth in the pronouncements require the Company to take into consideration current market conditions, fair value in relationship to cost, extent and nature of changes in fair value, issuer rating changes and trends, volatility of earnings, current analysts' evaluations, all available information relevant to the collectability of debt securities, the ability and intent to hold investments until a recovery of fair value which may be to maturity and other factors when evaluating for the existence of OTTI. The guidance requires that credit-related OTTI be recognized as a realized loss through earnings when there has been an adverse change in the holder's expected cash flows such that the full amount (principal and interest) will probably not be received. This requirement is consistent with the impairment model in the guidance for accounting for debt securities.

For all security types, as of June 30, 2018, the Company applied the criteria provided in the recognition and presentation guidance related to OTTI. That is, management has no intent to sell the securities and no conditions were identified by management that, more likely than not, would require the Company to sell the securities before recovery of their amortized cost basis. The results indicated there was no presence of OTTI in the Company's security portfolio. In addition, management believes the change in fair value is attributable to changes in interest rates.

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5. Loans and leases

The classifications of loans and leases at June 30, 2018 and December 31, 2017 are summarized as follows:

(dollars in thousands)	June 30, 2018	December 31, 2017
Commercial and industrial	$ 126,006	$ 113,601
Commercial real estate:		
Non-owner occupied	90,494	92,851
Owner occupied	113,103	109,383
Construction	5,988	6,228
Consumer:		
Home equity installment	29,017	27,317
Home equity line of credit	53,911	53,273
Auto loans and leases	105,588	83,510
Other	5,744	5,604
Residential:		
Real estate	144,864	136,901
Construction	11,831	9,931
Total	686,546	638,599
Less:		
Allowance for loan losses	(9,527)	(9,193)
Unearned lease revenue	(858)	(639)
Loans and leases, net	$ 676,161	$ 628,767

Net deferred loan costs of $2.4 million and $2.1 million have been included in the carrying values of loans at June 30, 2018 and December 31, 2017, respectively.

Unearned lease revenue represents the difference between the lessor's investment in the property and the gross investment in the lease. Unearned revenue is accrued over the life of the lease using the effective interest method. The residual value of leases is fully guaranteed by the dealerships. Residual values, a component of other assets on the balance sheet, amounted to $10.4 million and $9.4 million at June 30, 2018 and December 31, 2017, respectively.

The Company services real estate loans for investors in the secondary mortgage market which are not included in the accompanying consolidated balance sheets. The approximate unpaid principal balance of mortgages serviced amounted to $302.3 million as of June 30, 2018 and $299.3 million as of December 31, 2017. Mortgage servicing rights amounted to $1.2 million and $1.3 million as of June 30, 2018 and December 31, 2017, respectively.

Management is responsible for conducting the Company's credit risk evaluation process, which includes credit risk grading of individual commercial and industrial and commercial real estate loans. Commercial and industrial and commercial real estate loans are assigned credit risk grades based on the Company's assessment of conditions that

affect the borrower's ability to meet its contractual obligations under the loan agreement. That process includes reviewing borrowers' current financial information, historical payment experience, credit documentation, public information and other information specific to each individual borrower. Upon review, the commercial loan credit risk grade is revised or reaffirmed as the case may be. The credit risk grades may be changed at any time management feels an upgrade or downgrade may be warranted. The Company utilizes an external independent loan review firm that reviews and validates the credit risk program on at least an annual basis. Results of these reviews are presented to management and the board of directors. The loan review process complements and reinforces the risk identification and assessment decisions made by lenders and credit personnel, as well as the Company's policies and procedures.

Non-accrual loans

The decision to place loans on non-accrual status is made on an individual basis after considering factors pertaining to each specific loan. C&I and CRE loans are placed on non-accrual status when management has determined that payment of all contractual principal and interest is in doubt or the loan is past due 90 days or more as to principal and interest, unless well-secured and in the process of collection. Consumer loans secured by real estate and residential mortgage loans are placed on non-accrual status at 120 days past due as to principal and interest and unsecured consumer loans are charged-off when the loan is 90 days or more past due as to principal and interest. The Company considers all non-accrual loans to be impaired loans.

