

CODORUS VALLEY BANCORP INC  
Form 10-Q  
November 08, 2018

UNITED STATES SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

**Quarterly Report Pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934**

**For the quarterly period ended September 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: 0-15536**

**CODORUS VALLEY BANCORP, INC.**

(Exact name of registrant as specified in its charter)

**Pennsylvania**

(State or other jurisdiction of incorporation or organization)

**23-2428543**

(I.R.S. Employer Identification No.)

**105 Leader Heights Road, P.O. Box 2887, York, Pennsylvania 17405**

(Address of principal executive offices) (Zip code)

**717-747-1519**

(Registrant's telephone number, including area code)

**Not Applicable**

(Former name, former address and former fiscal year,  
if changed since the last report.)

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

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

Yes No

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

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

If an emerging growth company, indicate by 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 No

APPLICABLE ONLY TO CORPORATE ISSUERS

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date. On October 26, 2018, 8,956,679 shares of common stock, par value \$2.50, were outstanding.

Codorus Valley Bancorp, Inc.

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**PART I - FINANCIAL INFORMATION****Item 1. Financial Statements**

Codorus Valley Bancorp, Inc.

Consolidated Balance Sheets

|   | <b>(Unaudited)</b>                |                                  |
|---|-----------------------------------|----------------------------------|
|   | <b>September<br/>30,<br/>2018</b> | <b>December<br/>31,<br/>2017</b> |
| <b>(dollars in thousands, except per share data)</b>  |                                   |                                  |
| <b>Assets</b>   |                                   |                                  |
| Interest bearing deposits with banks  | \$ 60,421                         | \$ 55,566                        |
| Cash and due from banks   | 24,927                            | 23,958                           |
| Total cash and cash equivalents   | 85,348                            | 79,524                           |
| Securities, available-for-sale  | 146,089                           | 158,591                          |
| Restricted investment in bank stocks, at cost   | 6,122                             | 6,311                            |
| Loans held for sale   | 3,795                             | 1,715                            |
| Loans (net of deferred fees of \$3,866 - 2018 and \$4,039 - 2017)   | 1,494,027                         | 1,399,764                        |
| Less-allowance for loan losses  | (18,234 )                         | (16,689 )                        |
| Net loans   | 1,475,793                         | 1,383,075                        |
| Premises and equipment, net   | 24,844                            | 24,382                           |
| Goodwill  | 2,301                             | 2,301                            |
| Other assets  | 56,479                            | 53,306                           |
| Total assets  | \$ 1,800,771                      | \$ 1,709,205                     |
| <b>Liabilities</b>  |                                   |                                  |
| <b>Deposits</b>   |                                   |                                  |
| Noninterest bearing   | \$ 258,816                        | \$ 246,866                       |
| Interest bearing  | 1,211,443                         | 1,137,641                        |
| Total deposits  | 1,470,259                         | 1,384,507                        |
| Short-term borrowings   | 8,624                             | 20,495                           |
| Long-term debt  | 135,310                           | 130,310                          |
| Other liabilities   | 12,981                            | 9,674                            |
| Total liabilities   | 1,627,174                         | 1,544,986                        |
| <b>Shareholders' equity</b>   |                                   |                                  |
| Preferred stock, par value \$2.50 per share;<br>1,000,000 shares authorized; 0 shares issued and outstanding  | 0                                 | 0                                |
| Common stock, par value \$2.50 per share; 30,000,000 shares authorized at<br>September 30, 2018 and 15,000,000 at December 31, 2017; shares issued: | 23,504                            | 22,265                           |

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8,954,157 at September 30, 2018 and 8,906,052 at December 31, 2017; and shares outstanding: 8,953,998 at September 30, 2018 and 8,906,052 at December 31, 2017

|   |             |             |
|---|-------------|-------------|
| Additional paid-in capital                                | 134,143     | 120,052     |
| Retained earnings   | 19,880      | 22,860      |
| Accumulated other comprehensive loss                      | (3,925 )    | (958 )      |
| Treasury stock, at cost; 159 shares at September 30, 2018 | (5 )        | 0           |
| Total shareholders' equity                                | 173,597     | 164,219     |
| Total liabilities and shareholders' equity                | \$1,800,771 | \$1,709,205 |

See accompanying notes.

Codorus Valley Bancorp, Inc.

## Consolidated Statements of Income

Unaudited

| (dollars in thousands, except per share data)           | Three months ended |          | Nine months ended  |          |
|---|--------------------|----------|--------------------|----------|
|   | September 30, 2018 | 2017     | September 30, 2018 | 2017     |
| Interest income   |                    |          |                    |          |
| Loans, including fees                                   | \$19,580           | \$16,997 | \$55,723           | \$48,493 |
| Investment securities:                                  |                    |          |                    |          |
| Taxable   | 568                | 620      | 1,702              | 1,922    |
| Tax-exempt  | 261                | 297      | 817                | 946      |
| Dividends   | 100                | 78       | 318                | 236      |
| Other   | 287                | 71       | 663                | 266      |
| Total interest income                                   | 20,796             | 18,063   | 59,223             | 51,863   |
| Interest expense  |                    |          |                    |          |
| Deposits  | 3,581              | 2,071    | 9,283              | 5,826    |
| Federal funds purchased and other short-term borrowings | 15                 | 71       | 48                 | 263      |
| Long-term debt  | 768                | 629      | 2,036              | 1,794    |
| Total interest expense                                  | 4,364              | 2,771    | 11,367             | 7,883    |
| Net interest income                                     | 16,432             | 15,292   | 47,856             | 43,980   |
| Provision for loan losses                               | 1,300              | 2,100    | 1,800              | 3,575    |
| Net interest income after provision for loan losses     | 15,132             | 13,192   | 46,056             | 40,405   |
| Noninterest income                                      |                    |          |                    |          |
| Trust and investment services fees                      | 818                | 738      | 2,389              | 2,138    |
| Income from mutual fund, annuity and insurance sales    | 255                | 214      | 806                | 620      |
| Service charges on deposit accounts                     | 1,187              | 1,057    | 3,485              | 3,078    |
| Income from bank owned life insurance                   | 248                | 257      | 730                | 779      |
| Other income  | 364                | 276      | 1,221              | 817      |
| Gain on sales of loans held for sale                    | 435                | 252      | 1,436              | 823      |
| Gain on sales of securities                             | 0                  | 16       | 0                  | 79       |
| Total noninterest income                                | 3,307              | 2,810    | 10,067             | 8,334    |
| Noninterest expense                                     |                    |          |                    |          |
| Personnel   | 7,159              | 6,366    | 21,855             | 19,501   |
| Occupancy of premises, net                              | 860                | 793      | 2,556              | 2,471    |
| Furniture and equipment                                 | 701                | 724      | 2,262              | 2,115    |
| Postage, stationery and supplies                        | 196                | 181      | 560                | 572      |
| Professional and legal                                  | 286                | 294      | 609                | 616      |
| Marketing   | 373                | 459      | 1,200              | 1,156    |
| FDIC insurance  | 189                | 163      | 493                | 537      |

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|   |         |         |          |          |
|---|---------|---------|----------|----------|
| Debit card processing   | 318     | 294     | 902      | 780      |
| Charitable donations  | 119     | 148     | 1,792    | 982      |
| Telecommunications  | 119     | 204     | 500      | 608      |
| External data processing  | 579     | 405     | 1,563    | 1,252    |
| Foreclosed real estate including provision for (recovery of) losses | 13      | 10      | 33       | (18 )    |
| Other   | 1,090   | 945     | 2,557    | 2,644    |
| Total noninterest expense   | 12,002  | 10,986  | 36,882   | 33,216   |
| Income before income taxes  | 6,437   | 5,016   | 19,241   | 15,523   |
| Provision for income taxes  | 1,377   | 1,606   | 4,044    | 5,009    |
| Net income  | \$5,060 | \$3,410 | \$15,197 | \$10,514 |
| Net income per share, basic   | \$0.53  | \$0.37  | \$1.62   | \$1.13   |
| Net income per share, diluted                                       | \$0.53  | \$0.36  | \$1.60   | \$1.11   |

See accompanying notes.



Codorus Valley Bancorp, Inc.

Consolidated Statements of Comprehensive Income

Unaudited

| <b>(dollars in thousands)</b>  | <b>Three months ended</b> |                  |
|--|---------------------------|------------------|
|  | <b>September 30,</b>      | <b>2018 2017</b> |
| Net income   | \$5,060                   | \$3,410          |
| Other comprehensive income (loss):   |                           |                  |
| Securities available for sale:   |                           |                  |
| Net unrealized holding (losses) gains arising during the period (net of tax (benefit) expense of (\$203) and \$16, respectively) | (767 )                    | 30               |
| Reclassification adjustment for (gains) included in net income (net of tax expense of \$0 and \$6, respectively) (a) (b)         | 0                         | (10 )            |
| Net unrealized (losses) gains  | (767 )                    | 20               |
| Comprehensive income   | \$4,293                   | \$3,430          |

| <b>(dollars in thousands)</b>   | <b>Nine months ended</b> |                  |
|---|--------------------------|------------------|
|   | <b>September 30,</b>     | <b>2018 2017</b> |
| Net income  | \$15,197                 | \$10,514         |
| Other comprehensive income (loss):  |                          |                  |
| Securities available for sale:  |                          |                  |
| Net unrealized holding (losses) gains arising during the period (net of tax (benefit) expense of (\$788) and \$484, respectively) | (2,967 )                 | 899              |
| Reclassification adjustment for (gains) included in net income (net of tax expense of \$0 and \$28, respectively) (a) (b)         | 0                        | (51 )            |
| Net unrealized (losses) gains   | (2,967 )                 | 848              |
| Comprehensive income  | \$12,230                 | \$11,362         |

(a) Amounts are included in net gain on sales of securities on the Consolidated Statements of Income within noninterest income.

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

See accompanying notes.

Codorus Valley Bancorp, Inc.

## Consolidated Statements of Cash Flows

Unaudited

|   | <b>Nine months ended</b> |             |
|---|--------------------------|-------------|
|   | <b>September 30,</b>     |             |
| <b>(dollars in thousands)</b>   | <b>2018</b>              | <b>2017</b> |
| Cash flows from operating activities                                    |                          |             |
| Net income  | \$ 15,197                | \$ 10,514   |
| Adjustments to reconcile net income to net cash provided by operations: |                          |             |
| Depreciation/amortization   | 1,780                    | 1,755       |
| Net amortization of premiums on securities                              | 335                      | 535         |
| Amortization of deferred loan origination fees and costs                | (1,264 )                 | (1,128 )    |
| Provision for loan losses   | 1,800                    | 3,575       |
| Recovery of foreclosed real estate                                      | 0                        | (47 )       |
| Increase in bank owned life insurance                                   | (730 )                   | (779 )      |
| Originations of mortgage loans held for sale                            | (28,746)                 | (28,467 )   |
| Originations of SBA loans held for sale                                 | (12,292)                 | (3,186 )    |
| Proceeds from sales of mortgage loans held for sale                     | 29,744                   | 27,682      |
| Proceeds from sales of SBA loans held for sale                          | 10,352                   | 2,148       |
| Gain on sales of mortgage loans held for sale                           | (718 )                   | (694 )      |
| Gain on sales of SBA loans held for sale                                | (718 )                   | (129 )      |
| Gain on disposal of premises and equipment                              | (11 )                    | (8 )        |
| Gain on sales of securities, available-for-sale                         | 0                        | (79 )       |
| Loss (gain) on sales of foreclosed real estate                          | 3                        | (11 )       |
| Stock-based compensation  | 457                      | 509         |
| (Increase) decrease in interest receivable                              | (174 )                   | 173         |
| Decrease (increase) in other assets                                     | 355                      | (1,640 )    |
| Increase in interest payable  | 239                      | 127         |
| Increase (decrease) in other liabilities                                | 1,830                    | (63 )       |
| Net cash provided by operating activities                               | 17,439                   | 10,787      |
| Cash flows from investing activities                                    |                          |             |
| Purchases of securities, available-for-sale                             | (10,946)                 | (10,669 )   |
| Maturities, repayments and calls of securities, available-for-sale      | 20,616                   | 33,233      |
| Sales of securities, available-for-sale                                 | 0                        | 5,692       |
| Net decrease (increase) in restricted investment in bank stock          | 189                      | (98 )       |
| Net increase in loans made to customers                                 | (94,963)                 | (129,600)   |
| Purchases of premises and equipment                                     | (2,231 )                 | (1,275 )    |
| Investment in bank owned life insurance                                 | (7 )                     | (4,007 )    |
| Proceeds from sales of foreclosed real estate                           | 155                      | 452         |
| Net cash used in investing activities                                   | (87,187)                 | (106,272)   |
| Cash flows from financing activities                                    |                          |             |
| Net increase in demand and savings deposits                             | 69,510                   | 60,564      |
| Net increase (decrease) in time deposits                                | 16,242                   | (1,969 )    |

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|  |          |           |
|--|----------|-----------|
| Net decrease in short-term borrowings                | (11,871) | (24,713 ) |
| Proceeds from issuance of long-term debt             | 30,000   | 10,000    |
| Repayment of long-term debt                          | (25,000) | 0         |
| Cash dividends paid to shareholders                  | (4,151 ) | (3,418 )  |
| Issuance of stock                                    | 842      | 644       |
| Net cash provided by financing activities            | 75,572   | 41,108    |
| Net increase (decrease) in cash and cash equivalents | 5,824    | (54,377 ) |
| Cash and cash equivalents at beginning of year       | 79,524   | 74,032    |
| Cash and cash equivalents at end of period           | \$85,348 | \$19,655  |

See accompanying notes.

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Codorus Valley Bancorp, Inc.

## Consolidated Statements of Changes in Shareholders' Equity

Unaudited

| <i>(dollars in thousands, except per share data)</i>                  | Preferred |           | Additional         | Retained  | Accumulated<br>Other | Treasury | Total      |
|---|-----------|-----------|--------------------|-----------|----------------------|----------|------------|
|   | Stock     | Stock     | Paid-in<br>Capital | Earnings  | Loss                 | Stock    |            |
| Balance, January 1, 2018  | \$ 0      | \$22,265  | \$120,052          | \$22,860  | \$ (958)             | \$ 0     | \$164,219  |
| Net income  |           |           |                    | 15,197    |                      |          | 15,197     |
| Other comprehensive loss, net of tax                                  |           |           |                    |           | (2,967)              |          | (2,967)    |
| Cash dividends (\$0.443 per share, adjusted)                          |           |           |                    | (4,151)   |                      |          | (4,151)    |
| 5% stock dividend, 447,700 shares at fair value                       |           | 1,119     | 12,907             | (14,026)  |                      |          | 0          |
| Stock-based compensation  |           |           | 457                |           |                      |          | 457        |
| Forfeiture of restricted stock and withheld shares                    |           |           | 5                  |           |                      | (75)     | (70)       |
| Issuance and reissuance of stock:                                     |           |           |                    |           |                      |          |            |
| 12,718 shares under the dividend reinvestment and stock purchase plan |           | 31        | 322                |           |                      | 57       | 410        |
| 30,535 shares under the stock option plan                             |           | 70        | 305                |           |                      | 9        | 384        |
| 4,217 shares of stock-based compensation awards                       |           | 10        | (10)               |           |                      |          | 0          |
| 5,125 shares under employee stock purchase plan                       |           | 9         | 105                |           |                      | 4        | 118        |
| Balance, September 30, 2018   | \$ 0      | \$23,504  | \$134,143          | \$19,880  | \$ (3,925)           | \$ (5)   | \$173,597  |
| Balance, January 1, 2017  | \$ 0      | \$ 21,067 | \$ 106,102         | \$ 28,909 | \$ (1,121)           | \$ 0     | \$ 154,957 |
| Net income  |           |           |                    | 10,514    |                      |          | 10,514     |
| Other comprehensive income, net of tax                                |           |           |                    |           | 848                  |          | 848        |
| Cash dividends (\$0.368 per share, adjusted)                          |           |           |                    | (3,418)   |                      |          | (3,418)    |
| 5% stock dividend, 423,053 shares at fair value                       |           | 1,058     | 12,607             | (13,665)  |                      |          | 0          |
| Stock-based compensation  |           |           | 509                |           |                      |          | 509        |
| Forfeiture of restricted stock  |           |           | 4                  |           |                      | (9)      | (5)        |
| Issuance and reissuance of stock:                                     |           |           |                    |           |                      |          |            |
|   |           | 32        | 317                |           |                      |          | 349        |

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|  |      |          |            |           |          |        |           |
|--|------|----------|------------|-----------|----------|--------|-----------|
| 12,655 shares under the dividend<br>reinvestment and stock purchase plan |      |          |            |           |          |        |           |
| 11,397 shares under the stock option<br>plan                             | 28   | 157      |            |           |          | 185    |           |
| 7,037 shares of stock-based<br>compensation awards                       | 18   | (18)     |            |           |          | 0      |           |
| 4,844 shares under employee stock<br>purchase plan                       | 8    | 103      |            |           |          | 4      | 115       |
| Balance, September 30, 2017  | \$ 0 | \$22,211 | \$ 119,781 | \$ 22,340 | \$ (273) | \$ (5) | \$164,054 |

See accompanying notes.

Note 1—Summary of Significant Accounting Policies

Nature of Operations and Basis of Presentation

The accompanying consolidated balance sheet at December 31, 2017 has been derived from audited financial statements, and the unaudited interim consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America for interim financial information, the instructions to Form 10-Q, and FASB Accounting Standards Codification (ASC) 270. Accordingly, the interim financial statements do not include all of the financial information and notes required by generally accepted accounting principles for complete financial statements. In the opinion of management, the interim consolidated financial statements include all adjustments necessary to present fairly the financial condition and results of operations for the reported periods, and all such adjustments are of a normal and recurring nature.

Codorus Valley Bancorp, Inc. (“Corporation” or “Codorus Valley”) is a one-bank holding company headquartered in York, Pennsylvania that provides a full range of banking services through its subsidiary, PeoplesBank, A Codorus Valley Company (“PeoplesBank” or “Bank”). PeoplesBank operates three wholly-owned subsidiaries as of September 30, 2018. Codorus Valley Financial Advisors, Inc. d/b/a PeoplesWealth Advisors, which sells nondeposit investment products in Pennsylvania; SYC Settlement Services, Inc., which provides real estate settlement services and Codorus Valley Financial Advisors, Inc. d/b/a PeoplesWealth Advisors, which sells nondeposit investment products in Maryland. In addition, PeoplesBank may periodically create nonbank subsidiaries for the purpose of temporarily holding foreclosed properties pending the liquidation of these properties. PeoplesBank operates under a state charter and is subject to regulation by the Pennsylvania Department of Banking and Securities, and the Federal Deposit Insurance Corporation. The Corporation is subject to regulation by the Federal Reserve Board and the Pennsylvania Department of Banking and Securities.

The consolidated financial statements include the accounts of Codorus Valley and its wholly-owned bank subsidiary, PeoplesBank, and a wholly-owned nonbank subsidiary, SYC Realty Company, Inc. SYC Realty was inactive during the period ended September 30, 2018. The accounts of CVB Statutory Trust No. 1 and No. 2 are not included in the consolidated financial statements as discussed in Note 7—Short-Term Borrowings and Long-Term Debt. All significant intercompany account balances and transactions have been eliminated in consolidation. The accounting and reporting policies of Codorus Valley and subsidiaries conform to accounting principles generally accepted in the United States of America and have been followed on a consistent basis.

These consolidated statements should be read in conjunction with the notes to the audited consolidated financial statements contained in the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2017.

The results of operations for the three and nine months ended September 30, 2018 are not necessarily indicative of the results to be expected for the full year.

In accordance with FASB ASC 855, the Corporation evaluated the events and transactions that occurred after the balance sheet date of September 30, 2018 and through the date these consolidated financial statements were issued, for items of potential recognition or disclosure.

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## Loans

Loans receivable that management has the intent and ability to hold for the foreseeable future or until maturity or payoff are stated at their outstanding unpaid principal balances less amounts charged off, net of an allowance for loan losses and any deferred fees or costs. Interest income is accrued on the unpaid principal balance. Generally, loan origination fees, net of certain direct origination costs, are deferred and recognized as an adjustment of the yield (interest income) over the contractual life of the loan. The loans receivable portfolio is segmented into commercial and consumer loans. Commercial loans consist of the following industry classes: builder & developer, commercial real estate investor, residential real estate investor, hotel/motel, wholesale & retail, agriculture, manufacturing and all other. Consumer loans consist of the following classes: residential mortgage, home equity and all other.

Generally, for all classes of loans receivable, the accrual of interest is discontinued when the contractual payment of principal or interest has become 90 days past due or management has serious doubts about further collectability of principal or interest, even though the loan may be currently performing. A past due loan may remain on accrual status if it is in the process of collection and well secured. When a loan is placed on nonaccrual status, unpaid interest credited to income in the current year is reversed and unpaid interest accrued in prior years is charged against the allowance for loan losses. Interest received on nonaccrual loans, including impaired loans, generally is either applied against principal or reported as interest income, according to the Corporation's judgment as to the collectability of principal. Generally, nonaccrual loans are restored to accrual status when the obligation is brought current, has performed in accordance with the contractual terms for a reasonable period of time, generally six months, and the ultimate collectability of the total contractual principal and interest is no longer in doubt. The past due status of all classes of loans receivable is determined based on contractual due dates for loan payments.

## Acquired Loans

Acquired loans are initially recorded at their acquisition date fair values. The carryover of allowance for loan losses is prohibited as any credit losses in the loans are included in the determination of the fair value of the loans at the acquisition date. Fair values for acquired loans are based on a discounted cash flow methodology that involves assumptions and judgments as to credit risk, prepayment risk, liquidity risk, default rates, loss severity, payment speeds, collateral values and discount rate.

For acquired loans that are not deemed impaired at acquisition, credit discounts representing principal losses expected over the life of the loan are a component of the initial fair value and amortized over the life of the asset. Subsequent to the acquisition date, the methods used to estimate the required allowance for loan losses on these loans is similar to originated loans. However, the Corporation records a provision for loan losses only when the required allowance for loan losses exceeds any remaining credit discount. The remaining differences between the acquisition date fair value and the unpaid principal balance at the date of acquisition are recorded in interest income over the life of the loan.



Acquired loans that have evidence of deterioration in credit quality since origination and for which it is probable, at acquisition, that the Corporation will be unable to collect all contractually required payments are accounted for as impaired loans under FASB ASC 310-30. The excess of cash flows expected at acquisition over the estimated fair value is referred to as the accretable discount and is recognized into interest income over the remaining life of the loans. The difference between contractually required payments at acquisition and the cash flows expected to be collected at acquisition is referred to as the non-accretable discount. The non-accretable discount represents estimated future credit losses expected to be incurred over the life of the loan. Subsequent decreases to the expected cash flows require the Corporation to evaluate the need for an allowance for loan losses on these loans. Subsequent improvements in expected cash flows result in the reversal of a corresponding amount of the non-accretable discount which the Corporation then reclassifies as an accretable discount that is recognized into interest income over the remaining life of the loans using the interest method.

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## Allowance for Loan Losses

The allowance for loan losses represents the Corporation's estimate of losses inherent in the loan portfolio as of the balance sheet date and is recorded as a reduction to loans. The allowance for loan losses is increased by the provision for loan losses, and decreased by charge-offs, net of recoveries. Loans deemed to be uncollectable are charged against the allowance for loan losses, and subsequent recoveries, if any, are credited to the allowance. All, or part, of the principal balance of loans receivable are charged off to the allowance as soon as it is determined that the repayment of all, or part, of the principal balance is highly unlikely. While the Corporation attributes a portion of the allowance to individual loans and groups of loans that it evaluates and determines to be impaired, the allowance is available to cover all charge-offs that arise from the loan portfolio.

The allowance for loan losses is maintained at a level considered by management to be adequate to provide for losses that can be reasonably anticipated. The Corporation performs a quarterly evaluation of the adequacy of the allowance. The allowance is based on the Corporation's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrower's ability to repay, the estimated value of any underlying collateral, composition of the loan portfolio, current economic conditions and other relevant factors. This evaluation is inherently subjective as it requires material estimates that may be susceptible to significant revision as more information becomes available.

