

PENNS WOODS BANCORP INC  
Form 10-Q  
August 10, 2015  
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION  
WASHINGTON, D.C. 20549

FORM 10-Q

ý Quarterly Report pursuant to Section 13 or 15 (d) of the Securities Exchange Act of 1934  
for the Quarterly Period Ended June 30, 2015.

o Transition report pursuant to Section 13 or 15 (d) of the Exchange Act

For the Transition Period from \_\_\_\_\_ to \_\_\_\_\_.

No. 0-17077  
(Commission File Number)

PENNS WOODS BANCORP, INC.  
(Exact name of Registrant as specified in its charter)  
PENNSYLVANIA  
(State or other jurisdiction of  
incorporation or organization)

23-2226454  
(I.R.S. Employer  
Identification No.)

300 Market Street, P.O. Box 967 Williamsport,  
Pennsylvania  
(Address of principal executive offices)

17703-0967  
(Zip Code)

(570) 322-1111  
Registrant's telephone number, including area code

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 ý NO o

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

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

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Large accelerated filer   
Non-accelerated filer

Accelerated filer   
Small reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES  NO

On August 1, 2015 there were 4,765,526 shares of the Registrant's common stock outstanding.

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## Part I. FINANCIAL INFORMATION

## Item 1. Financial Statements

## PENNS WOODS BANCORP, INC.

## CONSOLIDATED BALANCE SHEET

## (UNAUDITED)

| (In Thousands, Except Share Data)                                                                   | June 30,<br>2015   | December 31,<br>2014 |
|-----------------------------------------------------------------------------------------------------|--------------------|----------------------|
| <b>ASSETS:</b>                                                                                      |                    |                      |
| Noninterest-bearing balances                                                                        | \$20,428           | \$19,403             |
| Interest-bearing balances in other financial institutions                                           | 1,441              | 505                  |
| Total cash and cash equivalents                                                                     | 21,869             | 19,908               |
| Investment securities, available for sale, at fair value                                            | 214,312            | 232,213              |
| Investment securities, trading                                                                      | 157                | —                    |
| Loans held for sale                                                                                 | 2,107              | 550                  |
| Loans                                                                                               | 977,878            | 915,579              |
| Allowance for loan losses                                                                           | (11,265            | ) (10,579            |
| Loans, net                                                                                          | 966,613            | 905,000              |
| Premises and equipment, net                                                                         | 20,816             | 21,109               |
| Accrued interest receivable                                                                         | 3,706              | 3,912                |
| Bank-owned life insurance                                                                           | 26,327             | 25,959               |
| Investment in limited partnerships                                                                  | 1,229              | 1,560                |
| Goodwill                                                                                            | 17,104             | 17,104               |
| Intangibles                                                                                         | 1,294              | 1,456                |
| Deferred tax asset                                                                                  | 8,772              | 8,101                |
| Other assets                                                                                        | 7,506              | 8,139                |
| <b>TOTAL ASSETS</b>                                                                                 | <b>\$1,291,812</b> | <b>\$1,245,011</b>   |
| <b>LIABILITIES:</b>                                                                                 |                    |                      |
| Interest-bearing deposits                                                                           | \$762,966          | \$738,041            |
| Noninterest-bearing deposits                                                                        | 244,502            | 243,378              |
| Total deposits                                                                                      | 1,007,468          | 981,419              |
| Short-term borrowings                                                                               | 59,026             | 40,818               |
| Long-term borrowings                                                                                | 75,426             | 71,176               |
| Accrued interest payable                                                                            | 410                | 381                  |
| Other liabilities                                                                                   | 14,484             | 15,250               |
| <b>TOTAL LIABILITIES</b>                                                                            | <b>1,156,814</b>   | <b>1,109,044</b>     |
| <b>SHAREHOLDERS' EQUITY:</b>                                                                        |                    |                      |
| Preferred stock, no par value, 3,000,000 shares authorized; no shares issued                        | —                  | —                    |
| Common stock, par value \$8.33, 15,000,000 shares authorized; 5,003,757 and 5,002,649 shares issued | 41,698             | 41,688               |
| Additional paid-in capital                                                                          | 49,933             | 49,896               |
| Retained earnings                                                                                   | 55,397             | 53,107               |
| Accumulated other comprehensive loss:                                                               |                    |                      |
| Net unrealized gain on available for sale securities                                                | 1,374              | 2,930                |
| Defined benefit plan                                                                                | (4,544             | ) (4,597             |

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|                                                    |             |             |   |
|----------------------------------------------------|-------------|-------------|---|
| Treasury stock at cost, 238,478 and 197,834 shares | (8,860      | ) (7,057    | ) |
| TOTAL SHAREHOLDERS' EQUITY                         | 134,998     | 135,967     |   |
| TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY         | \$1,291,812 | \$1,245,011 |   |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF INCOME  
(UNAUDITED)

| (In Thousands, Except Per Share Data)                   | Three Months Ended |           | Six Months Ended |           |
|---------------------------------------------------------|--------------------|-----------|------------------|-----------|
|                                                         | June 30,<br>2015   | 2014      | June 30,<br>2015 | 2014      |
| INTEREST AND DIVIDEND INCOME:                           |                    |           |                  |           |
| Loans, including fees                                   | \$9,752            | \$8,912   | \$19,075         | \$17,725  |
| Investment securities:                                  |                    |           |                  |           |
| Taxable                                                 | 885                | 1,406     | 1,899            | 2,864     |
| Tax-exempt                                              | 744                | 892       | 1,511            | 1,823     |
| Dividend and other interest income                      | 148                | 147       | 441              | 274       |
| TOTAL INTEREST AND DIVIDEND INCOME                      | 11,529             | 11,357    | 22,926           | 22,686    |
| INTEREST EXPENSE:                                       |                    |           |                  |           |
| Deposits                                                | 785                | 741       | 1,528            | 1,499     |
| Short-term borrowings                                   | 28                 | 12        | 47               | 27        |
| Long-term borrowings                                    | 494                | 473       | 1,018            | 942       |
| TOTAL INTEREST EXPENSE                                  | 1,307              | 1,226     | 2,593            | 2,468     |
| NET INTEREST INCOME                                     | 10,222             | 10,131    | 20,333           | 20,218    |
| PROVISION FOR LOAN LOSSES                               | 600                | 300       | 1,300            | 785       |
| NET INTEREST INCOME AFTER PROVISION FOR LOAN LOSSES     | 9,622              | 9,831     | 19,033           | 19,433    |
| NON-INTEREST INCOME:                                    |                    |           |                  |           |
| Service charges                                         | 598                | 607       | 1,151            | 1,202     |
| Securities gains, available for sale                    | 526                | 487       | 1,187            | 880       |
| Securities losses, trading                              | (4)                | —         | (4)              | —         |
| Bank-owned life insurance                               | 171                | 181       | 359              | 551       |
| Gain on sale of loans                                   | 482                | 421       | 781              | 711       |
| Insurance commissions                                   | 204                | 283       | 438              | 703       |
| Brokerage commissions                                   | 294                | 251       | 539              | 522       |
| Other                                                   | 786                | 699       | 1,866            | 1,571     |
| TOTAL NON-INTEREST INCOME                               | 3,057              | 2,929     | 6,317            | 6,140     |
| NON-INTEREST EXPENSE:                                   |                    |           |                  |           |
| Salaries and employee benefits                          | 4,301              | 4,167     | 8,771            | 8,670     |
| Occupancy                                               | 564                | 552       | 1,192            | 1,182     |
| Furniture and equipment                                 | 643                | 648       | 1,238            | 1,319     |
| Pennsylvania shares tax                                 | 243                | 262       | 467              | 506       |
| Amortization of investment in limited partnerships      | 166                | 166       | 331              | 331       |
| Federal Deposit Insurance Corporation deposit insurance | 230                | 201       | 445              | 379       |
| Marketing                                               | 145                | 126       | 274              | 236       |
| Intangible amortization                                 | 80                 | 88        | 162              | 180       |
| Other                                                   | 2,049              | 2,212     | 4,009            | 4,262     |
| TOTAL NON-INTEREST EXPENSE                              | 8,421              | 8,422     | 16,889           | 17,065    |
| INCOME BEFORE INCOME TAX PROVISION                      | 4,258              | 4,338     | 8,461            | 8,508     |
| INCOME TAX PROVISION                                    | 825                | 875       | 1,673            | 1,576     |
| NET INCOME                                              | \$3,433            | \$3,463   | \$6,788          | \$6,932   |
| EARNINGS PER SHARE - BASIC AND DILUTED                  | \$0.72             | \$0.72    | \$1.42           | \$1.44    |
|                                                         | 4,779,687          | 4,820,193 | 4,790,536        | 4,819,886 |

WEIGHTED AVERAGE SHARES OUTSTANDING - BASIC  
AND DILUTED

|                              |        |        |        |        |
|------------------------------|--------|--------|--------|--------|
| DIVIDENDS DECLARED PER SHARE | \$0.47 | \$0.47 | \$0.94 | \$0.94 |
|------------------------------|--------|--------|--------|--------|

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
 CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME  
 (UNAUDITED)

| (In Thousands)                                                    | Three Months Ended June 30, |         | Six Months Ended June 30, |          |   |
|-------------------------------------------------------------------|-----------------------------|---------|---------------------------|----------|---|
|                                                                   | 2015                        | 2014    | 2015                      | 2014     |   |
| Net Income                                                        | \$3,433                     | \$3,463 | \$6,788                   | \$6,932  |   |
| Other comprehensive (loss) income:                                |                             |         |                           |          |   |
| Change in unrealized (loss) gain on available for sale securities | (2,379                      | ) 3,930 | (1,171                    | ) 9,258  |   |
| Tax effect                                                        | 809                         | (1,337  | ) 398                     | (3,148   | ) |
| Net realized gain included in net income                          | (526                        | ) (487  | ) (1,187                  | ) (880   | ) |
| Tax effect                                                        | 179                         | 166     | 404                       | 299      |   |
| Amortization of unrecognized pension and post-retirement items    | 80                          | —       | 80                        | —        |   |
| Tax effect                                                        | (27                         | ) —     | (27                       | ) —      |   |
| Total other comprehensive (loss) income                           | (1,864                      | ) 2,272 | (1,503                    | ) 5,529  |   |
| Comprehensive income                                              | \$1,569                     | \$5,735 | \$5,285                   | \$12,461 |   |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY  
(UNAUDITED)

| (In Thousands, Except Per Share Data)                 | COMMON STOCK |          |          | ADDITIONAL<br>PAID-IN<br>CAPITAL | RETAINED<br>EARNINGS | ACCUMULATED                                |                   | TOTAL<br>SHAREHOLDERS'<br>EQUITY |
|-------------------------------------------------------|--------------|----------|----------|----------------------------------|----------------------|--------------------------------------------|-------------------|----------------------------------|
|                                                       | SHARES       | AMOUNT   |          |                                  |                      | OTHER<br>COMPREHENSIVE<br>INCOME<br>(LOSS) | TREASURY<br>STOCK |                                  |
| Balance, December 31, 2013                            | 4,999,929    | \$41,665 | \$49,800 | \$47,554                         | \$ (4,894 )          | \$ (6,310 )                                | \$ 127,815        |                                  |
| Net income                                            |              |          |          | 6,932                            |                      |                                            | 6,932             |                                  |
| Other comprehensive income                            |              |          |          |                                  | 5,529                |                                            | 5,529             |                                  |
| Dividends declared, (\$0.94 per share)                |              |          |          | (4,531 )                         |                      |                                            | (4,531 )          |                                  |
| Common shares issued for employee stock purchase plan | 1,293        | 11       | 46       |                                  |                      |                                            | 57                |                                  |
| Balance, June 30, 2014                                | 5,001,222    | \$41,676 | \$49,846 | \$49,955                         | \$ 635               | \$ (6,310 )                                | \$ 135,802        |                                  |

| (In Thousands, Except Per Share Data)                 | COMMON STOCK |          |          | ADDITIONAL<br>PAID-IN<br>CAPITAL | RETAINED<br>EARNINGS | ACCUMULATED                                |                   | TOTAL<br>SHAREHOLDERS'<br>EQUITY |
|-------------------------------------------------------|--------------|----------|----------|----------------------------------|----------------------|--------------------------------------------|-------------------|----------------------------------|
|                                                       | SHARES       | AMOUNT   |          |                                  |                      | OTHER<br>COMPREHENSIVE<br>INCOME<br>(LOSS) | TREASURY<br>STOCK |                                  |
| Balance, December 31, 2014                            | 5,002,649    | \$41,688 | \$49,896 | \$53,107                         | \$ (1,667 )          | \$ (7,057 )                                | \$ 135,967        |                                  |
| Net income                                            |              |          |          | 6,788                            |                      |                                            | 6,788             |                                  |
| Other comprehensive loss                              |              |          |          |                                  | (1,503 )             |                                            | (1,503 )          |                                  |
| Dividends declared, (\$0.94 per share)                |              |          |          | (4,498 )                         |                      |                                            | (4,498 )          |                                  |
| Common shares issued for employee stock purchase plan | 1,108        | 10       | 37       |                                  |                      |                                            | 47                |                                  |
| Purchase of treasury stock (40,644 shares)            |              |          |          |                                  |                      | (1,803 )                                   | (1,803 )          |                                  |
| Balance, June 30, 2015                                | 5,003,757    | \$41,698 | \$49,933 | \$55,397                         | \$ (3,170 )          | \$ (8,860 )                                | \$ 134,998        |                                  |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC.  
CONSOLIDATED STATEMENT OF CASH FLOWS  
(UNAUDITED)

| (In Thousands)                                                                    | Six Months Ended June 30, |               |
|-----------------------------------------------------------------------------------|---------------------------|---------------|
|                                                                                   | 2015                      | 2014          |
| <b>OPERATING ACTIVITIES:</b>                                                      |                           |               |
| Net Income                                                                        | \$6,788                   | \$6,932       |
| Adjustments to reconcile net income to net cash provided by operating activities: |                           |               |
| Depreciation and amortization                                                     | 1,642                     | 1,598         |
| Amortization of intangible assets                                                 | 162                       | 180           |
| Provision for loan losses                                                         | 1,300                     | 785           |
| Accretion and amortization of investment security discounts and premiums          | 418                       | 329           |
| Securities gains, net                                                             | (1,187)                   | ) (880)       |
| Originations of loans held for sale                                               | (27,170)                  | ) (21,292)    |
| Proceeds of loans held for sale                                                   | 26,394                    | 21,802        |
| Gain on sale of loans                                                             | (781)                     | ) (711)       |
| Securities losses, trading                                                        | 4                         | —             |
| Proceeds from the sale of trading securities                                      | 230                       | —             |
| Purchases of trading securities                                                   | (391)                     | ) —           |
| Earnings on bank-owned life insurance                                             | (359)                     | ) (551)       |
| Decrease in deferred tax asset                                                    | 131                       | 233           |
| Other, net                                                                        | (1,672)                   | ) (1,246)     |
| Net cash provided by operating activities                                         | 5,509                     | 7,179         |
| <b>INVESTING ACTIVITIES:</b>                                                      |                           |               |
| Proceeds from sales of available for sale securities                              | 31,693                    | 70,431        |
| Proceeds from calls and maturities of available for sale securities               | 9,873                     | 3,582         |
| Purchases of available for sale securities                                        | (23,987)                  | ) (39,578)    |
| Net increase in loans                                                             | (63,150)                  | ) (40,239)    |
| Acquisition of premises and equipment                                             | (483)                     | ) (1,571)     |
| Proceeds from the sale of foreclosed assets                                       | 1,547                     | 475           |
| Purchase of bank-owned life insurance                                             | (27)                      | ) (25)        |
| Proceeds from bank-owned life insurance death benefit                             | —                         | 367           |
| Proceeds from redemption of regulatory stock                                      | 5,162                     | 1,072         |
| Purchases of regulatory stock                                                     | (6,429)                   | ) (992)       |
| Net cash used for investing activities                                            | (45,801)                  | ) (6,478)     |
| <b>FINANCING ACTIVITIES:</b>                                                      |                           |               |
| Net increase (decrease) in interest-bearing deposits                              | 24,925                    | (2,557)       |
| Net increase in noninterest-bearing deposits                                      | 1,124                     | 11,381        |
| Proceeds from long-term borrowings                                                | 15,000                    | —             |
| Repayment of long-term borrowings                                                 | (10,750)                  | ) —           |
| Net increase (decrease) in short-term borrowings                                  | 18,208                    | (4,790)       |
| Dividends paid                                                                    | (4,498)                   | ) (4,531)     |
| Issuance of common stock                                                          | 47                        | 57            |
| Purchases of treasury stock                                                       | (1,803)                   | ) —           |
| Net cash provided by (used for) provided by financing activities                  | 42,253                    | (440)         |
| <b>NET INCREASE IN CASH AND CASH EQUIVALENTS</b>                                  | <b>1,961</b>              | <b>261</b>    |
| <b>CASH AND CASH EQUIVALENTS, BEGINNING</b>                                       | <b>19,908</b>             | <b>24,606</b> |

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|                                                    |          |          |
|----------------------------------------------------|----------|----------|
| CASH AND CASH EQUIVALENTS, ENDING                  | \$21,869 | \$24,867 |
| SUPPLEMENTAL DISCLOSURES OF CASH FLOW INFORMATION: |          |          |
| Interest paid                                      | \$2,564  | \$2,474  |
| Income taxes paid                                  | 1,600    | 1,665    |
| Transfer of loans to foreclosed real estate        | 237      | 134      |

See accompanying notes to the unaudited consolidated financial statements.

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PENNS WOODS BANCORP, INC. AND SUBSIDIARIES  
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS  
 (Unaudited)

Note 1. Basis of Presentation

The consolidated financial statements include the accounts of Penns Woods Bancorp, Inc. (the “Company”) and its wholly-owned subsidiaries: Woods Investment Company, Inc., Woods Real Estate Development Company, Inc., Luzerne Bank, and Jersey Shore State Bank (Jersey Shore State Bank and Luzerne Bank are referred to together as the “Banks”) and Jersey Shore State Bank’s wholly-owned subsidiary, The M Group, Inc. D/B/A The Comprehensive Financial Group (“The M Group”). All significant inter-company balances and transactions have been eliminated in the consolidation.