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Non-accrual loans, segregated by class, at June 30, 2018 and December 31, 2017, were as follows:

(dollars in thousands)	June 30, 2018	December 31, 2017
Commercial and industrial	$ 100	$ 36
Commercial real estate:		
Non-owner occupied	501	649
Owner occupied	923	942
Construction	159	161
Consumer:		
Home equity installment	82	15
Home equity line of credit	31	559
Auto loans and leases	51	5
Residential:		
Real estate	916	1,074
Total	$ 2,763	$ 3,441

Troubled Debt Restructuring

A modification of a loan constitutes a TDR when a borrower is experiencing financial difficulty and the modification constitutes a concession. The Company considers all TDRs to be impaired loans. The Company typically considers the following concessions when modifying a loan, which may include lowering interest rates below the market rate, temporary interest-only payment periods, term extensions at interest rates lower than the current market rate for new debt with similar risk and/or converting revolving credit lines to term loans. The Company typically does not consider forgiveness of principal when granting a TDR modification. Of the TDRs outstanding as of June 30, 2018 and 2017, when modified, the concessions granted consisted of temporary interest-only payments, extensions of maturity date, or a reduction in the rate of interest to a below-market rate for a contractual period of time. Other than the TDRs that were placed on non-accrual status, the TDRs were performing in accordance with their modified terms.

The following presents by class, information related to loans modified in a TDR:

	Loans modified as TDRs for the six months ended:					
(dollars in thousands)	June 30, 2018			June 30, 2017		
	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)

Commercial real estate - non-owner occupied	-	$ -	$ -	1	$ 119	$ 3
Commercial real estate - owner occupied	-	-	-	5	918	163
Consumer home equity installment	1	413	350	-	-	-
Residential real estate	1	316	-	-	-	-
Total	2	$ 729	$ 350	6	$ 1,037	$ 166

	Loans modified as TDRs for the three months ended:					
(dollars in thousands)	June 30, 2018			June 30, 2017		
	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)	Number of contracts	Recorded investment (as of period end)	Increase in allowance (as of period end)
Commercial real estate - owner occupied	-	$ -	$ -	1	$ 142	$ 7

In the above tables, the period end balance is inclusive of all partial pay downs and charge-offs since the modification date. For all loans modified in a TDR, the pre-modification recorded investment was the same as the post-modification recorded investment.

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The following presents by class, loans modified as a TDR that subsequently defaulted (i.e. 90 days or more past due following modification) during the periods indicated:

Loans modified as a TDR within the previous twelve months that subsequently defaulted during the six months ended:

(dollars in thousands)	June 30, 2018		June 30, 2017	
	Number of contracts	Recorded investment	Number of contracts	Recorded investment
Commercial real estate - owner occupied	-	$ -	1	$ 142

In the above table, the period end balances are inclusive of all partial pay downs and charge-offs since the modification date.

Loans modified in a TDR are closely monitored for delinquency as an early indicator of possible future default. If loans modified in a TDR subsequently default, the Company evaluates the loan for possible further impairment.

The allowance for loan losses (allowance) may be increased, adjustments may be made in the allocation of the allowance or partial charge-offs may be taken to further write-down the carrying value of the loan. An allowance for impaired loans that have been modified in a TDR is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or the loan's observable market price. If the loan is collateral dependent, the estimated fair value of the collateral is used to establish the allowance. As of June 30, 2018 and 2017, respectively, the allowance for impaired loans that have been modified in a TDR was $0.8 million and $0.9 million, respectively.

Past due loans

Loans are considered past due when the contractual principal and/or interest is not received by the due date. An aging analysis of past due loans, segregated by class, as of the period indicated is as follows (dollars in thousands):

		Past due					Recorded investment past
June 30, 2018	30 - 59 Days past due	60 - 89 Days past due	90 days or more (1)	Total past due	Current	Total loans (3)	due ≥ 90 days and accruing
Commercial and industrial	$ 247	$ 242	$ 100	$ 589	$ 125,417	$ 126,006	$ -
Commercial real estate:							
Non-owner occupied	115	-	501	616	89,878	90,494	-
Owner occupied	599	48	1,087	1,734	111,369	113,103	164
Construction	-	-	159	159	5,829	5,988	-

Consumer:							
Home equity installment	600	31	82	713	28,304	29,017	-
Home equity line of credit	365	125	31	521	53,390	53,911	-
Auto loans and leases	283	91	51	425	104,305	104,730 (2)	-
Other	38	21	-	59	5,685	5,744	-
Residential:							
Real estate	-	407	916	1,323	143,541	144,864	-
Construction	-	-	-	-	11,831	11,831	-
Total	$ 2,247	$ 965	$ 2,927	$ 6,139	$ 679,549	$ 685,688	$ 164

(1) Includes $2.8 million of non-accrual loans. (2) Net of unearned lease revenue of $0.9 million. (3) Includes net deferred loan costs of $2.4 million.

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December 31, 2017	30 - 59 Days past due	60 - 89 Days past due	Past due 90 days or more (1)	Total past due	Current	Total loans (3)	Recorded investment past due ≥ 90 days and accruing