The allowance consists of specific, general and unallocated components. The specific component relates to loans that are classified as impaired, generally substandard and nonaccrual loans. For loans that are classified as impaired, an allowance is established when the collateral value (or discounted cash flows or observable market price) of the impaired loan is lower than the carrying value of that loan. The general component covers pools of loans by loan class, including commercial loans not considered impaired, as well as smaller balance homogeneous loans such as residential real estate, home equity and other consumer loans. These pools of loans are evaluated for loss exposure based upon historical loss rates for each of these classes of loans, adjusted for qualitative (environmental) risk factors. Historical loss rates are based on a two year rolling average of net charge-offs. Qualitative risk factors that supplement historical losses in the evaluation of loan pools are shown below. Each factor is assigned a value to reflect improving, stable or declining conditions based on the Corporation's best judgment using relevant information available at the time of the evaluation.

Changes in national and local economies and business conditions

Changes in the value of collateral for collateral dependent loans

Changes in the level of concentrations of credit

Changes in the volume and severity of classified and past due loans

Changes in the nature and volume of the portfolio

Changes in collection, charge-off, and recovery procedures

Changes in underwriting standards and loan terms

Changes in the quality of the loan review system

Changes in the experience/ability of lending management and key lending staff

Regulatory and legal regulations that could affect the level of credit losses

Other pertinent environmental factors

Impact of imposed and proposed tariffs

The unallocated component is maintained to cover uncertainties that could affect the Corporation's estimate of probable losses. For example, increasing credit risks and uncertainties, not yet reflected in current leading indicators, associated with prolonged low economic growth, or recessionary business conditions for certain industries or the broad economy, or the erosion of real estate values, represent risk factors, the occurrence of any or all of which can adversely affect a borrowers' ability to service their loans. The unallocated component of the allowance also reflects the margin of imprecision inherent in the underlying assumptions used in the methodologies for estimating specific and general losses in the loan portfolio, including the unpredictable timing and amounts of charge-offs and related historical loss averages, and specific-credit or broader portfolio future cash flow value and collateral valuation uncertainties which could negatively impact unimpaired portfolio loss factors.

As disclosed in Note 4—Loans, the Corporation engages in commercial and consumer lending. Loans are made within the Corporation's primary market area and surrounding areas, and include the purchase of whole loan or participation interests in loans from other financial institutions or private equity companies. Commercial loans, which pose the greatest risk of loss to the Corporation, whether originated or purchased, are generally secured by real estate. Within the broad commercial loan segment, the builder & developer and commercial real estate investor loan classes generally present a higher level of risk than other commercial loan classifications. This greater risk is due to several factors, including the concentration of principal in a limited number of loans and borrowers, the effect of general economic conditions on income producing properties, unstable real estate prices and the dependency upon successful construction and sale or operation of the real estate project. Within the consumer loan segment, junior (i.e., second) liens present a higher risk to the Corporation because economic and housing market conditions can adversely affect the underlying value of the collateral, which could render the Corporation under-secured or unsecured. In addition, economic and housing market conditions can adversely affect the ability of some borrowers to service their debt.

A loan is considered impaired when, based on current information and events, it is probable that the Corporation will be unable to collect the scheduled payments of principal or interest when due according to the contractual terms of the loan agreement. Factors considered in determining impairment include payment status and the probability of collecting scheduled principal and interest payments when due. Loans that experience insignificant payment delays and payment shortfalls generally are not classified as impaired. The Corporation determines the significance of payment delays and payment shortfalls on a case-by-case basis, taking into consideration all of the circumstances surrounding the loan and the borrower, including the length of the delay, the reasons for the delay, the borrower's prior payment record and the amount of the shortfall in relation to the principal and interest owed. Loans that are deemed impaired are evaluated for impairment loss based on the net realizable value of the collateral, as applicable. Loans that are not collateral dependent will rely on the present value of expected future cash flows discounted at the loan's effective interest rate to determine impairment loss. Large groups of smaller balance homogeneous loans such as residential mortgage loans, home equity loans and other consumer loans are collectively evaluated for impairment, unless they are classified as impaired.

An allowance for loan losses is established for an impaired commercial loan if its carrying value exceeds its estimated fair value. For commercial loans secured by real estate, estimated fair values are determined primarily through third-party appraisals of the underlying collateral. When a real estate secured loan becomes impaired, a decision is made regarding whether an updated certified appraisal of the real estate is necessary. This decision is based on various considerations, including the age of the most recent appraisal, the loan-to-value ratio based on the most recent appraisal and the condition of the property. Appraisals are generally discounted to provide for selling costs and other factors to determine an estimate of the net realizable value of the property. For commercial loans secured by non-real estate collateral, such as accounts receivable, inventory and equipment, estimated fair values are determined based on the borrower's financial statements, inventory reports, accounts receivable aging or equipment appraisals or invoices. Indications of value from these sources are generally discounted based on the age of the financial information or the quality of the assets. In instances when specific consumer related loans become impaired, they may be partially or fully charged off, which obviates the need for a specific allowance.

Loans whose terms are modified are classified as troubled debt restructurings if the Corporation grants borrowers experiencing financial difficulties concessions that it would not otherwise consider. Concessions granted under a troubled debt restructuring may involve an interest rate that is below the market rate given the associated credit risk of the loan or an extension of a loan's stated maturity date. Loans classified as troubled debt restructurings are designated as impaired. Non-accrual troubled debt restructurings are restored to accrual status if principal and interest payments, under the modified terms, are current for a reasonable period of time, generally six consecutive months after modification and future payments are reasonably assured.

Banking regulatory agencies, as an integral part of their examination process, periodically review the Corporation's allowance for loan losses and may require the Corporation to recognize additions to the allowance based on their judgments about information available to them at the time of their examination, which may not be currently available to the Corporation. Based on an analysis of the loan portfolio, the Corporation believes that the level of the allowance for loan losses at September 30, 2018 is adequate.

#### Foreclosed Real Estate

Foreclosed real estate, included in other assets, is comprised of property acquired through a foreclosure proceeding or property that is acquired through in-substance foreclosure. Foreclosed real estate is initially recorded at fair value minus estimated costs to sell at the date of foreclosure, establishing a new cost basis. Any difference between the carrying value and the new cost basis is charged against the allowance for loan losses. Appraisals, obtained from an independent third party, are generally used to determine fair value. After foreclosure, management reviews valuations at least quarterly and adjusts the asset to the lower of cost or fair value minus estimated costs to sell through a valuation allowance or a write-down. Costs related to the improvement of foreclosed real estate are generally capitalized until the real estate reaches a saleable condition subject to fair value limitations. Revenue and expense from operations and changes in the valuation allowance are included in noninterest expense. When a foreclosed real estate asset is ultimately sold, any gain or loss on the sale is included in the income statement as a component of noninterest expense. At September 30, 2018, there was \$1,767,000 of foreclosed real estate, which included \$32,000 of residential real estate, compared to \$216,000, which included \$96,000 of residential real estate, at December 31, 2017. Included within loans receivable as of September 30, 2018 was a recorded investment of \$18,000 of consumer mortgage loans secured by residential real estate properties, for which formal foreclosure proceedings were in process according to local requirements of the applicable jurisdiction.

#### Mortgage Servicing Rights

The mortgage servicing rights (MSRs) associated with the sold loans are included in other assets on the consolidated balance sheets at an amount equal to the estimated fair value of the contractual rights to service the mortgage loans. The MSR asset is amortized as a reduction to servicing income. The MSR asset is evaluated periodically for impairment and carried at the lower of amortized cost or fair value. A third party calculates fair value by discounting the estimated cash flows from servicing income using a rate consistent with the risk associated with these assets and an expected life commensurate with the expected life of the underlying loans. In the event that the amortized cost of the MSR asset exceeds the fair value of the asset, a valuation allowance would be established through a charge against servicing income. Subsequent fair value evaluations may determine that impairment has been reduced or eliminated, in which case the valuation allowance would be reduced through a credit to earnings. At September 30, 2018, the balance of residential mortgage loans serviced for third parties was \$94,004,000 compared to \$70,780,000 at December 31, 2017.

|        |        |
|--------|--------|
| Three  | Nine   |
| months | months |
| ended  | ended  |

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|   | September<br>30, |       | September<br>30, |       |
|---|------------------|-------|------------------|-------|
| (dollars in thousands)                    | 2018             | 2017  | 2018             | 2017  |
| Amortized cost:                           |                  |       |                  |       |
| Balance at beginning of period            | \$808            | \$492 | \$672            | \$324 |
| Originations of mortgage servicing rights | 104              | 77    | 297              | 277   |
| Amortization expense                      | (36)             | (20)  | (93)             | (52)  |
| Balance at end of period                  | \$876            | \$549 | \$876            | \$549 |

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## Goodwill and Core Deposit Intangible Assets

Goodwill arising from acquisitions is not amortized, but is subject to an annual impairment test. This test consists of a qualitative analysis. If the Corporation determines events or circumstances indicate that it is more likely than not that goodwill is impaired, a quantitative analysis must be completed. Analyses may also be performed between annual tests. Significant judgment is applied when goodwill is assessed for impairment. This judgment includes developing cash flow projections, selecting appropriate discount rates, identifying relevant market comparables, incorporating general economic and market conditions, and selecting an appropriate control premium. The Corporation completes its annual goodwill impairment test on October 1<sup>st</sup> of each year. Based upon a qualitative analysis of goodwill, the Corporation concluded that the amount of recorded goodwill was not impaired as of October 1, 2018.

Core deposit intangibles represent the value assigned to demand, interest checking, money market, and savings accounts acquired as part of an acquisition. The core deposit intangible value represents the future economic benefit of potential cost savings from acquiring core deposits as part of an acquisition compared to the cost of alternative funding sources and the alternative cost to grow a similar core deposit base. The core deposit intangible asset resulting from the merger with Madison Bancorp, Inc. was determined to have a definite life and is being amortized using the sum of the years' digits method over ten years. All intangible assets must be evaluated for impairment if certain events or changes in circumstances occur. Any impairment write-downs would be recognized as expense on the consolidated statements of income.

At September 30, 2018, the Corporation does not have any indicators of potential impairment of either goodwill or core deposit intangibles.

## Revenue from Contracts with Customers

Revenue from contracts with customers that are required to be recognized under FASB ASC Topic 606 - Revenue from Contracts with Customers (ASC 606) is measured based on consideration specified in a contract with a customer, and excludes any sales incentives and amounts collected on behalf of third parties. The Corporation recognizes revenue when it satisfies a performance obligation by transferring control over a product or service to a customer.

The majority of the Corporation's revenue-generating transactions are not within the scope of ASC 606, including revenue generated from financial instruments, such as our loans, letters of credit, derivatives and investment securities, as well as revenue related to our mortgage servicing activities, as these activities are subject to other U.S. Generally Accepted Accounting Principles (GAAP) discussed elsewhere within our disclosures. Descriptions of our revenue-generating activities that are within the scope of ASC 606, which are presented in our consolidated statements of income as components of non-interest income are as follows:



Trust and investment service fees - The Corporation provides trust, investment management custody and irrevocable life insurance trust services to customers. Such services are rendered in accordance with the underlying contracts for which fees are earned. Performance obligations are typically fulfilled on a monthly basis which is when revenue is recognized.

Income from mutual fund, annuity and insurance sales – The Corporation sells mutual funds, annuity and insurance products to its customers. The Corporation’s performance obligation is met upon the signing of the product agreement and, in certain cases, a time component may exist when the customer has the right to rescind the agreement with or without penalty. The Corporation recognizes revenues upon delivery of the product or service unless there is a time component and revenues are recognized utilizing the expected value method.

Service charges on deposits accounts - These represent general service fees for monthly account maintenance and activity- or transaction based fees and consist of transaction-based revenue, time-based revenue (service period), item-based revenue or some other individual attribute-based revenue. Revenue is recognized when the performance obligation is completed which is generally monthly for account maintenance services or when a transaction has been completed.

## Per Share Data

All per share computations include the effect of stock dividends declared, including the 5 percent stock dividend declared on October 9, 2018. The computation of net income per share is provided in the table below.

| (in thousands, except per share data)   | Three months ended |                    | Nine months ended  |                    |
|---|--------------------|--------------------|--------------------|--------------------|
|   | September 30, 2018 | September 30, 2017 | September 30, 2018 | September 30, 2017 |
| Net income  | \$5,060            | \$3,410            | \$15,197           | \$10,514           |
| Weighted average shares outstanding (basic)                                     | 9,398              | 9,325              | 9,379              | 9,308              |
| Effect of dilutive stock options  | 107                | 103                | 96                 | 105                |
| Weighted average shares outstanding (diluted)                                   | 9,505              | 9,428              | 9,475              | 9,413              |
| Basic earnings per share  | \$0.53             | \$0.37             | \$1.62             | \$1.13             |
| Diluted earnings per share  | \$0.53             | \$0.36             | \$1.60             | \$1.11             |
| Anti-dilutive stock options excluded from the computation of earnings per share | 1                  | 0                  | 2                  | 0                  |

## Comprehensive Income

Accounting principles generally accepted in the United States require that recognized revenue, expenses, gains and losses be included in net income. Although certain changes in assets and liabilities, such as unrealized gains and losses on available-for-sale securities, are reported as a separate component of the shareholders' equity section of the balance sheet, such items, along with net income, are components of comprehensive income.

## Cash Flow Information

For purposes of the statements of cash flows, the Corporation considers interest bearing deposits with banks, cash and due from banks, and federal funds sold to be cash and cash equivalents.

Supplemental cash flow information is provided in the table below.

Nine months  
ended  
September 30,

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| (dollars in thousands)  | 2018     | 2017    |
|---|----------|---------|
| Cash paid during the period for:  |          |         |
| Income taxes  | \$3,115  | \$6,425 |
| Interest  | \$11,128 | \$7,756 |
| Noncash investing activities:   |          |         |
| Transfer of loans to foreclosed real estate   | \$1,709  | \$0     |
| Transfer of loans held for sale to the held-to-maturity portfolio                   | \$0      | \$228   |
| Sale of foreclosed real estate through loans  | \$0      | \$2,310 |
| Increase in other liabilities for purchase of securities settling after quarter end | \$1,258  | \$0     |

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## Recent Accounting Pronouncements

### *Pronouncements Adopted in 2018*

In August 2016, the FASB issued ASU 2016-15, Classification of Certain Cash Receipts and Cash Payments. This standard clarifies how certain cash receipts and cash payments are presented and classified in the statement of cash flows to reduce diversity in practice. This standard contains guidance clarifying when an entity should separate cash receipts and cash payments and classify them into more than one class of cash flows (including when reasonable judgment is required to estimate and allocate cash flows) versus when an entity should classify the aggregate amount into one class of cash flows on the basis of predominance. The new standard is effective for fiscal years beginning after December 15, 2017, including interim periods within those fiscal years. The Corporation adopted this standard effective with its March 31, 2018 quarterly report on Form 10-Q. The adoption of the new standard did not have a material impact on its consolidated financial statements.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (Topic 606).

This standards update provides a framework that replaces most existing revenue recognition guidance. The guidance requires an entity to recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the company expects to be entitled in exchange for those goods or services. In December 2016, the FASB issued ASU 2016-20, Technical Corrections and Improvements to Topic 606, Revenue from Contracts with Customers. This ASU amends the new revenue standard to make minor technical corrections that affect narrow aspects of the guidance, including contract cost accounting, disclosures, and other matters. ASU 2014-09 and ASU 2016-20 are effective for interim and annual reporting periods beginning after December 15, 2017. The Corporation has determined that certain noninterest income financial statement line items, including trust and investment services fees, income from mutual fund, annuity and insurance sales, service charges on deposit accounts, and other noninterest income, contain revenue streams that are in scope of these updates. The Corporation adopted this standard on January 1, 2018 utilizing the modified retrospective method and the adoption of the new standard did not have a material impact on the recognition of revenue.

In January 2016, the FASB issued ASU No. 2016-01, Financial Instruments – Overall (Subtopic 825-10) - Recognition and Measurement of Financial Assets and Financial Liabilities. ASU 2016-01 is intended to improve the recognition and measurement of financial instruments by requiring equity investments to be measured at fair value with changes in fair value recognized in net income requiring public business entities to use the exit price notion when measuring the fair value of financial instruments for disclosure purposes requiring separate presentation of financial assets and financial liabilities by measurement category and form of financial asset on the balance sheet or the accompanying notes to the financial statements eliminating 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 and amortized at cost on the balance sheet and requiring a reporting organization to present separately in other comprehensive income the portion of the total change in the fair value of a liability resulting from a change in

the instrument-specific credit risk when the organization has elected to measure the liability at fair value in accordance with the fair value option for financial instruments. ASU 2016-01 is effective for annual periods and interim periods within those annual periods, beginning after December 15, 2017. The amendments should be applied by means of a cumulative effect adjustment to the balance sheet as of the beginning of the fiscal year of adoption. The amendments related to equity securities without readily determinable fair values (including disclosure requirements) should be applied prospectively to equity investments that exist as of the date of adoption. In February 2018, the FASB issued ASU No. 2018-03 which includes technical corrections and improvements to clarify the guidance in ASU No. 2016-01. The Corporation adopted ASU 2016-01 on January 1, 2018 and it did not have a material effect on its accounting for fair value disclosures and other disclosure requirements.

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*Pronouncements Not Yet Effective*

In January 2017, the FASB issued ASU 2017-04, Intangibles – Goodwill and Other (Topic 350). This standard simplifies the test for goodwill impairment by eliminating the requirement to calculate the implied fair value of goodwill, which currently is Step 2 of the goodwill impairment test. Instead, the goodwill impairment test will consist of a single quantitative step comparing the fair value of the reporting unit with its carrying amount. An entity should recognize a goodwill impairment charge for the amount by which the carrying amount exceeds the reporting unit's fair value. The new standard is effective for annual and any interim goodwill impairment tests in reporting periods beginning after December 15, 2019. Early adoption is permitted. The Corporation intends to adopt this standard effective with its October 1, 2020 goodwill impairment test and the adoption of this standard is not expected to have a material impact on its consolidated financial statements based on current circumstances.

In June 2016, the FASB issued ASU 2016-13, Financial Instruments – Credit Losses (Topic 326). This standard adds a new Topic 326 which requires companies to measure and record impairment on financial instruments at the time of origination using the expected credit loss (CECL) model. The CECL model calculates impairment based on historical experience, current conditions, and reasonable and supportable forecasts, and reflects the organization's current estimate of all expected credit losses over the contractual term of its financial assets. The new standard is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Early adoption is permitted for fiscal years beginning after December 15, 2018. The Corporation is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements and is in the initial stages of assessing and gathering the necessary data to implement the new standard.

In February 2016, the FASB issued ASU 2016-02, Leases and in July 2018 issued ASU 2018-10 and ASU 2018-11, Codification Improvements to Topic 842, Leases. From the lessee's perspective, the new standard establishes a right-of-use (ROU) model that requires a lessee to record a ROU asset and a lease liability on the balance sheet for all leases with terms longer than 12 months. Leases will be classified as either finance or operating, with classification affecting the pattern of expense recognition in the income statement for a lessees. From the lessor's perspective, the new standard requires a lessor to classify leases as either sales-type, finance or operating. A lease will be treated as a sale if it transfers all of the risks and rewards, as well as control of the underlying asset, to the lessee. If risks and rewards are conveyed without the transfer of control, the lease is treated as a financing lease. If the lessor doesn't convey risks and rewards or control, an operating lease results. The new standard is effective for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years. A modified retrospective transition approach is required for lessees for capital and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. A modified retrospective transition approach is required for lessors for sales-type, direct financing, and operating leases existing at, or entered into after, the beginning of the earliest comparative period presented in the financial statements, with certain practical expedients available. The Corporation is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements. The Corporation has determined that the provisions of ASU 2016-02 will result in an increase in assets to recognize the present value of the lease obligations (right-of-use assets) with a corresponding increase in liabilities. The initial measurement of the right-of-use asset and the corresponding liability will be affected by certain key assumptions such as expectations of renewals or extensions

and the interest rate to be used to discount the future lease obligations. The Corporation is currently assessing its lease portfolio to determine the key assumptions and financial statement impact; however, the total impact of the new standard will be affected by any new leases that are executed, leases that are terminated prior to the effective date, and any leases with changes to key assumptions or expectations such as renewals and extensions, and discount rates. The adoption is not expected to have an overall material impact on the Corporation's consolidated financial statements of income.

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In July 2018, the FASB issued ASU 2018-07, Improvements to Nonemployee Share-Based Payment Accounting. This standard expands the scope of Topic 718, Compensation – Stock Compensation to include share-based payment transactions for acquiring goods and services from nonemployees. This standard requires application of Topic 718 to nonemployee awards for specific guidance on inputs to an option pricing model and the attribution of costs (that is, the period of time over which share-based payment awards vest and the pattern of cost recognition over that period). The amendments in the Update are effective for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year. The adoption of this standard is not expected to have a material impact on the Corporation's consolidated financial statements based on current circumstances.

In August 2018, the FASB issued ASU 2018-13, Fair Value Measurement. The amendments in this update modify the disclosure requirements in Topic 820, Fair Value Measurement. The following disclosure requirements were removed: the amount of and reasons for transfers between Level 1 and Level 2, the policy for timing of transfers between levels, and the valuation processes for Level 3 fair value measurements. The following disclosure requirements were modified: for investments in certain entities that calculate net asset value, and entity is required to disclose the timing of liquidation of investee's assets and the amendments clarify that the measurement uncertainty disclosure is to communicate information about the uncertainty in measurement as of the reporting date. The following disclosure requirements were added: the changes in unrealized gains and losses for the period included in other comprehensive income for recurring Level 3 fair value measurements and the range and weighted average of significant unobservable inputs used to develop Level 3 fair value measurements. The update is effective for fiscal years beginning after December 15, 2019. The Corporation is currently evaluating the impact of the adoption of this update on its disclosures.

In August 2018, the FASB issued ASU 2018-14, Compensation-Retirement Benefits-Defined Benefit Plans-General (Subtopic 715-20). The amendments in this update remove disclosures that are no longer considered cost beneficial, clarify the specific requirements of disclosures, and add disclosure requirements identified as relevant. The update is effective for fiscal years ending after December 15, 2020. Early adoption is permitted. The Corporation is currently evaluating the impact of the adoption of this update on its disclosures.

In August 2018, the FASB issued ASU 2018-15, Intangibles-Goodwill and Other-Internal-Use Software. This standard aligns the requirements for capitalizing implementation costs incurred in a hosting arrangement that is a service contract with those incurred to develop or obtain internal-use software. This standard requires application of Subtopic 350-40 to determine which costs to implement the service contract would be capitalized as an asset and which costs would be expensed. The amendments in the Update are effective for the years beginning after December 15, 2019. The Corporation is currently evaluating the impact of the adoption of this guidance on its consolidated financial statements.