The interim financial statements are unaudited, but in the opinion of management reflect all adjustments necessary for the fair presentation of results for such periods. The results of operations for any interim period are not necessarily indicative of results for the full year. These financial statements should be read in conjunction with the financial statements and notes thereto contained in the Company’s Annual Report on Form 10-K for the year ended December 31, 2014.

The accounting policies followed in the presentation of interim financial results are the same as those followed on an annual basis. These policies are presented on pages 39 through 45 of the Form 10-K for the year ended December 31, 2014.

In reference to the attached financial statements, all adjustments are of a normal recurring nature pursuant to Rule 10-01(b) (8) of Regulation S-X.

Note 2. Accumulated Other Comprehensive Income (Loss)

The changes in accumulated other comprehensive income (loss) by component as of June 30, 2015 and 2014 were as follows:

| (In Thousands)                                                          | Three Months Ended June 30, 2015                     |                      |            | Three Months Ended June 30, 2014                            |                      |            |
|-------------------------------------------------------------------------|------------------------------------------------------|----------------------|------------|-------------------------------------------------------------|----------------------|------------|
|                                                                         | Net Unrealized Gain on Available for Sale Securities | Defined Benefit Plan | Total      | Net Unrealized Gain (Loss) on Available for Sale Securities | Defined Benefit Plan | Total      |
| Beginning balance                                                       | \$3,291                                              | \$(4,597 )           | \$(1,306 ) | \$1,088                                                     | \$(2,725 )           | \$(1,637 ) |
| Other comprehensive (loss) income before reclassifications              | (1,570 )                                             | —                    | (1,570 )   | 2,593                                                       | —                    | 2,593      |
| Amounts reclassified from accumulated other comprehensive (loss) income | (347 )                                               | 53                   | (294 )     | (321 )                                                      | —                    | (321 )     |
| Net current-period other comprehensive (loss) income                    | (1,917 )                                             | 53                   | (1,864 )   | 2,272                                                       | —                    | 2,272      |
| Ending balance                                                          | \$1,374                                              | \$(4,544 )           | \$(3,170 ) | \$3,360                                                     | \$(2,725 )           | \$635      |
| (In Thousands)                                                          | Six Months Ended June 30, 2015                       |                      |            | Six Months Ended June 30, 2014                              |                      |            |
|                                                                         | Net Unrealized Gain                                  | Defined Benefit      | Total      | Net Unrealized Gain                                         | Defined Benefit      | Total      |

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|                                                                               | (Loss) on Available-Plan<br>for Sale Securities |            | (Loss) on Available-Plan<br>for Sale Securities |            |
|-------------------------------------------------------------------------------|-------------------------------------------------|------------|-------------------------------------------------|------------|
| Beginning balance                                                             | \$2,930                                         | \$(4,597 ) | \$(1,667 )                                      | \$(2,169 ) |
| Other comprehensive (loss) income<br>before reclassifications                 | (773 )                                          | —          | (773 )                                          | 6,110      |
| Amounts reclassified from<br>accumulated other comprehensive<br>(loss) income | (783 )                                          | 53         | (730 )                                          | —          |
| Net current-period other<br>comprehensive (loss) income                       | (1,556 )                                        | 53         | (1,503 )                                        | 5,529      |
| Ending balance                                                                | \$1,374                                         | \$(4,544 ) | \$(3,170 )                                      | \$3,360    |

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The reclassifications out of accumulated other comprehensive income (loss) as of June 30, 2015 and 2014 were as follows:

| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified from Three Months Ended June 30, 2015 | Accumulated Other Comprehensive Income Three Months Ended June 30, 2014 | Affected Line Item in the Consolidated Statement of Income |
|------------------------------------------------------------------------|-----------------------------------------------------------|-------------------------------------------------------------------------|------------------------------------------------------------|
| Net unrealized gain on available for sale securities                   | \$ 526                                                    | \$ 487                                                                  | Securities gains, net                                      |
| Income tax effect                                                      | (179)                                                     | (166)                                                                   | Income tax provision                                       |
| Total reclassifications for the period                                 | \$ 347                                                    | \$ 321                                                                  | Net of tax                                                 |
| Net unrecognized pension costs                                         | \$ (80)                                                   | \$ —                                                                    | Salaries and employee benefits                             |
| Income tax effect                                                      | 27                                                        | —                                                                       | Income tax provision                                       |
| Total reclassifications for the period                                 | \$ (53)                                                   | \$ —                                                                    | Net of tax                                                 |
| Details about Accumulated Other Comprehensive Income (Loss) Components | Amount Reclassified from Six Months Ended June 30, 2015   | Accumulated Other Comprehensive Income Six Months Ended June 30, 2014   | Affected Line Item in the Consolidated Statement of Income |
| Net unrealized gain on available for sale securities                   | \$ 1,187                                                  | \$ 880                                                                  | Securities gains, net                                      |
| Income tax effect                                                      | (404)                                                     | (299)                                                                   | Income tax provision                                       |
| Total reclassifications for the period                                 | \$ 783                                                    | \$ 581                                                                  | Net of tax                                                 |
| Net unrecognized pension costs                                         | \$ (80)                                                   | \$ —                                                                    | Salaries and employee benefits                             |
| Income tax effect                                                      | 27                                                        | —                                                                       | Income tax provision                                       |
| Total reclassifications for the period                                 | \$ (53)                                                   | \$ —                                                                    | Net of tax                                                 |

### Note 3. Recent Accounting Pronouncements

In January 2014, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update ("ASU") 2014-01, Investments - Equity Method and Joint Ventures (Topic 323): Accounting for Investments in Qualified Affordable Housing Projects. The amendments in this update permit reporting entities to make an accounting policy election to account for their investments in qualified affordable housing projects using the proportional amortization method if certain conditions are met. Under the proportional amortization method, an entity amortizes the initial cost of the investment in proportion to the tax credits and other tax benefits received and recognizes the net investment performance in the income statement as a component of income tax expense (benefit). The amendments in this update should be applied retrospectively to all periods presented. A reporting entity that uses the effective yield method to account for its investments in qualified affordable housing projects before the date of adoption may continue to apply the effective yield method for those preexisting investments. The amendments in this update are effective for public

business entities for annual periods and interim reporting periods within those annual periods, beginning after December 15, 2014. Early adoption is permitted. This ASU did not have an impact on the Company's financial statements.

In January 2014, the FASB issued ASU 2014-04, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40): Reclassification of Residential Real Estate Collateralized Consumer Mortgage Loans upon Foreclosure. The amendments in this update clarify that an in substance repossession or foreclosure occurs, and a creditor is considered to have received physical possession of residential real estate property collateralizing a consumer mortgage loan, upon either (1) the creditor obtaining legal title to the residential real estate property upon completion of a foreclosure or (2) the borrower conveying all interest in the residential real estate property to the creditor to satisfy that loan through completion of a deed in lieu of foreclosure or through a similar legal agreement. Additionally, the amendments require interim and annual disclosure of both (1) the amount of foreclosed residential real estate property held by the creditor, and (2) the recorded investment in consumer mortgage loans collateralized by residential real estate property that are in the process of foreclosure according to local requirements of the applicable jurisdiction. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. An entity can elect to adopt the amendments in this update using either a modified retrospective transition method or a prospective transition method. The Company has provided the necessary disclosures in Note 7. Loans.

In May 2014, the FASB issued ASU 2014-09, Revenue from Contracts with Customers (a new revenue recognition standard). The update's core principle is that a company will recognize revenue to depict the transfer of goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. In addition, this update specifies the accounting for certain costs to obtain or fulfill a contract with a customer and expands disclosure requirements for revenue recognition. This update is effective for annual reporting periods beginning after December 15, 2016, including interim periods within that reporting period. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operation.



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In June 2014, the FASB issued ASU 2014-11, Transfers and Servicing (Topic 860): Repurchase-to-Maturity Transactions, Repurchase Financings, and Disclosures. The amendments in this update change the accounting for repurchase-to-maturity transactions to secured borrowing accounting. For repurchase financing arrangements, the amendments require separate accounting for a transfer of a financial asset executed contemporaneously with a repurchase agreement with the same counterparty, which will result in secured borrowing accounting for the repurchase agreement. The amendments also require enhanced disclosures. The accounting changes in this update are effective for the first interim or annual period beginning after December 15, 2014. An entity is required to present changes in accounting for transactions outstanding on the effective date as a cumulative-effect adjustment to retained earnings as of the beginning of the period of adoption. Earlier application is prohibited. The disclosure for certain transactions accounted for as a sale is required to be presented for interim and annual periods beginning after December 15, 2014, and the disclosure for repurchase agreements, securities lending transactions, and repurchase-to-maturity transactions accounted for as secured borrowings is required to be presented for annual periods beginning after December 15, 2014, and for interim periods beginning after March 15, 2015. The disclosures are not required to be presented for comparative periods before the effective date. This ASU did not have an impact on the Company's financial statements.

In June 2014, the FASB issued ASU 2014-12, Compensation-Stock Compensation (Topic 718): Accounting for Share-Based Payments when the Terms of an Award Provide that a Performance Target Could Be Achieved After the Requisite Service Period. The amendments require that a performance target that affects vesting and that could be achieved after the requisite service period be treated as a performance condition. The amendments in this update are effective for annual periods and interim periods within those annual periods beginning after December 15, 2015. Earlier adoption is permitted. Entities may apply the amendments in this update either (a) prospectively to all awards granted or modified after the effective date or (b) retrospectively to all awards with performance targets that are outstanding as of the beginning of the earliest annual period presented in the financial statements and to all new or modified awards thereafter. If retrospective transition is adopted, the cumulative effect of applying this update as of the beginning of the earliest annual period presented in the financial statements should be recognized as an adjustment to the opening retained earnings balance at that date. Additionally, if retrospective transition is adopted, an entity may use hindsight in measuring and recognizing the compensation cost. This ASU is not expected to have a significant impact on the Company's financial statements.

In August 2014, the FASB issued ASU 2014-14, Receivables - Troubled Debt Restructurings by Creditors (Subtopic 310-40). The amendments in this update require that a mortgage loan be de-recognized and that a separate other receivable be recognized upon foreclosure if the following conditions are met: (1) the loan has a government guarantee that is not separable from the loan before foreclosure, (2) at the time of foreclosure, the creditor has the intent to convey the real estate property to the guarantor and make a claim on the guarantee, and the creditor has the ability to recover under that claim, and (3) at the time of foreclosure, any amount of the claim that is determined on the basis of the fair value of the real estate is fixed. Upon foreclosure, the separate other receivable should be measured based on the amount of the loan balance (principal and interest) expected to be recovered from the guarantor. The amendments in this update are effective for public business entities for annual periods, and interim periods within those annual periods, beginning after December 15, 2014. This ASU did not have an impact on the Company's financial statements.

In August 2014, the FASB issued ASU 2014-15, Presentation of Financial Statements - Going Concern (Subtopic 205-40). The amendments in this update provide guidance in accounting principles generally accepted in the United States of America about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related footnote disclosures. The amendments in this update are effective for the annual period ending after December 15, 2016, and for annual periods and interim periods thereafter.

Early application is permitted. This ASU is not expected to have a significant impact on the Company's financial statements.

In November 2014, the FASB issued ASU 2014-17, Business Combinations (Topic 805): Pushdown Accounting. The amendments in this update apply to the separate financial statements of an acquired entity and its subsidiaries that are a business or nonprofit activity (either public or nonpublic) upon the occurrence of an event in which an acquirer (an individual or an entity) obtains control of the acquired entity. An acquired entity may elect the option to apply pushdown accounting in the reporting period in which the change-in-control event occurs. If pushdown accounting is not applied in the reporting period in which the change-in-control event occurs, an acquired entity will have the option to elect to apply pushdown accounting in a subsequent reporting period to the acquired entity's most recent change-in-control event. The amendments in this update are effective on November 18, 2014. After the effective date, an acquired entity can make an election to apply the guidance to future change-in-control events or to its most recent change-in-control event. This update is not expected to have a significant impact on the Company's financial statements.

In January 2015, the FASB issued ASU 2015-01, Income Statement -Extraordinary and Unusual Items, as part of its initiative to reduce complexity in accounting standards. This update eliminates from GAAP the concept of extraordinary items. The amendments in this update are effective for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. A

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reporting entity may apply the amendments prospectively. A reporting entity also may apply the amendments retrospectively to all prior periods presented in the financial statements. Early adoption is permitted provided that the guidance is applied from the beginning of the fiscal year of adoption. This update is not expected to have a significant impact on the Company's financial statements.

In February 2015, the FASB issued ASU 2015-02, Consolidation (Topic 810). The amendments in this update affect reporting entities that are required to evaluate whether they should consolidate certain legal entities. All legal entities are subject to reevaluation under the revised consolidation model. Specifically, the amendments (1) Modify the evaluation of whether limited partnerships and similar legal entities are variable interest entities (VIEs) or voting interest entities; (2) Eliminate the presumption that a general partner should consolidate a limited partnership; (3) Affect the consolidation analysis of reporting entities that are involved with VIEs, particularly those that have fee arrangements and related party relationships; (4) Provide a scope exception from consolidation guidance for reporting entities with interests in legal entities that are required to comply with or operate in accordance with requirements that are similar to those in Rule 2a-7 of the Investment Company Act of 1940 for registered money market funds. The amendments in this update are effective for public business entities for fiscal years, and for interim periods within those fiscal years, beginning after December 15, 2015. The Company is currently evaluating the impact the adoption of the standard will have on the Company's financial position or results of operations.

In April 2015, the FASB issued ASU 2015-03, Interest-Imputation of Interest (Subtopic 835-30), as part of its initiative to reduce complexity in accounting standards. To simplify presentation of debt issuance costs, the amendments in this update require that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. The recognition and measurement guidance for debt issuance costs are not affected by the amendments in this update. For public business entities, the amendments in this update are effective for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. An entity should apply the new guidance on a retrospective basis, wherein the balance sheet of each individual period presented should be adjusted to reflect the period-specific effects of applying the new guidance. This update is not expected to have a significant impact on the Company's financial statements.

In April 2015, the FASB issued ASU 2015-04, Compensation-Retirement Benefits (Topic 715), as part of its initiative to reduce complexity in accounting standards. For an entity with a fiscal year-end that does not coincide with a month-end, the amendments in this update provide a practical expedient that permits the entity to measure defined benefit plan assets and obligations using the month-end that is closest to the entity's fiscal year-end and apply that practical expedient consistently from year to year. The practical expedient should be applied consistently to all plans if an entity has more than one plan. The amendments in this update are effective for public business entities for financial statements issued for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. Earlier application is permitted. This update is not expected to have a significant impact on the Company's financial statements.

In April 2015, the FASB issued ASU 2015-05, Intangible - Goodwill and Other Internal Use Software (Topic 350-40), as part of its initiative to reduce complexity in accounting standards. This guidance will help entities evaluate the accounting for fees paid by a customer in a cloud computing arrangement. The amendments in this update provide guidance to customers about whether a cloud computing arrangement includes a software license. If a cloud computing arrangement includes a software license, then the customer should account for the software license element of the arrangement consistent with the acquisition of other software licenses. If a cloud computing arrangement does not include a software license, the customer should account for the arrangement as a service contract. For public business entities, the Board decided that the amendments will be effective for annual periods, including interim periods within those annual periods, beginning after December 15, 2015. Early adoption is permitted for all entities.

This update is not expected to have a significant impact on the Company's financial statements.

In May 2015, the FASB issued ASU 2015-07, Disclosures for Investments in Certain Entities That Calculate Net Asset Value per Share (or Its Equivalent). The update applies to reporting entities that elect to measure the fair value of an investment using the net asset value per share (or its equivalent) practical expedient. Under the amendments in this update, investments for which fair value is measured at net asset value per share (or its equivalent) using the practical expedient should not be categorized in the fair value hierarchy. Removing those investments from the fair value hierarchy not only eliminates the diversity in practice resulting from the way in which investments measured at net asset value per share (or its equivalent) with future redemption dates are classified, but also ensures that all investments categorized in the fair value hierarchy are classified using a consistent approach. Investments that calculate net asset value per share (or its equivalent), but for which the practical expedient is not applied will continue to be included in the fair value hierarchy. A reporting entity should continue to disclose information on investments for which fair value is measured at net asset value (or its equivalent) as a practical expedient to help users understand the nature and risks of the investments and whether the investments, if sold, are probable of being sold at amounts different from net asset value. The amendments in this update are effective for public business entities for fiscal years beginning after December 15, 2015, and interim periods within those fiscal years. For all other entities, the amendments in this update are effective for fiscal years beginning

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after December 15, 2016, and interim periods within those fiscal years. A reporting entity should apply the amendments retrospectively to all periods presented. The retrospective approach requires that an investment for which fair value is measured using the net asset value per share practical expedient be removed from the fair value hierarchy in all periods presented in an entity's financial statements. Earlier application is permitted. This update is not expected to have a significant impact on the Company's financial statements.

In May 2015, the FASB issued ASU 2015-08, Business Combinations - Pushdown Accounting - Amendment to SEC Paragraphs Pursuant to Staff Accounting Bulletin No. 115. This ASU was issued to amend various SEC paragraphs pursuant to the issuance of Staff Accounting Bulletin No. 115. This update is not expected to have a significant impact on the Company's financial statements.

In June 2015, the FASB issued ASU 2015-10, Technical Corrections and Improvements. The amendments in this update represent changes to clarify the Codification, correct unintended application of guidance, or make minor improvements to the Codification that are not expected to have a significant effect on current accounting practice or create a significant administrative cost to most entities. Transition guidance varies based on the amendments in this update. The amendments in this update that require transition guidance are effective for all entities for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2015. Early adoption is permitted, including adoption in an interim period. All other amendments will be effective upon the issuance of this update. This Update is not expected to have a significant impact on the Company's financial statements.