## **Note 2-Securities**



A summary of securities available-for-sale at September 30, 2018 and December 31, 2017 is provided below. The securities available-for-sale portfolio is generally comprised of high quality debt instruments, principally obligations of the United States government or agencies thereof and investments in the obligations of states and municipalities. The majority of municipal bonds in the portfolio are general obligation bonds, which can draw upon multiple sources of revenue, including taxes, for payment. Only a few bonds are revenue bonds, which are dependent upon a single revenue stream for payment, but they are for critical services such as water and sewer. In many cases, municipal debt issues are insured or, in the case of school districts of selected states, backed by specific loss reserves. At September 30, 2018, 86 percent of the fair value of the municipal bond portfolio was concentrated in the Commonwealth of Pennsylvania.

| (dollars in thousands)                   | Amortized<br>Cost | Gross<br>Unrealized |           | Fair<br>Value |
|--|-------------------|---------------------|-----------|---------------|
|  |                   | Gains               | Losses    |               |
| September 30, 2018                       |                   |                     |           |               |
| Debt securities:                         |                   |                     |           |               |
| U.S. Treasury notes                      | \$ 14,779         | \$0                 | \$(1,207) | \$13,572      |
| U.S. agency                              | 16,000            | 0                   | (1,258)   | 14,742        |
| U.S. agency mortgage-backed, residential | 73,794            | 37                  | (1,765)   | 72,066        |
| State and municipal                      | 46,484            | 42                  | (817 )    | 45,709        |
| Total debt securities                    | \$ 151,057        | \$79                | \$(5,047) | \$146,089     |
| December 31, 2017                        |                   |                     |           |               |
| Debt securities:                         |                   |                     |           |               |
| U.S. Treasury notes                      | \$ 14,758         | \$0                 | \$(687 )  | \$14,071      |
| U.S. agency                              | 18,015            | 0                   | (712 )    | 17,303        |
| U.S. agency mortgage-backed, residential | 75,204            | 327                 | (356 )    | 75,175        |
| State and municipal                      | 51,827            | 304                 | (89 )     | 52,042        |
| Total debt securities                    | \$ 159,804        | \$631               | \$(1,844) | \$158,591     |

The amortized cost and estimated fair value of debt securities at September 30, 2018 by contractual maturity are shown below. Actual maturities may differ from contractual maturities if call options on select debt issues are exercised in the future. Mortgage-backed securities are included in the maturity categories based on average expected life.

| (dollars in thousands)                 | Available-for-sale |               |
|--|--------------------|---------------|
|  | Amortized<br>Cost  | Fair<br>Value |
| Due in one year or less                | \$9,013            | \$9,026       |
| Due after one year through five years  | 88,647             | 86,107        |
| Due after five years through ten years | 44,759             | 42,323        |
| Due after ten years                    | 8,638              | 8,633         |
| Total debt securities                  | \$ 151,057         | \$ 146,089    |

Gross realized gains and losses on sales of securities available-for-sale are shown below. Realized gains and losses are computed on the basis of specific identification of the adjusted cost of each security and are shown net as a separate line item in the income statement.

| (dollars in thousands) | Three<br>months<br>ended<br>September<br>30, |       | Nine<br>months<br>ended<br>September<br>30, |       |
|------------------------|--|-------|---|-------|
|                        | 2018   | 2017  | 2018  | 2017  |
| Realized gains         | \$ 0   | \$ 16 | \$ 0  | \$ 79 |

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|                 |      |       |      |       |
|-----------------|------|-------|------|-------|
| Realized losses | 0    | 0     | 0    | 0     |
| Net gains       | \$ 0 | \$ 16 | \$ 0 | \$ 79 |

Investment securities having a carrying value of \$135,246,000 and \$105,603,000 on September 30, 2018 and December 31, 2017, respectively, were pledged to secure public and trust deposits, repurchase agreements and other short-term borrowings.

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The table below shows gross unrealized losses and fair value, aggregated by investment category and length of time, for securities that have been in a continuous unrealized loss position, at September 30, 2018 and December 31, 2017.

| (dollars in thousands)   | Less than 12 months  |            |                   | 12 months or more    |            |                   | Total                |            |                   |
|--|----------------------|------------|-------------------|----------------------|------------|-------------------|----------------------|------------|-------------------|
|  | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses | Number of Securities | Fair Value | Unrealized Losses |
| September 30, 2018   |                      |            |                   |                      |            |                   |                      |            |                   |
| Debt securities:   |                      |            |                   |                      |            |                   |                      |            |                   |
| U.S. Treasury notes  | 0                    | \$0        | \$0               | 3                    | \$13,572   | \$(1,207)         | 3                    | \$13,572   | \$(1,207)         |
| U.S. agency  | 0                    | 0          | 0                 | 4                    | 14,742     | (1,258)           | 4                    | 14,742     | (1,258)           |
| U.S. agency mortgage-backed, residential                       | 36                   | 46,566     | (1,107)           | 11                   | 16,963     | (658)             | 47                   | 63,529     | (1,765)           |
| State and municipal  | 58                   | 28,641     | (517)             | 12                   | 7,083      | (300)             | 70                   | 35,724     | (817)             |
| Total temporarily impaired debt securities, available-for-sale | 94                   | \$75,207   | \$(1,624)         | 30                   | \$52,360   | \$(3,423)         | 124                  | \$127,567  | \$(5,047)         |
| December 31, 2017  |                      |            |                   |                      |            |                   |                      |            |                   |
| Debt securities:   |                      |            |                   |                      |            |                   |                      |            |                   |
| U.S. Treasury notes  | 0                    | \$0        | \$0               | 3                    | \$14,071   | \$(687)           | 3                    | \$14,071   | \$(687)           |
| U.S. agency  | 1                    | 989        | (12)              | 4                    | 16,314     | (700)             | 5                    | 17,303     | (712)             |
| U.S. agency mortgage-backed, residential                       | 25                   | 43,329     | (261)             | 2                    | 5,051      | (95)              | 27                   | 48,380     | (356)             |
| State and municipal  | 27                   | 12,171     | (60)              | 5                    | 3,277      | (29)              | 32                   | 15,448     | (89)              |
| Total temporarily impaired debt securities, available-for-sale | 53                   | \$56,489   | \$(333)           | 14                   | \$38,713   | \$(1,511)         | 67                   | \$95,202   | \$(1,844)         |

Securities available-for-sale are analyzed quarterly for possible other-than-temporary impairment. The analysis considers, among other factors: 1) whether the Corporation has the intent to sell its securities prior to market recovery or maturity; 2) whether it is more likely than not that the Corporation will be required to sell its securities prior to market recovery or maturity; 3) default rates/history by security type; 4) third-party securities ratings; 5) third-party guarantees; 6) subordination; 7) payment delinquencies; 8) nature of the issuer; and 9) current financial news.

The Corporation believes that unrealized losses at September 30, 2018 were primarily the result of changes in market interest rates and that the Corporation has the ability to hold these investments for a time necessary to recover the amortized cost. Through September 30, 2018 the Corporation has collected all interest and principal on its investment securities as scheduled. The Corporation believes that collection of the contractual principal and interest is probable and, therefore, all impairment is considered to be temporary.

Note 3—Restricted Investment in Bank Stocks

Restricted stock, which represents required investments in the common stock of correspondent banks, is carried at cost and, as of September 30, 2018 and December 31, 2017, consisted primarily of the common stock of the Federal Home Loan Bank of Pittsburgh (“FHLBP”) and, to a lesser degree, Atlantic Community Bancshares, Inc. (“ACBI”), the parent company of Atlantic Community Bankers Bank (“ACBB”). Under the FHLBP’s Capital Plan member banks, including PeoplesBank, are required to maintain a minimum stock investment. The FHLBP uses a formula to determine the minimum stock investment, which is based on the volume of loans outstanding, unused borrowing capacity and other factors.

The FHLBP paid dividends during the periods ended September 30, 2018 and 2017. The FHLBP restricts the repurchase of the excess capital stock of member banks. The amount of excess capital stock that can be repurchased from any member is currently the lesser of five percent of the member’s total capital stock outstanding or its excess capital stock outstanding.

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Management evaluates the restricted stock for impairment in accordance with FASB ASC Topic 942. Management's determination of whether these investments are impaired is based on their assessment of the ultimate recoverability of their cost rather than by recognizing temporary declines in value. Using the FHLBP as an example, the determination of whether a decline affects the ultimate recoverability of cost is influenced by criteria such as: (1) the significance of the decline in net assets of the FHLBP as compared to the capital stock amount for the FHLBP and the length of time this situation has persisted; (2) commitments by the FHLBP to make payments required by law or regulation and the level of such payments in relation to the operating performance of the FHLBP; and (3) the impact of legislative and regulatory changes on institutions and, accordingly, on the customer base of the FHLBP. Management believes no impairment charge was necessary related to the restricted stock during the periods ended September 30, 2018 and 2017.

#### Note 4—Loans

##### *Loan Portfolio Composition*

The table below provides the composition of the loan portfolio at September 30, 2018 and December 31, 2017. The portfolio is comprised of two segments, commercial and consumer loans. The commercial loan segment is disaggregated by industry class which allows the Corporation to monitor risk and performance. Those industries representing the largest dollar investment and most risk are listed separately. The "Other" commercial loans category is comprised of various industries. The consumer related segment is comprised of residential mortgages, home equity and other consumer loans. The Corporation has not engaged in sub-prime residential mortgage originations.

|                                  | September<br>30,<br>2018 | %<br>Total<br>Loans | December<br>31,<br>2017 | %<br>Total<br>Loans |
|----------------------------------|--------------------------|---------------------|-------------------------|---------------------|
| (dollars in thousands)           |                          |                     |                         |                     |
| Builder & developer              | \$162,602                | 10.9                | \$184,402               | 13.2                |
| Commercial real estate investor  | 219,424                  | 14.7                | 230,827                 | 16.5                |
| Residential real estate investor | 235,126                  | 15.7                | 209,414                 | 15.0                |
| Hotel/Motel                      | 86,815                   | 5.8                 | 63,195                  | 4.5                 |
| Wholesale & retail               | 105,949                  | 7.1                 | 103,040                 | 7.3                 |
| Manufacturing                    | 84,441                   | 5.7                 | 62,510                  | 4.5                 |
| Agriculture                      | 65,520                   | 4.4                 | 59,931                  | 4.3                 |
| Other                            | 330,643                  | 22.1                | 284,511                 | 20.3                |
| Total commercial related loans   | 1,290,520                | 86.4                | 1,197,830               | 85.6                |
| Residential mortgages            | 82,763                   | 5.5                 | 79,325                  | 5.6                 |
| Home equity                      | 97,301                   | 6.5                 | 97,950                  | 7.0                 |
| Other                            | 23,443                   | 1.6                 | 24,659                  | 1.8                 |
| Total consumer related loans     | 203,507                  | 13.6                | 201,934                 | 14.4                |
| Total loans                      | \$1,494,027              | 100.0               | \$1,399,764             | 100.0               |

*Loan Risk Ratings*

The Corporation's internal risk rating system follows regulatory guidance as to risk classifications and definitions. Every approved loan is assigned a risk rating. Generally, risk ratings for commercial related loans and residential mortgages held for investment are determined by a formal evaluation of risk factors performed by the Corporation's underwriting staff. For consumer loans, and commercial loans up to \$500,000, the Corporation uses third-party credit scoring software models for risk rating purposes. The loan portfolio is monitored on a continuous basis by loan officers, loan review personnel and senior management. Adjustments of loan risk ratings are generally performed by the Special Asset Committee, which includes senior management. The Committee, which meets at a minimum quarterly, makes changes, as appropriate, to risk ratings when it becomes aware of credit events such as payment delinquency, cessation of a business or project, bankruptcy or death of the borrower, or changes in collateral value.

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The Corporation uses ten risk ratings to grade loans. The first seven ratings, representing the lowest risk, are combined and given a “pass” rating. A pass rating is a satisfactory credit rating, which applies to a loan that is expected to perform in accordance with the loan agreement and has a low probability of loss. A loan rated “special mention” has a potential weakness which may, if not corrected, weaken the loan or inadequately protect the Corporation’s position at some future date. A loan rated “substandard” is inadequately protected by the current net worth or paying capacity of the borrower or of the collateral pledged. A substandard loan has a well-defined weakness or weaknesses that could jeopardize liquidation of the loan, which exposes the Corporation to loss if the deficiencies are not corrected. A loan classified “doubtful” has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions and value highly improbable and the possibility of loss extremely high. When circumstances indicate that collection of the loan is doubtful, the loan is risk rated “nonaccrual,” the accrual of interest income is discontinued, and any unpaid interest previously credited to income is reversed. The table below does not include the regulatory classification of “doubtful,” which is subsumed within the nonaccrual risk rating category, nor does it include the regulatory classification of “loss” because the Corporation promptly charges off known loan losses.

The table below presents a summary of loan risk ratings by loan class at September 30, 2018 and December 31, 2017.

| (dollars in thousands)           | Pass        | Special<br>Mention | Substandard | Nonaccrual | Total       |
|----------------------------------|-------------|--------------------|-------------|------------|-------------|
| September 30, 2018               |             |                    |             |            |             |
| Builder & developer              | \$161,351   | \$836              | \$415       | \$0        | \$162,602   |
| Commercial real estate investor  | 214,458     | 0                  | 4,365       | 601        | 219,424     |
| Residential real estate investor | 225,570     | 7,380              | 1,171       | 1,005      | 235,126     |
| Hotel/Motel                      | 86,815      | 0                  | 0           | 0          | 86,815      |
| Wholesale & retail               | 92,858      | 5,177              | 97          | 7,817      | 105,949     |
| Manufacturing                    | 80,629      | 568                | 1,375       | 1,869      | 84,441      |
| Agriculture                      | 61,656      | 3,203              | 374         | 287        | 65,520      |
| Other                            | 327,020     | 2,506              | 955         | 162        | 330,643     |
| Total commercial related loans   | 1,250,357   | 19,670             | 8,752       | 11,741     | 1,290,520   |
| Residential mortgage             | 82,206      | 7                  | 83          | 467        | 82,763      |
| Home equity                      | 96,808      | 0                  | 0           | 493        | 97,301      |
| Other                            | 23,198      | 3                  | 9           | 233        | 23,443      |
| Total consumer related loans     | 202,212     | 10                 | 92          | 1,193      | 203,507     |
| Total loans                      | \$1,452,569 | \$19,680           | \$8,844     | \$12,934   | \$1,494,027 |
| December 31, 2017                |             |                    |             |            |             |
| Builder & developer              | \$179,897   | \$1,832            | \$581       | \$2,092    | \$184,402   |
| Commercial real estate investor  | 224,822     | 360                | 4,339       | 1,306      | 230,827     |
| Residential real estate investor | 204,139     | 4,065              | 711         | 499        | 209,414     |
| Hotel/Motel                      | 63,195      | 0                  | 0           | 0          | 63,195      |
| Wholesale & retail               | 95,128      | 254                | 7,658       | 0          | 103,040     |
| Manufacturing                    | 58,082      | 588                | 3,840       | 0          | 62,510      |
| Agriculture                      | 57,140      | 2,476              | 0           | 315        | 59,931      |



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|                                |             |          |          |         |             |
|--------------------------------|-------------|----------|----------|---------|-------------|
| Other                          | 283,086     | 507      | 918      | 0       | 284,511     |
| Total commercial related loans | 1,165,489   | 10,082   | 18,047   | 4,212   | 1,197,830   |
| Residential mortgage           | 79,068      | 10       | 85       | 162     | 79,325      |
| Home equity                    | 97,498      | 0        | 0        | 452     | 97,950      |
| Other                          | 24,394      | 30       | 9        | 226     | 24,659      |
| Total consumer related loans   | 200,960     | 40       | 94       | 840     | 201,934     |
| Total loans                    | \$1,366,449 | \$10,122 | \$18,141 | \$5,052 | \$1,399,764 |

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*Impaired Loans*

The table below presents a summary of impaired loans at September 30, 2018 and December 31, 2017. Generally, impaired loans are certain loan risk rated substandard and all loans risk rated nonaccrual or classified as troubled debt restructuring. An allowance is established for individual loans that are commercial related where the Corporation has doubt as to full recovery of the outstanding principal balance. Typically, impaired consumer related loans are partially or fully charged-off eliminating the need for a specific allowance. The recorded investment represents outstanding unpaid principal loan balances adjusted for charge-offs.

| (dollars in thousands)                  | With No Allowance   |                  | With A Related Allowance |                  |                   | Total               |                  |
|---|---------------------|------------------|--------------------------|------------------|-------------------|---------------------|------------------|
|   | Recorded Investment | Unpaid Principal | Recorded Investment      | Unpaid Principal | Related Allowance | Recorded Investment | Unpaid Principal |
| September 30, 2018                      |                     |                  |                          |                  |                   |                     |                  |
| Builder & developer                     | \$277               | \$ 571           | \$138                    | \$ 138           | \$ 51             | \$415               | \$ 709           |
| Commercial real estate investor         | 4,966               | 4,966            | 0                        | 0                | 0                 | 4,966               | 4,966            |
| Residential real estate investor        | 2,176               | 2,176            | 0                        | 0                | 0                 | 2,176               | 2,176            |
| Hotel/Motel                             | 0                   | 0                | 0                        | 0                | 0                 | 0                   | 0                |
| Wholesale & retail                      | 347                 | 347              | 7,817                    | 7,817            | 757               | 8,164               | 8,164            |
| Manufacturing                           | 1,393               | 1,393            | 1,851                    | 1,851            | 539               | 3,244               | 3,244            |
| Agriculture                             | 661                 | 661              | 0                        | 0                | 0                 | 661                 | 661              |
| Other commercial                        | 1,117               | 1,117            | 0                        | 0                | 0                 | 1,117               | 1,117            |
| Total impaired commercial related loans | 10,937              | 11,231           | 9,806                    | 9,806            | 1,347             | 20,743              | 21,037           |
| Residential mortgage                    | 550                 | 574              | 0                        | 0                | 0                 | 550                 | 574              |
| Home equity                             | 493                 | 493              | 0                        | 0                | 0                 | 493                 | 493              |
| Other consumer                          | 242                 | 242              | 0                        | 0                | 0                 | 242                 | 242              |
| Total impaired consumer related loans   | 1,285               | 1,309            | 0                        | 0                | 0                 | 1,285               | 1,309            |
| Total impaired loans                    | \$12,222            | \$12,540         | \$9,806                  | \$9,806          | \$ 1,347          | \$22,028            | \$22,346         |
| December 31, 2017                       |                     |                  |                          |                  |                   |                     |                  |
| Builder & developer                     | \$2,673             | \$3,008          | \$0                      | \$0              | \$0               | \$2,673             | \$3,008          |
| Commercial real estate investor         | 4,585               | 4,601            | 1,060                    | 1,060            | 243               | 5,645               | 5,661            |
| Residential real estate investor        | 1,210               | 1,510            | 0                        | 0                | 0                 | 1,210               | 1,510            |
| Hotel/Motel                             | 0                   | 0                | 0                        | 0                | 0                 | 0                   | 0                |
| Wholesale & retail                      | 7,912               | 7,912            | 0                        | 0                | 0                 | 7,912               | 7,912            |
| Manufacturing                           | 3,840               | 3,840            | 0                        | 0                | 0                 | 3,840               | 3,840            |
| Agriculture                             | 315                 | 315              | 0                        | 0                | 0                 | 315                 | 315              |
| Other commercial                        | 918                 | 918              | 0                        | 0                | 0                 | 918                 | 918              |
| Total impaired commercial related loans | 21,453              | 22,104           | 1,060                    | 1,060            | 243               | 22,513              | 23,164           |
| Residential mortgage                    | 247                 | 276              | 0                        | 0                | 0                 | 247                 | 276              |
| Home equity                             | 452                 | 452              | 0                        | 0                | 0                 | 452                 | 452              |
| Other consumer                          | 235                 | 235              | 0                        | 0                | 0                 | 235                 | 235              |
| Total impaired consumer related loans   | 934                 | 963              | 0                        | 0                | 0                 | 934                 | 963              |
| Total impaired loans                    | \$22,387            | \$23,067         | \$1,060                  | \$1,060          | \$243             | \$23,447            | \$24,127         |



The table below presents a summary of average impaired loans and related interest income that was included in net income for the three and nine months ended September 30, 2018 and 2017.

|   | With No Related Allowance |                 |                 | With A Related Allowance |                 |                 | Total               |                 |                 |
|---|---------------------------|-----------------|-----------------|--------------------------|-----------------|-----------------|---------------------|-----------------|-----------------|
|   | Average                   | Total           | Cash Basis      | Average                  | Total           | Cash Basis      | Average             | Total           | Cash Basis      |
| (dollars in thousands)                  | Recorded Investment       | Interest Income | Interest Income | Recorded Investment      | Interest Income | Interest Income | Recorded Investment | Interest Income | Interest Income |
| Three months ended September 30, 2018   |                           |                 |                 |                          |                 |                 |                     |                 |                 |
| Builder & developer                     | \$1,280                   | \$ 4            | \$ 0            | \$69                     | \$ 2            | \$ 0            | \$1,349             | \$ 6            | \$ 0            |
| Commercial real estate investor         | 6,040                     | 75              | 7               | 0                        | 0               | 0               | 6,040               | 75              | 7               |
| Residential real estate investor        | 1,909                     | 13              | 4               | 0                        | 0               | 0               | 1,909               | 13              | 4               |
| Hotel/Motel                             | 0                         | 0               | 0               | 0                        | 0               | 0               | 0                   | 0               | 0               |
| Wholesale & retail                      | 3,538                     | 3               | 0               | 3,909                    | 116             | 0               | 7,447               | 119             | 0               |
| Manufacturing                           | 2,422                     | 23              | 0               | 925                      | 69              | 0               | 3,347               | 92              | 0               |
| Agriculture                             | 477                       | 3               | 0               | 0                        | 0               | 0               | 477                 | 3               | 0               |
| Other commercial                        | 1,039                     | 17              | 1               | 0                        | 0               | 0               | 1,039               | 17              | 1               |
| Total impaired commercial related loans | 16,705                    | 138             | 12              | 4,903                    | 187             | 0               | 21,608              | 325             | 12              |
| Residential mortgage                    | 394                       | 16              | 15              | 0                        | 0               | 0               | 394                 | 16              | 15              |
| Home equity                             | 529                       | 3               | 3               | 0                        | 0               | 0               | 529                 | 3               | 3               |
| Other consumer                          | 248                       | 4               | 4               | 0                        | 0               | 0               | 248                 | 4               | 4               |
| Total impaired consumer related loans   | 1,171                     | 23              | 22              | 0                        | 0               | 0               | 1,171               | 23              | 22              |
| Total impaired loans                    | \$17,876                  | \$ 161          | \$ 34           | \$4,903                  | \$ 187          | \$ 0            | \$22,779            | \$ 348          | \$ 34           |
| Three months ended September 30, 2017   |                           |                 |                 |                          |                 |                 |                     |                 |                 |
| Builder & developer                     | \$4,199                   | \$ 48           | \$ 0            | \$2,336                  | \$ 0            | \$ 0            | \$6,535             | \$ 48           | \$ 0            |
| Commercial real estate investor         | 5,233                     | 62              | 4               | 550                      | 0               | 0               | 5,783               | 62              | 4               |
| Residential real estate investor        | 1,420                     | 12              | 2               | 299                      | 0               | 0               | 1,719               | 12              | 2               |
| Hotel/Motel                             | 0                         | 0               | 0               | 0                        | 0               | 0               | 0                   | 0               | 0               |
| Wholesale & retail                      | 6,628                     | 90              | 0               | 0                        | 0               | 0               | 6,628               | 90              | 0               |
| Manufacturing                           | 3,581                     | 82              | 0               | 1,188                    | 17              | 0               | 4,769               | 99              | 0               |
| Agriculture                             | 165                       | 0               | 0               | 168                      | 0               | 0               | 333                 | 0               | 0               |
| Other commercial                        | 1,146                     | 14              | 0               | 92                       | 0               | 0               | 1,238               | 14              | 0               |
| Total impaired commercial related loans | 22,372                    | 308             | 6               | 4,633                    | 17              | 0               | 27,005              | 325             | 6               |
| Residential mortgage                    | 93                        | 0               | 0               | 0                        | 0               | 0               | 93                  | 0               | 0               |
| Home equity                             | 375                       | 3               | 3               | 0                        | 0               | 0               | 375                 | 3               | 3               |
| Other consumer                          | 293                       | 0               | 0               | 0                        | 0               | 0               | 293                 | 0               | 0               |
| Total impaired consumer related loans   | 761                       | 3               | 3               | 0                        | 0               | 0               | 761                 | 3               | 3               |
| Total impaired loans                    | \$23,133                  | \$ 311          | \$ 9            | \$4,633                  | \$ 17           | \$ 0            | \$27,766            | \$ 328          | \$ 9            |



|   | With No Related Allowance |                 |                 | With A Related Allowance |                 |                 | Total               |                 |                 |
|---|---------------------------|-----------------|-----------------|--------------------------|-----------------|-----------------|---------------------|-----------------|-----------------|
|   | Average                   | Total           | Cash Basis      | Average                  | Total           | Cash Basis      | Average             | Total           | Cash Basis      |
| (dollars in thousands)                  | Recorded Investment       | Interest Income | Interest Income | Recorded Investment      | Interest Income | Interest Income | Recorded Investment | Interest Income | Interest Income |
| Nine months ended September 30, 2018    |                           |                 |                 |                          |                 |                 |                     |                 |                 |
| Builder & developer                     | \$1,883                   | \$ 10           | \$ 0            | \$35                     | \$ 7            | \$ 0            | \$1,918             | \$ 17           | \$ 0            |
| Commercial real estate investor         | 5,296                     | 210             | 14              | 265                      | 0               | 0               | 5,561               | 210             | 14              |
| Residential real estate investor        | 1,637                     | 33              | 9               | 0                        | 0               | 0               | 1,637               | 33              | 9               |
| Hotel/Motel                             | 0                         | 0               | 0               | 0                        | 0               | 0               | 0                   | 0               | 0               |
| Wholesale & retail                      | 5,316                     | 8               | 0               | 1,954                    | 301             | 0               | 7,270               | 309             | 0               |
| Manufacturing                           | 3,087                     | 68              | 0               | 463                      | 206             | 0               | 3,550               | 274             | 0               |
| Agriculture                             | 427                       | 4               | 0               | 0                        | 0               | 0               | 427                 | 4               | 0               |
| Other commercial                        | 1,031                     | 47              | 1               | 0                        | 0               | 0               | 1,031               | 47              | 1               |
| Total impaired commercial related loans | 18,677                    | 380             | 24              | 2,717                    | 514             | 0               | 21,394              | 894             | 24              |
| Residential mortgage                    | 327                       | 17              | 15              | 0                        | 0               | 0               | 327                 | 17              | 15              |
| Home equity                             | 492                       | 15              | 14              | 0                        | 0               | 0               | 492                 | 15              | 14              |
| Other consumer                          | 242                       | 13              | 13              | 0                        | 0               | 0               | 242                 | 13              | 13              |
| Total impaired consumer related loans   | 1,061                     | 45              | 42              | 0                        | 0               | 0               | 1,061               | 45              | 42              |
| Total impaired loans                    | \$19,738                  | \$ 425          | \$ 66           | \$2,717                  | \$ 514          | \$ 0            | \$22,455            | \$ 939          | \$ 66           |
| Nine months ended September 30, 2017    |                           |                 |                 |                          |                 |                 |                     |                 |                 |
| Builder & developer                     | \$3,741                   | \$ 149          | \$ 0            | \$1,360                  | \$ 0            | \$ 0            | \$5,101             | \$ 149          | \$ 0            |
| Commercial real estate investor         | 5,281                     | 185             | 15              | 275                      | 0               | 0               | 5,556               | 185             | 15              |
| Residential real estate investor        | 1,411                     | 38              | 9               | 379                      | 0               | 0               | 1,790               | 38              | 9               |
| Hotel/Motel                             | 90                        | 0               | 0               | 9                        | 0               | 0               | 99                  | 0               | 0               |
| Wholesale & retail                      | 5,198                     | 174             | 0               | 0                        | 0               | 0               | 5,198               | 174             | 0               |
| Manufacturing                           | 2,431                     | 168             | 0               | 913                      | 35              | 0               | 3,344               | 203             | 0               |
| Agriculture                             | 224                       | 0               | 0               | 262                      | 0               | 0               | 486                 | 0               | 0               |
| Other commercial                        | 1,086                     | 41              | 0               | 137                      | 0               | 0               | 1,223               | 41              | 0               |
| Total impaired commercial related loans | 19,462                    | 755             | 24              | 3,335                    | 35              | 0               | 22,797              | 790             | 24              |
| Residential mortgage                    | 105                       | 1               | 0               | 0                        | 0               | 0               | 105                 | 1               | 0               |
| Home equity                             | 348                       | 7               | 7               | 0                        | 0               | 0               | 348                 | 7               | 7               |
| Other consumer                          | 264                       | 6               | 5               | 0                        | 0               | 0               | 264                 | 6               | 5               |
| Total impaired consumer related loans   | 717                       | 14              | 12              | 0                        | 0               | 0               | 717                 | 14              | 12              |
| Total impaired loans                    | \$20,179                  | \$ 769          | \$ 36           | \$3,335                  | \$ 35           | \$ 0            | \$23,514            | \$ 804          | \$ 36           |

*Past Due and Nonaccrual*

The performance and credit quality of the loan portfolio is also monitored by using an aging schedule that shows the length of time a loan is past due. The table below presents a summary of past due loans, nonaccrual loans and current loans by loan segment and class at September 30, 2018 and December 31, 2017.

| (dollars in thousands)           | 30-59<br>Days<br>Past<br>Due | 60-89<br>Days<br>Past<br>Due | ≥ 90 Days                   |            | Total Past            |             | Total<br>Loans |
|----------------------------------|------------------------------|------------------------------|-----------------------------|------------|-----------------------|-------------|----------------|
|                                  |                              |                              | Past Due<br>and<br>Accruing | Nonaccrual | Due and<br>Nonaccrual | Current     |                |
| September 30, 2018               |                              |                              |                             |            |                       |             |                |
| Builder & developer              | \$550                        | \$223                        | \$ 118                      | \$ 0       | \$ 891                | \$161,711   | \$162,602      |
| Commercial real estate investor  | 1,828                        | 0                            | 0                           | 601        | 2,429                 | 216,995     | 219,424        |
| Residential real estate investor | 1,910                        | 930                          | 0                           | 1,005      | 3,845                 | 231,281     | 235,126        |
| Hotel/Motel                      | 0                            | 0                            | 0                           | 0          | 0                     | 86,815      | 86,815         |
| Wholesale & retail               | 0                            | 0                            | 0                           | 7,817      | 7,817                 | 98,132      | 105,949        |
| Manufacturing                    | 0                            | 0                            | 0                           | 1,869      | 1,869                 | 82,572      | 84,441         |
| Agriculture                      | 0                            | 17                           | 0                           | 287        | 304                   | 65,216      | 65,520         |
| Other                            | 461                          | 63                           | 100                         | 162        | 786                   | 329,857     | 330,643        |
| Total commercial related loans   | 4,749                        | 1,233                        | 218                         | 11,741     | 17,941                | 1,272,579   | 1,290,520      |
| Residential mortgage             | 364                          | 11                           | 67                          | 467        | 909                   | 81,854      | 82,763         |
| Home equity                      | 207                          | 112                          | 0                           | 493        | 812                   | 96,489      | 97,301         |
| Other                            | 116                          | 78                           | 8                           | 233        | 435                   | 23,008      | 23,443         |
| Total consumer related loans     | 687                          | 201                          | 75                          | 1,193      | 2,156                 | 201,351     | 203,507        |
| Total loans                      | \$5,436                      | \$1,434                      | \$ 293                      | \$ 12,934  | \$ 20,097             | \$1,473,930 | \$1,494,027    |
| December 31, 2017                |                              |                              |                             |            |                       |             |                |
| Builder & developer              | \$615                        | \$26                         | \$ 0                        | \$ 2,092   | \$ 2,733              | \$181,669   | \$184,402      |
| Commercial real estate investor  | 0                            | 0                            | 0                           | 1,306      | 1,306                 | 229,521     | 230,827        |
| Residential real estate investor | 347                          | 0                            | 0                           | 499        | 846                   | 208,568     | 209,414        |
| Hotel/Motel                      | 0                            | 0                            | 0                           | 0          | 0                     | 63,195      | 63,195         |
| Wholesale & retail               | 0                            | 0                            | 0                           | 0          | 0                     | 103,040     | 103,040        |
| Manufacturing                    | 0                            | 0                            | 0                           | 0          | 0                     | 62,510      | 62,510         |
| Agriculture                      | 0                            | 137                          | 0                           | 315        | 452                   | 59,479      | 59,931         |
| Other                            | 203                          | 117                          | 0                           | 0          | 320                   | 284,191     | 284,511        |
| Total commercial related loans   | 1,165                        | 280                          | 0                           | 4,212      | 5,657                 | 1,192,173   | 1,197,830      |
| Residential mortgage             | 392                          | 72                           | 67                          | 162        | 693                   | 78,632      | 79,325         |
| Home equity                      | 264                          | 5                            | 0                           | 452        | 721                   | 97,229      | 97,950         |
| Other                            | 123                          | 5                            | 9                           | 226        | 363                   | 24,296      | 24,659         |
| Total consumer related loans     | 779                          | 82                           | 76                          | 840        | 1,777                 | 200,157     | 201,934        |
| Total loans                      | \$1,944                      | \$362                        | \$ 76                       | \$ 5,052   | \$ 7,434              | \$1,392,330 | \$1,399,764    |





*Troubled Debt Restructurings*

Loans classified as troubled debt restructurings (TDRs) are designated impaired and arise when the Corporation grants borrowers experiencing financial difficulties concessions that it would not otherwise consider. Concessions granted with respect to these loans generally involve an extension of the maturity date or a below market interest rate relative to new debt with similar credit risk. Generally, these loans are secured by real estate. If repayment of the loan is determined to be collateral dependent, the loan is evaluated for impairment loss based on the fair value of the collateral. For loans that are not collateral dependent, the present value of expected future cash flows, discounted at the loan's original effective interest rate, is used to determine any impairment loss. A nonaccrual TDR represents a nonaccrual loan, as previously defined, which includes an economic concession. Nonaccrual TDRs are restored to accrual status if principal and interest payments, under the modified terms, are current for six consecutive payments after the modification and future principal and interest payments are reasonably assured. In contrast, an accruing TDR represents a loan that, at the time of the modification, has a demonstrated history of payments and management believes that future loan payments are reasonably assured under the modified terms.

The table below shows loans whose terms have been modified under TDRs during the three and nine months ended September 30, 2018 and 2017. There were no impairment losses recognized on any of these TDRs, and one of the loans modified in the third quarter of 2018 is not performing under their modified terms. There were no defaults during the three and nine months ended September 30, 2018 for TDRs entered into during the previous 12 month period.

|                                   | <b>Modifications</b>                |   |                                 |
|-----------------------------------|-------------------------------------|---|---------------------------------|
|                                   | <b>Pre-Modification</b>             | <b>Post-Modification</b>                | <b>Recorded</b>                 |
| <b>(dollars in thousands)</b>     | <b>Number of Recorded Contracts</b> | <b>Outstanding Recorded Investments</b> | <b>Investment at Period End</b> |
| <b><u>Three months ended:</u></b> |                                     |   |                                 |
| September 30, 2018                |                                     |   |                                 |
| Commercial related loans accruing | 2 \$ 1,114                          | \$ 1,155                                | \$ 1,154                        |
| September 30, 2017                |                                     |   |                                 |
| None                              |                                     |   |                                 |
| <b>Nine months ended:</b>         |                                     |   |                                 |
| September 30, 2018                |                                     |   |                                 |
| Commercial related loans accruing | 3 \$ 1,264                          | \$ 1,305                                | \$ 1,293                        |
| September 30, 2017                |                                     |   |                                 |
| None                              |                                     |   |                                 |



**NOTE 5 – Allowance for Loan Losses**

The table below shows the activity in and the composition of the allowance for loan losses by loan segment and class detail as of and for the three and nine months ended September 30, 2018 and 2017.

| (dollars in thousands)           | Allowance for Loan Losses |             |            |           | September 30, 2018 |
|----------------------------------|---------------------------|-------------|------------|-----------|--------------------|
|                                  | July 1, 2018              |             |            |           |                    |
|                                  | Balance                   | Charge-offs | Recoveries | Provision | Balance            |
| Builder & developer              | \$2,899                   | \$(144)     | ) \$41     | \$218     | \$3,014            |
| Commercial real estate investor  | 2,695                     | 0           | 0          | 49        | 2,744              |
| Residential real estate investor | 2,424                     | (1)         | ) 3        | 68        | 2,494              |
| Hotel/Motel                      | 764                       | 0           | 0          | 46        | 810                |
| Wholesale & retail               | 938                       | 0           | 1          | 775       | 1,714              |
| Manufacturing                    | 645                       | 0           | 0          | 681       | 1,326              |
| Agriculture                      | 471                       | 0           | 0          | 76        | 547                |
| Other commercial                 | 2,955                     | 0           | 18         | (63)      | 2,910              |
| Total commercial related loans   | 13,791                    | (145)       | ) 63       | 1,850     | 15,559             |
| Residential mortgage             | 114                       | 0           | 9          | (1)       | 122                |
| Home equity                      | 203                       | (123)       | ) 0        | 203       | 283                |
| Other consumer                   | 192                       | (30)        | ) 13       | (17)      | 158                |
| Total consumer related loans     | 509                       | (153)       | ) 22       | 185       | 563                |
| Unallocated                      | 2,847                     | 0           | 0          | (735)     | 2,112              |
| Total                            | \$17,147                  | \$(298)     | ) \$85     | \$1,300   | \$18,234           |

| (dollars in thousands)           | Allowance for Loan Losses |             |            |           | September 30, 2017 |
|----------------------------------|---------------------------|-------------|------------|-----------|--------------------|
|                                  | July 1, 2017              |             |            |           |                    |
|                                  | Balance                   | Charge-offs | Recoveries | Provision | Balance            |
| Builder & developer              | \$3,511                   | \$(1,474)   | ) \$0      | \$1,913   | \$3,950            |
| Commercial real estate investor  | 3,073                     | 0           | 0          | 128       | 3,201              |
| Residential real estate investor | 2,458                     | 0           | 3          | 71        | 2,532              |
| Hotel/Motel                      | 662                       | 0           | 0          | 7         | 669                |
| Wholesale & retail               | 845                       | 0           | 0          | 34        | 879                |
| Manufacturing                    | 906                       | 0           | 0          | 55        | 961                |
| Agriculture                      | 673                       | 0           | 0          | (257)     | 416                |
| Other commercial                 | 2,434                     | (68)        | ) 0        | 113       | 2,479              |
| Total commercial related loans   | 14,562                    | (1,542)     | ) 3        | 2,064     | 15,087             |
| Residential mortgage             | 94                        | 0           | 0          | 11        | 105                |
| Home equity                      | 182                       | (137)       | ) 0        | 153       | 198                |
| Other consumer                   | 73                        | (51)        | ) 4        | 47        | 73                 |
| Total consumer related loans     | 349                       | (188)       | ) 4        | 211       | 376                |
| Unallocated                      | 1,504                     | 0           | 0          | (175)     | 1,329              |
| Total                            | \$16,415                  | \$(1,730)   | ) \$7      | \$2,100   | \$16,792           |



| (dollars in thousands)           | Allowance for Loan Losses |             |            |           | September 30, 2018 |
|----------------------------------|---------------------------|-------------|------------|-----------|--------------------|
|                                  | January 1, 2018           | Charge-offs | Recoveries | Provision |                    |
|                                  | Balance                   |             |            |           | Balance            |
| Builder & developer              | \$3,388                   | \$(144)     | ) \$59     | \$(289)   | ) \$3,014          |
| Commercial real estate investor  | 3,013                     | 0           | 0          | (269)     | ) 2,744            |
| Residential real estate investor | 2,505                     | (2)         | ) 77       | (86)      | ) 2,494            |
| Hotel/Motel                      | 637                       | 0           | 0          | 173       | 810                |
| Wholesale & retail               | 909                       | 0           | 3          | 802       | 1,714              |
| Manufacturing                    | 592                       | 0           | 0          | 734       | 1,326              |
| Agriculture                      | 431                       | 0           | 0          | 116       | 547                |
| Other commercial                 | 2,643                     | 0           | 18         | 249       | 2,910              |
| Total commercial related loans   | 14,118                    | (146)       | ) 157      | 1,430     | 15,559             |
| Residential mortgage             | 108                       | (10)        | ) 10       | 14        | 122                |
| Home equity                      | 217                       | (123)       | ) 0        | 189       | 283                |
| Other consumer                   | 66                        | (166)       | ) 23       | 235       | 158                |
| Total consumer related loans     | 391                       | (299)       | ) 33       | 438       | 563                |
| Unallocated                      | 2,180                     | 0           | 0          | (68)      | ) 2,112            |
| Total                            | \$16,689                  | \$(445)     | ) \$190    | \$1,800   | \$18,234           |

| (dollars in thousands)           | Allowance for Loan Losses |             |            |           | September 30, 2017 |
|----------------------------------|---------------------------|-------------|------------|-----------|--------------------|
|                                  | January 1, 2017           | Charge-offs | Recoveries | Provision |                    |
|                                  | Balance                   |             |            |           | Balance            |
| Builder & developer              | \$2,384                   | \$(1,474)   | ) \$2      | \$3,038   | \$3,950            |
| Commercial real estate investor  | 2,870                     | 0           | 0          | 331       | 3,201              |
| Residential real estate investor | 2,517                     | (110)       | ) 59       | 66        | 2,532              |
| Hotel/Motel                      | 807                       | (36)        | ) 36       | (138)     | ) 669              |
| Wholesale & retail               | 803                       | 0           | 0          | 76        | 879                |
| Manufacturing                    | 307                       | 0           | 0          | 654       | 961                |
| Agriculture                      | 619                       | 0           | 0          | (203)     | ) 416              |
| Other commercial                 | 2,467                     | (68)        | ) 0        | 80        | 2,479              |
| Total commercial related loans   | 12,774                    | (1,688)     | ) 97       | 3,904     | 15,087             |
| Residential mortgage             | 85                        | 0           | 5          | 15        | 105                |
| Home equity                      | 179                       | (137)       | ) 0        | 156       | 198                |
| Other consumer                   | 193                       | (61)        | ) 9        | (68)      | ) 73               |
| Total consumer related loans     | 457                       | (198)       | ) 14       | 103       | 376                |
| Unallocated                      | 1,761                     | 0           | 0          | (432)     | ) 1,329            |
| Total                            | \$14,992                  | \$(1,886)   | ) \$111    | \$3,575   | \$16,792           |



The table below shows the allowance amount required for loans individually evaluated for impairment and the amount required for loans collectively evaluated for impairment at September 30, 2018, December 31, 2017, and September 30, 2017.

| (dollars in thousands)           | Allowance for Loan Losses                      |  |          | Loans  |  |              |
|----------------------------------|--|--|----------|--|--|--------------|
|                                  | Individually<br>Evaluated<br>For<br>Impairment | Collectively<br>Evaluated<br>For<br>Impairment | Balance  | Individually<br>Evaluated<br>For<br>Impairment | Collectively<br>Evaluated<br>For<br>Impairment | Balance      |
| September 30, 2018               |  |  |          |  |  |              |
| Builder & developer              | \$51   | \$ 2,963                                       | \$3,014  | \$415  | \$ 162,187                                     | \$162,602    |
| Commercial real estate investor  | 0  | 2,744  | 2,744    | 4,966  | 214,458  | 219,424      |
| Residential real estate investor | 0  | 2,494  | 2,494    | 2,176  | 232,950  | 235,126      |
| Hotel/Motel                      | 0  | 810  | 810      | 0  | 86,815   | 86,815       |
| Wholesale & retail               | 757  | 957  | 1,714    | 8,164  | 97,785   | 105,949      |
| Manufacturing                    | 539  | 787  | 1,326    | 3,244  | 81,197   | 84,441       |
| Agriculture                      | 0  | 547  | 547      | 661  | 64,859   | 65,520       |
| Other commercial                 | 0  | 2,910  | 2,910    | 1,117  | 329,526  | 330,643      |
| Total commercial related         | 1,347  | 14,212   | 15,559   | 20,743   | 1,269,777                                      | 1,290,520    |
| Residential mortgage             | 0  | 122  | 122      | 550  | 82,213   | 82,763       |
| Home equity                      | 0  | 283  | 283      | 493  | 96,808   | 97,301       |
| Other consumer                   | 0  | 158  | 158      | 242  | 23,201   | 23,443       |
| Total consumer related           | 0  | 563  | 563      | 1,285  | 202,222  | 203,507      |
| Unallocated                      | 0  | 2,112  | 2,112    | —  | —  | —            |
| Total                            | \$1,347  | \$ 16,887                                      | \$18,234 | \$22,028                                       | \$ 1,471,999                                   | \$ 1,494,027 |
| December 31, 2017                |  |  |          |  |  |              |
| Builder & developer              | \$0  | \$3,388  | \$3,388  | \$2,673  | \$181,729                                      | \$184,402    |
| Commercial real estate investor  | 243  | 2,770  | 3,013    | 5,645  | 225,182  | 230,827      |
| Residential real estate investor | 0  | 2,505  | 2,505    | 1,210  | 208,204  | 209,414      |
| Hotel/Motel                      | 0  | 637  | 637      | 0  | 63,195   | 63,195       |
| Wholesale & retail               | 0  | 909  | 909      | 7,912  | 95,128   | 103,040      |
| Manufacturing                    | 0  | 592  | 592      | 3,840  | 58,670   | 62,510       |
| Agriculture                      | 0  | 431  | 431      | 315  | 59,616   | 59,931       |
| Other commercial                 | 0  | 2,643  | 2,643    | 918  | 283,593  | 284,511      |
| Total commercial related         | 243  | 13,875   | 14,118   | 22,513   | 1,175,317                                      | 1,197,830    |
| Residential mortgage             | 0  | 108  | 108      | 247  | 79,078   | 79,325       |
| Home equity                      | 0  | 217  | 217      | 452  | 97,498   | 97,950       |
| Other consumer                   | 0  | 66   | 66       | 235  | 24,424   | 24,659       |
| Total consumer related           | 0  | 391  | 391      | 934  | 201,000  | 201,934      |
| Unallocated                      | 0  | 2,180  | 2,180    | —  | —  | —            |
| Total                            | \$243  | \$16,446                                       | \$16,689 | \$23,447                                       | \$1,376,317                                    | \$1,399,764  |
| September 30, 2017               |  |  |          |  |  |              |
| Builder & developer              | \$200  | \$3,750  | \$3,950  | \$5,783  | \$190,828                                      | \$196,611    |
| Commercial real estate investor  | 243  | 2,958  | 3,201    | 5,747  | 240,250  | 245,997      |

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|                                  |       |          |          |          |             |             |
|----------------------------------|-------|----------|----------|----------|-------------|-------------|
| Residential real estate investor | 154   | 2,378    | 2,532    | 1,716    | 209,732     | 211,448     |
| Hotel/Motel                      | 0     | 669      | 669      | 0        | 66,291      | 66,291      |
| Wholesale & retail               | 0     | 879      | 879      | 7,046    | 91,327      | 98,373      |
| Manufacturing                    | 400   | 561      | 961      | 4,522    | 54,439      | 58,961      |
| Agriculture                      | 0     | 416      | 416      | 329      | 57,598      | 57,927      |
| Other commercial                 | 0     | 2,479    | 2,479    | 1,063    | 264,535     | 265,598     |
| Total commercial related         | 997   | 14,090   | 15,087   | 26,206   | 1,175,000   | 1,201,206   |
| Residential mortgage             | 0     | 105      | 105      | 93       | 79,895      | 79,988      |
| Home equity                      | 0     | 198      | 198      | 360      | 95,123      | 95,483      |
| Other consumer                   | 0     | 73       | 73       | 304      | 25,281      | 25,585      |
| Total consumer related           | 0     | 376      | 376      | 757      | 200,299     | 201,056     |
| Unallocated                      | 0     | 1,329    | 1,329    | —        | —           | —           |
| Total                            | \$997 | \$15,795 | \$16,792 | \$26,963 | \$1,375,299 | \$1,402,262 |

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## Note 6—Deposits

The composition of deposits as of September 30, 2018 and December 31, 2017 is shown below. The aggregate amount of demand deposit overdrafts that were reclassified as loans were \$190,000 at September 30, 2018, compared to \$199,000 at December 31, 2017.

| <b>(dollars in thousands)</b>        | <b>September<br/>30,<br/>2018</b> | <b>December<br/>31,<br/>2017</b> |
|--------------------------------------|-----------------------------------|----------------------------------|
| Noninterest bearing demand           | \$258,816                         | \$246,866                        |
| Interest Bearing Demand              | 160,100                           | 157,903                          |
| Money market                         | 503,017                           | 447,425                          |
| Savings                              | 86,063                            | 86,292                           |
| Time deposits less than \$100,000    | 268,486                           | 260,482                          |
| Time deposits \$100,000 to \$250,000 | 142,950                           | 135,242                          |
| Time deposits \$250,000 or more      | 50,827                            | 50,297                           |
| Total deposits                       | \$1,470,259                       | \$1,384,507                      |

## Note 7—Short-Term Borrowings and Long-Term Debt

Short-term borrowings consist of securities sold under agreements to repurchase, federal funds purchased and other borrowings. At September 30, 2018, the balance of securities sold under agreements to repurchase was \$8,624,000 compared to \$10,295,000 at December 31, 2017. At September 30, 2018, there were no other short-term borrowings compared to \$10,200,000 at December 31, 2017.