## Note 4. Per Share Data

There are no convertible securities which would affect the denominator in calculating basic and dilutive earnings per share. Net income as presented on the consolidated statement of income will be used as the numerator. The following table sets forth the composition of the weighted average common shares (denominator) used in the basic and dilutive earnings per share computation.

|                                                                                                                    | Three Months Ended June 30, |            | Six Months Ended June 30, |            |
|--------------------------------------------------------------------------------------------------------------------|-----------------------------|------------|---------------------------|------------|
|                                                                                                                    | 2015                        | 2014       | 2015                      | 2014       |
| Weighted average common shares issued                                                                              | 5,003,365                   | 5,000,789  | 5,003,100                 | 5,000,482  |
| Average treasury stock shares                                                                                      | (223,678                    | ) (180,596 | ) (212,564                | ) (180,596 |
| Weighted average common shares and common stock equivalents used to calculate basic and diluted earnings per share | 4,779,687                   | 4,820,193  | 4,790,536                 | 4,819,886  |

## Note 5. Investment Securities

The amortized cost and fair values of investment securities available for sale at June 30, 2015 and December 31, 2014 are as follows:

|                                       | June 30, 2015  |                        |                         |            |
|---------------------------------------|----------------|------------------------|-------------------------|------------|
| (In Thousands)                        | Amortized Cost | Gross Unrealized Gains | Gross Unrealized Losses | Fair Value |
| Available for sale (AFS)              |                |                        |                         |            |
| U.S. Government and agency securities | \$3,706        | \$—                    | \$(51                   | ) \$3,655  |
| Mortgage-backed securities            | 10,843         | 386                    | (30                     | ) 11,199   |
| Asset-backed securities               | 2,209          | 25                     | (2                      | ) 2,232    |
| State and political securities        | 100,456        | 2,074                  | (759                    | ) 101,771  |

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|                                         |           |         |          |             |
|-----------------------------------------|-----------|---------|----------|-------------|
| Other debt securities                   | 80,527    | 867     | (1,369   | ) 80,025    |
| Total debt securities                   | 197,741   | 3,352   | (2,211   | ) 198,882   |
| Financial institution equity securities | 9,736     | 1,065   | (4       | ) 10,797    |
| Other equity securities                 | 4,753     | 55      | (175     | ) 4,633     |
| Total equity securities                 | 14,489    | 1,120   | (179     | ) 15,430    |
| Total investment securities AFS         | \$212,230 | \$4,472 | \$(2,390 | ) \$214,312 |

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| (In Thousands)                          | December 31, 2014 |                              |                               |               |
|-----------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                         | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Available for sale (AFS)                |                   |                              |                               |               |
| U.S. Government and agency securities   | \$3,953           | \$—                          | \$(112)                       | ) \$3,841     |
| Mortgage-backed securities              | 12,240            | 485                          | (28)                          | ) 12,697      |
| Asset-backed securities                 | 2,468             | 27                           | (3)                           | ) 2,492       |
| State and political securities          | 104,820           | 3,885                        | (589)                         | ) 108,116     |
| Other debt securities                   | 89,911            | 1,031                        | (1,299)                       | ) 89,643      |
| Total debt securities                   | 213,392           | 5,428                        | (2,031)                       | ) 216,789     |
| Financial institution equity securities | 8,823             | 1,110                        | (18)                          | ) 9,915       |
| Other equity securities                 | 5,558             | 79                           | (128)                         | ) 5,509       |
| Total equity securities                 | 14,381            | 1,189                        | (146)                         | ) 15,424      |
| Total investment securities AFS         | \$227,773         | \$6,617                      | \$(2,177)                     | ) \$232,213   |

The amortized cost and fair values of trading investment securities at June 30, 2015 are as follows. There were no trading securities at December 31, 2014.

| (In Thousands)                          | June 30, 2015     |                              |                               |               |
|-----------------------------------------|-------------------|------------------------------|-------------------------------|---------------|
|                                         | Amortized<br>Cost | Gross<br>Unrealized<br>Gains | Gross<br>Unrealized<br>Losses | Fair<br>Value |
| Trading                                 |                   |                              |                               |               |
| Financial institution equity securities | 77                | —                            | (3)                           | ) 74          |
| Other equity securities                 | 87                | —                            | (4)                           | ) 83          |
| Total equity securities                 | 164               | —                            | (7)                           | ) 157         |
| Total trading securities                | 164               | —                            | (7)                           | ) 157         |

Total net unrealized losses of \$7,000 and realized gains of \$3,000 for the six months ended June 30, 2015 were included in the Consolidated Statement of Income.

The following tables show the Company's gross unrealized losses and fair value, aggregated by investment category and length of time, that the individual securities have been in a continuous unrealized loss position, at June 30, 2015 and December 31, 2014.

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| (In Thousands)                          | June 30, 2015           |                         |                          |                         |            |                         |
|-----------------------------------------|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
|                                         | Less than Twelve Months |                         | Twelve Months or Greater |                         | Total      |                         |
|                                         | Fair Value              | Gross Unrealized Losses | Fair Value               | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Government and agency securities   | \$—                     | \$—                     | \$3,655                  | \$(51)                  | \$3,655    | \$(51)                  |
| Mortgage-backed securities              | 6,514                   | (30)                    | —                        | —                       | 6,514      | (30)                    |
| Asset-backed securities                 | —                       | —                       | 417                      | (2)                     | 417        | (2)                     |
| State and political securities          | 20,528                  | (411)                   | 1,455                    | (348)                   | 21,983     | (759)                   |
| Other debt securities                   | 24,216                  | (649)                   | 19,332                   | (720)                   | 43,548     | (1,369)                 |
| Total debt securities                   | 51,258                  | (1,090)                 | 24,859                   | (1,121)                 | 76,117     | (2,211)                 |
| Financial institution equity securities | 141                     | (4)                     | —                        | —                       | 141        | (4)                     |
| Other equity securities                 | 2,589                   | (145)                   | 800                      | (30)                    | 3,389      | (175)                   |
| Total equity securities                 | 2,730                   | (149)                   | 800                      | (30)                    | 3,530      | (179)                   |
| Total                                   | \$53,988                | \$(1,239)               | \$25,659                 | \$(1,151)               | \$79,647   | \$(2,390)               |

| (In Thousands)                          | December 31, 2014       |                         |                          |                         |            |                         |
|-----------------------------------------|-------------------------|-------------------------|--------------------------|-------------------------|------------|-------------------------|
|                                         | Less than Twelve Months |                         | Twelve Months or Greater |                         | Total      |                         |
|                                         | Fair Value              | Gross Unrealized Losses | Fair Value               | Gross Unrealized Losses | Fair Value | Gross Unrealized Losses |
| U.S. Government and agency securities   | \$—                     | \$—                     | \$3,841                  | \$(112)                 | \$3,841    | \$(112)                 |
| Mortgage-backed securities              | 6,741                   | (28)                    | —                        | —                       | 6,741      | (28)                    |
| Asset-backed securities                 | —                       | —                       | 519                      | (3)                     | 519        | (3)                     |
| State and political securities          | 8,243                   | (14)                    | 6,382                    | (575)                   | 14,625     | (589)                   |
| Other debt securities                   | 23,174                  | (718)                   | 29,266                   | (581)                   | 52,440     | (1,299)                 |
| Total debt securities                   | 38,158                  | (760)                   | 40,008                   | (1,271)                 | 78,166     | (2,031)                 |
| Financial institution equity securities | 407                     | (18)                    | —                        | —                       | 407        | (18)                    |
| Other equity securities                 | 1,837                   | (100)                   | 773                      | (28)                    | 2,610      | (128)                   |
| Total equity securities                 | 2,244                   | (118)                   | 773                      | (28)                    | 3,017      | (146)                   |
| Total                                   | \$40,402                | \$(878)                 | \$40,781                 | \$(1,299)               | \$81,183   | \$(2,177)               |

At June 30, 2015 there were a total of 66 securities in a continuous unrealized loss position for less than twelve months and 15 individual securities that were in a continuous unrealized loss position for twelve months or greater.

The Company reviews its position quarterly and has determined that, at June 30, 2015, the declines outlined in the above table represent temporary declines and the Company does not intend to sell and does not believe it will be required to sell these securities before recovery of their cost basis, which may be at maturity. The Company has concluded that the unrealized losses disclosed above are not other than temporary but are the result of interest rate changes, sector credit ratings changes, or company-specific ratings changes that are not expected to result in the non-collection of principal and interest during the period.

The amortized cost and fair value of debt securities at June 30, 2015, by contractual maturity, are shown below. Expected maturities may differ from contractual maturities since borrowers may have the right to call or prepay



obligations with or without call or prepayment penalties.

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| (In Thousands)                    | Amortized Cost | Fair Value |
|-----------------------------------|----------------|------------|
| Due in one year or less           | \$995          | \$998      |
| Due after one year to five years  | 40,107         | 40,464     |
| Due after five years to ten years | 97,091         | 96,528     |
| Due after ten years               | 59,548         | 60,892     |
| Total                             | \$197,741      | \$198,882  |

Total gross proceeds from sales of securities available for sale were \$31,693,000 and \$70,431,000 for the six months ended June 30, 2015 and 2014, respectively.

The following table represents gross realized gains and losses within the available for sale portfolio:

| (In Thousands)                          | Three Months Ended June 30, |       | Six Months Ended June 30, |         |
|-----------------------------------------|-----------------------------|-------|---------------------------|---------|
|                                         | 2015                        | 2014  | 2015                      | 2014    |
| Gross realized gains:                   |                             |       |                           |         |
| U.S. Government and agency securities   | \$—                         | \$49  | \$—                       | \$49    |
| Mortgage-backed securities              | —                           | 76    | —                         | 76      |
| State and political securities          | 350                         | 387   | 746                       | 732     |
| Other debt securities                   | 185                         | 155   | 259                       | 462     |
| Financial institution equity securities | 7                           | 16    | 162                       | 128     |
| Other equity securities                 | —                           | 64    | 132                       | 119     |
| Total gross realized gains              | \$542                       | \$747 | \$1,299                   | \$1,566 |
| Gross realized losses:                  |                             |       |                           |         |
| U.S. Government and agency securities   | \$—                         | \$14  | \$—                       | \$45    |
| State and political securities          | —                           | 83    | 22                        | 403     |
| Other debt securities                   | 15                          | 97    | 47                        | 172     |
| Other equity securities                 | 1                           | 66    | 43                        | 66      |
| Total gross realized losses             | \$16                        | \$260 | \$112                     | \$686   |

The following table represents gross realized gains and losses within the trading portfolios:

| (In Thousands)                          | Three Months Ended June 30, |      | Six Months Ended June 30, |      |
|-----------------------------------------|-----------------------------|------|---------------------------|------|
|                                         | 2015                        | 2014 | 2015                      | 2014 |
| Gross realized gains:                   |                             |      |                           |      |
| Financial institution equity securities | 2                           | —    | 2                         | —    |
| Other equity securities                 | 1                           | —    | 1                         | —    |
| Total gross realized gains              | \$3                         | \$—  | \$3                       | \$—  |
| Gross realized losses:                  |                             |      |                           |      |
| Financial institution equity securities | 3                           | —    | 3                         | —    |
| Other equity securities                 | 4                           | —    | 4                         | —    |
| Total gross realized losses             | \$7                         | \$—  | \$7                       | \$—  |

There were no impairment charges included in gross realized losses for the three and six months ended June 30, 2015 and 2014, respectively.

Investment securities with a carrying value of approximately \$143,865,000 and \$128,501,000 at June 30, 2015 and December 31, 2014, respectively, were pledged to secure certain deposits, repurchase agreements, and for other purposes as required by law.

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## Note 6. Federal Home Loan Bank Stock

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

Management evaluated the stock and concluded that the stock was not impaired for the periods presented herein. Management considered that the FHLB maintains regulatory capital ratios in excess of all regulatory capital requirements, liquidity appears adequate, new shares of FHLB stock continue to be transferred at the \$100 par value, and the payment of dividends.

## Note 7. Loans

Management segments the Banks' loan portfolio to a level that enables risk and performance monitoring according to similar risk characteristics. Loans are segmented based on the underlying collateral characteristics. Categories include commercial, financial, and agricultural, real estate, and installment loans to individuals. Real estate loans are further segmented into three categories: residential, commercial, and construction.

The following table presents the related aging categories of loans, by segment, as of June 30, 2015 and December 31, 2014:

| (In Thousands)                          | June 30, 2015 |                              |                                                 |                 | Total      |
|-----------------------------------------|---------------|------------------------------|-------------------------------------------------|-----------------|------------|
|                                         | Current       | Past Due<br>30 To 89<br>Days | Past Due 90<br>Days Or More<br>& Still Accruing | Non-<br>Accrual |            |
| Commercial, financial, and agricultural | \$ 138,551    | \$ 945                       | \$ —                                            | \$ 553          | \$ 140,049 |
| Real estate mortgage:                   |               |                              |                                                 |                 |            |
| Residential                             | 490,222       | 2,994                        | 52                                              | 852             | 494,120    |
| Commercial                              | 284,145       | 2,085                        | 783                                             | 6,499           | 293,512    |
| Construction                            | 24,321        | —                            | —                                               | 895             | 25,216     |
| Installment loans to individuals        | 25,650        | 468                          | 55                                              | —               | 26,173     |
|                                         | 962,889       | \$ 6,492                     | \$ 890                                          | \$ 8,799        | 979,070    |
| Net deferred loan fees and discounts    | (1,192 )      |                              |                                                 |                 | (1,192 )   |
| Allowance for loan losses               | (11,265 )     |                              |                                                 |                 | (11,265 )  |
| Loans, net                              | \$ 950,432    |                              |                                                 |                 | \$ 966,613 |

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| (In Thousands)                          | December 31, 2014 |                              |                                                 |                 | Total     |
|-----------------------------------------|-------------------|------------------------------|-------------------------------------------------|-----------------|-----------|
|                                         | Current           | Past Due<br>30 To 89<br>Days | Past Due 90<br>Days Or More<br>& Still Accruing | Non-<br>Accrual |           |
| Commercial, financial, and agricultural | \$122,624         | \$773                        | \$ —                                            | \$759           | \$124,156 |
| Real estate mortgage:                   |                   |                              |                                                 |                 |           |
| Residential                             | 450,503           | 6,078                        | 332                                             | 847             | 457,760   |
| Commercial                              | 279,731           | 1,819                        | 54                                              | 9,744           | 291,348   |
| Construction                            | 21,485            | —                            | —                                               | 511             | 21,996    |
| Installment loans to individuals        | 21,125            | 383                          | 1                                               | —               | 21,509    |
|                                         | 895,468           | \$9,053                      | \$ 387                                          | \$11,861        | 916,769   |
| Net deferred loan fees and discounts    | (1,190 )          |                              |                                                 |                 | (1,190 )  |
| Allowance for loan losses               | (10,579 )         |                              |                                                 |                 | (10,579 ) |
| Loans, net                              | \$883,699         |                              |                                                 |                 | \$905,000 |

Purchased loans acquired are recorded at fair value on their purchase date without a carryover of the related allowance for loan losses.

Upon the acquisition of Luzerne Bank on June 1, 2013, the Company evaluated whether each acquired loan (regardless of size) was within the scope of ASC 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality. Purchased credit-impaired loans are loans that have evidence of credit deterioration since origination and it is probable at the date of acquisition that the Company will not collect all contractually required principal and interest payments. There were no material increases or decreases in the expected cash flows of these loans between June 1, 2013 (the “acquisition date”) and June 30, 2015. The fair value of purchased credit-impaired loans, on the acquisition date, was determined, primarily based on the fair value of loan collateral. The carrying value of purchased loans acquired with deteriorated credit quality was \$447,000 at June 30, 2015.

On the acquisition date, the preliminary estimate of the unpaid principal balance for all loans evidencing credit impairment acquired in the Luzerne Bank acquisition was \$1,211,000 and the estimated fair value of the loans was \$878,000. Total contractually required payments on these loans, including interest, at the acquisition date was \$1,783,000. However, the Company’s preliminary estimate of expected cash flows was \$941,000. At such date, the Company established a credit risk related non-accretable discount (a discount representing amounts which are not expected to be collected from either the customer or liquidation of collateral) of \$842,000 relating to these impaired loans, reflected in the recorded net fair value. Such amount is reflected as a non-accretable fair value adjustment to loans. The Company further estimated the timing and amount of expected cash flows in excess of the estimated fair value and established an accretable discount of \$63,000 on the acquisition date relating to these impaired loans.

The carrying value of the loans acquired in the Luzerne Bank transaction with specific evidence of deterioration in credit quality was determined by projecting discounted contractual cash flows. The table below presents the components of the purchase accounting adjustments related to the purchased impaired loans acquired in the Luzerne Bank acquisition as of June 1, 2013.

The amortizable yield for purchased credit-impaired loans was fully amortized during 2014. Changes in the amortizable yield for purchased credit-impaired loans were as follows for the six months ended June 30, 2014:

| (In Thousands)                                   | June 30, 2014 |
|--------------------------------------------------|---------------|
| Balance at beginning of period or at acquisition | \$35          |
| Accretion                                        | (12 )         |

Balance at end of period \$23

The following table presents additional information regarding loans acquired in the Luzerne Bank transaction with specific evidence of deterioration in credit quality:

| (In Thousands)      | June 30, 2015 | December 31, 2014 |
|---------------------|---------------|-------------------|
| Outstanding balance | \$447         | \$449             |
| Carrying amount     | 347           | 349               |

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There were no material increases or decreases in the expected cash flows of these loans between June 1, 2013 (the “acquisition date”) and June 30, 2015. There has been no allowance for loan losses recorded for acquired loans with specific evidence of deterioration in credit quality as of June 30, 2015.