The following table presents a summary of long-term debt as of September 30, 2018 and December 31, 2017. PeoplesBank's long-term debt obligations to the FHLBP are fixed rate instruments. Under terms of a blanket collateral agreement with the FHLBP, the obligations are secured by FHLBP stock and PeoplesBank qualifying loan receivables, principally real estate secured loans.

| <b>(dollars in thousands)</b>                | <b>September<br/>30,<br/>2018</b> | <b>December<br/>31,<br/>2017</b> |
|--|-----------------------------------|----------------------------------|
| PeoplesBank's obligations:                   |                                   |                                  |
| Federal Home Loan Bank of Pittsburgh (FHLBP) |                                   |                                  |
| Due March 2018, 1.17%                        | \$ 0                              | \$ 10,000                        |
| Due June 2018, 1.87%                         | 0                                 | 5,000                            |
| Due June 2018, 1.41%                         | 0                                 | 10,000                           |

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|   |            |            |
|---|------------|------------|
| Due November 2018, 1.62%  | 5,000      | 5,000      |
| Due December 2018, 1.60%  | 15,000     | 15,000     |
| Due April 2019, 1.64%   | 10,000     | 10,000     |
| Due June 2019, 1.64%  | 5,000      | 5,000      |
| Due June 2019, 2.10%  | 5,000      | 5,000      |
| Due December 2019, 1.89%  | 15,000     | 15,000     |
| Due March 2020, 1.86%   | 10,000     | 10,000     |
| Due June 2020, 1.87%  | 15,000     | 15,000     |
| Due June 2020, 2.70%  | 10,000     | 0          |
| Due June 2021, 2.14%  | 15,000     | 15,000     |
| Due June 2021, 2.81%  | 10,000     | 0          |
| Due May 2022, 2.98%   | 10,000     | 0          |
| Total FHLBP   | 125,000    | 120,000    |
| Codorus Valley Bancorp, Inc. obligations:   |            |            |
| Junior subordinated debt  |            |            |
| Due 2034, 4.35%, floating rate based on 3 month<br>LIBOR plus 2.02%, callable quarterly | 3,093      | 3,093      |
| Due 2036, 3.88% floating rate based on 3 month<br>LIBOR plus 1.54%, callable quarterly  | 7,217      | 7,217      |
| Total long-term debt  | \$ 135,310 | \$ 130,310 |

At September 30, 2018 and December 31, 2017, municipal deposit letters of credit issued by the FHLBP on behalf of PeoplesBank naming applicable municipalities as beneficiaries were \$42,000,000. The letters of credit took the place of securities pledged to the municipalities for their deposits maintained at PeoplesBank.

In June 2006, Codorus Valley formed CVB Statutory Trust No. 2, a wholly-owned special purpose subsidiary whose sole purpose was to facilitate a pooled trust preferred debt issuance of \$7,217,000. In November 2004, Codorus Valley formed CVB Statutory Trust No. 1 to facilitate a pooled trust preferred debt issuance of \$3,093,000. The Corporation owns all of the common stock of these nonbank subsidiaries, and the debentures are the sole assets of the Trusts. The accounts of both Trusts are not consolidated for financial reporting purposes in accordance with FASB ASC 810. For regulatory capital purposes, all of the Corporation's trust preferred securities qualified as Tier 1 capital for all reported periods. Trust preferred securities are subject to capital limitations under the FDIC's risk-based capital guidelines. The Corporation used the net proceeds from these offerings to fund its operations.

#### Note 8—Regulatory Matters

The Corporation and PeoplesBank are subject to various regulatory capital requirements. Failure to meet minimum capital requirements can initiate certain mandatory and possible additional discretionary actions by regulators that, if imposed, could have a material adverse effect on the Corporation's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Corporation and PeoplesBank must meet specific capital guidelines that involve quantitative measures of assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The capital amounts and classifications are also subject to qualitative judgments by the regulators.

On July 2, 2013, the Board of Governors of the Federal Reserve System finalized its rule implementing the Basel III regulatory capital framework, which the FDIC adopted on July 9, 2013. Under the rule, minimum requirements increased both the quantity and quality of capital held by banking organizations. Consistent with the Basel III framework, the rule included a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5 percent, and a common equity Tier 1 conservation buffer of 2.5 percent of risk-weighted assets, that applies to all supervised financial institutions, which is to be phased in over a four year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019. The rule also raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4 percent to 6 percent, and includes a minimum leverage ratio of 4 percent for all banking organizations. The new rule also increased the risk weights for past-due loans, certain commercial real estate loans, and some equity exposures, and makes selected other changes in risk weights and credit conversion factors. The rule for smaller, less complex institutions, including the Corporation, took effect January 1, 2015.

As of September 30, 2018, the Corporation and PeoplesBank met the minimum requirements of the Basel III framework, and PeoplesBank's capital ratios exceeded the amount to be considered "well capitalized" as defined in the regulations. The table below provides a comparison of the Corporation's and PeoplesBank's risk-based capital ratios and leverage ratios to the minimum regulatory requirement for the periods indicated.

|  | Actual     |        | Minimum for<br>Capital Adequacy<br>(1) |        | Well Capitalized<br>Minimum (2) |        |
|--|------------|--------|--|--------|---------------------------------|--------|
|  | Amount     | Ratio  | Amount                                 | Ratio  | Amount                          | Ratio  |
| (dollars in thousands)                             |            |        |  |        |                                 |        |
| <b>Codorus Valley Bancorp, Inc. (consolidated)</b> |            |        |  |        |                                 |        |
| at September 30, 2018                              |            |        |  |        |                                 |        |
| Capital ratios:                                    |            |        |  |        |                                 |        |
| Common equity Tier 1                               | \$ 175,204 | 11.82% | \$ 94,493                              | 6.375% | n/a                             | n/a    |
| Tier 1 risk based                                  | 185,204    | 12.49  | 116,726                                | 7.875  | n/a                             | n/a    |
| Total risk based                                   | 203,438    | 13.73  | 146,371                                | 9.875  | n/a                             | n/a    |
| Leverage   | 185,204    | 10.39  | 71,335                                 | 4.00   | n/a                             | n/a    |
| at December 31, 2017                               |            |        |  |        |                                 |        |
| Capital ratios:                                    |            |        |  |        |                                 |        |
| Common equity Tier 1                               | \$ 162,860 | 11.58% | \$ 80,842                              | 5.750% | n/a                             | n/a    |
| Tier 1 risk based                                  | 172,860    | 12.29  | 101,932                                | 7.250  | n/a                             | n/a    |
| Total risk based                                   | 189,549    | 13.48  | 130,051                                | 9.250  | n/a                             | n/a    |
| Leverage   | 172,860    | 10.26  | 67,382                                 | 4.00   | n/a                             | n/a    |
| PeoplesBank, A Codorus Valley Company              |            |        |  |        |                                 |        |
| at September 30, 2018                              |            |        |  |        |                                 |        |
| Capital ratios:                                    |            |        |  |        |                                 |        |
| Common equity Tier 1                               | \$ 181,193 | 12.25% | \$ 94,260                              | 6.375% | \$ 96,108                       | 6.50 % |
| Tier 1 risk based                                  | 181,193    | 12.25  | 116,439                                | 7.875  | 118,287                         | 8.00   |
| Total risk based                                   | 199,427    | 13.49  | 146,011                                | 9.875  | 147,859                         | 10.00  |
| Leverage   | 181,193    | 10.18  | 71,188                                 | 4.00   | 88,986                          | 5.00   |
| at December 31, 2017                               |            |        |  |        |                                 |        |
| Capital ratios:                                    |            |        |  |        |                                 |        |
| Common equity Tier 1                               | \$ 168,879 | 12.04% | \$ 80,630                              | 5.750% | \$ 91,147                       | 6.50 % |
| Tier 1 risk based                                  | 168,879    | 12.04  | 101,664                                | 7.250  | 112,181                         | 8.00   |
| Total risk based                                   | 185,568    | 13.23  | 129,709                                | 9.250  | 140,226                         | 10.00  |
| Leverage   | 168,879    | 10.05  | 67,234                                 | 4.00   | 84,043                          | 5.00   |

(1) Minimum amounts and ratios as of September 30, 2018 include the third year phase in of the capital conservation buffer of 1.875 percent required by the Basel III framework. At December 31, 2017, the minimum amounts and ratios included the second year phase in of the capital conservation buffer of 1.25 percent required by the Basel III framework. The conservation buffer is to be phased in over a four year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019.

(2) To be “well capitalized” under the prompt corrective action provisions in the Basel III framework. “Well capitalized” applies to PeoplesBank only.

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Note 9—Shareholders' Equity

*Authorized Shares*

At the May 15, 2018 annual shareholder meeting, the shareholders of the Corporation approved a change in the Articles of Incorporation to increase the number of authorized shares of common stock from 15,000,000 to 30,000,000.

*Stock Dividend*

Periodically, the Corporation distributes stock dividends on its stock. On October 9, 2018, the Corporation declared a 5 percent stock dividend payable on December 11, 2018, to shareholders of record at close of business on October 23, 2018. Distribution of this stock dividend will result in the issuance of approximately 447,700 additional shares. The Corporation distributed a 5 percent stock dividend on December 12, 2017 which resulted in the issuance of 422,439 additional shares.

Note 10—Contingent Liabilities

There are no legal proceedings pending against Codorus Valley Bancorp, Inc. or any of its subsidiaries which are expected to have a material impact upon the consolidated financial position and/or operating results of the Corporation, other than routine litigation incidental to the business. Management is not aware of any proceedings known or contemplated by government authorities.

**Note 11—Guarantees**

Codorus Valley does not issue any guarantees that would require liability recognition or disclosure, other than its standby letters of credit. Standby letters of credit are written conditional commitments issued by PeoplesBank to guarantee the performance of a client to a third party. Generally, all letters of credit, when issued, have expiration dates within one year. The credit risk involved in issuing letters of credit is essentially the same as those that are involved in extending loan facilities to clients. The Corporation generally holds collateral and/or personal guarantees supporting these commitments. The Corporation had \$27,564,000 of standby letters of credit outstanding on

September 30, 2018, compared to \$23,603,000 on December 31, 2017. Management believes that the proceeds obtained through a liquidation of collateral and the enforcement of guarantees would be sufficient to cover the potential amount of future payments required under the corresponding letters of credit. The amount of the liability as of September 30, 2018 and December 31, 2017, for guarantees under standby letters of credit issued, was not material. Many of the commitments are expected to expire without being drawn upon and, therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

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## Note 12—Fair Value of Assets and Liabilities

The Corporation uses its best judgment in estimating the fair value of the Corporation's assets and liabilities; however, there are inherent weaknesses in any estimation technique. Therefore, the fair value estimates herein are not necessarily indicative of the amounts that could be realized in sales transactions on the dates indicated. The estimated fair value amounts have been measured as of their respective period-ends and have not been re-evaluated or updated for purposes of these financial statements subsequent to those respective dates. As such, the estimated fair values subsequent to the respective reporting dates may be different than the amounts reported at each period end.

Fair value is defined as the price that would be received to sell an asset or paid to transfer a liability in the principal or most advantageous market for an asset or liability in an orderly transaction (that is, not a forced liquidation or distressed sale) between market participants at the measurement date. GAAP establishes a fair value hierarchy that prioritizes the use of inputs used in valuation methodologies into the following three levels:

Level 1: Inputs to the valuation methodology are quoted prices, unadjusted, for identical assets or liabilities in active markets. A quoted price in an active market provides the most reliable evidence of fair value and shall be used to measure fair value whenever available.

Level 2: Inputs to the valuation methodology include quoted prices for similar assets or liabilities in active markets; inputs to the valuation methodology include quoted prices for identical or similar assets or liabilities in markets that are not active; or inputs to the valuation methodology that utilize model-based techniques for which all significant assumptions are observable in the market.

Level 3: Inputs to the valuation methodology are unobservable and significant to the fair value measurement; inputs to the valuation methodology that utilize model-based techniques for which significant assumptions are not observable in the market; or inputs to the valuation methodology that require significant management judgment or estimation, some of which may be internally developed.

Since management maximizes the use of observable inputs and minimizes the use of unobservable inputs when determining fair value, an asset's or liability's level within the fair value hierarchy is based on the lowest level of input that is significant to the fair value measurement. Management reviews and updates the fair value hierarchy classifications on a quarterly basis.





**Assets Measured at Fair Value on a Recurring Basis****Securities available-for-sale**

The fair values of investment securities were measured using information from a third-party pricing service. The pricing service uses quoted market prices on nationally recognized securities exchanges (Level 1), or matrix pricing (Level 2), which is a mathematical technique, used widely in the industry to value debt securities without relying exclusively on quoted market prices for the specific securities, but rather, by relying on the securities' relationship to other benchmark quoted prices. At least annually, the Corporation reviews a random sample of the pricing information received from the third-party pricing service by comparing it to price quotes from third-party brokers. Historically, price deviations have been immaterial.

| (dollars in thousands)                   | Total    | Fair Value Measurements   |   |   |
|--|----------|---|---|---|
|  |          | (Level 1)<br>Quoted Prices<br>in<br>Active<br>Markets<br>for<br>Identical<br>Assets | (Level 2)<br>Significant<br>Other<br>Observable<br>Inputs | (Level 3)<br>Significant<br>Other<br>Unobservable<br>Inputs |
| September 30, 2018                       |          |   |   |   |
| Securities available-for-sale:           |          |   |   |   |
| U.S. Treasury notes                      | \$13,572 | \$13,572  | \$ 0  | \$ 0  |
| U.S. agency                              | 14,742   | 0   | 14,742  | 0   |
| U.S. agency mortgage-backed, residential | 72,066   | 0   | 72,066  | 0   |
| State and municipal                      | 45,709   | 0   | 45,709  | 0   |
| December 31, 2017                        |          |   |   |   |
| Securities available-for-sale:           |          |   |   |   |
| U.S. Treasury notes                      | \$14,071 | \$14,071  | \$ 0  | \$ 0  |
| U.S. agency                              | 17,303   | 0   | 17,303  | 0   |
| U.S. agency mortgage-backed, residential | 75,175   | 0   | 75,175  | 0   |
| State and municipal                      | 52,042   | 0   | 52,042  | 0   |

**Assets Measured at Fair Value on a Nonrecurring Basis**

### **Impaired loans**

Impaired loans are those that are accounted for under FASB ASC Topic 310, in which the Corporation has measured impairment generally based on the fair value of the loan's collateral. Fair value is generally determined based upon independent third-party appraisals of the properties, or discounted cash flows based upon the expected proceeds. These loans are included as Level 3 fair values, based on the lowest level of input that is significant to the fair value measurements. At September 30, 2018, the fair value of impaired loans with a valuation allowance or charge-off was \$8,683,000, net of valuation allowances of \$1,347,000 and charge-offs of \$159,000. At December 31, 2017 the fair value of impaired loans with a valuation allowance or charge-off was \$1,331,000, net of valuation allowances of \$243,000 and charge-offs of \$506,000.

### **Foreclosed Real Estate**

Other real estate property acquired through foreclosure is initially recorded at fair value of the property at the transfer date less estimated selling cost. Subsequently, other real estate owned is carried at the lower of its carrying value or the fair value less estimated selling cost. Fair value is usually determined based on an independent third-party appraisal of the property or occasionally on a recent sales offer. At September 30, 2018 and December 31, 2017, there were no foreclosed real estate assets with a valuation allowance or write-down.

## Mortgage Servicing Rights

Mortgage servicing rights are initially recorded at fair value upon the sale of residential mortgage loans to secondary market investors. The fair value of servicing rights is based on the present value of estimated future cash flows on pools of mortgages stratified by rate and original time to maturity. Mortgage servicing rights are subsequently evaluated for impairment on a quarterly basis. Significant inputs to the valuation include expected cash flow, expected net servicing income, a cash flow discount rate and the expected life of the underlying loans. At September 30, 2018, the fair value of the mortgage servicing rights asset was \$1,081,000. At December 31, 2017, the fair value of the mortgage servicing rights asset was \$769,000.

| (dollars in thousands)    | Total   | Fair Value Measurements<br>(Level 1)                                |   |   |
|---------------------------|---------|---|---|---|
|                           |         | Quoted Prices<br>in Active<br>Markets<br>for<br>Identical<br>Assets | Significant<br>Other<br>Observable<br>Inputs<br>(Level 2) | Significant<br>Other<br>Unobservable<br>Inputs<br>(Level 3) |
| September 30, 2018        |         |   |   |   |
| Impaired loans            | \$8,683 | \$0   | \$0   | \$8,683   |
| Mortgage servicing rights | 1,081   | 0   | 0   | 1,081   |
| December 31, 2017         |         |   |   |   |
| Impaired loans            | \$1,331 | \$0   | \$0   | \$1,331   |
| Mortgage servicing rights | 769     | 0   | 0   | 769   |

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

| (dollars in thousands)    | Quantitative Information about Level 3 Fair Value Measurements |                                     |   |             | Weighted |   |
|---------------------------|--|-------------------------------------|---|-------------|----------|---|
|                           | Fair Value Estimate  | Valuation Techniques                | Unobservable Input                                | Range       | Average  |   |
| September 30, 2018        |  |                                     |   |             |          |   |
| Impaired loans            | \$311  | Appraisal <sup>(1)</sup>            | Appraisal adjustments <sup>(2)</sup>              | 15% - 25%   | 23       | % |
| Impaired loans            | 8,372  | Financial statements <sup>(3)</sup> | Valuation adjustments <sup>(2)</sup>              | 0% - 52%    | 50       | % |
| Mortgage servicing rights | 1,081  | Multiple of annual service fee      | Estimated prepayment speed based on rate and term | 7.2% - 8.3% | 7.4      | % |
| December 31, 2017         |  |                                     |   |             |          |   |

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|                           |         |                                |   |             |     |   |
|---------------------------|---------|--------------------------------|---|-------------|-----|---|
| Impaired loans            | \$1,331 | Appraisal <sup>(1)</sup>       | Appraisal adjustments <sup>(2)</sup>              | 24% - 52%   | 38  | % |
| Mortgage servicing rights | 769     | Multiple of annual service fee | Estimated prepayment speed based on rate and term | 6.9% - 8.5% | 7.6 | % |

(1) Fair value is generally determined through independent appraisals, which generally include various level 3 inputs that are not identifiable.

(2) Appraisals and financial statement amounts may be adjusted downward by the Corporation's management for qualitative factors such as economic conditions and estimated liquidation expenses. The range of liquidation expenses and other adjustments are a percent of the appraisal or financial statement book value.

(3) Internal financial statements provided by customers.

### **Disclosures about Fair Value of Financial Instruments**

The following methods and assumptions were used to estimate the fair value of the Corporation's financial instruments as of September 30, 2018 and December 31, 2017:

#### **Cash and cash equivalents**

The carrying amount is a reasonable estimate of fair value.

#### **Securities available for sale**

The fair value of securities available for sale is determined in accordance with the methods described under FASB ASC Topic 820 as described above.

#### **Restricted investment in bank stocks**

The carrying amount of restricted investment in bank stocks is a reasonable estimate of fair value. The Corporation is required to maintain minimum investment balances in these stocks. These stocks are not actively traded and, therefore, have no readily determinable market value.

#### **Loans held for sale**

The fair value of loans held for sale is determined, when possible, using quoted secondary-market prices. If no such quoted prices exist, the fair value of a loan is determined using quoted prices for a similar loan or loans, adjusted for the specific attributes of that loan.

#### **Loans, net**

The fair value of loans, for September 30, 2018, are estimated on an exit price basis incorporating adjustments for such factors as credit, liquidity and marketability factors. This is not comparable with the fair values disclosed for December 31, 2017, which were based on an entrance price basis. For that date, fair values of variable rate loans that repriced frequently and with no significant change in credit risk were based on carrying values. The fair values of other loans as of that date were estimated using discounted cash flow analyses which used interest rates then being offered for loans with similar terms to borrowers of similar credit quality.

### **Interest receivable**

The carrying value of interest receivable is a reasonable estimate of fair value.

### **Deposits**

The fair value of demand deposits, savings accounts and money market deposits is the amount payable on demand at the reporting date. The fair values of time deposits are estimated using a discounted cash flow analyses. The discount rates used are based on rates currently offered for deposits with similar remaining maturities. The fair values of variable rate time deposits that reprice frequently are based on carrying value. The fair values of time deposit liabilities do not take into consideration the value of the Corporation's long-term relationships with depositors, which may have significant value.

### **Short-term borrowings**

For these short-term instruments, the carrying amount is a reasonable estimate of fair value.

### **Long-term debt**

Long-term debt includes FHLBP advances (Level 2) and junior subordinated debt (Level 3). The fair value of FHLBP advances is estimated using discounted cash flow analysis, based on quoted prices for new FHLBP advances with similar credit risk characteristics, terms and remaining maturity. These prices are obtained from this active market and represent a market value that is deemed to represent the transfer price if the liability were assumed by a third party. The fair value of junior subordinated debt is estimated using discounted cash flow analysis, based on market rates and spread characteristics of similar debt with similar credit risk characteristics, terms and remaining maturity.

**Interest payable**

The carrying value of interest payable is a reasonable estimate of fair value.

**Off-balance sheet instruments**

Off-balance sheet instruments consist of lending commitments and letters of credit and are based on fees currently charged in the market to enter into similar arrangements, taking into account the remaining terms of the agreements and counterparties' credit standing. These amounts were not considered material.

The following presents the carrying amounts and estimated fair values of the Corporation's financial instruments as of September 30, 2018 and December 31, 2017.

| (dollars in thousands)               | Carrying Amount | Estimated Fair Value | Fair Value Estimates<br>(Level 1)                    |   |   |
|--------------------------------------|-----------------|----------------------|--|---|---|
|                                      |                 |                      | Quoted Prices in Active Markets for Identical Assets | (Level 2) Significant Other Observable Inputs | (Level 3) Significant Other Unobservable Inputs |
| September 30, 2018                   |                 |                      |  |   |   |
| Financial assets                     |                 |                      |  |   |   |
| Cash and cash equivalents            | \$85,348        | \$85,348             | \$85,348   | \$0   | \$0   |
| Securities available-for-sale        | 146,089         | 146,089              | 13,572   | 132,517                                       | 0   |
| Restricted investment in bank stocks | 6,122           | 6,122                | 0  | 6,122   | 0   |
| Loans held for sale                  | 3,795           | 3,928                | 0  | 3,928   | 0   |
| Loans, net                           | 1,475,793       | 1,452,672            | 0  | 0   | 1,452,672                                       |
| Interest receivable                  | 5,142           | 5,142                | 0  | 5,142   | 0   |
| Mortgage servicing rights            | 876             | 1,081                | 0  | 0   | 1,081   |
| Financial liabilities                |                 |                      |  |   |   |
| Deposits                             | \$1,470,259     | \$1,452,587          | \$0  | \$1,452,587                                   | \$0   |
| Short-term borrowings                | 8,624           | 8,624                | 0  | 8,624   | 0   |
| Long-term debt                       | 135,310         | 132,178              | 0  | 123,740                                       | 8,438   |
| Interest payable                     | 865             | 865                  | 0  | 865   | 0   |
| Off-balance sheet instruments        | 0               | 0                    | 0  | 0   | 0   |



December 31, 2017

## Financial assets

|                                      |           |           |          |         |           |
|--------------------------------------|-----------|-----------|----------|---------|-----------|
| Cash and cash equivalents            | \$79,524  | \$79,524  | \$79,524 | \$0     | \$0       |
| Securities available-for-sale        | 158,591   | 158,591   | 14,071   | 144,520 | 0         |
| Restricted investment in bank stocks | 6,311     | 6,311     | 0        | 6,311   | 0         |
| Loans held for sale                  | 1,715     | 1,798     | 0        | 1,798   | 0         |
| Loans, net                           | 1,383,075 | 1,368,753 | 0        | 0       | 1,368,753 |
| Interest receivable                  | 4,968     | 4,968     | 0        | 4,968   | 0         |
| Mortgage servicing rights            | 672       | 769       | 0        | 0       | 769       |

## Financial liabilities

|                               |             |             |     |             |       |
|-------------------------------|-------------|-------------|-----|-------------|-------|
| Deposits                      | \$1,384,507 | \$1,369,008 | \$0 | \$1,369,008 | \$0   |
| Short-term borrowings         | 20,495      | 20,495      | 0   | 20,495      | 0     |
| Long-term debt                | 130,310     | 127,586     | 0   | 119,474     | 8,112 |
| Interest payable              | 626         | 626         | 0   | 626         | 0     |
| Off-balance sheet instruments | 0           | 0           | 0   | 0           | 0     |

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**Note 13—Assets and Liabilities Subject to Offsetting***Securities Sold Under Agreements to Repurchase*

PeoplesBank enters into agreements with clients in which it sells securities subject to an obligation to repurchase the same securities (“repurchase agreements”). The contractual maturity of the repurchase agreement is overnight and continues until either party terminates the agreement. These repurchase agreements are accounted for as a collateralized financing arrangement (i.e., secured borrowings) and not as a sale and subsequent repurchase of securities. The obligation to repurchase the securities is reflected as a liability (short-term borrowings) in the Corporation’s consolidated financial statements of condition, while the securities underlying the repurchase agreements are appropriately segregated for safekeeping purposes and remain in the respective securities asset accounts. Thus, there is no offsetting or netting of the securities with the repurchase agreement liabilities.

| (dollars in thousands) | Gross<br>Amounts of<br>Recognized<br>Liabilities | Gross<br>Amounts<br>Offset in<br>the<br>Statements<br>of<br>Condition | Net<br>Amounts<br>of<br>Liabilities<br>Presented<br>in<br>the<br>Statements<br>of<br>Condition | Gross amounts Not Offset in<br>the Statements of Condition                                      |      |                       |               |
|------------------------|--|---|--|---|------|-----------------------|---------------|
|                        |  |   |  | Financial<br>Instruments<br>U.S.<br>agency<br>mortgage-backed,<br>U.S.<br>agency<br>residential | Cash | Collateral<br>Pledged | Net<br>Amount |
| September 30, 2018     |  |   |  |   |      |                       |               |
| Repurchase Agreements  | \$ 8,624   | \$ 0  | \$ 8,624   | \$(8,624)   | \$ 0 | \$ 0                  | \$ 0          |
| December 31, 2017      |  |   |  |   |      |                       |               |
| Repurchase Agreements  | \$ 10,295  | \$ 0  | \$ 10,295  | \$(10,295)  | \$ 0 | \$ 0                  | \$ 0          |

As of September 30, 2018 and December 31, 2017, the carrying value of securities pledged in connection with repurchase agreements was \$9,406,000 and \$15,545,000, respectively.

## **Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

Management's discussion and analysis of the significant changes in the results of operations, capital resources and liquidity presented in the accompanying consolidated financial statements for Codorus Valley Bancorp, Inc. ("Codorus Valley" or "the Corporation"), a bank holding company, and its wholly-owned subsidiary, PeoplesBank, A Codorus Valley Company ("PeoplesBank"), are provided below. Codorus Valley's consolidated financial condition and results of operations consist almost entirely of PeoplesBank's financial condition and results of operations. Current performance does not guarantee, and may not be indicative of, similar performance in the future.

### **Forward-looking Statements**

Management of the Corporation has made forward-looking statements in this Form 10-Q. These forward-looking statements may be subject to risks and uncertainties. Forward-looking statements include information concerning possible or assumed future results of operations of the Corporation and its subsidiaries. When words such as "believes," "expects," "anticipates" or similar expressions occur in the Form 10-Q, management is making forward-looking statements.

Note that many factors, some of which are discussed elsewhere in this report and in the documents that are incorporated by reference, could affect the future financial results of the Corporation and its subsidiaries, both individually and collectively, and could cause those results to differ materially from those expressed in the forward-looking statements contained or incorporated by reference in this Form 10-Q. These factors include, but are not limited to, the following:

Operating, legal and regulatory risks;

Credit risk, including an increase in nonperforming assets requiring loss provisions and the incurrence of carrying costs related to nonperforming assets;

Interest rate fluctuations which could increase our cost of funds or decrease our yield on earning assets and therefore reduce our net interest income;

Declines in the market value of investment securities considered to be other-than-temporary;

Unavailability of capital when needed, or availability at less than favorable terms;

Unauthorized disclosure of sensitive or confidential client or customer information, whether through a breach of our computer systems or otherwise, which may adversely affect the Corporation's operations, net income or reputation;

Inability to achieve merger-related synergies, and difficulties in integrating the business and operations of acquired institutions;

A prolonged economic downturn;

Political and competitive forces affecting banking, securities, asset management and credit services businesses;

The effects of and changes in the rate of FDIC premiums, including special assessments;

Future legislative or administrative changes to U.S. governmental capital programs;

Future changes in federal or state tax laws or tax rates;

Enacted financial reform legislation, e.g., Dodd-Frank Wall Street Reform and Consumer Protection Act, may have a significant impact on the Corporation's business and results of operations; and

The risk that management's analyses of these risks and forces could be incorrect and/or that the strategies developed to address them could be unsuccessful.

The Corporation undertakes no obligation to publicly revise or update these forward-looking statements to reflect events or circumstances that arise after the date of this report.

## **Critical Accounting Policies**

The Corporation's critical accounting policies, as summarized in Note 1—Summary of Significant Accounting Policies, include those related to the allowance for loan losses, valuation of foreclosed real estate, evaluation of other-than-temporary impairment of securities, and determination of acquisition-related goodwill and fair value adjustments, which require management to make significant judgments, estimates and assumptions that have a material impact on the carrying value of the respective assets and liabilities. For this Form 10-Q, there were no material changes made to the Corporation's critical accounting policies, which are more fully disclosed in Item 7 of the Corporation's previously filed Annual Report on Form 10-K for the year ended December 31, 2017.

## **Three Months Ended September 30, 2018 vs. Three Months Ended September 30, 2017**

### **Financial Highlights**

The Corporation's net income (earnings) was \$5,060,000 for the quarter ended September 30, 2018, as compared to \$3,410,000 for the quarter ended September 30, 2017, an increase of \$1,650,000 or 48 percent.

Net interest income for the third quarter of 2018 increased \$1,140,000 or 7 percent above the same period in 2017, primarily due to increased interest income from a higher volume of commercial loans in the third quarter of 2018 as compared to the third quarter of 2017.

The Corporation's net interest margin (tax-equivalent basis) for the third quarter of 2018 was 3.86 percent, compared to 3.88 percent for the third quarter of 2017. The net interest margin contraction was a result of an increase in the volume and cost of interest-bearing liabilities, partially offset by an increase in the volume of interest earning assets.

The provision for loan losses was \$1,300,000 for the third quarter of 2018, an \$800,000 decrease as compared to a provision of \$2,100,000 for the third quarter of 2017. The change in the provision for the third quarter of 2018 was primarily due to specific loan loss reserves assigned during the third quarter of 2018 as compared to a larger aggregate amount of net charge-offs and specific reserves taken during the third quarter of 2017. The allowance as a percentage of total loans was 1.22 percent at September 30, 2018 as compared to 1.19 percent at December 31, 2017 and 1.20 percent at September 30, 2017.

Noninterest income for the third quarter of 2018 increased \$497,000 or 18 percent compared to the third quarter of 2017. Several sources contributed to the rise in noninterest income, including increased gains on sales of loans held

for sale, service charges on deposit accounts, trust and investment services fees, income from mutual fund, annuity and insurance sales and other income.

Noninterest expenses in the third quarter of 2018 were \$1,016,000 or 9 percent higher than the third quarter of 2017. Higher personnel costs, which include compensation and benefit expenses, external data processing and other expenses accounted for a majority of the increase. The increase was partially offset by decreases in marketing and telecommunications.

The provision for income taxes for the third quarter of 2018 decreased by \$229,000 or 14 percent as compared to the third quarter of 2017 as a result of the new corporate tax rate of 21 percent enacted as part of the Tax Cuts and Jobs Act that became effective January 1, 2018.

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The schedule below presents selected performance metrics for the third quarter of both 2018 and 2017. Per share computations include the effect of stock dividends, including the 5 percent stock dividend declared on October 9, 2018.

|  | <b>Three months ended</b> |             |
|--|---------------------------|-------------|
|  | <b>September 30,</b>      |             |
|  | <b>2018</b>               | <b>2017</b> |
| Basic earnings per common share            | \$0.53                    | \$0.37      |
| Diluted earnings per common share          | \$0.53                    | \$0.36      |
| Cash dividend payout ratio                 | 27.40%                    | 33.46%      |
| Return on average assets                   | 1.14 %                    | 0.82 %      |
| Return on average equity                   | 11.66%                    | 8.30 %      |
| Net interest margin (tax equivalent basis) | 3.86 %                    | 3.88 %      |
| Net overhead ratio                         | 1.95 %                    | 1.96 %      |
| Efficiency ratio                           | 60.30%                    | 59.54%      |
| Average equity to average assets           | 9.74 %                    | 9.84 %      |

A more detailed analysis of the factors and trends affecting the Corporation's earnings and financial position follows.

## **Income Statement Analysis**

### **Net Interest Income**

Unless otherwise noted, this section discusses interest income and interest expense amounts as reported in the Consolidated Statements of Income, which are not presented on a tax equivalent basis.

Net interest income for the quarter ended September 30, 2018 was \$16,432,000, an increase of \$1,140,000 or 7 percent compared to net interest income of \$15,292,000 for the third quarter of 2017. The increase was primarily attributable to higher loan interest income. The Corporation's net interest margin, computed as interest income (tax-equivalent basis) annualized as a percentage of average interest earning assets, was 3.86 percent for the third quarter of 2018 compared to the 3.88 percent for the third quarter of 2017.

Total interest income for the third quarter of 2018 totaled \$20,796,000, an increase of \$2,733,000 or 15 percent above the amount of total interest income for the third quarter of 2017. The change was primarily a result of a significant increase in loan income, partially offset by a decline in investment income.

Interest and dividend income on investments decreased \$66,000 or 7 percent in the third quarter of 2018 compared to the same period in 2017. The average balance of the investment securities portfolio decreased \$26,918,000 or 15 percent when comparing the third quarter of 2018 to the same period in 2017. The tax-equivalent yield on investments for the third quarter of 2018 was 2.49 percent or 3 basis points higher than the 2.46 percent experienced in the third quarter of 2017.

Interest income on loans increased \$2,583,000 or 15 percent in the third quarter of 2018 compared to the same period in 2017. The average balance of outstanding loans, primarily commercial loans, increased approximately \$105,090,000 or 8 percent comparing the third quarter of 2018 to the same period in 2017 which was the primary driver to the increase in interest income on loans. The tax-equivalent yield on loans for the third quarter 2018 was 5.24 percent or 33 basis points more than the 4.91 percent experienced in the third quarter of 2017.



Total interest expense for the third quarter of 2018 was \$4,364,000, an increase of \$1,593,000 or 57 percent as compared to total interest expense of \$2,771,000 for the third quarter of 2017. The change was primarily the result of an increase in the cost of deposits.

Interest expense on deposits increased \$1,510,000 or 73 percent in the third quarter of 2018 compared to the same period in 2017. The average rate paid on interest-bearing deposits was 1.19 percent in the third quarter of 2018 or 44 basis points higher than the average rate paid of 0.75 percent in the third quarter of 2017. The average balance of interest-bearing deposits for the third quarter of 2018 increased by \$91,947,000 or 8 percent compared to the third quarter of 2017. Also, the Corporation experienced favorable growth in noninterest-bearing deposits, with the average volume for the third quarter of 2018 increasing 16 percent to \$257,749,000 as compared to \$221,474,000 for the third quarter of 2017.

For the third quarter of 2018 interest expense on borrowings increased \$83,000 or 12 percent compared to the third quarter of 2017. Short-term borrowings consisting of repurchase agreements and other short-term borrowings averaged \$10,430,000 for the third quarter of 2018, compared to an average balance of \$37,307,000 for the third quarter of 2017. The rate on average short-term borrowings for the third quarter of 2018 was 0.57 percent, a decrease as compared to a rate of 0.76 percent for the third quarter of 2017. Long-term debt, primarily from the Federal Home Loan Bank of Pittsburgh (FHLBP), averaged \$135,310,000 for both the third quarter of 2018 and the third quarter of 2017. For the third quarter of 2018, the rate on average long-term borrowings was 2.25 percent, an increase as compared to a rate of 1.84 percent for the third quarter of 2017.

Table 1-Average Balances and Interest Rates (tax equivalent basis)

| (dollars in thousands)                      | Three months ended September 30, |          |            |                 |          |            |
|---|----------------------------------|----------|------------|-----------------|----------|------------|
|   | 2018                             |          |            | 2017            |          |            |
|   | Average Balance                  | Interest | Yield/Rate | Average Balance | Interest | Yield/Rate |
| <b>Assets</b>                               |                                  |          |            |                 |          |            |
| Interest bearing deposits with banks        | \$57,361                         | \$287    | 1.99%      | \$22,629        | \$71     | 1.24%      |
| Investment securities:                      |                                  |          |            |                 |          |            |
| Taxable                                     | 111,601                          | 668      | 2.37       | 130,756         | 698      | 2.12       |
| Tax-exempt                                  | 46,254                           | 324      | 2.78       | 54,017          | 447      | 3.28       |
| Total investment securities                 | 157,855                          | 992      | 2.49       | 184,773         | 1,145    | 2.46       |
| <b>Loans:</b>                               |                                  |          |            |                 |          |            |
| Taxable (1)                                 | 1,468,188                        | 19,465   | 5.26       | 1,361,637       | 16,875   | 4.92       |
| Tax-exempt                                  | 15,923                           | 144      | 3.59       | 17,384          | 185      | 4.22       |
| Total loans                                 | 1,484,111                        | 19,609   | 5.24       | 1,379,021       | 17,060   | 4.91       |
| Total earning assets                        | 1,699,327                        | 20,888   | 4.88       | 1,586,423       | 18,276   | 4.57       |
| Other assets (2)                            | 83,115                           |          |            | 82,580          |          |            |
| Total assets                                | \$1,782,442                      |          |            | \$1,669,003     |          |            |
| <b>Liabilities and Shareholders' Equity</b> |                                  |          |            |                 |          |            |
| <b>Deposits:</b>                            |                                  |          |            |                 |          |            |
| Interest bearing demand                     | \$648,634                        | \$1,702  | 1.04%      | \$585,856       | \$716    | 0.48%      |
| Savings                                     | 87,465                           | 21       | 0.10       | 87,474          | 22       | 0.10       |
| Time  | 456,246                          | 1,858    | 1.62       | 427,068         | 1,333    | 1.24       |
| Total interest bearing deposits             | 1,192,345                        | 3,581    | 1.19       | 1,100,398       | 2,071    | 0.75       |
| Short-term borrowings                       | 10,430                           | 15       | 0.57       | 37,307          | 71       | 0.76       |
| Long-term debt                              | 135,310                          | 768      | 2.25       | 135,310         | 629      | 1.84       |
| Total interest bearing liabilities          | 1,338,085                        | 4,364    | 1.29       | 1,273,015       | 2,771    | 0.86       |
| Noninterest bearing deposits                | 257,749                          |          |            | 221,474         |          |            |
| Other liabilities                           | 13,018                           |          |            | 10,252          |          |            |
| Shareholders' equity                        | 173,590                          |          |            | 164,262         |          |            |
| Total liabilities and shareholders' equity  | \$1,782,442                      |          |            | \$1,669,003     |          |            |
| Net interest income (tax equivalent basis)  |                                  | \$16,524 |            |                 | \$15,505 |            |
| Net interest margin (3)                     |                                  |          | 3.86%      |                 |          | 3.88%      |
| Tax equivalent adjustment                   |                                  | (92 )    |            |                 | (213 )   |            |
| Net interest income                         |                                  | \$16,432 |            |                 | \$15,292 |            |

(1) Average balance includes average nonaccrual loans of \$4,232,000 for 2018 and \$7,095,000 for 2017.

Interest includes net loan fees of \$868,000 for 2018 and \$680,000 for 2017.

(2)

Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.

- (3) Net interest income (tax equivalent basis) annualized as a percentage of average earning assets.

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Table 2-Rate/Volume Analysis of Changes in Net Interest Income (tax equivalent basis)

| (dollars in thousands)                     | Three months ended<br>September 30,<br>2018 vs. 2017 |             |            |
|--|--|-------------|------------|
|  | <b>Increase (decrease) due to<br/>change in*</b>     |             |            |
|  | <b>Volume</b>  | <b>Rate</b> | <b>Net</b> |
| Interest Income                            |  |             |            |
| Interest bearing deposits with banks       | \$ 110   | \$ 106      | \$ 216     |
| Investment securities:                     |  |             |            |
| Taxable                                    | (99 )  | 69          | (30 )      |
| Tax-exempt                                 | (64 )  | (59 )       | (123 )     |
| Loans:                                     |  |             |            |
| Taxable                                    | 1,548  | 1,042       | 2,590      |
| Tax-exempt                                 | (16 )  | (25 )       | (41 )      |
| Total interest income                      | 1,479  | 1,133       | 2,612      |
| Interest Expense                           |  |             |            |
| Deposits:                                  |  |             |            |
| Interest bearing demand                    | 78   | 908         | 986        |
| Savings                                    | (1 )   | 0           | (1 )       |
| Time                                       | 91   | 434         | 525        |
| Short-term borrowings                      | (56 )  | 0           | (56 )      |
| Long-term debt                             | 0  | 139         | 139        |
| Total interest expense                     | 112  | 1,481       | 1,593      |
| Net interest income (tax equivalent basis) | \$ 1,367   | \$(348 )    | \$ 1,019   |

\*Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate.

### Provision for Loan Losses

The provision for loan losses is an expense charged to earnings to cover the estimated losses attributable to uncollected loans. The provision reflects management's judgment of an appropriate level for the allowance for loan losses. The provision for loan losses was \$1,300,000 for the third quarter of 2018, an \$800,000 decrease as compared to a provision of \$2,100,000 for the third quarter of 2017. The provision in the third quarter of 2018 was primarily due to approximately \$1,347,000 of specific loan loss reserves assigned during the quarter, provision related to net loan growth during the quarter, net charge-offs of \$213,000 and the net impact of adjustments made to certain qualitative factors and the unallocated reserve. The provision of \$2,100,000 in the third quarter of 2017 related primarily to individual net loan charge-off of \$1,730,000 and provision related to net loan growth during the quarter. The provision

for both periods supported adequate allowance for loan loss coverage considering several factors, including the Corporation's continued commercial loan growth. The allowance as a percentage of total loans was 1.22 percent at September 30, 2018, as compared to 1.19 percent at December 31, 2017 and 1.20 percent at September 30, 2017.

More information about the allowance for loan losses can be found in this report under the caption Allowance for Loan Losses on page 63.

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**Noninterest Income**

The following table presents the components of total noninterest income for the third quarter of 2018, compared to the third quarter of 2017.

Table 3 - Noninterest income

| (dollars in thousands)                               | Three months ended |         | Change              |       |
|--|--------------------|---------|---------------------|-------|
|  | September 30,      |         | Increase (Decrease) |       |
|  | 2018               | 2017    | \$                  | %     |
| Trust and investment services fees                   | \$818              | \$738   | \$80                | 11 %  |
| Income from mutual fund, annuity and insurance sales | 255                | 214     | 41                  | 19    |
| Service charges on deposit accounts                  | 1,187              | 1,057   | 130                 | 12    |
| Income from bank owned life insurance                | 248                | 257     | (9 )                | (4 )  |
| Other income   | 364                | 276     | 88                  | 32    |
| Gain on sales of loans held for sale                 | 435                | 252     | 183                 | 73    |
| Gain on sales of securities                          | 0                  | 16      | (16)                | (100) |
| Total noninterest income                             | \$3,307            | \$2,810 | \$497               | 18 %  |

The discussion that follows addresses changes in selected categories of noninterest income.

**Service charges on deposits accounts**—The \$130,000 or 12 percent increase in service charges on deposit accounts was due to the higher volume of demand deposit accounts subject to fees and debit card transactions.

**Other income**—The \$88,000 or 32 percent increase in other income was due to higher loan related income such as mortgage and SBA loan servicing income, letter of credit fees and miscellaneous client based service charges such as gift card and credit card merchant fees.

**Gain on sales of loans held for sale**—The \$183,000 or 73 percent increase in gain on sales of loans was due to the sale of a higher volume of the guaranteed portion of SBA loans to the secondary market.



**Noninterest Expense**

The following table presents the components of total noninterest expense for the third quarter of 2018, compared to the third quarter of 2017.

Table 4 - Noninterest expense

| (dollars in thousands)                                | Three months ended |          | Change              |      |
|---|--------------------|----------|---------------------|------|
|   | September 30,      |          | Increase (Decrease) |      |
|   | 2018               | 2017     | \$                  | %    |
| Personnel   | \$7,159            | \$6,366  | \$793               | 12 % |
| Occupancy of premises, net                            | 860                | 793      | 67                  | 8    |
| Furniture and equipment                               | 701                | 724      | (23 )               | (3 ) |
| Postage, stationery and supplies                      | 196                | 181      | 15                  | 8    |
| Professional and legal                                | 286                | 294      | (8 )                | (3 ) |
| Marketing   | 373                | 459      | (86 )               | (19) |
| FDIC insurance  | 189                | 163      | 26                  | 16   |
| Debit card processing                                 | 318                | 294      | 24                  | 8    |
| Charitable donations                                  | 119                | 148      | (29 )               | (20) |
| Telecommunications                                    | 119                | 204      | (85 )               | (42) |
| External data processing                              | 579                | 405      | 174                 | 43   |
| Foreclosed real estate including provision for losses | 13                 | 10       | 3                   | 30   |
| Other   | 1,090              | 945      | 145                 | 15   |
| Total noninterest expense                             | \$12,002           | \$10,986 | \$1,016             | 9 %  |

The discussion that follows addresses changes in selected categories of noninterest expense.

**Personnel**—The \$793,000 or 12 percent increase in personnel expense was largely due to the addition of new employees to support the Corporation's business and consumer banking services in our Maryland and Pennsylvania markets and higher health insurance costs.

**Marketing**—The \$86,000 or 19 percent decrease in marketing expenses is attributed to a decrease in advertising costs during the quarter as compared to the prior year.



**Telecommunications**—The \$85,000 or 42 percent decrease was due to a change in network providers which provide a higher level of service for a lower cost.

**External data processing**—The \$174,000 or 43 percent increase in external data processing expenses reflects increased reliance on outsourcing transaction processing to specialized vendors, which is typically performed on such vendors' hosted and secure websites. Transaction volumes in both accounts and transactions year over year due to business expansion resulted in higher costs. The Corporation continues to expand and enhance electronic banking services provided to our clients which contributed to the increase in the expense.

**Other**—The \$145,000 or 15 percent increase in other expenses, which is comprised of many underlying expenses, is primarily due to liability insurance, PA shares tax and other miscellaneous loan expense.

### **Provision for Income Taxes**

The provision for income taxes for the third quarter of 2018 was \$1,377,000, a decrease of \$229,000 or

14 percent as compared to the third quarter of 2017. For the third quarter of 2018 the Corporation's statutory federal income tax rate was 21 percent compared to 35 percent for the third quarter of 2017. The effective income tax rate was 21 percent and 32 percent for the quarters ended September 30, 2018 and 2017, respectively. The effective tax rate differs from the statutory tax rate due to the impact of certain elements with specific tax benefits, including tax-exempt income, such as income from tax-exempt investments, tax-exempt loans, and bank-owned life insurance. Decreases in the provision for income taxes and effective tax rate were due to the new 21 percent corporate tax rate enacted as part of the Tax Cuts and Jobs Act that became effective January 1, 2018.

**Nine Months Ended September 30, 2018 vs. Nine Months Ended September 30, 2017**

**Financial Highlights**

The Corporation's net income (earnings) was \$15,197,000 for the first nine months of 2018 compared to \$10,514,000 for the first nine months of 2017, an increase of \$4,683,000 or 45 percent.

Net interest income for the first nine months of 2018 increased \$3,876,000 or 9 percent above the first nine months of 2017, primarily due to increased interest income from a higher volume of commercial loan growth over the previous twelve months.