The following table presents interest income the Banks would have recorded if interest had been recorded based on the original loan agreement terms and rate of interest for non-accrual loans and interest income recognized on a cash basis for non-accrual loans for the three and six months ended June 30, 2015 and 2014:

| (In Thousands)                          | Three Months Ended June 30,<br>2015                                                    |                                                 | 2014                                                                                   |                                                 |
|-----------------------------------------|----------------------------------------------------------------------------------------|-------------------------------------------------|----------------------------------------------------------------------------------------|-------------------------------------------------|
|                                         | Interest Income That<br>Would Have Been<br>Recorded Based on<br>Original Term and Rate | Interest<br>Income<br>Recorded on<br>Cash Basis | Interest Income That<br>Would Have Been<br>Recorded Based on<br>Original Term and Rate | Interest<br>Income<br>Recorded on<br>Cash Basis |
| Commercial, financial, and agricultural | \$2                                                                                    | \$—                                             | \$15                                                                                   | \$1                                             |
| Real estate mortgage:                   |                                                                                        |                                                 |                                                                                        |                                                 |
| Residential                             | 16                                                                                     | 10                                              | 5                                                                                      | 5                                               |
| Commercial                              | 66                                                                                     | 10                                              | 147                                                                                    | 53                                              |
| Construction                            | 15                                                                                     | 29                                              | 24                                                                                     | —                                               |
|                                         | \$99                                                                                   | \$49                                            | \$191                                                                                  | \$59                                            |
| (In Thousands)                          | Six Months Ended June 30,<br>2015                                                      |                                                 | 2014                                                                                   |                                                 |
|                                         | Interest Income That<br>Would Have Been<br>Recorded Based on<br>Original Term and Rate | Interest<br>Income<br>Recorded on<br>Cash Basis | Interest Income That<br>Would Have Been<br>Recorded Based on<br>Original Term and Rate | Interest<br>Income<br>Recorded on<br>Cash Basis |
| Commercial, financial, and agricultural | \$14                                                                                   | \$8                                             | \$17                                                                                   | \$1                                             |
| Real estate mortgage:                   |                                                                                        |                                                 |                                                                                        |                                                 |
| Residential                             | 21                                                                                     | 19                                              | 7                                                                                      | 9                                               |
| Commercial                              | 171                                                                                    | 35                                              | 275                                                                                    | 86                                              |
| Construction                            | 30                                                                                     | 36                                              | 35                                                                                     | —                                               |
|                                         | \$236                                                                                  | \$98                                            | \$334                                                                                  | \$96                                            |

**Impaired Loans**

Impaired loans are loans for which it is probable the Banks will not be able to collect all amounts due according to the contractual terms of the loan agreement. The Banks evaluate such loans for impairment individually and does not aggregate loans by major risk classifications. The definition of “impaired loans” is not the same as the definition of “non-accrual loans,” although the two categories overlap. The Banks may choose to place a loan on non-accrual status due to payment delinquency or uncertain collectability, while not classifying the loan as impaired. Factors considered by management in determining impairment include payment status and collateral value. The amount of impairment for these types of loans is determined by the difference between the present value of the expected cash flows related to the loan, using the original interest rate, and its recorded value, or as a practical expedient in the case of collateralized loans, the difference between the fair value of the collateral and the recorded amount of the loan. When foreclosure is probable, impairment is measured based on the fair value of the collateral.

Management evaluates individual loans in all of the commercial segments for possible impairment if the loan is greater than \$100,000 and if the loan is either on non-accrual status or has a risk rating of substandard. Management

may also elect to measure an individual loan for impairment if less than \$100,000 on a case-by-case basis.

Mortgage loans on one-to-four family properties and all consumer loans are large groups of smaller-balance homogeneous loans and are measured for impairment collectively. Loans that experience insignificant payment delays, which are defined as 90 days or less, generally are not classified as impaired. Management determines the significance of payment delays on a case-by-case basis taking into consideration all circumstances surrounding the loan and the borrower including the length of the delay, the borrower's prior payment record, and the amount of shortfall in relation to the principal and interest owed. Interest income for impaired loans is recorded consistent with the Banks' policy on non-accrual loans.



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The following table presents the recorded investment, unpaid principal balance, and related allowance of impaired loans by segment as of June 30, 2015 and December 31, 2014:

| (In Thousands)                                                   | June 30, 2015<br>Recorded<br>Investment | Unpaid Principal<br>Balance | Related<br>Allowance |
|------------------------------------------------------------------|-----------------------------------------|-----------------------------|----------------------|
| With no related allowance recorded:                              |                                         |                             |                      |
| Commercial, financial, and agricultural<br>Real estate mortgage: | \$506                                   | \$506                       | \$—                  |
| Residential                                                      | 792                                     | 792                         | —                    |
| Commercial                                                       | 4,124                                   | 4,124                       | —                    |
| Construction                                                     | 610                                     | 610                         | —                    |
|                                                                  | 6,032                                   | 6,032                       | —                    |
| With an allowance recorded:                                      |                                         |                             |                      |
| Commercial, financial, and agricultural<br>Real estate mortgage: | 435                                     | 435                         | 48                   |
| Residential                                                      | 1,143                                   | 1,243                       | 168                  |
| Commercial                                                       | 9,787                                   | 9,837                       | 1,397                |
| Construction                                                     | 294                                     | 294                         | 54                   |
|                                                                  | 11,659                                  | 11,809                      | 1,667                |
| Total:                                                           |                                         |                             |                      |
| Commercial, financial, and agricultural<br>Real estate mortgage: | 941                                     | 941                         | 48                   |
| Residential                                                      | 1,935                                   | 2,035                       | 168                  |
| Commercial                                                       | 13,911                                  | 13,961                      | 1,397                |
| Construction                                                     | 904                                     | 904                         | 54                   |
|                                                                  | \$17,691                                | \$17,841                    | \$1,667              |

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| (In Thousands)                                                | December 31, 2014   |                          |                   |
|---------------------------------------------------------------|---------------------|--------------------------|-------------------|
|                                                               | Recorded Investment | Unpaid Principal Balance | Related Allowance |
| With no related allowance recorded:                           |                     |                          |                   |
| Commercial, financial, and agricultural Real estate mortgage: | \$439               | \$439                    | \$—               |
| Residential                                                   | 139                 | 139                      | —                 |
| Commercial                                                    | 3,228               | 3,228                    | —                 |
| Construction                                                  | 716                 | 716                      | —                 |
|                                                               | 4,522               | 4,522                    | —                 |
| With an allowance recorded:                                   |                     |                          |                   |
| Commercial, financial, and agricultural Real estate mortgage: | 673                 | 673                      | 298               |
| Residential                                                   | 1,327               | 1,449                    | 147               |
| Commercial                                                    | 10,745              | 10,889                   | 1,581             |
| Construction                                                  | 309                 | 309                      | 67                |
|                                                               | 13,054              | 13,320                   | 2,093             |
| Total:                                                        |                     |                          |                   |
| Commercial, financial, and agricultural Real estate mortgage: | 1,112               | 1,112                    | 298               |
| Residential                                                   | 1,466               | 1,588                    | 147               |
| Commercial                                                    | 13,973              | 14,117                   | 1,581             |
| Construction                                                  | 1,025               | 1,025                    | 67                |
|                                                               | \$17,576            | \$17,842                 | \$2,093           |

The following table presents the average recorded investment in impaired loans and related interest income recognized for the three and six months ended for June 30, 2015 and 2014:

| (In Thousands)                                                | Three Months Ended June 30, 2015     |                                                                  |                                                              | 2014                                 |                                                                  |                                                              |
|---------------------------------------------------------------|--------------------------------------|------------------------------------------------------------------|--------------------------------------------------------------|--------------------------------------|------------------------------------------------------------------|--------------------------------------------------------------|
|                                                               | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans |
| Commercial, financial, and agricultural Real estate mortgage: | \$1,064                              | \$ 5                                                             | \$ 3                                                         | \$517                                | \$ 7                                                             | \$ —                                                         |
| Residential                                                   | 1,922                                | 16                                                               | 12                                                           | 1,117                                | 3                                                                | 3                                                            |
| Commercial                                                    | 14,271                               | 77                                                               | 11                                                           | 10,901                               | 19                                                               | 2                                                            |
| Construction                                                  | 910                                  | —                                                                | 29                                                           | 1,025                                | —                                                                | —                                                            |
|                                                               | \$18,167                             | \$ 98                                                            | \$ 55                                                        | \$13,560                             | \$ 29                                                            | \$ 5                                                         |
| (In Thousands)                                                | Six Months Ended June 30, 2015       |                                                                  |                                                              | 2014                                 |                                                                  |                                                              |
|                                                               | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans | Average Investment in Impaired Loans | Interest Income Recognized on an Accrual Basis on Impaired Loans | Interest Income Recognized on a Cash Basis on Impaired Loans |

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|                                                                           |          |        |       |          |       |       |
|---------------------------------------------------------------------------|----------|--------|-------|----------|-------|-------|
| Commercial,<br>financial, and<br>agricultural<br>Real estate<br>mortgage: | \$1,080  | \$ 10  | \$ 10 | \$522    | \$ 13 | \$ —  |
| Residential                                                               | 1,741    | 28     | 17    | 1,142    | 14    | 7     |
| Commercial                                                                | 14,486   | 148    | 36    | 10,008   | 61    | 14    |
| Construction                                                              | 780      | —      | 36    | 1,030    | 2     | 8     |
|                                                                           | \$18,087 | \$ 186 | \$ 99 | \$12,702 | \$ 90 | \$ 29 |

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Currently, there is \$189,000 committed to be advanced in connection with impaired loans.

### Troubled Debt Restructurings

The loan portfolio also includes certain loans that have been modified in a Troubled Debt Restructuring (“TDR”), where economic concessions have been granted to borrowers who have experienced or are expected to experience financial difficulties. These concessions typically result from loss mitigation activities and could include reductions in the interest rate, payment extensions, forgiveness of principal, forbearance, or other actions. Certain TDRs are classified as nonperforming at the time of restructure and may only be returned to performing status after considering the borrower’s sustained repayment performance for a reasonable period, generally six months.

There were no loan modifications considered TDRs completed during the three and six months ended June 30, 2014. Loan modifications that are considered TDRs completed during the three and six months ended June 30, 2015 were as follows:

| (In Thousands, Except Number of Contracts) | Three Months Ended June 30,<br>2015 |                                                           |                                                            |
|--------------------------------------------|-------------------------------------|-----------------------------------------------------------|------------------------------------------------------------|
|                                            | Number<br>of<br>Contracts           | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Real estate mortgage:                      |                                     |                                                           |                                                            |
| Residential                                | 1                                   | 88                                                        | 88                                                         |
| Commercial                                 | 1                                   | 247                                                       | 247                                                        |
| Construction                               | 1                                   | 398                                                       | 398                                                        |
|                                            | 3                                   | \$ 733                                                    | \$ 733                                                     |
| (In Thousands, Except Number of Contracts) | Six Months Ended June 30,<br>2015   |                                                           |                                                            |
|                                            | Number<br>of<br>Contracts           | Pre-Modification<br>Outstanding<br>Recorded<br>Investment | Post-Modification<br>Outstanding<br>Recorded<br>Investment |
| Commercial, financial, and agricultural    | 2                                   | \$ 97                                                     | \$ 97                                                      |
| Real estate mortgage:                      |                                     |                                                           |                                                            |
| Residential                                | 6                                   | 322                                                       | 322                                                        |
| Commercial                                 | 2                                   | 517                                                       | 517                                                        |
| Construction                               | 1                                   | 398                                                       | 398                                                        |
|                                            | 11                                  | \$ 1,334                                                  | \$ 1,334                                                   |

There were three loan modifications considered to be TDRs made during the twelve months previous to June 30, 2015 that defaulted during the six months ended June 30, 2015. The defaulted loan types and recorded investments at June 30, 2015 are as follows: one commercial loan with a recorded investment of \$46,000, one commercial real estate loan with a recorded investment of \$247,000, and one residential real estate loan with a recorded investment of \$87,000. There were two loan modifications considered TDRs made during the twelve months previous to June 30, 2014 that defaulted during the six months ended June 30, 2014. The loans that defaulted were commercial real estate loans that were in litigation with a recorded investment of \$1,634,000 at June 30, 2014.

Troubled debt restructurings amounted to \$9,666,000 and \$11,810,000 as of June 30, 2015 and December 31, 2014.

The amount of foreclosed residential real estate held at June 30, 2015 and December 31, 2014, totaled \$70,000 and \$324,000, respectively. Consumer mortgage loans secured by residential real estate properties for which formal foreclosure proceedings are in process at June 30, 2015 and December 31, 2014, totaled \$261,000 and \$382,000, respectively.

#### Internal Risk Ratings

Management uses a ten point internal risk rating system to monitor the credit quality of the overall loan portfolio. The first six categories are considered not criticized, and are aggregated as “Pass” rated. The criticized rating categories utilized by management

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generally follow bank regulatory definitions. The special mention category includes assets that are currently protected but are potentially weak, resulting in an undue and unwarranted credit risk, but not to the point of justifying a substandard classification. Loans in the substandard category have well-defined weaknesses that jeopardize the liquidation of the debt, and have a distinct possibility that some loss will be sustained if the weaknesses are not corrected. All loans greater than 90 days past due are evaluated for substandard classification. Loans in the doubtful category exhibit the same weaknesses found in the substandard loans, however, the weaknesses are more pronounced. Such loans are static and collection in full is improbable. However, these loans are not yet rated as loss because certain events may occur which would salvage the debt. Loans classified loss are considered uncollectible and charge-off is imminent.

To help ensure that risk ratings are accurate and reflect the present and future capacity of borrowers to repay a loan as agreed, the Banks have a structured loan rating process with several layers of internal and external oversight. Generally, consumer and residential mortgage loans are included in the pass category unless a specific action, such as bankruptcy, repossession, or death occurs to raise awareness of a possible credit event. An external annual loan review of large commercial relationships is performed, as well as a sample of smaller transactions. Confirmation of the appropriate risk category is included in the review. Detailed reviews, including plans for resolution, are performed on loans classified as substandard, doubtful, or loss on a quarterly basis.

The following table presents the credit quality categories identified above as of June 30, 2015 and December 31, 2014:

| (In Thousands)  | June 30, 2015                                 |                       |            |              |                   |           |
|-----------------|-----------------------------------------------|-----------------------|------------|--------------|-------------------|-----------|
|                 | Commercial,<br>Financial, and<br>Agricultural | Real Estate Mortgages |            |              | Installment Loans |           |
|                 |                                               | Residential           | Commercial | Construction | to Individuals    | Totals    |
| Pass            | \$137,169                                     | \$491,003             | \$264,352  | \$24,206     | \$ 26,173         | \$942,903 |
| Special Mention | 1,014                                         | 2,008                 | 12,928     | 400          | —                 | 16,350    |
| Substandard     | 1,866                                         | 1,109                 | 16,232     | 610          | —                 | 19,817    |
|                 | \$140,049                                     | \$494,120             | \$293,512  | \$25,216     | \$ 26,173         | \$979,070 |
| (In Thousands)  | December 31, 2014                             |                       |            |              |                   |           |
|                 | Commercial,<br>Financial, and<br>Agricultural | Real Estate Mortgages |            |              | Installment Loans |           |
|                 |                                               | Residential           | Commercial | Construction | to Individuals    | Totals    |
| Pass            | \$118,210                                     | \$454,885             | \$256,444  | \$20,927     | \$ 21,509         | \$871,975 |
| Special Mention | 3,186                                         | 2,384                 | 16,262     | 445          | —                 | 22,277    |
| Substandard     | 2,760                                         | 491                   | 18,642     | 624          | —                 | 22,517    |
|                 | \$124,156                                     | \$457,760             | \$291,348  | \$21,996     | \$ 21,509         | \$916,769 |

Allowance for Loan Losses

An allowance for loan losses (“ALL”) is maintained to absorb losses from the loan portfolio. The ALL is based on management’s continuing evaluation of the risk characteristics and credit quality of the loan portfolio, assessment of current economic conditions, diversification and size of the portfolio, adequacy of collateral, past and anticipated future loss experience, and the amount of non-performing loans.

The Banks' methodology for determining the ALL is based on the requirements of ASC Section 310-10-35 for loans individually evaluated for impairment (previously discussed) and ASC Subtopic 450-20 for loans collectively evaluated for impairment, as well as the Interagency Policy Statements on the Allowance for Loan and Lease Losses

and other bank regulatory guidance. The total of the two components represents the Banks' ALL.

Loans that are collectively evaluated for impairment are analyzed with general allowances being made as appropriate. Allowances are segmented based on collateral characteristics previously disclosed, and consistent with credit quality monitoring. Loans that are collectively evaluated for impairment are grouped into two classes for evaluation. A general allowance is determined for "Pass" rated credits, while a separate pool allowance is provided for "Criticized" rated credits that are not individually evaluated for impairment.

For the general allowances, historical loss trends are used in the estimation of losses in the current portfolio. These historical loss amounts are modified by other qualitative factors. A historical charge-off factor is calculated utilizing a twelve quarter moving average. Management has identified a number of additional qualitative factors which it uses to supplement the historical charge-off factor because these factors are likely to cause estimated credit losses associated with the existing loan pools to differ from historical loss experience. The additional factors that are evaluated quarterly and updated using information obtained from internal, regulatory, and governmental sources are: national and local economic trends and conditions; levels of and trends in delinquency

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rates and non-accrual loans; trends in volumes and terms of loans; effects of changes in lending policies; experience, ability, and depth of lending staff; value of underlying collateral; and concentrations of credit from a loan type, industry and/or geographic standpoint.

Loans in the criticized pools, which possess certain qualities or characteristics that may lead to collection and loss issues, are closely monitored by management and subject to additional qualitative factors. Management also monitors industry loss factors by loan segment for applicable adjustments to actual loss experience.

Management reviews the loan portfolio on a quarterly basis in order to make appropriate and timely adjustments to the ALL. When information confirms all or part of specific loans to be uncollectible, these amounts are promptly charged off against the ALL.

Activity in the allowance is presented for the three and six months ended June 30, 2015 and 2014:

| (In Thousands)    | Three Months Ended June 30, 2015              |                       |            |              |                   |        |                    |
|-------------------|-----------------------------------------------|-----------------------|------------|--------------|-------------------|--------|--------------------|
|                   | Commercial,<br>Financial, and<br>Agricultural | Real Estate Mortgages |            |              | Installment Loans |        | Unallocated Totals |
|                   |                                               | Residential           | Commercial | Construction | to Individuals    |        |                    |
| Beginning Balance | \$ 1,478                                      | \$ 4,227              | \$ 3,873   | \$ 752       | \$ 193            | \$ 303 | \$ 10,826          |
| Charge-offs       | (263                                          | ) —                   | —          | (46          | ) (58             | ) —    | (367               |
| Recoveries        | 2                                             | 13                    | 169        | 5            | 17                | —      | 206                |
| Provision         | 69                                            | 94                    | (173       | ) (163       | ) 85              | 688    | 600                |
| Ending Balance    | \$ 1,286                                      | \$ 4,334              | \$ 3,869   | \$ 548       | \$ 237            | \$ 991 | \$ 11,265          |
|                   |                                               |                       |            |              |                   |        |                    |
| (In Thousands)    | Three Months Ended June 30, 2014              |                       |            |              |                   |        |                    |
|                   | Commercial,<br>Financial, and<br>Agricultural | Real Estate Mortgages |            |              | Installment Loans |        | Unallocated Totals |
|                   |                                               | Residential           | Commercial | Construction | to Individuals    |        |                    |
| Beginning Balance | \$ 537                                        | \$ 3,062              | \$ 3,324   | \$ 795       | \$ 161            | \$ 641 | \$ 8,520           |
| Charge-offs       | —                                             | (7                    | ) —        | —            | (28               | ) —    | (35                |
| Recoveries        | 8                                             | 1                     | —          | —            | 17                | —      | 26                 |
| Provision         | 149                                           | 206                   | 70         | (77          | ) 48              | (96    | ) 300              |
| Ending Balance    | \$ 694                                        | \$ 3,262              | \$ 3,394   | \$ 718       | \$ 198            | \$ 545 | \$ 8,811           |
|                   |                                               |                       |            |              |                   |        |                    |
| (In Thousands)    | Six Months Ended June 30, 2015                |                       |            |              |                   |        |                    |
|                   | Commercial,<br>Financial, and<br>Agricultural | Real Estate Mortgages |            |              | Installment Loans |        | Unallocated Totals |
|                   |                                               | Residential           | Commercial | Construction | to Individuals    |        |                    |
| Beginning Balance | \$ 1,124                                      | \$ 3,755              | \$ 4,205   | \$ 786       | \$ 245            | \$ 464 | \$ 10,579          |
| Charge-offs       | (283                                          | ) (1                  | ) (449     | ) (46        | ) (114            | ) —    | (893               |
| Recoveries        | 28                                            | 37                    | 169        | 16           | 29                | —      | 279                |
| Provision         | 417                                           | 543                   | (56        | ) (208       | ) 77              | 527    | 1,300              |
| Ending Balance    | \$ 1,286                                      | \$ 4,334              | \$ 3,869   | \$ 548       | \$ 237            | \$ 991 | \$ 11,265          |
|                   |                                               |                       |            |              |                   |        |                    |
| (In Thousands)    | Six Months Ended June 30, 2014                |                       |            |              |                   |        |                    |
|                   | Commercial,<br>Financial, and<br>Agricultural | Real Estate Mortgages |            |              | Installment Loans |        | Unallocated Totals |
|                   |                                               | Residential           | Commercial | Construction | to Individuals    |        |                    |



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|                   | Agricultural |         |          |       |       |        |          |
|-------------------|--------------|---------|----------|-------|-------|--------|----------|
| Beginning Balance | \$474        | \$3,917 | \$4,079  | \$741 | \$139 | \$794  | \$10,144 |
| Charge-offs       | —            | (63 )   | (2,038 ) | —     | (68 ) | —      | (2,169 ) |
| Recoveries        | 11           | 3       | —        | —     | 37    | —      | 51       |
| Provision         | 209          | (595 )  | 1,353    | (23 ) | 90    | (249 ) | 785      |
| Ending Balance    | \$694        | \$3,262 | \$3,394  | \$718 | \$198 | \$545  | \$8,811  |

The Company grants commercial, industrial, residential, and installment loans to customers throughout north-east and central Pennsylvania. Although the Company has a diversified loan portfolio, a substantial portion of its debtors' ability to honor their contracts is dependent on the economic conditions within this region.

The Company has a concentration of the following to gross loans at June 30, 2015 and 2014:



Total ending allowance  
balance

Loans:

|                                                 |           |           |           |          |          |           |
|-------------------------------------------------|-----------|-----------|-----------|----------|----------|-----------|
| Individually evaluated for impairment           | \$1,112   | \$1,117   | \$13,973  | \$1,025  | \$ —     | \$17,227  |
| Loans acquired with deteriorated credit quality | —         | 349       | —         | —        | —        | 349       |
| Collectively evaluated for impairment           | 123,044   | 456,294   | 277,375   | 20,971   | 21,509   | 899,193   |
| Total ending loans balance                      | \$124,156 | \$457,760 | \$291,348 | \$21,996 | \$21,509 | \$916,769 |

#### Note 8. Net Periodic Benefit Cost-Defined Benefit Plans

For a detailed disclosure on the Company's pension and employee benefits plans, please refer to Note 13 of the Company's Consolidated Financial Statements included in the Annual Report on Form 10-K for the year ended December 31, 2014.

The following sets forth the components of the net periodic benefit cost of the domestic non-contributory defined benefit plan for the three and six months ended June 30, 2015 and 2014, respectively:

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| (In Thousands)                 | Three Months Ended June 30, |        | Six Months Ended June 30, |         |
|--------------------------------|-----------------------------|--------|---------------------------|---------|
|                                | 2015                        | 2014   | 2015                      | 2014    |
| Service cost                   | \$ 16                       | \$ 140 | \$ 32                     | \$ 280  |
| Interest cost                  | 189                         | 214    | 378                       | 429     |
| Expected return on plan assets | (210                        | ) (289 | ) (491                    | ) (577  |
| Amortization of net loss       | 40                          | 53     | 80                        | 105     |
| Net periodic (benefit) cost    | \$ 35                       | \$ 118 | \$(1                      | ) \$237 |

## Employer Contributions

The Company previously disclosed in its consolidated financial statements, included in the Annual Report on Form 10-K for the year ended December 31, 2014, that it expected to contribute a minimum of \$600,000 to its defined benefit plan in 2015. As of June 30, 2015, there were contributions of \$465,000 made to the plan with additional contributions of at least \$400,000 anticipated during the remainder of 2015.

## Note 9. Employee Stock Purchase Plan

The Company maintains an Employee Stock Purchase Plan ("Plan"). The Plan is intended to encourage employee participation in the ownership and economic progress of the Company. The Plan allows for up to 1,000,000 shares to be purchased by employees. The purchase price of the shares is 95% of market value with an employee eligible to purchase up to the lesser of 15% of base compensation or \$12,000 in market value annually. During the six months ended June 30, 2015 and 2014, there were 1,108 and 1,293 shares issued under the plan, respectively.

## Note 10. Off Balance Sheet Risk

The Company is a party to financial instruments with off-balance sheet risk in the normal course of business to meet the financing needs of its customers. These financial instruments are primarily comprised of commitments to extend credit, standby letters of credit, and credit exposure from the sale of assets with recourse. These instruments involve, to varying degrees, elements of credit, interest rate, or liquidity risk in excess of the amount recognized in the Consolidated Balance Sheet. The contract amounts of these instruments express the extent of involvement the Company has in particular classes of financial instruments.

The Company's exposure to credit loss from nonperformance by the other party to the financial instruments for commitments to extend credit and standby letters of credit is represented by the contractual amount of these instruments. The Company uses the same credit policies in making commitments and conditional obligations as it does for on-balance sheet instruments. The Company may require collateral or other security to support financial instruments with off-balance sheet credit risk.

Financial instruments whose contract amounts represent credit risk are as follows at June 30, 2015 and December 31, 2014:

| (In Thousands)                                        | June 30, 2015 | December 31, 2014 |
|-------------------------------------------------------|---------------|-------------------|
| Commitments to extend credit                          | \$ 234,521    | \$ 235,940        |
| Standby letters of credit                             | 7,185         | 7,490             |
| Credit exposure from the sale of assets with recourse | 4,970         | 3,465             |
|                                                       | \$ 241,706    | \$ 243,430        |

Commitments to extend credit are legally binding agreements to lend to customers. Commitments generally have fixed expiration dates or other termination clauses and may require payment of fees. Since many of the commitments are expected to expire without being drawn upon, the total commitment amounts do not necessarily represent future liquidity requirements. The Company evaluates each customer's credit worthiness on a case-by-case basis. The amount of collateral obtained, if deemed necessary by the Company, on an extension of credit is based on management's credit assessment of the counterparty.

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

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earned from the issuance of these letters are recognized upon expiration of the coverage period. For secured letters of credit, the collateral is typically Bank deposit instruments or customer business assets.

## Note 11. Fair Value Measurements

The following disclosures show the hierarchal disclosure framework associated with the level of pricing observations utilized in measuring assets and liabilities at fair value.

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

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

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

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

The following table presents the assets reported on the balance sheet at their fair value on a recurring basis as of June 30, 2015 and December 31, 2014, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (In Thousands)                             | June 30, 2015     |           |           |           |
|--------------------------------------------|-------------------|-----------|-----------|-----------|
|                                            | Level I           | Level II  | Level III | Total     |
| Assets measured on a recurring basis:      |                   |           |           |           |
| Investment securities, available for sale: |                   |           |           |           |
| U.S. Government and agency securities      | \$—               | \$3,655   | \$—       | \$3,655   |
| Mortgage-backed securities                 | —                 | 11,199    | —         | 11,199    |
| Asset-backed securities                    | —                 | 2,232     | —         | 2,232     |
| State and political securities             | —                 | 101,771   | —         | 101,771   |
| Other debt securities                      | —                 | 80,025    | —         | 80,025    |
| Financial institution equity securities    | 10,797            | —         | —         | 10,797    |
| Other equity securities                    | 4,633             | —         | —         | 4,633     |
| Investment securities, trading:            |                   |           |           |           |
| Financial institution equity securities    | 74                | —         | —         | 74        |
| Other equity securities                    | 83                | —         | —         | 83        |
| Total assets measured on a recurring basis | \$15,587          | \$198,882 | \$—       | \$214,469 |
|                                            |                   |           |           |           |
|                                            | December 31, 2014 |           |           |           |
| (In Thousands)                             | Level I           | Level II  | Level III | Total     |
| Assets measured on a recurring basis:      |                   |           |           |           |
| Investment securities, available for sale: |                   |           |           |           |
| U.S. Government and agency securities      | \$—               | \$3,841   | \$—       | \$3,841   |
| Mortgage-backed securities                 | —                 | 12,697    | —         | 12,697    |
| Asset-backed securities                    | —                 | 2,492     | —         | 2,492     |
| State and political securities             | —                 | 108,116   | —         | 108,116   |
| Other debt securities                      | —                 | 89,643    | —         | 89,643    |

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|                                            |          |           |     |           |
|--------------------------------------------|----------|-----------|-----|-----------|
| Financial institution equity securities    | 9,915    | —         | —   | 9,915     |
| Other equity securities                    | 5,509    | —         | —   | 5,509     |
| Total assets measured on a recurring basis | \$15,424 | \$216,789 | \$— | \$232,213 |

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The following table presents the assets reported on the Consolidated Balance Sheet at their fair value on a non-recurring basis as of June 30, 2015 and December 31, 2014, by level within the fair value hierarchy. Financial assets and liabilities are classified in their entirety based on the lowest level of input that is significant to the fair value measurement.

| (In Thousands)                                 | June 30, 2015     |          |           |          |
|------------------------------------------------|-------------------|----------|-----------|----------|
|                                                | Level I           | Level II | Level III | Total    |
| Assets measured on a non-recurring basis:      |                   |          |           |          |
| Impaired loans                                 | \$—               | \$—      | \$16,024  | \$16,024 |
| Other real estate owned                        | —                 | —        | 2,127     | 2,127    |
| Total assets measured on a non-recurring basis | \$—               | \$—      | \$18,151  | \$18,151 |
| (In Thousands)                                 | December 31, 2014 |          |           |          |
|                                                | Level I           | Level II | Level III | Total    |
| Assets measured on a non-recurring basis:      |                   |          |           |          |
| Impaired loans                                 | \$—               | \$—      | \$15,483  | \$15,483 |
| Other real estate owned                        | —                 | —        | 3,241     | 3,241    |
| Total assets measured on a non-recurring basis | \$—               | \$—      | \$18,724  | \$18,724 |

The following tables present a listing of significant unobservable inputs used in the fair value measurement process for items valued utilizing level III techniques as of June 30, 2015 and December 31, 2014:

| (In Thousands)          | June 30, 2015 |                             |                                       |            |                  |
|-------------------------|---------------|-----------------------------|---------------------------------------|------------|------------------|
|                         | Fair Value    | Valuation Technique(s)      | Unobservable Inputs                   | Range      | Weighted Average |
| Impaired loans          | \$5,803       | Discounted cash flow        | Temporary reduction in payment amount | 0 to (91)% | (10)%            |
|                         |               |                             | Probability of default                | —%         | —%               |
|                         |               |                             | Appraisal adjustments (1)             | 0 to (20)% | (15)%            |
| Other real estate owned | \$2,127       | Appraisal of collateral (1) |                                       |            |                  |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

| (In Thousands)          | December 31, 2014 |                             |                                       |            |                  |
|-------------------------|-------------------|-----------------------------|---------------------------------------|------------|------------------|
|                         | Fair Value        | Valuation Technique(s)      | Unobservable Inputs                   | Range      | Weighted Average |
| Impaired loans          | \$4,749           | Discounted cash flow        | Temporary reduction in payment amount | 0 to (91)% | (12)%            |
|                         |                   |                             | Probability of default                | —%         | —%               |
|                         |                   |                             | Appraisal adjustments (1)             | 0 to (44)% | (15)%            |
| Other real estate owned | \$3,241           | Appraisal of collateral (1) |                                       |            |                  |

(1) Appraisals may be adjusted by management for qualitative factors such as economic conditions and estimated liquidation expenses.

The significant unobservable inputs used in the fair value measurement of the Company's impaired loans using the discounted cash flow valuation technique include temporary changes in payment amounts and the probability of default. Significant increases (decreases) in payment amounts would result in significantly higher (lower) fair value



measurements. The probability of default is 0% for impaired loans using the discounted cash flow valuation technique because all defaulted impaired loans are valued using the appraisal of collateral valuation technique.

The significant unobservable input used in the fair value measurement of the Company's impaired loans using the appraisal of collateral valuation technique include appraisal adjustments, which are adjustments to appraisals by management for qualitative factors such as economic conditions and estimated liquidation expenses. The significant unobservable input used in the fair value measurement of the Company's other real estate owned are the same inputs used to value impaired loans using the appraisal of collateral valuation technique.

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## Note 12. Fair Value of Financial Instruments

The Company is required to disclose fair values for its financial instruments. Fair values are made at a specific point in time, based on relevant market information and information about the financial instrument. These estimates do not reflect any premium or discount that could result from offering for sale at one time the Company's entire holdings of a particular financial instrument. Also, it is the Company's general practice and intention to hold most of its financial instruments to maturity and not to engage in trading or sales activities. Because no market exists for a significant portion of the Company's financial instruments, fair value estimates are based on judgments regarding future expected loss experience, current economic conditions, risk characteristics of various financial instruments, and other factors. These fair values are subjective in nature and involve uncertainties and matters of significant judgment and therefore cannot be determined with precision. Changes in assumptions can significantly affect the fair values.

Fair values have been determined by the Company using historical data and an estimation methodology suitable for each category of financial instruments. The Company's fair values, methods, and assumptions are set forth below for the Company's other financial instruments.

As certain assets and liabilities, such as deferred tax assets, premises and equipment, and many other operational elements of the Company, are not considered financial instruments but have value, this fair value of financial instruments would not represent the full market value of the Company.