The Corporation's net interest margin (tax-equivalent basis) for the nine months ended September 30, 2018 was 3.88 percent, compared to 3.82 percent for the first nine months of 2017. The net interest margin expansion was a result of a change in the mix of interest earning assets and an increase in noninterest bearing demand deposits, which more than offset the increase in the volume and cost of interest bearing liabilities.

The provision for loan losses for the first nine months of 2018 was \$1,800,000 or a \$1,775,000 decrease as compared to a provision of \$3,575,000 for the first nine months of 2017. The change in provision for 2018 was primarily due to specific loan loss reserves assigned during 2018 as compared to a larger amount of aggregate net charge-offs and specific reserves taken during 2017. The provision for both periods supported adequate allowance for loan loss coverage considering several factors, including the Corporation's substantial growth in commercial loans. The allowance as a percentage of total loans was 1.22 percent at September 30, 2018, as compared to 1.19 percent at December 31, 2017, and 1.20 percent at September 30, 2017.

Noninterest income for the first nine months of 2018 increased \$1,733,000 or 21 percent (\$1,812,000 or 22 percent excluding gain on sales of securities) compared to the first nine months of 2017. Contributing to the rise in noninterest income were income from mutual fund, annuity and insurance sales, gain on sales of loans and other income. Offsetting some of the increase was a decline in gain on sales of securities.

Noninterest expenses for the first nine months of 2018 were \$36,882,000 or 11 percent higher than the first nine months of 2017. The increase was primarily attributable to higher personnel costs, debit card processing, charitable donations and external data processing costs. Offsetting some of the increase were declines in FDIC insurance fees and other expenses.

The provision for income taxes for the first nine months of 2018 decreased \$965,000 or 19 percent as compared to the first nine months of 2017 as a result of the new corporate tax rate of 21 percent enacted as part of the Tax Cuts and

Jobs Act that became effective January 1, 2018.

On September 30, 2018, the Corporation's total assets were over \$1.80 billion, an increase of 5 percent since December 31, 2017. The increase was attributed to loan growth, primarily in commercial loans.

The Corporation's capital level remained sound as evidenced by regulatory capital ratios that exceed current regulatory requirements for well capitalized institutions. As of September 30, 2018, the Corporation's capital calculations and ratios reflect full compliance with the Basel III regulatory capital framework, which became effective on January 1, 2015.

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The schedule below presents selected performance metrics for the first nine months of both 2018 and 2017. Per share computations include the effect of stock dividends, including the 5 percent stock dividend declared October 9, 2018.

|  | <b>Nine months<br/>ended<br/>September 30,<br/>2018      2017</b> |         |
|--|---|---------|
| Basic earnings per common share            | \$ 1.62   | \$ 1.13 |
| Diluted earnings per common share          | \$ 1.60   | \$ 1.11 |
| Cash dividend payout ratio                 | 27.31 %   | 32.50 % |
| Return on average assets                   | 1.16 %  | 0.85 %  |
| Return on average equity                   | 11.97 %   | 8.72 %  |
| Net interest margin (tax equivalent basis) | 3.88 %  | 3.82 %  |
| Net overhead ratio                         | 2.06 %  | 2.02 %  |
| Efficiency ratio                           | 63.12 %   | 62.24 % |
| Average equity to average assets           | 9.73 %  | 9.77 %  |

A more detailed analysis of the factors and trends affecting the Corporation's earnings and financial position follows.

## **Income Statement Analysis**

### **Net Interest Income**

Net interest income for the nine months ending September 30, 2018 was \$47,856,000, an increase of \$3,876,000 or 9 percent compared to net interest income of \$43,980,000 for the first nine months of 2017. The increase was primarily attributable to higher loan interest income. The Corporation's net interest margin, computed as interest income (tax-equivalent basis) annualized as a percentage of average interest earning assets, was 3.88 percent for the first nine months of 2018, representing an increase compared to the 3.82 percent net interest margin for the first nine months of 2017.

Total interest income for the first nine months of 2018 totaled \$59,223,000, an increase of \$7,360,000 or 14 percent above the amount of total interest income for the first nine months of 2017. The change was primarily a result of a significant increase in loan income, partially offset by a decline in investment income.

Interest income on loans increased \$7,230,000 or 15 percent in the first nine months of 2018 compared to the same period in 2017. The average balance of outstanding loans increased approximately \$112,743,000 or 8 percent in the first nine months of 2018 compared to the first nine months of 2017, reflecting commercial loan growth over the past year.

Investment income for the first nine months of 2018 decreased \$267,000 or 9 percent compared to the first nine months of 2017. The tax-equivalent yield on investments for the first nine months of 2018 was 2.52 percent or 5 basis points higher than the 2.47 percent experienced during the first nine months of 2017, as the yields on maturing investments were generally higher than those on investments purchased in the current lower interest rate environment.

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Total interest expense for the first nine months of 2018 was \$11,367,000, an increase of \$3,484,000 or 44 percent as compared to total interest expense of \$7,883,000 for the first nine months of 2017. The change in interest expense was primarily a result of an increase in the cost of deposits and long-term borrowings.

Interest expense on deposits increased \$3,457,000 or 59 percent in the first nine months of 2018 compared to the same period in 2017. The change was due to both an increase in the costs of and growth in deposits. The average balance of interest-bearing deposits for the first nine months of 2018, primarily in lower cost core deposits, increased by \$84,331,000 or 8 percent compared to the average for the first nine months of 2017. The average rate paid on interest-bearing deposits in the first nine months of 2018 was 1.06 percent, an increase from the average rate of 0.72 percent paid on interest-bearing deposits during the first nine months of 2017. Also, the Corporation experienced favorable growth in noninterest-bearing deposits, with the average volume for the first nine months of 2018 increasing to \$247,484,000, as compared to \$211,582,000 for the first nine months of 2017.

Interest expense on borrowings for the first nine months of 2018 increased \$27,000 or 1 percent compared to the first nine months of 2017, due to a higher cost of long-term debt, which was partially offset by a decrease in volume of short-term borrowings and long-term debt. Outstanding long-term debt, consisting primarily of Federal Home Loan Bank of Pittsburgh (FHLBP) advances, averaged \$130,347,000 for the first nine months of 2018, compared to an average balance of approximately \$132,233,000 for the same period of 2017. The rate on average long-term debt for the first nine months of 2018 was 2.09 percent, an increase as compared to the rate of 1.81 percent for the same period of 2017.

Table 5-Average Balances and Interest Rates (tax equivalent basis)

| (dollars in thousands)                      | Nine months ended September 30, |          |                |                    |          |                |
|---|---------------------------------|----------|----------------|--------------------|----------|----------------|
|   | 2018                            |          |                | 2017               |          |                |
|   | Average<br>Balance              | Interest | Yield/<br>Rate | Average<br>Balance | Interest | Yield/<br>Rate |
| <b>Assets</b>                               |                                 |          |                |                    |          |                |
| Interest bearing deposits with banks        | \$48,520                        | \$663    | 1.83 %         | \$34,218           | \$266    | 1.04 %         |
| Investment securities:                      |                                 |          |                |                    |          |                |
| Taxable                                     | 113,256                         | 2,020    | 2.38           | 136,642            | 2,158    | 2.11           |
| Tax-exempt                                  | 47,916                          | 1,018    | 2.84           | 57,169             | 1,427    | 3.34           |
| Total investment securities                 | 161,172                         | 3,038    | 2.52           | 193,811            | 3,585    | 2.47           |
| <b>Loans:</b>                               |                                 |          |                |                    |          |                |
| Taxable (1)                                 | 1,432,389                       | 55,364   | 5.17           | 1,318,529          | 48,117   | 4.88           |
| Tax-exempt                                  | 16,676                          | 449      | 3.60           | 17,793             | 569      | 4.28           |
| Total loans                                 | 1,449,065                       | 55,813   | 5.15           | 1,336,322          | 48,686   | 4.87           |
| Total earning assets                        | 1,658,757                       | 59,514   | 4.80           | 1,564,351          | 52,537   | 4.49           |
| Other assets (2)                            | 80,911                          |          |                | 81,445             |          |                |
| Total assets                                | \$1,739,668                     |          |                | \$1,645,796        |          |                |
| <b>Liabilities and Shareholders' Equity</b> |                                 |          |                |                    |          |                |
| <b>Deposits:</b>                            |                                 |          |                |                    |          |                |
| Interest bearing demand                     | \$630,302                       | \$4,147  | 0.88 %         | \$574,941          | \$1,950  | 0.45 %         |
| Savings                                     | 88,090                          | 66       | 0.10           | 86,288             | 64       | 0.10           |
| Time  | 451,666                         | 5,070    | 1.50           | 424,498            | 3,812    | 1.20           |
| Total interest bearing deposits             | 1,170,058                       | 9,283    | 1.06           | 1,085,727          | 5,826    | 0.72           |
| Short-term borrowings                       | 10,812                          | 48       | 0.59           | 44,353             | 263      | 0.79           |
| Long-term debt                              | 130,347                         | 2,036    | 2.09           | 132,233            | 1,794    | 1.81           |
| Total interest bearing liabilities          | 1,311,217                       | 11,367   | 1.16           | 1,262,313          | 7,883    | 0.83           |
| Noninterest bearing deposits                | 247,484                         |          |                | 211,582            |          |                |
| Other liabilities                           | 11,675                          |          |                | 11,156             |          |                |
| Shareholders' equity                        | 169,292                         |          |                | 160,745            |          |                |
| Total liabilities and shareholders' equity  | \$1,739,668                     |          |                | \$1,645,796        |          |                |
| Net interest income (tax equivalent basis)  |                                 | \$48,147 |                |                    | \$44,654 |                |
| Net interest margin (3)                     |                                 |          | 3.88 %         |                    |          | 3.82 %         |
| Tax equivalent adjustment                   |                                 | (291 )   |                |                    | (674 )   |                |
| Net interest income                         |                                 | \$47,856 |                |                    | \$43,980 |                |

(1) Average balance includes average nonaccrual loans of \$4,389,000 for 2018 and \$4,712,000 for 2017.

Interest includes net loan fees of \$2,555,000 for 2018 and \$2,057,000 for 2017.

(2)



Average balance includes average bank owned life insurance, foreclosed real estate and unrealized holding gains (losses) on investment securities.

- (3) Net interest income (tax equivalent basis) annualized as a percentage of average interest earning assets.

Table 6-Rate/Volume Analysis of Changes in Net Interest Income (tax equivalent basis)

| (dollars in thousands)                     | Nine months ended<br>September 30,<br>2018 vs. 2017 |             |            |
|--|---|-------------|------------|
|  | <b>Increase (decrease) due to<br/>change in*</b>    |             |            |
|  | <b>Volume</b>                                       | <b>Rate</b> | <b>Net</b> |
| Interest Income                            |   |             |            |
| Interest bearing deposits with banks       | \$ 111  | \$ 286      | \$ 397     |
| Investment securities:                     |   |             |            |
| Taxable                                    | (360 )  | 222         | (138 )     |
| Tax-exempt                                 | (231 )  | (178 )      | (409 )     |
| Loans:                                     |   |             |            |
| Taxable                                    | 4,549   | 2,698       | 7,247      |
| Tax-exempt                                 | (36 )   | (84 )       | (120 )     |
| Total interest income                      | 4,033   | 2,944       | 6,977      |
| Interest Expense                           |   |             |            |
| Deposits:                                  |   |             |            |
| Interest bearing demand                    | 178   | 2,019       | 2,197      |
| Savings                                    | 2   | 0           | 2          |
| Time                                       | 244   | 1,014       | 1,258      |
| Short-term borrowings                      | (217 )  | 2           | (215 )     |
| Long-term debt                             | (24 )   | 266         | 242        |
| Total interest expense                     | 183   | 3,301       | 3,484      |
| Net interest income (tax equivalent basis) | \$3,850   | \$(357 )    | \$3,493    |

\*Changes which are due to both volume and rate are allocated in proportion to their relationship to the amount of change attributed directly to volume or rate.

### Provision for Loan Losses

For the first nine months of 2018, the provision for loan losses was \$1,800,000, as compared to a provision of \$3,575,000 for the first nine months of 2017. The provision in 2018 was due to approximately \$1,347,000 of specific loan loss reserves assigned during 2018, provision related to net loan growth during 2018, net charge-offs of \$255,000 and the net impact of adjustments made to certain qualitative factors and the unallocated reserve. The provision of \$3,575,000 in 2017 was related primarily to net loan charge-offs of \$1,775,000 and provision related to net loan growth during 2017. The provision for both periods supported adequate allowance for loan loss coverage, including the Corporation's substantial growth in commercial loans. The allowance as a percentage of total loans was 1.22 percent at September 30, 2018, as compared to 1.19 percent at December 31, 2017, and 1.20 percent at September 30,

2017.

More information about the allowance for loan losses can be found in this report under the caption Allowance for Loan Losses on page 63.

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**Noninterest Income**

The following table presents the components of total noninterest income for the first nine months of 2018, compared to the first nine months of 2017.

Table 7 - Noninterest income

| (dollars in thousands)                               | Nine months ended |         | Change   |       |
|--|-------------------|---------|----------|-------|
|  | September 30,     |         | Increase |       |
|  | 2018              | 2017    | \$       | %     |
| Trust and investment services fees                   | \$2,389           | \$2,138 | \$251    | 12 %  |
| Income from mutual fund, annuity and insurance sales | 806               | 620     | 186      | 30    |
| Service charges on deposit accounts                  | 3,485             | 3,078   | 407      | 13    |
| Income from bank owned life insurance                | 730               | 779     | (49 )    | (6 )  |
| Other income   | 1,221             | 817     | 404      | 49    |
| Gain on sales of loans held for sale                 | 1,436             | 823     | 613      | 74    |
| Gain on sales of securities                          | 0                 | 79      | (79 )    | (100) |
| Total noninterest income                             | \$10,067          | \$8,334 | \$1,733  | 21 %  |

The discussion that follows addresses changes in selected categories of noninterest income.

**Income from mutual fund, annuity and insurance sales**—The \$186,000 or 30 percent increase in income from the sale of mutual fund, annuity and insurance products by CVFA d/b/a PeoplesWealth Advisors was due to the higher volume of assets under management during the first nine months of 2018 and a \$74,000 fee received during the first quarter of 2018 associated with a one-time transaction associated with an Internal Revenue Code Section 1031 exchange.

**Service charges on deposit accounts**—The \$407,000 or 13 percent increase in service charge income on deposit accounts was due to a growth in the volume of deposit accounts subject to fees.

**Other income**—The \$404,000 or 49 percent increase in other income was due to higher loan related income such as mortgage and SBA loan servicing income, letter of credit and referral fees and miscellaneous client based service charges such as gift card and credit card merchant and ATM fees.

***Gain on sales of loans held for sale***—The \$613,000 or 74 percent increase in gain on sales of loans was due to the sale of a higher volume of the guaranteed portion of SBA loans to the secondary market.

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**Noninterest Expense**

The following table presents the components of total noninterest expense for the first nine months of 2018, compared to the first nine months of 2017.

Table 8 - Noninterest expense

| (dollars in thousands)  | Nine months ended |          | Change   |       |
|---|-------------------|----------|----------|-------|
|   | September 30,     |          | Increase |       |
|   | 2018              | 2017     | \$       | %     |
| Personnel   | \$21,855          | \$19,501 | \$2,354  | 12 %  |
| Occupancy of premises, net  | 2,556             | 2,471    | 85       | 3     |
| Furniture and equipment   | 2,262             | 2,115    | 147      | 7     |
| Postage, stationery and supplies                                    | 560               | 572      | (12 )    | (2 )  |
| Professional and legal  | 609               | 616      | (7 )     | (1 )  |
| Marketing   | 1,200             | 1,156    | 44       | 4     |
| FDIC insurance  | 493               | 537      | (44 )    | (8 )  |
| Debit card processing   | 902               | 780      | 122      | 16    |
| Charitable donations  | 1,792             | 982      | 810      | 82    |
| Telecommunications  | 500               | 608      | (108 )   | (18 ) |
| External data processing  | 1,563             | 1,252    | 311      | 25    |
| Foreclosed real estate including provision for (recovery of) losses | 33                | (18 )    | 51       | *nm   |
| Other   | 2,557             | 2,644    | (87 )    | (3 )  |
| Total noninterest expense   | \$36,882          | \$33,216 | \$3,666  | 11 %  |

\*nm – not meaningful

The discussion that follows addresses changes in selected categories of noninterest expense.

**Personnel**—The \$2,354,000 or 12 percent increase in personnel expense was due largely to the addition of new employees to support the Corporation's business growth, severance costs incurred on the termination of an executive officer of PeoplesBank, one-time bonuses to non-executive officers and higher health insurance costs.

**FDIC insurance**—The \$44,000 or 8 percent decrease was a result of a lower assessment rate used to calculate the quarterly premiums.

**Debit card processing**—The \$122,000 or 16 percent increase in debit card processing was a result of a higher assessment base and rate for card processing and a decrease in incentive credits received as compared to the prior year.

**Charitable donations**—The \$810,000 or 82 percent increase in charitable contributions was primarily due to a donation to the recently formed PeoplesBank Charitable Foundation and an increase in donations that qualify for educational improvement tax credits which reduces Pennsylvania bank shares tax.

**External data processing**—The \$311,000 or 25 percent increase in external data processing expenses reflects increased reliance on outsourcing transaction processing to specialized vendors, which is typically performed on such vendors' hosted and secure websites. In addition, increased volumes in both accounts and transactions year over year due to business expansion resulted in higher costs. The Corporation continues to expand and enhance electronic banking services provided to our clients which contributed to the increase in the expense.

### **Provision for Income Taxes**

The provision for income taxes for the first nine months of 2018 was \$4,044,000, a decrease of \$965,000 or 19 percent as compared to the first nine months of 2017. For the first nine months of 2018, the Corporation's statutory federal income tax rate was 21 percent compared to 35 percent for the first nine months of 2017. The effective income tax rate was 21 percent and 32 percent for the first nine months ended September 30, 2018 and 2017, respectively. The effective tax rate differs from the statutory tax rate due to the impact of certain elements with specific tax benefits, including tax-exempt income, such as income from tax-exempt investments, tax-exempt loans, and bank-owned life insurance. Decreases in the provision for income taxes and effective tax rate were due to the new 21 percent corporate tax rate enacted as part of the Tax Cuts and Jobs Act that became effective January 1, 2018.



## **Balance Sheet Review**

### **Interest Bearing Deposits with Banks**

On September 30, 2018, interest bearing deposits with banks totaled \$60,421,000, an increase of \$4,855,000 or 9 percent, compared to the level at year-end 2017. The increase was primarily the result of the growth in client deposits.

### **Investment Securities (Available-for-Sale)**

The Corporation's entire investment securities portfolio is classified available-for-sale, and is comprised primarily of interest-earning debt securities. The overall composition of the Corporation's investment securities portfolio is provided in Note 2—Securities. On September 30, 2018, the fair value of investment securities available-for-sale totaled \$146,089,000, which represented a decrease of \$12,502,000 as compared to the fair value of investment securities at year-end 2017. Principal reductions from investment maturities and mortgage-backed security payments exceeded new investments during the first nine months of 2018 and were redeployed in higher yielding loans.

### **Loans**

On September 30, 2018, total loans, net of deferred fees, were \$1.49 billion, which was \$94,263,000 or 7 percent higher than the level at year-end 2017. This change in volume was due primarily to an increase in commercial loans, particularly within the residential real estate investor sector and the other sector, which reflected continued commercial loan demand in our markets. Commercial loans within the commercial real estate investor, residential real estate investor and builder & developer sectors each represented more than 10 percent of the total portfolio. The composition of the Corporation's loan portfolio is provided in Note 4—Loans.

### **Deposits**

Deposits are the Corporation's principal source of funding for earning assets. On September 30, 2018, deposits totaled \$1.47 billion, which reflected an \$85,752,000 or 6 percent increase compared to the level at year-end 2017. Of the increase in total deposits, \$11,950,000 was attributable to noninterest bearing deposits and \$57,560,000 related to growth in interest bearing demand, money market and savings deposits. Time deposits increased \$16,242,000

compared to the level at year-end 2017. The composition of the Corporation's total deposit portfolio is provided in Note 6—Deposits.

### **Short-term Borrowings**

Short-term borrowings, which consist of securities sold under agreements to repurchase (repurchase agreements), federal funds purchased, and other short-term borrowings, totaled \$8,624,000 at September 30, 2018, which reflected an \$11,871,000 or 58 percent decrease compared to the level at year-end 2017. The decrease was primarily attributed to a reduction of \$10,200,000 in other short-term borrowings.

### **Long-term Debt**

The Corporation uses long-term borrowings as a secondary funding source for asset growth and to manage interest rate risk. On September 30, 2018, long-term debt totaled \$135,310,000 compared to \$130,310,000 at year-end 2017. The \$5,000,000 increase was due to \$30,000,000 in new advances and \$25,000,000 of maturities during the first nine months of 2018. A listing of outstanding long-term debt obligations is provided in Note 7—Short-Term Borrowings and Long-Term Debt.

## Shareholders' Equity and Capital Adequacy

Shareholders' equity, or capital, enables Codorus Valley to maintain asset growth and absorb losses. Capital adequacy can be affected by a multitude of factors, including profitability, new stock issuances, corporate expansion and acquisitions, dividend policy and distributions, and regulatory mandates. The Corporation's total shareholders' equity was approximately \$173,597,000 on September 30, 2018, an increase of approximately \$9,378,000 or 6 percent, compared to the level at year-end 2017.

### *Cash Dividends on Stock*

The Corporation has historically paid cash dividends on its stock on a quarterly basis. The Board of Directors determines the dividend rate after considering the Corporation's capital requirements, current and projected net income, and other relevant factors. As recently announced, the Board of Directors declared a quarterly cash dividend of \$0.155 per share on October 9, 2018, payable on November 13, 2018, to shareholders of record at the close of business on October 23, 2018. This cash dividend follows the \$0.155 cash dividend distributed in August 2018.

### *Capital Adequacy*

The Corporation and PeoplesBank are subject to various regulatory capital requirements administered by banking regulators that involve quantitative guidelines and qualitative judgments. The regulatory capital measures for the Corporation and PeoplesBank as of September 30, 2018 and the minimum capital ratios established by regulators are set forth in Note 8—Regulatory Matters to the financial statements. We believe that both Codorus Valley and PeoplesBank were well capitalized on September 30, 2018.

Our capital adequacy as of September 30, 2018, reflects updated regulatory capital guidelines from the Board of Governors of the Federal Reserve System finalized rule which implemented the Basel III regulatory capital framework, and which became effective for the Corporation and PeoplesBank on January 1, 2015. Under the revised regulatory capital framework, minimum requirements increased both the quantity and quality of capital held by banking organizations. Additionally, a new minimum ratio of common equity Tier 1 capital to risk-weighted assets of 4.5 percent and a common equity Tier 1 conservation buffer of risk-weighted assets applies to all supervised financial institutions. The rule also raised the minimum ratio of Tier 1 capital to risk-weighted assets from 4 percent to 6 percent and includes a minimum leverage ratio of 4 percent for all banks. The new rule also increases the risk weights for past-due loans, certain commercial real estate loans and some equity exposures, and makes selected other changes in risk weights and credit conversion factors.

The new rule further provides that, in order to avoid restrictions on capital distributions, including dividend payments and certain discretionary bonus payments to executive officers, a banking organization must hold the 2.5 percent capital conservation buffer, which is to be phased in over a four year period beginning January 1, 2016, with the full 2.5 percent required as of January 1, 2019.