The fair values of the Company's financial instruments are as follows at June 30, 2015 and December 31, 2014:

| (In Thousands)               | Carrying Value | Fair Value | Fair Value Measurements at June 30, 2015 |          |           |
|------------------------------|----------------|------------|------------------------------------------|----------|-----------|
|                              |                |            | Level I                                  | Level II | Level III |
| Financial assets:            |                |            |                                          |          |           |
| Cash and cash equivalents    | \$21,869       | \$21,869   | \$21,869                                 | \$—      | \$—       |
| Investment securities:       |                |            |                                          |          |           |
| Available for sale           | 214,312        | 214,312    | 15,430                                   | 198,882  | —         |
| Trading                      | 157            | 157        | 157                                      | —        | —         |
| Loans held for sale          | 2,107          | 2,107      | 2,107                                    | —        | —         |
| Loans, net                   | 966,613        | 974,138    | —                                        | —        | 974,138   |
| Bank-owned life insurance    | 26,327         | 26,327     | 26,327                                   | —        | —         |
| Accrued interest receivable  | 3,706          | 3,706      | 3,706                                    | —        | —         |
| Financial liabilities:       |                |            |                                          |          |           |
| Interest-bearing deposits    | \$762,966      | \$741,900  | \$522,033                                | \$—      | \$219,867 |
| Noninterest-bearing deposits | 244,502        | 244,502    | 244,502                                  | —        | —         |
| Short-term borrowings        | 59,026         | 59,026     | 59,026                                   | —        | —         |
| Long-term borrowings         | 75,426         | 76,325     | —                                        | —        | 76,325    |
| Accrued interest payable     | 410            | 410        | 410                                      | —        | —         |

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| (In Thousands)               | Carrying Value | Fair Value | Fair Value Measurements at December 31, 2014 |          |            |
|------------------------------|----------------|------------|----------------------------------------------|----------|------------|
|                              |                |            | Level I                                      | Level II | Level III  |
| Financial assets:            |                |            |                                              |          |            |
| Cash and cash equivalents    | \$ 19,908      | \$ 19,908  | \$ 19,908                                    | \$—      | \$—        |
| Investment securities:       |                |            |                                              |          |            |
| Available for sale           | 232,213        | 232,213    | 15,424                                       | 216,789  | —          |
| Loans held for sale          | 550            | 550        | 550                                          | —        | —          |
| Loans, net                   | 905,000        | 916,597    | —                                            | —        | 916,597    |
| Bank-owned life insurance    | 25,959         | 25,959     | 25,959                                       | —        | —          |
| Accrued interest receivable  | 3,912          | 3,912      | 3,912                                        | —        | —          |
| Financial liabilities:       |                |            |                                              |          |            |
| Interest-bearing deposits    | \$ 738,041     | \$ 722,724 | \$ 506,875                                   | \$—      | \$ 215,849 |
| Noninterest-bearing deposits | 243,378        | 243,378    | 243,378                                      | —        | —          |
| Short-term borrowings        | 40,818         | 40,818     | 40,818                                       | —        | —          |
| Long-term borrowings         | 71,176         | 73,084     | —                                            | —        | 73,084     |
| Accrued interest payable     | 381            | 381        | 381                                          | —        | —          |

Cash and Cash Equivalents, Loans Held for Sale, Accrued Interest Receivable, Short-term Borrowings, and Accrued Interest Payable:

The fair value is equal to the carrying value.

Investment Securities:

The fair value of investment securities available for sale and trading is equal to the available quoted market price. If no quoted market price is available, fair value is estimated using the quoted market price for similar securities.

Regulatory stocks' fair value is equal to the carrying value.

Loans:

Fair values are estimated for portfolios of loans with similar financial characteristics. Loans are segregated by type such as commercial, financial, and agricultural, commercial real estate, residential real estate, construction real estate, and installment loans to individuals. Each loan category is further segmented into fixed and adjustable rate interest terms and by performing and nonperforming categories.

The fair value of performing loans is calculated by discounting scheduled cash flows through the estimated maturity using estimated market discount rates that reflect the credit and interest rate risk inherent in the loan. The estimate of maturity is based on the Company's historical experience with repayments for each loan classification, modified, as required, by an estimate of the effect of current economic and lending conditions.

Fair value for significant nonperforming loans is based on recent external appraisals. If appraisals are not available, estimated cash flows are discounted using a rate commensurate with the risk associated with the estimated cash flows. Assumptions regarding credit risk, cash flows, and discounted rates are judgmentally determined using available market information and specific borrower information.

Bank-Owned Life Insurance:

The fair value is equal to the cash surrender value of the life insurance policies.

Deposits:

The fair value of deposits with no stated maturity, such as noninterest-bearing demand deposits, savings, NOW, and money market accounts, is equal to the amount payable on demand. The fair value of certificates of deposit is based on the discounted value of contractual cash flows.

The fair value estimates above do not include the benefit that results from the low-cost funding provided by the deposit liabilities compared to the cost of borrowing funds in the market, commonly referred to as the core deposit intangible.

**Long Term Borrowings:**

The fair value of long term borrowings is based on the discounted value of contractual cash flows.

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Commitments to Extend Credit, Standby Letters of Credit, and Financial Guarantees Written:

There is no material difference between the notional amount and the estimated fair value of off-balance sheet items. The contractual amounts of unfunded commitments and letters of credit are presented in Note 10 (Off Balance Sheet Risk).

Note 13. Reclassification of Comparative Amounts

Certain comparative amounts for the prior period have been reclassified to conform to current period presentations. Such reclassifications had no effect on net income or shareholders' equity.

CAUTIONARY STATEMENT FOR PURPOSES OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Report contains certain "forward-looking statements" including statements concerning plans, objectives, future events or performance and assumptions and other statements which are other than statements of historical fact. The Company cautions readers that the following important factors, among others, may have affected and could in the future affect the Company's actual results and could cause the Company's actual results for subsequent periods to differ materially from those expressed in any forward-looking statement made by or on behalf of the Company herein: (i) the effect of changes in laws and regulations, including federal and state banking laws and regulations, with which the Company must comply, and the associated costs of compliance with such laws and regulations either currently or in the future as applicable; (ii) the effect of changes in accounting policies and practices, as may be adopted by the regulatory agencies as well as by the Financial Accounting Standards Board, or of changes in the Company's organization, compensation and benefit plans; (iii) the effect on the Company's competitive position within its market area of the increasing consolidation within the banking and financial services industries, including the increased competition from larger regional and out-of-state banking organizations as well as non-bank providers of various financial services; (iv) the effect of changes in interest rates; and (v) the effect of changes in the business cycle and downturns in the local, regional or national economies.

You should not put undue reliance on any forward-looking statements. These statements speak only as of the date of this Quarterly Report on Form 10-Q, even if subsequently made available by the Company on its website or otherwise. The Company undertakes no obligation to update or revise these statements to reflect events or circumstances occurring after the date of this Quarterly Report on Form 10-Q.

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

## EARNINGS SUMMARY

## Comparison of the Three and Six Months Ended June 30, 2015 and 2014

## Summary Results

Net income for the three months ended June 30, 2015 was \$3,433,000 compared to \$3,463,000 for the same period of 2014 as after-tax securities gains increased \$24,000 (from a gain of \$321,000 to a gain of \$345,000). In addition, a gain of \$174,000 on death benefits related to bank-owned life insurance was recorded during the first quarter of 2014. Basic and diluted earnings per share for the three months ended June 30, 2015 and 2014 were \$0.72 for both periods. Return on average assets and return on average equity were 1.07% and 10.05% for the three months ended June 30, 2015 compared to 1.13% and 10.29% for the corresponding period of 2014. Net income from core operations ("operating earnings") decreased to \$3,088,000 for the three months ended June 30, 2015 compared to \$3,142,000 for the same period of 2014. Operating earnings per share for the three months ended June 30, 2015 and 2014 were \$0.65 basic and dilutive for both periods.

The six months ended June 30, 2015 generated net income of \$6,788,000 compared to \$6,932,000 for the same period of 2014. Comparable results were impacted by an increase in after-tax securities gains of \$200,000 (from a gain of \$581,000 to a gain of \$781,000). In addition, a gain of \$174,000 on death benefit related to bank owned life insurance was recorded during the six months ended June 30, 2014. Earnings per share, basic and dilutive, for the six months ended June 30, 2015 were \$1.42 compared to \$1.44 for the comparable period of 2014. Return on average assets and return on average equity were 1.07% and 9.90% for the six months ended June 30, 2015 compared to 1.14% and 10.43% for the corresponding period of 2014. Operating earnings decreased slightly to \$6,007,000 for the six months ended June 30, 2015 compared to \$6,177,000 for the same period of 2014. Operating earnings per share for the six months ended June 30, 2015 were \$1.25 basic and dilutive compared to \$1.28 basic and dilutive for the six months ended June 30, 2014.

Management uses the non-GAAP measure of net income from core operations, or operating earnings, in its analysis of the Company's performance. This measure, as used by the Company, adjusts net income by excluding significant gains or losses that are unusual in nature. Because certain of these items and their impact on the Company's performance are difficult to predict, management believes the presentation of financial measures excluding the impact of such items provides useful supplemental information in evaluating the operating results of the Company's core businesses. For purposes of this Quarterly Report on Form 10-Q, net income from core operations, or operating earnings, means net income adjusted to exclude after-tax net securities gains or losses and bank-owned life insurance gains on death benefit. These disclosures should not be viewed as a substitute for net income determined in accordance with GAAP, nor are they necessarily comparable to non-GAAP performance measures that may be presented by other companies.

## Reconciliation of GAAP and Non-GAAP Financial Measures

(Dollars in Thousands, Except Per Share Data)

|                                                                      | Three Months           |         | Six Months Ended |         |
|----------------------------------------------------------------------|------------------------|---------|------------------|---------|
|                                                                      | Ended June 30,<br>2015 | 2014    | June 30,<br>2015 | 2014    |
| GAAP net income                                                      | \$3,433                | \$3,463 | \$6,788          | \$6,932 |
| Less: net securities and bank-owned life insurance gains, net of tax | 345                    | 321     | 781              | 755     |
| Non-GAAP operating earnings                                          | \$3,088                | \$3,142 | \$6,007          | \$6,177 |

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|                                                                      | Three Months Ended |        | Six Months Ended |        |   |
|----------------------------------------------------------------------|--------------------|--------|------------------|--------|---|
|                                                                      | June 30,           |        | June 30,         |        |   |
|                                                                      | 2015               | 2014   | 2015             | 2014   |   |
| Return on average assets (ROA)                                       | 1.07               | % 1.13 | % 1.07           | % 1.14 | % |
| Less: net securities and bank-owned life insurance gains, net of tax | 0.11               | % 0.10 | % 0.13           | % 0.12 | % |
| Non-GAAP operating ROA                                               | 0.96               | % 1.03 | % 0.94           | % 1.02 | % |

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|                                                                      | Three Months Ended<br>June 30, |         | Six Months Ended<br>June 30, |         |   |  |  |  |
|----------------------------------------------------------------------|--------------------------------|---------|------------------------------|---------|---|--|--|--|
|                                                                      | 2015                           | 2014    | 2015                         | 2014    |   |  |  |  |
| Return on average equity (ROE)                                       | 10.05                          | % 10.29 | % 9.90                       | % 10.43 | % |  |  |  |
| Less: net securities and bank-owned life insurance gains, net of tax | 1.01                           | % 0.96  | % 1.14                       | % 1.14  | % |  |  |  |
| Non-GAAP operating ROE                                               | 9.04                           | % 9.33  | % 8.76                       | % 9.29  | % |  |  |  |
|                                                                      | Three Months<br>Ended June 30, |         | Six Months Ended<br>June 30, |         |   |  |  |  |
|                                                                      | 2015                           | 2014    | 2015                         | 2014    |   |  |  |  |
| Basic earnings per share (EPS)                                       | \$0.72                         | \$0.72  | \$1.42                       | \$1.44  |   |  |  |  |
| Less: net securities and bank-owned life insurance gains, net of tax | 0.07                           | 0.07    | 0.17                         | 0.16    |   |  |  |  |
| Non-GAAP basic operating EPS                                         | \$0.65                         | \$0.65  | \$1.25                       | \$1.28  |   |  |  |  |
|                                                                      | Three Months<br>Ended June 30, |         | Six Months Ended<br>June 30, |         |   |  |  |  |
|                                                                      | 2015                           | 2014    | 2015                         | 2014    |   |  |  |  |
| Dilutive EPS                                                         | \$0.72                         | \$0.72  | \$1.42                       | \$1.44  |   |  |  |  |
| Less: net securities and bank-owned life insurance gains, net of tax | 0.07                           | 0.07    | 0.17                         | 0.16    |   |  |  |  |
| Non-GAAP dilutive operating EPS                                      | \$0.65                         | \$0.65  | \$1.25                       | \$1.28  |   |  |  |  |

## Interest and Dividend Income

Interest and dividend income for the three months ended June 30, 2015 increased to \$11,529,000 compared to \$11,357,000 for the same period of 2014. Loan portfolio income increased as the impact of portfolio growth, due primarily to an increase in home equity products, offset a reduction in yield of 22 basis points (“bp”) due to the competitive landscape and the continued low rate environment that is impacting new loan rates as well as the variable rate segment of the loan portfolio. The loan portfolio income increase was offset by a decrease in investment portfolio interest due to a decline in the average taxable equivalent yield of 32 bp as the duration in the investment portfolio continues to be shortened in order to reduce interest rate and market risk in the future. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. To offset the revenue impact of the declining asset yields, a focus has been placed on increasing earning assets by adding quality short and intermediate term loans such as home equity loans, even though these new earning assets are at lower yields than legacy assets.

During the six months ended June 30, 2015, interest and dividend income was \$22,926,000, an increase of \$240,000 over the same period in 2014. Interest income on the loan portfolio increased as the growth in the portfolio was countered by a 25 bp decline in average yield. The investment portfolio interest income decreased as the portfolio size was decreased in order to reduce interest rate and market risk, while the yield on the investment portfolio declined 18 bp.

Interest and dividend income composition for the three and six months ended June 30, 2015 and 2014 was as follows:

|                        | Three Months Ended<br>June 30, 2015 |         | June 30, 2014 |         | Change  |          |   |   |
|------------------------|-------------------------------------|---------|---------------|---------|---------|----------|---|---|
| (In Thousands)         | Amount                              | % Total | Amount        | % Total | Amount  | %        |   | % |
| Loans including fees   | \$9,752                             | 84.59   | % \$8,912     | 78.48   | % \$840 | 9.43     |   |   |
| Investment securities: |                                     |         |               |         |         |          |   |   |
| Taxable                | 885                                 | 7.68    | 1,406         | 12.38   | (521    | ) (37.06 | ) |   |
| Tax-exempt             | 744                                 | 6.45    | 892           | 7.85    | (148    | ) (16.59 | ) |   |



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|                                    |          |        |            |        |         |      |   |
|------------------------------------|----------|--------|------------|--------|---------|------|---|
| Dividend and other interest income | 148      | 1.28   | 147        | 1.29   | 1       | 0.68 |   |
| Total interest and dividend income | \$11,529 | 100.00 | % \$11,357 | 100.00 | % \$172 | 1.51 | % |

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| (In Thousands)                     | Six Months Ended<br>June 30, 2015 |         | June 30, 2014 |         | Change    |          |  |   |
|------------------------------------|-----------------------------------|---------|---------------|---------|-----------|----------|--|---|
|                                    | Amount                            | % Total | Amount        | % Total | Amount    | %        |  |   |
| Loans including fees               | \$19,075                          | 83.21   | % \$17,725    | 78.13   | % \$1,350 | 7.62     |  | % |
| Investment securities:             |                                   |         |               |         |           |          |  |   |
| Taxable                            | 1,899                             | 8.28    | 2,864         | 12.62   | (965 )    | (33.69 ) |  |   |
| Tax-exempt                         | 1,511                             | 6.59    | 1,823         | 8.04    | (312 )    | (17.11 ) |  |   |
| Dividend and other interest income | 441                               | 1.92    | 274           | 1.21    | 167       | 60.95    |  |   |
| Total interest and dividend income | \$22,926                          | 100.00  | % \$22,686    | 100.00  | % \$240   | 1.06     |  | % |

## Interest Expense

Interest expense for the three months ended June 30, 2015 increased \$81,000 to \$1,307,000 compared to \$1,226,000 for the same period of 2014. The increase in interest expense is primarily associated with the lengthening of the time deposit portfolio as part of a strategy to build balance sheet protection in a rising rate environment, coupled with an additional \$15,000,000 of long term borrowings entered into during the first quarter of 2015.

Interest expense for the six months ended June 30, 2015 increased 5.06% from the same period of 2014. The reasons noted for the increase in interest expense for the three month period comparison also apply to the six month period.

Interest expense composition for the three and six months ended June 30, 2015 and 2014 was as follows:

| (In Thousands)         | Three Months Ended<br>June 30, 2015 |         | June 30, 2014 |         | Change  |        |  |   |
|------------------------|-------------------------------------|---------|---------------|---------|---------|--------|--|---|
|                        | Amount                              | % Total | Amount        | % Total | Amount  | %      |  |   |
| Deposits               | \$785                               | 60.06   | % \$741       | 60.44   | % \$44  | 5.94   |  | % |
| Short-term borrowings  | 28                                  | 2.14    | 12            | 0.98    | 16      | 133.33 |  |   |
| Long-term borrowings   | 494                                 | 37.80   | 473           | 38.58   | 21      | 4.44   |  |   |
| Total interest expense | \$1,307                             | 100.00  | % \$1,226     | 100.00  | % \$81  | 6.61   |  | % |
|                        | Six Months Ended<br>June 30, 2015   |         | June 30, 2014 |         | Change  |        |  |   |
| (In Thousands)         | Amount                              | % Total | Amount        | % Total | Amount  | %      |  |   |
| Deposits               | \$1,528                             | 58.93   | % \$1,499     | 60.74   | % \$29  | 1.93   |  | % |
| Short-term borrowings  | 47                                  | 1.81    | 27            | 1.09    | 20      | 74.07  |  |   |
| Long-term borrowings   | 1,018                               | 39.26   | 942           | 38.17   | 76      | 8.07   |  |   |
| Total interest expense | \$2,593                             | 100.00  | % \$2,468     | 100.00  | % \$125 | 5.06   |  | % |

## Net Interest Margin

The net interest margin ("NIM") for the three months ended June 30, 2015 was 3.64% compared to 3.84% for the corresponding period of 2014. The decline in the net interest margin was driven by a decreasing yield on the loan and investment portfolios due to the continued low rate environment. The impact of the declining earning asset yield and decreasing investment portfolio balance was partially offset by a 15.59% growth in the balance of the average loan portfolio from June 30, 2014 to June 30, 2015 resulting in net interest income on a taxable equivalent basis remaining flat compared to the comparable three month period of 2014. The primary funding for the loan growth was an increase in borrowings and core deposits. These deposits represent a lower cost funding source than time deposits and comprise 78.16% of total deposits at June 30, 2015 compared to 77.30% at June 30, 2014. Limiting the positive impact on the net interest margin caused by the growth in core deposits was the lengthening of the time deposit

portfolio coupled with additional FHLB long-term borrowings as part of our strategy to prepare the balance sheet for a rising rate environment.

The NIM for the six months ended June 30, 2015 was 3.66% compared to 3.88% for the same period of 2014. The impact of the items mentioned in the three month discussion also applies to the six months ended.

The following is a schedule of average balances and associated yields for the three and six months ended June 30, 2015 and 2014:

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| (In Thousands)                               | AVERAGE BALANCES AND INTEREST RATES |          |              |   |                                  |          |              |   |
|----------------------------------------------|-------------------------------------|----------|--------------|---|----------------------------------|----------|--------------|---|
|                                              | Three Months Ended June 30, 2015    |          |              |   | Three Months Ended June 30, 2014 |          |              |   |
|                                              | Average Balance                     | Interest | Average Rate |   | Average Balance                  | Interest | Average Rate |   |
| <b>Assets:</b>                               |                                     |          |              |   |                                  |          |              |   |
| Tax-exempt loans                             | \$39,977                            | \$388    | 3.89         | % | \$26,040                         | \$286    | 4.41         | % |
| All other loans                              | 921,769                             | 9,496    | 4.13         | % | 805,971                          | 8,723    | 4.34         | % |
| Total loans                                  | 961,746                             | 9,884    | 4.12         | % | 832,011                          | 9,009    | 4.34         | % |
| Federal funds sold                           | —                                   | —        | —            | % | 128                              | —        | —            | % |
| Taxable securities                           | 130,730                             | 1,030    | 3.15         | % | 175,374                          | 1,540    | 3.51         | % |
| Tax-exempt securities                        | 87,509                              | 1,127    | 5.15         | % | 98,589                           | 1,352    | 5.66         | % |
| Total securities                             | 218,239                             | 2,157    | 3.95         | % | 273,963                          | 2,892    | 4.27         | % |
| Interest-bearing deposits                    | 3,781                               | 3        | 0.32         | % | 14,396                           | 13       | 0.36         | % |
| Total interest-earning assets                | 1,183,766                           | 12,044   | 4.08         | % | 1,120,498                        | 11,914   | 4.27         | % |
| Other assets                                 | 98,039                              |          |              |   | 105,066                          |          |              |   |
| Total assets                                 | \$1,281,805                         |          |              |   | \$1,225,564                      |          |              |   |
| <b>Liabilities and shareholders' equity:</b> |                                     |          |              |   |                                  |          |              |   |
| Savings                                      | \$143,305                           | 14       | 0.04         | % | \$141,837                        | 20       | 0.06         | % |
| Super Now deposits                           | 187,828                             | 124      | 0.26         | % | 189,473                          | 150      | 0.32         | % |
| Money market deposits                        | 209,624                             | 143      | 0.27         | % | 211,788                          | 138      | 0.26         | % |
| Time deposits                                | 220,851                             | 504      | 0.92         | % | 225,548                          | 433      | 0.77         | % |
| Total interest-bearing deposits              | 761,608                             | 785      | 0.41         | % | 768,646                          | 741      | 0.39         | % |
| Short-term borrowings                        | 39,166                              | 28       | 0.28         | % | 15,422                           | 11       | 0.29         | % |
| Long-term borrowings                         | 81,924                              | 494      | 2.39         | % | 71,202                           | 474      | 2.63         | % |
| Total borrowings                             | 121,090                             | 522      | 1.71         | % | 86,624                           | 485      | 2.22         | % |
| Total interest-bearing liabilities           | 882,698                             | 1,307    | 0.59         | % | 855,270                          | 1,226    | 0.57         | % |
| Demand deposits                              | 244,205                             |          |              |   | 220,975                          |          |              |   |
| Other liabilities                            | 18,231                              |          |              |   | 14,651                           |          |              |   |
| Shareholders' equity                         | 136,671                             |          |              |   | 134,668                          |          |              |   |
| Total liabilities and shareholders' equity   | \$1,281,805                         |          |              |   | \$1,225,564                      |          |              |   |
| Interest rate spread                         |                                     |          | 3.49         | % |                                  |          | 3.70         | % |
| Net interest income/margin                   |                                     | \$10,737 | 3.64         | % |                                  | \$10,688 | 3.84         | % |

- Information on this table has been calculated using average daily balance sheets to obtain average balances.
- Non-accrual loans have been included with loans for the purpose of analyzing net interest earnings.
- Income and rates on a fully taxable equivalent basis include an adjustment for the difference between annual income from tax-exempt obligations and the taxable equivalent of such income at the standard 34% tax rate.



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| (In Thousands)                               | AVERAGE BALANCES AND INTEREST RATES |          |              |   |                                |          |              |   |
|----------------------------------------------|-------------------------------------|----------|--------------|---|--------------------------------|----------|--------------|---|
|                                              | Six Months Ended June 30, 2015      |          |              |   | Six Months Ended June 30, 2014 |          |              |   |
|                                              | Average Balance                     | Interest | Average Rate |   | Average Balance                | Interest | Average Rate |   |
| <b>Assets:</b>                               |                                     |          |              |   |                                |          |              |   |
| Tax-exempt loans                             | \$38,303                            | \$771    | 4.06         | % | \$26,714                       | \$592    | 4.47         | % |
| All other loans                              | 906,693                             | 18,566   | 4.13         | % | 798,552                        | 17,334   | 4.38         | % |
| Total loans                                  | 944,996                             | 19,337   | 4.13         | % | 825,266                        | 17,926   | 4.38         | % |
| Federal funds sold                           | —                                   | —        | —            | % | 344                            | —        | —            | % |
| Taxable securities                           | 137,041                             | 2,333    | 3.40         | % | 176,046                        | 3,116    | 3.54         | % |
| Tax-exempt securities                        | 87,667                              | 2,289    | 5.22         | % | 97,864                         | 2,762    | 5.64         | % |
| Total securities                             | 224,708                             | 4,622    | 4.11         | % | 273,910                        | 5,878    | 4.29         | % |
| Interest-bearing deposits                    | 5,152                               | 7        | 0.27         | % | 10,000                         | 22       | 0.44         | % |
| Total interest-earning assets                | 1,174,856                           | 23,966   | 4.11         | % | 1,109,520                      | 23,826   | 4.32         | % |
| Other assets                                 | 97,043                              |          |              |   | 105,718                        |          |              |   |
| Total assets                                 | \$1,271,899                         |          |              |   | \$1,215,238                    |          |              |   |
| <b>Liabilities and shareholders' equity:</b> |                                     |          |              |   |                                |          |              |   |
| Savings                                      | \$142,537                           | 29       | 0.04         | % | \$140,803                      | 51       | 0.07         | % |
| Super Now deposits                           | 189,125                             | 253      | 0.27         | % | 183,174                        | 307      | 0.34         | % |
| Money market deposits                        | 207,446                             | 279      | 0.27         | % | 209,314                        | 272      | 0.26         | % |
| Time deposits                                | 218,824                             | 967      | 0.89         | % | 228,846                        | 869      | 0.77         | % |
| Total interest-bearing deposits              | 757,932                             | 1,528    | 0.41         | % | 762,137                        | 1,499    | 0.40         | % |
| Short-term borrowings                        | 33,728                              | 47       | 0.28         | % | 17,749                         | 27       | 0.31         | % |
| Long-term borrowings                         | 82,961                              | 1,018    | 2.44         | % | 71,202                         | 942      | 2.63         | % |
| Total borrowings                             | 116,689                             | 1,065    | 1.82         | % | 88,951                         | 969      | 2.17         | % |
| Total interest-bearing liabilities           | 874,621                             | 2,593    | 0.59         | % | 851,088                        | 2,468    | 0.58         | % |
| Demand deposits                              | 242,488                             |          |              |   | 216,588                        |          |              |   |
| Other liabilities                            | 17,687                              |          |              |   | 14,642                         |          |              |   |
| Shareholders' equity                         | 137,103                             |          |              |   | 132,920                        |          |              |   |
| Total liabilities and shareholders' equity   | \$1,271,899                         |          |              |   | \$1,215,238                    |          |              |   |
| Interest rate spread                         |                                     |          | 3.52         | % |                                |          | 3.74         | % |
| Net interest income/margin                   |                                     | \$21,373 | 3.66         | % |                                | \$21,358 | 3.88         | % |

The following table presents the adjustment to convert net interest income to net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2015 and 2014.

| (In Thousands) | Three Months Ended June 30, |      | Six Months Ended June 30, |      |
|----------------|-----------------------------|------|---------------------------|------|
|                | 2015                        | 2014 | 2015                      | 2014 |

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|                                                |          |          |          |          |
|------------------------------------------------|----------|----------|----------|----------|
| Total interest income                          | \$11,529 | \$11,357 | \$22,926 | \$22,686 |
| Total interest expense                         | 1,307    | 1,226    | 2,593    | 2,468    |
| Net interest income                            | 10,222   | 10,131   | 20,333   | 20,218   |
| Tax equivalent adjustment                      | 515      | 557      | 1,040    | 1,140    |
| Net interest income (fully taxable equivalent) | \$10,737 | \$10,688 | \$21,373 | \$21,358 |

The following table sets forth the respective impact that both volume and rate changes have had on net interest income on a fully taxable equivalent basis for the three and six months ended June 30, 2015 and 2014:

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| (In Thousands)                     | Three Months Ended June 30,<br>2015 vs. 2014 |         |         | Six Months Ended June 30,<br>2015 vs. 2014 |           |         |
|------------------------------------|----------------------------------------------|---------|---------|--------------------------------------------|-----------|---------|
|                                    | Increase (Decrease) Due to<br>Volume         | Rate    | Net     | Increase (Decrease) Due to<br>Volume       | Rate      | Net     |
| Interest income:                   |                                              |         |         |                                            |           |         |
| Tax-exempt loans                   | \$ 138                                       | \$(36)  | ) \$102 | \$237                                      | \$(58)    | ) \$179 |
| All other loans                    | 1,202                                        | (429)   | ) 773   | 2,260                                      | (1,028)   | ) 1,232 |
| Federal funds sold                 | —                                            | —       | —       | —                                          | —         | —       |
| Taxable investment securities      | (363)                                        | ) (147) | ) (510) | ) (665)                                    | ) (118)   | ) (783) |
| Tax-exempt investment securities   | (146)                                        | ) (79)  | ) (225) | ) (277)                                    | ) (196)   | ) (473) |
| Interest bearing deposits          | (10)                                         | ) —     | (10)    | ) (11)                                     | ) (4)     | ) (15)  |
| Total interest-earning assets      | 821                                          | (691)   | ) 130   | 1,544                                      | (1,404)   | ) 140   |
| Interest expense:                  |                                              |         |         |                                            |           |         |
| Savings deposits                   | —                                            | (6)     | ) (6)   | ) 1                                        | (23)      | ) (22)  |
| Super Now deposits                 | (1)                                          | ) (25)  | ) (26)  | ) 10                                       | (64)      | ) (54)  |
| Money market deposits              | (1)                                          | ) 6     | 5       | (17)                                       | ) 24      | 7       |
| Time deposits                      | (10)                                         | ) 81    | 71      | (38)                                       | ) 136     | 98      |
| Short-term borrowings              | 17                                           | —       | 17      | 23                                         | (3)       | ) 20    |
| Long-term borrowings               | 55                                           | (35)    | ) 20    | 146                                        | (70)      | ) 76    |
| Total interest-bearing liabilities | 60                                           | 21      | 81      | 125                                        | —         | 125     |
| Change in net interest income      | \$761                                        | \$(712) | ) \$49  | \$1,419                                    | \$(1,404) | ) \$15  |

## Provision for Loan Losses

The provision for loan losses is based upon management's quarterly review of the loan portfolio. The purpose of the review is to assess loan quality, identify impaired loans, analyze delinquencies, ascertain loan growth, evaluate potential charge-offs and recoveries, and assess general economic conditions in the markets served. An external independent loan review is also performed annually for the Banks. Management remains committed to an aggressive program of problem loan identification and resolution.

The allowance for loan losses is determined by applying loss factors to outstanding loans by type, excluding loans for which a specific allowance has been determined. Loss factors are based on management's consideration of the nature of the portfolio segments, changes in mix and volume of the loan portfolio, and historical loan loss experience. In addition, management considers industry standards and trends with respect to non-performing loans and its knowledge and experience with specific lending segments.

Although management believes it uses the best information available to make such determinations and that the allowance for loan losses is adequate at June 30, 2015, future adjustments could be necessary if circumstances or economic conditions differ substantially from the assumptions used in making the initial determinations. A downturn in the local economy, increased unemployment, and delays in receiving financial information from borrowers could result in increased levels of nonperforming assets, charge-offs, loan loss provisions, and reductions in income. Additionally, as an integral part of the examination process, bank regulatory agencies periodically review the Banks' loan loss allowance. The banking agencies could require the recognition of additions to the loan loss allowance based on their judgment of information available to them at the time of their examination.

When determining the appropriate allowance level, management has attributed the allowance for loan losses to various portfolio segments; however, the allowance is available for the entire portfolio as needed.



The allowance for loan losses increased from \$10,579,000 at December 31, 2014 to \$11,265,000 at June 30, 2015. The increase in the allowance for loan losses was driven by the loan growth and net charge-offs during the six months ended June 30, 2015 of \$614,000. The majority of the loans charged-off had a specific allowance within the allowance for losses. At June 30, 2015 and December 31, 2014, the allowance for loan losses to total loans was 1.15% and 1.16%, respectively.

The provision for loan losses totaled \$600,000 and \$300,000 for the three months ended June 30, 2015 and 2014. The amount of the provision for loan losses was the result of several factors, including but not limited to, a ratio of nonperforming loans to total loans of 0.99% and 1.40% at June 30, 2015 and 2014, respectively, and a ratio of the allowance for loan losses to nonperforming loans of 116.27% and 73.55% at June 30, 2015 and 2014, respectively.

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Nonperforming loans decreased to \$9,689,000 at June 30, 2015 from \$11,979,000 at June 30, 2014 is primarily the result of a large commercial real estate loan that was removed from non-accrual status due to improved company performance and a solid payment history. Internal loan review and analysis coupled with the ratios and loan growth noted previously dictated a provision for loan losses of \$1,300,000 for the six months ended June 30, 2015.

The following is a table showing total nonperforming loans as of:

| (In Thousands)     | Total Nonperforming Loans |             |         |
|--------------------|---------------------------|-------------|---------|
|                    | 90 Days Past Due          | Non-accrual | Total   |
| June 30, 2015      | \$890                     | \$8,799     | \$9,689 |
| March 31, 2015     | 391                       | 10,766      | 11,157  |
| December 31, 2014  | 387                       | 11,861      | 12,248  |
| September 30, 2014 | 202                       | 12,092      | 12,294  |
| June 30, 2014      | 397                       | 11,582      | 11,979  |

## Non-interest Income

Total non-interest income for the three months ended June 30, 2015 compared to the same period in 2014 increased \$128,000 to \$3,057,000. Excluding net securities gains, non-interest income for the three months ended June 30, 2015 increased \$93,000 compared to the same period in 2014. The decrease in service charges was driven by a decline in overdraft income. Insurance commissions decreased due primarily to a shift in product mix. The increase in other non-interest income is the result of increased card usage related to both debit and credit cards.

Total non-interest income for the six months ended June 30, 2015 compared to the same period in 2014 increased \$177,000. Excluding net securities gains, non-interest income decreased \$126,000 compared to the 2014 period. The decrease in bank-owned life insurance is primarily due to a gain on death benefit recorded during the first quarter of 2014. The reasons noted for the three month period comparison also apply to the six month period.

Non-interest income composition for the three and six months ended June 30, 2015 and 2014 was as follows:

| (In Thousands)                       | Three Months Ended |         | June 30, 2014 |        | Change  |           |    |  |
|--------------------------------------|--------------------|---------|---------------|--------|---------|-----------|----|--|
|                                      | June 30, 2015      |         | June 30, 2014 |        | Amount  | %         |    |  |
| Service charges                      | \$598              | 19.56   | % \$607       | 20.72  | % \$(9  | ) (1.48   | )% |  |
| Securities gains, available for sale | 526                | 17.21   | 487           | 16.63  | 39      | 8.01      |    |  |
| Securities losses, trading           | (4                 | ) (0.13 | ) —           | —      | (4      | ) (100.00 | )  |  |
| Bank-owned life insurance            | 171                | 5.59    | 181           | 6.18   | (10     | ) (5.52   | )  |  |
| Gain on sale of loans                | 482                | 15.77   | 421           | 14.37  | 61      | 14.49     |    |  |
| Insurance commissions                | 204                | 6.67    | 283           | 9.66   | (79     | ) (27.92  | )  |  |
| Brokerage commissions                | 294                | 9.62    | 251           | 8.57   | 43      | 17.13     |    |  |
| Other                                | 786                | 25.71   | 699           | 23.87  | 87      | 12.45     |    |  |
| Total non-interest income            | \$3,057            | 100.00  | % \$2,929     | 100.00 | % \$128 | 4.37      | %  |  |



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| (In Thousands)                       | Six Months Ended |         | June 30, 2014 |         | Change  |          |           |    |
|--------------------------------------|------------------|---------|---------------|---------|---------|----------|-----------|----|
|                                      | June 30, 2015    |         | June 30, 2014 |         | Amount  | %        |           |    |
|                                      | Amount           | % Total | Amount        | % Total | Amount  | %        |           |    |
| Service charges                      | \$1,151          | 18.22   | % \$1,202     | 19.58   | % \$(51 | )        | (4.24     | )% |
| Securities gains, available for sale | 1,187            | 18.79   | 880           | 14.33   | 307     |          | 34.89     |    |
| Securities losses, trading           | (4               | ) (0.06 | )             | —       | —       | (4       | ) (100.00 | )  |
| Bank-owned life insurance            | 359              | 5.68    | 551           | 8.97    | (192    | ) (34.85 | )         |    |
| Gain on sale of loans                | 781              | 12.36   | 711           | 11.58   | 70      |          | 9.85      |    |
| Insurance commissions                | 438              | 6.93    | 703           | 11.45   | (265    | ) (37.70 | )         |    |
| Brokerage commissions                | 539              | 8.53    | 522           | 8.50    | 17      |          | 3.26      |    |
| Other                                | 1,866            | 29.55   | 1,571         | 25.59   | 295     |          | 18.78     |    |
| Total non-interest income            | \$6,317          | 100.00  | % \$6,140     | 100.00  | % \$177 |          | 2.88      | %  |

## Non-interest Expense

Total non-interest expense decreased \$1,000 for the three months ended June 30, 2015 compared to the same period of 2014. The increase in salaries and employee benefits is primarily attributable to increases in health insurance.