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The transition schedule for new ratios, including the capital conservation buffer, is as follows:

|   | <b>As of January 1:</b> |             |             |             |             |
|---|-------------------------|-------------|-------------|-------------|-------------|
|   | <b>2015</b>             | <b>2016</b> | <b>2017</b> | <b>2018</b> | <b>2019</b> |
| Minimum common equity Tier 1 capital ratio                                  | 4.5 %                   | 4.5 %       | 4.5 %       | 4.5 %       | 4.5 %       |
| Common equity Tier 1 capital conservation buffer                            | N/A                     | 0.625 %     | 1.25 %      | 1.875 %     | 2.5 %       |
| Minimum common equity Tier 1 capital ratio plus capital conservation buffer | 4.5 %                   | 5.125 %     | 5.75 %      | 6.375 %     | 7.0 %       |
| Phase-in of most deductions from common equity Tier 1 capital               | 40 %                    | 60 %        | 80 %        | 100 %       | 100 %       |
| Minimum Tier 1 capital ratio  | 6.0 %                   | 6.0 %       | 6.0 %       | 6.0 %       | 6.0 %       |
| Minimum Tier 1 capital ratio plus capital conservation buffer               | N/A                     | 6.625 %     | 7.25 %      | 7.875 %     | 8.5 %       |
| Minimum total capital ratio   | 8.0 %                   | 8.0 %       | 8.0 %       | 8.0 %       | 8.0 %       |
| Minimum total capital ratio plus capital conservation buffer                | N/A                     | 8.625 %     | 9.25 %      | 9.875 %     | 10.5 %      |

As fully phased in, a banking organization with a buffer greater than 2.5 percent would not be subject to limits on dividend payments or discretionary bonus payments; however, a banking organization with a buffer less than 2.5 percent would be subject to increasingly stringent limitations as the buffer approaches zero. The new rule also prohibits a banking organization from paying dividends or discretionary bonuses if its eligible net income is negative in that quarter and its capital conservation buffer ratio was less than 2.5 percent as of the beginning of that quarter. Eligible net income is defined as net income for the four calendar quarters preceding the current calendar quarter, net of any distributions and associated tax effects not already reflected in net income.

A summary of payout restrictions based on the capital conservation buffer is as follows:

| <b>Capital Conservation Buffer</b>      | <b>Maximum Payout</b>                  |
|---|--|
| <b>(as a % of risk-weighted assets)</b> | <b>(as a % of eligible net income)</b> |
| Greater than 2.5%                       | No payout limitation applies           |
| ≤2.5% and >1.875%                       | 60%                                    |
| ≤1.875% and >1.25%                      | 40%                                    |
| ≤1.25% and >0.625%                      | 20%                                    |
| ≤0.625%                                 | 0%                                     |

Under the new rule as effective through the nine months ending September 30, 2018, the Corporation and PeoplesBank had no regulatory dividend restrictions and remained well capitalized by all regulatory capital measures (see Note 8—Regulatory Matters to the financial statements). The Corporation plans to manage its capital adequacy to ensure continued compliance with the new capital rules.



## **Risk Management**

### **Credit Risk Management**

Credit risk represents the possibility that a loan client, counterparty or issuer may not perform in accordance with contractual terms, posing one of the most significant risks of loss to the Corporation. Accordingly, the Corporation emphasizes the management of credit risk, and has established a lending policy which management believes is sound given the nature and scope of our operations. The Credit Risk Management section included in Item 7 of the Corporation's previously filed Annual Report on Form 10-K for the year ended December 31, 2017, provides a more detailed overview of the Corporation's credit risk management process.

### *Nonperforming Assets*

Nonperforming assets, as shown in the table below, are asset categories that pose the greatest risk of loss. The level of nonperforming assets at September 30, 2018 has increased by approximately \$9,650,000 or 181 percent when compared to year-end 2017. The increase was the result of increases in both nonaccrual loans and foreclosed real estate, net of allowance.

The Corporation regularly monitors large and criticized assets in its commercial loan portfolio recognizing that prolonged low economic growth, or a weakening economy, could have negative effects on these commercial borrowers. Nonperforming assets are monitored and managed for collection of these accounts. Collection efforts, including modification of contractual terms for individual accounts based on prevailing market conditions and liquidation of collateral assets, are employed to maximize recovery. A special assets committee meets regularly, at a minimum quarterly, to review nonperforming assets. We generally rely on appraisals performed by independent licensed appraisers to determine the value of real estate collateral for impaired collateral-dependent loans. Generally, an appraisal is performed when: an account reaches 90 days past due, unless a certified appraisal was completed within the past twelve months; market values have changed significantly; the condition of the property has changed significantly; or the existing appraisal is outdated based upon regulatory or policy requirements. In instances where the value of the collateral, net of costs to sell, is less than the net carrying amount for impaired commercial related loans, a specific loss allowance is established for the difference. Further provisions for loan losses may be required for nonaccrual loans as additional information becomes available or conditions change. When it is probable that some portion or an entire loan balance will not be collected, that amount is charged off as loss against the allowance.

The paragraphs and table below address significant changes in the nonperforming asset categories as of September 30, 2018 compared to December 31, 2017.

Table 9 - Nonperforming Assets

| <b>(dollars in thousands)</b>  | <b>September<br/>30,<br/>2018</b> | <b>December<br/>31,<br/>2017</b> |        |   |
|--|-----------------------------------|----------------------------------|--------|---|
| Nonaccrual loans   | \$12,934                          | \$5,052                          |        |   |
| Accruing loans 90 days or more past due  | 293                               | 76                               |        |   |
| Total nonperforming loans  | 13,227                            | 5,128                            |        |   |
| Foreclosed real estate, net of allowance   | 1,767                             | 216                              |        |   |
| Total nonperforming assets   | \$14,994                          | \$5,344                          |        |   |
| Accruing troubled debt restructurings  | \$4,079                           | \$3,344                          |        |   |
| <br>   |                                   |                                  |        |   |
| Total period-end loans, net of deferred fees   | \$1,494,027                       | \$1,399,764                      |        |   |
| Allowance for loan losses (ALL)  | \$18,234                          | \$16,689                         |        |   |
| ALL as a % of total period-end loans   | 1.22                              | %                                | 1.19   | % |
| Net charge-offs year-to-date, annualized as a % of average total loans               | 0.02                              | %                                | 0.18   | % |
| ALL as a % of nonperforming loans  | 137.86                            | %                                | 325.48 | % |
| Nonperforming loans as a % of total period-end loans                                 | 0.89                              | %                                | 0.37   | % |
| Nonperforming assets as a % of total period-end loans and net foreclosed real estate | 1.00                              | %                                | 0.38   | % |
| Nonperforming assets as a % of total period-end assets                               | 0.83                              | %                                | 0.31   | % |
| Nonperforming assets as a % of total period-end shareholders' equity                 | 8.64                              | %                                | 3.25   | % |

### *Nonperforming loans*

Nonperforming loans consist of nonaccrual loans and accruing loans 90 days or more past due. We generally place a loan on nonaccrual status and cease accruing interest income (i.e., recognize interest income on a cash basis, as long as the loan is sufficiently collateralized) when loan payment performance is unsatisfactory and the loan is past due 90 days or more. A loan is returned to interest accruing status when we determine that circumstances have improved to the extent that all of the principal and interest amounts contractually due are current for at least six consecutive payments and future payments are reasonably assured. Loans past due 90 days or more and still accruing interest represent loans that are contractually past due, but are well collateralized and in the process of collection. As of September 30, 2018, the nonperforming loan portfolio balance totaled \$13,227,000, compared to \$5,128,000 at year-end 2017. The increase of \$8,099,000 was primarily the result of the transfer of four loans to nonaccrual status totaling approximately \$9,686,000 offset by the transfer of a loan to foreclosed real estate totaling \$1,618,000. For both periods, the nonperforming portfolio balance was comprised primarily of collateralized commercial loans.



*Foreclosed Real Estate*

Foreclosed real estate represents real estate acquired to satisfy debts owed to PeoplesBank and is included in the Other Assets category on the Corporation's balance sheet. The carrying amount of foreclosed real estate as of September 30, 2018, net of allowance, totaled \$1,767,000 compared to \$216,000 at year-end 2017. The increase is attributable to the acquisition of a commercial property during the third quarter of 2018.

### *Troubled Debt Restructurings*

Troubled debt restructurings pertain to loans whose terms have been modified to include a concession that we would not ordinarily consider due to the debtor's financial difficulties. Concessions granted under a troubled debt restructuring typically involve a reduction of interest rate lower than the current market rate for new debt with similar risk, the deferral of payments or extension of the stated maturity date. Troubled debt restructurings are evaluated for impairment if they have been restructured during the most recent calendar year, or if they cease to perform in accordance with the modified terms. As of September 30, 2018, the accruing troubled debt restructuring portfolio balance totaled \$4,079,000, compared to \$3,344,000 at year-end 2017. The \$735,000 increase was the result of a modification to three loans with combined principal balances of \$1,305,000 during the second and third quarters of 2018 which was offset by principal repayments of \$337,000 and a payoff of \$221,000.

### *Allowance for Loan Losses*

Although the Corporation believes that it maintains sound credit policies, certain loans deteriorate and must be charged off as losses. The allowance for loan losses is maintained to absorb losses inherent in the portfolio. The allowance is increased by provisions charged to expense and is reduced by loan charge-offs, net of recoveries. The allowance is based upon management's continuous evaluation of the loan portfolio coupled with a formal review of adequacy on a quarterly basis, which is subject to review and approval by the Board.

The allowance for loan losses consists primarily of three components: specific allowances for individually impaired commercial loans; allowances calculated for pools of loans; and an unallocated component, which reflects the margin of imprecision inherent in the assumptions that underlie the evaluation of the adequacy of the allowance. The Corporation uses an internal risk rating system to evaluate individual loans. Loans are segmented into industry groups or pools with similar characteristics, and an allowance for loan losses is allocated to each segment based on quantitative factors such as recent loss history (two-year rolling average of net charge-offs) and qualitative factors, such as the results of internal and external credit reviews, changes in the size and composition of the loan portfolio, adequacy of collateral, and general economic conditions. Determining the level of the allowance for probable loan losses at any given period is subjective, particularly during deteriorating or uncertain economic periods, and requires that we make estimates using assumptions. There is also the potential for adjustment to the allowance as a result of regulatory examinations.

The following table presents an analysis of the activity in the allowance for loan losses for nine months ended September 30, 2018 and 2017:

Table 10 - Analysis of Allowance for Loan Losses

| <b>(dollars in thousands)</b>  | <b>2018</b> | <b>2017</b> |
|--|-------------|-------------|
| Balance-January 1,   | \$16,689    | \$14,992    |
| Provision charged to operating expense                                 | 1,800       | 3,575       |
| Loans charged off:   |             |             |
| Commercial, financial and agricultural                                 | 146         | 214         |
| Real estate - construction and land development                        | 0           | 1,474       |
| Real estate - residential mortgages                                    | 10          | 0           |
| Consumer and home equity   | 289         | 198         |
| Total loans charged off  | 445         | 1,886       |
| Recoveries:  |             |             |
| Commercial, financial and agricultural                                 | 139         | 97          |
| Real estate - construction and land development                        | 18          | 0           |
| Real estate - residential mortgages                                    | 10          | 5           |
| Consumer and home equity   | 23          | 9           |
| Total recoveries   | 190         | 111         |
| Net charge-offs  | 255         | 1,775       |
| Balance-September 30,  | \$18,234    | \$16,792    |
| Ratios:  |             |             |
| Allowance for loan losses as a % of total period-end loans             | 1.22 %      | 1.20 %      |
| Net charge-offs year-to-date, annualized as a % of average total loans | 0.02 %      | 0.17 %      |
| Allowance for loan losses as a % of nonperforming loans                | 137.86 %    | 262.72 %    |

The provision for loan losses decreased \$1,775,000 or 50 percent from September 30, 2017 to September 30, 2018. The change in provision for 2018 was primarily due to specific loan loss reserves assigned during 2018 as compared to a larger amount of net charge-offs taken during 2017. The provision for both periods supported adequate allowance for loan loss coverage considering several factors, including the Corporation's substantial growth in commercial loans.

Net charge-offs for the first nine months of 2018 were \$255,000 compared to \$1,775,000 for the same period of 2017. During the first nine months of 2018, there were \$445,000 of charge-offs as compared to \$1,886,000 during the same period in 2017. The risks and uncertainties associated with weak economic and business conditions, or the erosion of real estate values may adversely affect our borrowers' ability to service their loans, causing significant fluctuations in the level of charge-offs and provision expense from one period to another. The provision for loan losses for the first nine months of 2018 was \$1,800,000, compared to \$3,575,000 for the same period of 2017. The allowance as a percentage of total loans was 1.22 percent at September 30, 2018, as compared to 1.19 percent at December 31, 2017.

and 1.20 percent at September 30, 2017. The unallocated portion of the allowance was \$2,112,000 or 12 percent of the total allowance as of September 30, 2018, as compared to \$2,180,000 or 13 percent of the total allowance as of December 31, 2017.

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## **Liquidity Risk Management**

Maintaining adequate liquidity provides the Corporation with the ability to meet financial obligations to depositors, loan clients, employees, and shareholders on a timely and cost effective basis in the normal course of business. Additionally, adequate liquidity provides funds for growth and business opportunities as they arise. Liquidity is generated from transactions relating to both the Corporation's assets and liabilities. The primary sources of asset liquidity are funds received from client loan payments, investment maturities and cash inflows from mortgage-backed securities, and the net proceeds of asset sales. The primary sources of liability liquidity are deposit growth, and funds obtained from short-term borrowings and long-term debt. The Consolidated Statements of Cash Flows, included in this report, present the changes in cash from operating, investing and financing activities. At September 30, 2018, we believe that liquidity was adequate based upon the potential liquidation of unpledged available-for-sale securities with a fair value totaling approximately \$9,585,000 and available credit from the Federal Home Loan Bank of Pittsburgh totaling approximately \$381,144,000. The Corporation's loan-to-deposit ratio was approximately 102 percent as of September 30, 2018, 106 percent as of September 30, 2017 and 101 percent as of December 31, 2017.

## **Off-Balance Sheet Arrangements**

The Corporation's financial statements do not reflect various commitments that are made in the normal course of business, which may involve some liquidity risk. These commitments consist primarily of commitments to grant new loans, unfunded commitments under existing loan facilities, and letters of credit issued under the same standards as on-balance sheet instruments. Unused commitments on September 30, 2018, totaled \$488,031,000 and consisted of \$389,572,000 in unfunded commitments under existing loan facilities, \$70,895,000 to grant new loans and \$27,564,000 in letters of credit. Generally these commitments have fixed expiration dates or termination clauses and are for specific purposes. Accordingly, many of the commitments are expected to expire without being drawn upon and, therefore, generally do not present significant liquidity risk to the Corporation or PeoplesBank.

## **Recent Legislative Developments**

On May 24, 2018, President Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"), which was designed to ease certain restrictions imposed by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Most of the changes made by the new Act can be grouped into five general areas: mortgage lending; certain regulatory relief for "community" banks; enhanced consumer protections in specific areas, including subjecting credit reporting agencies to additional requirements; certain regulatory relief for large financial institutions, including increasing the threshold at which institutions are classified a systemically important financial institutions (from \$50 billion to \$250 billion) and therefore subject to stricter oversight, and revising the rules for larger institution stress testing; and certain changes to federal securities regulations designed to promote capital formation. Some of the key provisions of the Act as it relates to community banks and bank holding

companies include, but are not limited to: (i) designating mortgages held in portfolio as “qualified mortgages” for banks with less than \$10 billion in assets, subject to certain documentation and product limitations; (ii) exempting banks with less than \$10 billion in assets from Volcker Rule requirements relating to proprietary trading; (iii) simplifying capital calculations for banks with less than \$10 billion in assets by requiring federal banking agencies to establish a community bank leverage ratio of tangible equity to average consolidated assets of not less than 8% or more than 10%, and provide that banks that maintain tangible equity in excess of such ratio will be deemed to be in compliance with risk-based capital and leverage requirements; (iv) assisting smaller banks with obtaining stable funding by providing an exception for reciprocal deposits from FDIC restrictions on acceptance of brokered deposits; (v) raising the eligibility for use of short-form Call Reports from \$1 billion to \$5 billion in assets; and (vi) clarifying definitions pertaining to high volatility commercial real estate loans (HVCRE), which require higher capital allocations, so that only loans with increased risk are subject to higher risk weightings. As required by the Act, the Federal Reserve Board issued an interim final rule that expanded applicability of the Board’s small bank holding company policy statement, raising the policy statement’s asset threshold from \$1 billion to \$3 billion in total consolidated assets for a bank holding company or savings and loan holding company, subject to other conditions. Management believes the Corporation meets the conditions of the Federal Reserve’s small bank holding company policy statement and is therefore excluded from consolidated capital requirements as of September 30, 2018. Further, qualification as a small bank holding company allows the Corporation to file more abbreviated, and less frequent, consolidated and holding company reports with the Federal Reserve. The Corporation continues to analyze the changes implemented by the Act, but does not believe that such changes will materially impact the Corporation’s business, operations, or financial results.

**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

The most significant market risk to which the Corporation is exposed is interest rate risk. The primary business of the Corporation and the composition of its balance sheet consist of investments in interest earning assets (primarily loans and securities), which are funded by interest bearing liabilities (deposits and borrowings), all of which have varying levels of sensitivity to changes in market interest rates. Changes in rates also have an impact on the Corporation's liquidity position and could affect its ability to meet obligations and continue to grow.

The Corporation employs various management techniques to minimize its exposure to interest rate risk. An Asset Liability Management Committee, consisting of key financial and senior management personnel, meets on a regular basis. The Committee is responsible for reviewing the interest rate sensitivity and liquidity positions of the Corporation, reviewing projected sources and uses of funds, approving asset and liability management policies, monitoring economic conditions, and overseeing the formulation and implementation of strategies regarding balance sheet positions.

Simulation of net interest income is performed for the next twelve-month period. A variety of interest rate scenarios are used to measure the effects of sudden and gradual movements upward and downward in the yield curve. These results are compared to the results obtained in a flat or unchanged interest rate scenario. Simulation of net interest income is used primarily to measure the Corporation's short-term earnings exposure to rate movements. A "shock" is an immediate upward or downward movement of interest rates. The shocks do not take into account changes in client behavior that could result in changes to mix and/or volumes in the balance sheet, nor do they account for competitive pricing over the forward 12-month period. The Corporation applies these interest rate "shocks" to its financial instruments up and down 100, 200, 300, and 400 basis points. A 300 and 400 basis point decrease in interest rates cannot be simulated at this time due to the historically low interest rate environment.

The following table summarizes the expected impact of interest rate shocks on net interest income as well as the Corporation's policy limits at each level. All scenarios were within policy limits at September 30, 2018.

| <b>Change in Interest Rates<br/>(basis points)</b> | <b>Annual<br/>Change in<br/>Net<br/>Interest<br/>Income (in<br/>thousands)</b> | <b>%<br/>Change<br/>in Net<br/>Interest<br/>Income</b> | <b>%<br/>Change<br/>Policy<br/>Limit</b> |
|--|--|--|--|
| +100   | \$ 2,625   | 3.86 %   | (5.00) %                                 |
| -100   | \$ (2,656)   | (3.91)%  | (5.00) %                                 |

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|      |            |         |          |
|------|------------|---------|----------|
| +200 | \$ 5,106   | 7.51 %  | (15.00)% |
| -200 | \$ (4,327) | (6.36)% | (15.00)% |
| +300 | \$ 7,728   | 11.36 % | (25.00)% |
| +400 | \$ 10,374  | 15.25 % | (35.00)% |

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#### **Item 4. Controls and Procedures**

The Corporation carried out an evaluation, under the supervision and with the participation of the Corporation's management, including the Corporation's Chief Executive Officer and Treasurer, of the effectiveness of its disclosure controls and procedures, as defined in Exchange Act Rules 13a-15(e) and 15d-15(e). Based upon the evaluation, the Corporation's Chief Executive Officer and Treasurer concluded that, as of September 30, 2018, the Corporation's disclosure controls and procedures were effective. The Corporation's disclosure controls and procedures are designed to provide reasonable, not absolute, assurance that information required to be disclosed in the Corporation's reports filed or submitted under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. A control system, no matter how well conceived and operated, must reflect the fact that there are resource constraints and that the benefits of controls must be considered relative to their costs, and no evaluation of controls can provide absolute assurance that all control issues and instances of fraud, if any, within a company have been detected.

There has been no change in the Corporation's internal control over financial reporting that occurred during the three and nine months ended September 30, 2018, that has materially affected, or is reasonably likely to materially affect, the Corporation's internal control over financial reporting.

#### **Part II—OTHER INFORMATION**

##### **Item 1. Legal Proceedings**

The Corporation and PeoplesBank are involved in routine litigation incidental to their business. In the opinion of management, there are no legal proceedings pending against the Corporation or any of its subsidiaries which are expected to have a material impact upon the consolidated financial position and/or operating results of the Corporation. Management is not aware of any adverse proceedings known or contemplated by government authorities.

##### **Item 1A. Risk Factors**

There have been no material changes to the risk factors as previously disclosed in Item 1A – Risk Factors – in our Annual Report on Form 10-K for the year ended December 31, 2017.

##### **Item 2. Unregistered Sales of Equity Securities and Use of Proceeds**

The Corporation relies on its subsidiary PeoplesBank, A Codorus Valley Company, for dividend distributions, which are subject to restrictions as reported in Note 9—Regulatory Matters of the Corporation’s Annual Report on Form 10-K for the year ended December 31, 2017.

The Corporation has a Share Repurchase Program (Program), which was authorized in 1995, and has been periodically amended, to permit the purchase of up to a maximum of 4.9 percent of the outstanding shares of the Corporation’s common stock at a price per share no greater than 200 percent of the latest quarterly published book value. No shares were repurchased in 2017 under the 1995 Program. On February 13, 2018, the Corporation cancelled the prior Program and authorized a new Share Repurchase Program (2018 Program), to permit the purchase of up to a maximum of 4.9 percent of the outstanding shares of the Corporation’s common stock at a price per share no greater than 150 percent of the latest quarterly published book value. For the nine month period ended September 30, 2018 the Corporation had not acquired any of its common stock under the 2018 Program.

**Item 3. Defaults Upon Senior Securities**

None

**Item 4. Mine Safety Disclosures**

This Item 4 is not applicable to the Corporation.

**Item 5. Other Information**

None

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**Item 6. Exhibits**

| <u>Exhibit<br/>Number</u> | <u>Description of Exhibit</u>  |
|---------------------------|--|
| 3.1                       | <u>Amended Articles of Incorporation (Incorporated by reference to Exhibit 3.1 to the Quarterly Report on Form 10-Q for June 30, 2018, filed with the Commission on August 6, 2018)</u>  |
| 3.2                       | <u>Amended By-laws (Incorporated by reference to Exhibit 3.1 to the Registrant’s Current Report on Form 8-K, filed with the Commission on January 12, 2016)</u>  |
| 10.1                      | <u>Change of Control Agreement by and among Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Larry D. Pickett, dated August 9, 2018 (incorporated by reference to Exhibit 10.1 to the Registrant’s Current Report on Form 8-K filed with the Commission on August 9, 2018)*</u> |
| 10.2                      | <u>Employment Agreement by and among Codorus Valley Bancorp, Inc., PeoplesBank, A Codorus Valley Company and Craig L. Kauffman, dated August 6, 2018 (incorporated by reference to Exhibit 10.1 to the Registrant’s Current Report on Form 8-K filed with the Commission on August 16, 2018)*</u>      |
| 31.1                      | <u>Certification of Principal Executive Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 – filed herewith.</u>  |
| 31.2                      | <u>Certification of Principal Financial Officer Pursuant to Section 302 of the Sarbanes-Oxley Act of 2002 – filed herewith.</u>  |
| 32                        | <u>Certification of Principal Executive Officer and Principal Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 – filed herewith.</u>  |

Financial statements from the Quarterly Report on Form 10-Q of Codorus Valley Bancorp, Inc. for the quarter ended September 30, 2018, formatted in XBRL: (i) the Consolidated Balance Sheets, (ii) the Consolidated Statements of Income (iii) the Consolidated Statements of Comprehensive Income (iv) the Consolidated Statements of Cash Flows, (v) the Consolidated Statements of Changes in Shareholder’s Equity, and (vi) the Notes to Consolidated Financial Statements – filed herewith.

\*Management contract or compensation plan or arrangement required to be filed or incorporated as an exhibit.



**Signatures**

Pursuant to the requirements of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

Codorus Valley Bancorp, Inc.  
(Registrant)

November 8, 2018 /s/ Larry J. Miller  
Date Larry J. Miller  
Chairman, President and Chief Executive Officer  
(Principal Executive Officer)

November 8, 2018 /s/ Larry D. Pickett  
Date Larry D. Pickett, CPA  
Treasurer  
(Principal Financial and Accounting Officer)