Furniture and equipment expenses decreased due to a significant amount of maintenance that was performed during 2014. Other expenses decreased primarily due to decreased expenses related to the integration of Luzerne Bank.

Total non-interest expense for the six months ended June 30, 2015 compared to the same period in 2014 decreased \$176,000. The reasons noted for the three month period comparison also apply to the six month period.

Non-interest expense composition for the three and six months ended June 30, 2015 and 2014 was as follows:

| (In Thousands)                                          | Three Months Ended |         | June 30, 2014 |         | Change  |         |       |   |
|---------------------------------------------------------|--------------------|---------|---------------|---------|---------|---------|-------|---|
|                                                         | June 30, 2015      |         | June 30, 2014 |         | Amount  | %       |       |   |
|                                                         | Amount             | % Total | Amount        | % Total | Amount  | %       |       |   |
| Salaries and employee benefits                          | \$4,301            | 51.07   | % \$4,167     | 49.48   | % \$134 |         | 3.22  | % |
| Occupancy                                               | 564                | 6.70    | 552           | 6.55    | 12      |         | 2.17  |   |
| Furniture and equipment                                 | 643                | 7.64    | 648           | 7.69    | (5      | ) (0.77 | )     |   |
| Pennsylvania shares tax                                 | 243                | 2.89    | 262           | 3.11    | (19     | ) (7.25 | )     |   |
| Amortization of investment in limited partnerships      | 166                | 1.97    | 166           | 1.97    | —       |         | —     |   |
| Federal Deposit Insurance Corporation deposit insurance | 230                | 2.73    | 201           | 2.39    | 29      |         | 14.43 |   |
| Marketing                                               | 145                | 1.72    | 126           | 1.50    | 19      |         | 15.08 |   |
| Intangible amortization                                 | 80                 | 0.95    | 88            | 1.04    | (8      | ) (9.09 | )     |   |
| Other                                                   | 2,049              | 24.33   | 2,212         | 26.27   | (163    | ) (7.37 | )     |   |
| Total non-interest expense                              | \$8,421            | 100.00  | % \$8,422     | 100.00  | % \$(1  | ) (0.01 | )%    |   |

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| (In Thousands)                                          | Six Months Ended |          | June 30, 2014 |          | Change  |        |   |    |
|---------------------------------------------------------|------------------|----------|---------------|----------|---------|--------|---|----|
|                                                         | June 30, 2015    |          | Amount        | % Total  | Amount  | %      |   |    |
| Salaries and employee benefits                          | \$8,771          | 51.93 %  | \$8,670       | 50.81 %  | \$101   | 1.16 % |   |    |
| Occupancy                                               | 1,192            | 7.06     | 1,182         | 6.93     | 10      | 0.85   |   |    |
| Furniture and equipment                                 | 1,238            | 7.33     | 1,319         | 7.73     | (81)    | (6.14) | ) | )  |
| Pennsylvania shares tax                                 | 467              | 2.77     | 506           | 2.97     | (39)    | (7.71) | ) | )  |
| Amortization of investment in limited partnerships      | 331              | 1.96     | 331           | 1.94     | —       | —      |   |    |
| Federal Deposit Insurance Corporation deposit insurance | 445              | 2.63     | 379           | 2.22     | 66      | 17.41  |   |    |
| Marketing                                               | 274              | 1.62     | 236           | 1.38     | 38      | 16.10  |   |    |
| Intangible amortization                                 | 162              | 0.96     | 180           | 1.05     | (18)    | (10)   | ) | )  |
| Other                                                   | 4,009            | 23.74    | 4,262         | 24.97    | (253)   | (5.94) | ) | )  |
| Total non-interest expense                              | \$16,889         | 100.00 % | \$17,065      | 100.00 % | \$(176) | (1.03) | ) | )% |

## Provision for Income Taxes

Income taxes decreased \$50,000 for the three months ended June 30, 2015 and increased \$97,000 for the six months ended June 30, 2015 compared to the same periods of 2014. The primary cause of the decrease in tax expense for the three months ended June 30, 2015 compared to 2014 is the impact of the decreased pre-tax income. The primary cause of the increase in tax expense for the six months ended June 30, 2015 compared to 2014 is the impact of an increased level of security gains and a decrease in the amount of tax-free interest generated from the investment portfolio. Excluding the impact of the net securities gains, the effective tax rate for the three and six months ended June 30, 2015 was 17.34% and 17.46% compared to 18.41% and 16.74% for the same period of 2014. The Company currently is in a deferred tax asset position due to the low income housing tax credits earned both currently and previously. Management has reviewed the deferred tax asset and has determined that the asset will be utilized within the appropriate carry forward period and therefore does not require a valuation allowance.

## ASSET/LIABILITY MANAGEMENT

## Cash and Cash Equivalents

Cash and cash equivalents increased \$1,961,000 from \$19,908,000 at December 31, 2014 to \$21,869,000 at June 30, 2015 primarily as a result of the following activities during the six months ended June 30, 2015:

## Loans Held for Sale

Activity regarding loans held for sale resulted in sales proceeds trailing loan originations, less \$781,000 in realized gains, by \$1,557,000 for the six months ended June 30, 2015.

## Loans

Gross loans increased \$62,299,000 since December 31, 2014 due to an increase in commercial, financial, and agricultural loans coupled with an increase in home equity products and auto loans.

The allocation of the loan portfolio, by category, as of June 30, 2015 and December 31, 2014 is presented below:



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| (In Thousands)                          | June 30, 2015 |         | December 31, 2014 |         | Change      |       |   |  |
|-----------------------------------------|---------------|---------|-------------------|---------|-------------|-------|---|--|
|                                         | Amount        | % Total | Amount            | % Total | Amount      | %     |   |  |
| Commercial, financial, and agricultural | \$ 140,049    | 14.32   | % \$ 124,156      | 13.56   | % \$ 15,893 | 12.80 | % |  |
| Real estate mortgage:                   |               |         |                   |         |             |       |   |  |
| Residential                             | 494,120       | 50.52   | 457,760           | 50.00   | 36,360      | 7.94  | % |  |
| Commercial                              | 293,512       | 30.02   | 291,348           | 31.82   | 2,164       | 0.74  | % |  |
| Construction                            | 25,216        | 2.58    | 21,996            | 2.40    | 3,220       | 14.64 | % |  |
| Installment loans to individuals        | 26,173        | 2.68    | 21,509            | 2.35    | 4,664       | 21.68 | % |  |
| Net deferred loan fees and discounts    | (1,192 )      | (0.12 ) | (1,190 )          | (0.13 ) | (2 )        | 0.17  | % |  |
| Gross loans                             | \$977,878     | 100.00  | % \$915,579       | 100.00  | % \$ 62,299 | 6.80  | % |  |

The following table shows the amount of accrual and non-accrual TDRs at June 30, 2015 and December 31, 2014:

| (In Thousands)                          | June 30, 2015 |             |         | December 31, 2014 |             |          |
|-----------------------------------------|---------------|-------------|---------|-------------------|-------------|----------|
|                                         | Accrual       | Non-accrual | Total   | Accrual           | Non-accrual | Total    |
| Commercial, financial, and agricultural | \$388         | \$446       | \$834   | \$551             | \$440       | \$991    |
| Real estate mortgage:                   |               |             |         |                   |             |          |
| Residential                             | 846           | 267         | 1,113   | 697               | 181         | 878      |
| Commercial                              | 4,210         | 3,102       | 7,312   | 3,267             | 6,160       | 9,427    |
| Construction                            | 9             | 398         | 407     | 514               | —           | 514      |
|                                         | \$5,453       | \$4,213     | \$9,666 | \$5,029           | \$6,781     | \$11,810 |

## Investments

The fair value of the investment securities portfolio at June 30, 2015 decreased \$17,744,000 since December 31, 2014 while the amortized cost of the portfolio decreased \$15,543,000. The decrease in value is the result of the investment portfolio being actively managed in order to reduce interest rate and market risk. This is being undertaken primarily through the sale of long-term municipal bonds that have a maturity date of 2025 or later and securities with a call date within the next five years. The proceeds of the bond sales are being deployed into loans and intermediate term corporate bonds and short and intermediate term municipal bonds. The strategy to sell a portion of the long-term bond portfolio does negatively impact current earnings, but this action plays a key role in our long-term asset liability management strategy as the balance sheet is shortened to better prepare for a rising rate environment. The unrealized losses within the debt securities portfolio are the result of market activity, not credit issues/ratings, as approximately 90% of the debt securities portfolio on an amortized cost basis is currently rated A or higher by either S&P or Moody's.

The Company considers various factors, which include examples from applicable accounting guidance, when analyzing the available for sale portfolio for possible other than temporary impairment. The Company primarily considers the following factors in its analysis: length of time and severity of the market value being less than carrying value; reduction of dividend paid (equities); continued payment of dividend/interest, credit rating, and financial condition of an issuer; intent and ability to hold until anticipated recovery (which may be maturity); and general outlook for the economy, specific industry, and entity in question.

The bond portion of the portfolio review is conducted with emphases on several factors. Continued payment of principal and interest is given primary importance with credit rating and financial condition of the issuer following as the next most important. Credit ratings were reviewed with the ratings of the bonds being satisfactory. Bonds that

were not currently rated were discussed with a third party and/or underwent an internal financial review. The Company also monitors whether each of the investments incurred a decline in market value from carrying value of at least 20% for twelve consecutive months or a similar decline of at least 50% for three consecutive months. Each bond is reviewed to determine whether it is a general obligation bond, which is backed by the credit and taxing power of the issuing jurisdiction, or revenue bond, which is only payable from specified revenues. Based on the review undertaken by the Company, the Company determined that the decline in value of the various bond holdings were temporary and were the result of the general market downturns and interest rate/yield curve changes, not credit issues. The fact that almost all of such bonds are general obligation bonds further solidified the Company's determination that the decline in the value of these bond holdings is temporary.



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The fair value of the equity portfolio continues to fluctuate as the economic turbulence continues to impact stock pricing. The amortized cost of the available for sale equity securities portfolio has increased \$108,000 to \$14,489,000 at June 30, 2015 from \$14,381,000 at December 31, 2014 while the fair value increased \$6,000 over the same time period.

The equity portion of the portfolio is reviewed for possible other than temporary impairment in a similar manner to the bond portfolio with greater emphasis placed on the length of time the fair market value has been less than the carrying value and financial sector outlook. The Company also reviews dividend payment activities. The starting point for the equity analysis is the length and severity of a market price decline. The Company monitors two primary measures: 20% decline in fair market value from carrying value for twelve consecutive months and 50% decline for three consecutive months.

The distribution of credit ratings by amortized cost and fair values for the debt security portfolio at June 30, 2015 follows:

| (In Thousands)                        | A- to AAA      |            | B- to BBB+     |            | Not Rated      |            | Total          |            |
|---------------------------------------|----------------|------------|----------------|------------|----------------|------------|----------------|------------|
|                                       | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value | Amortized Cost | Fair Value |
| Available for sale (AFS)              |                |            |                |            |                |            |                |            |
| U.S. Government and agency securities | \$—            | \$—        | \$—            | \$—        | \$3,706        | \$3,655    | \$3,706        | \$3,655    |
| Mortgage-backed securities            | 10,843         | 11,199     | —              | —          | —              | —          | 10,843         | 11,199     |
| Asset-backed securities               | 2,209          | 2,232      | —              | —          | —              | —          | 2,209          | 2,232      |
| State and political securities        | 97,746         | 99,077     | —              | —          | 2,710          | 2,694      | 100,456        | 101,771    |
| Other debt securities                 | 68,555         | 68,383     | 11,972         | 11,642     | —              | —          | 80,527         | 80,025     |
| Total debt securities AFS             | \$179,353      | \$180,891  | \$11,972       | \$11,642   | \$6,416        | \$6,349    | \$197,741      | \$198,882  |

## Financing Activities

## Deposits

Total deposits increased \$26,049,000 from December 31, 2014 to June 30, 2015. The growth was led by an increase in NOW deposit accounts from December 31, 2014 to June 30, 2015 of 5.69%. The increase in core deposits (deposits less time deposits) has provided relationship driven funding for the loan and investment portfolios. The increase in deposits is the result of our focus on building relationships, not by offering market leading rates.

Deposit balances and their changes for the periods being discussed follow:

| (In Thousands)        | June 30, 2015 |         | December 31, 2014 |         | Change   |      |   |  |
|-----------------------|---------------|---------|-------------------|---------|----------|------|---|--|
|                       | Amount        | % Total | Amount            | % Total | Amount   | %    |   |  |
| Demand deposits       | \$244,502     | 24.27   | \$243,378         | 24.80   | \$1,124  | 0.46 | % |  |
| NOW accounts          | 188,092       | 18.67   | 177,970           | 18.13   | 10,122   | 5.69 |   |  |
| Money market deposits | 211,412       | 20.98   | 204,535           | 20.84   | 6,877    | 3.36 |   |  |
| Savings deposits      | 143,415       | 14.24   | 139,278           | 14.19   | 4,137    | 2.97 |   |  |
| Time deposits         | 220,047       | 21.84   | 216,258           | 22.04   | 3,789    | 1.75 |   |  |
|                       | \$1,007,468   | 100.00  | \$981,419         | 100.00  | \$26,049 | 2.65 | % |  |

## Borrowed Funds

Total borrowed funds increased 20.05% or \$22,458,000 to \$134,452,000 at June 30, 2015 compared to \$111,994,000 at December 31, 2014. Short-term borrowings primarily increased due to an increase in the funding necessary for the growth in the loan portfolio.

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| (In Thousands)                                | June 30, 2015 |          | December 31, 2014 |          | Change   |         |  |  |
|-----------------------------------------------|---------------|----------|-------------------|----------|----------|---------|--|--|
|                                               | Amount        | % Total  | Amount            | % Total  | Amount   | %       |  |  |
| Short-term borrowings:                        |               |          |                   |          |          |         |  |  |
| FHLB repurchase agreements                    | \$42,760      | 31.80 %  | \$26,831          | 23.96 %  | \$15,929 | 59.37 % |  |  |
| Securities sold under agreement to repurchase | 16,266        | 12.10    | 13,987            | 12.49    | 2,279    | 16.29   |  |  |
| Total short-term borrowings                   | 59,026        | 43.90    | 40,818            | 36.45    | 18,208   | 44.61   |  |  |
| Long-term borrowings:                         |               |          |                   |          |          |         |  |  |
| Long-term FHLB borrowings                     | 75,000        | 55.78    | 70,750            | 63.17    | 4,250    | 6.01    |  |  |
| Long-term capital lease                       | 426           | 0.32     | 426               | 0.38     | —        | —       |  |  |
| Total long-term borrowings                    | 75,426        | 56.10    | 71,176            | 63.55    | 4,250    | 5.97 %  |  |  |
| Total borrowed funds                          | \$134,452     | 100.00 % | \$111,994         | 100.00 % | \$22,458 | 20.05 % |  |  |

## Capital

The adequacy of the Company's capital is reviewed on an ongoing basis with reference to the size, composition, and quality of the Company's resources and regulatory guidelines. Management seeks to maintain a level of capital sufficient to support existing assets and anticipated asset growth, maintain favorable access to capital markets, and preserve high quality credit ratings.

Bank holding companies are required to comply with the Federal Reserve Board's risk-based capital guidelines. The risk-based capital rules are designed to make regulatory capital requirements more sensitive to differences in risk profiles among banks and bank holding companies and to minimize disincentives for holding liquid assets. Specifically, each is required to maintain certain minimum dollar amounts and ratios of common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital. In addition to the capital requirements, the Federal Deposit Insurance Corporation Improvements Act (FDICIA) established five capital categories ranging from "well capitalized" to "critically undercapitalized." To be classified as "well capitalized", common equity tier I risk-based, tier I risk-based, total risk-based, and tier I leverage capital ratios must be at least 6.5%, 8%, 10%, and 5%, respectively.

The Company's capital ratios as of June 30, 2015 and December 31, 2014 were as follows:

| (In Thousands)                                         | June 30, 2015 |       | December 31, 2014 |       |  |   |
|--------------------------------------------------------|---------------|-------|-------------------|-------|--|---|
|                                                        | Amount        | Ratio | Amount            | Ratio |  |   |
| Common Equity Tier I Capital (to Risk-weighted Assets) |               |       |                   |       |  |   |
| Actual                                                 | \$119,334     | 11.21 | % \$—             | —     |  | % |
| For Capital Adequacy Purposes                          | 47,885        | 4.50  | —                 | —     |  |   |
| To Be Well Capitalized                                 | 69,168        | 6.50  | —                 | —     |  |   |
| Tier I Capital (to Risk-weighted Assets)               |               |       |                   |       |  |   |
| Actual                                                 | \$119,334     | 11.21 | % \$112,290       | 11.51 |  | % |
| For Capital Adequacy Purposes                          | 63,847        | 6.00  | 39,010            | 4.00  |  |   |
| To Be Well Capitalized                                 | 85,129        | 8.00  | 58,514            | 6.00  |  |   |
| Total Capital (to Risk-weighted Assets)                |               |       |                   |       |  |   |
| Actual                                                 | \$131,055     | 12.32 | % \$123,371       | 12.65 |  | % |
| For Capital Adequacy Purposes                          | 85,129        | 8.00  | 78,019            | 8.00  |  |   |
| To Be Well Capitalized                                 | 106,412       | 10.00 | 97,524            | 10.00 |  |   |
| Tier I Capital (to Average Assets)                     |               |       |                   |       |  |   |
| Actual                                                 | \$119,334     | 9.47  | % \$112,290       | 9.27  |  | % |

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|                               |        |      |        |      |
|-------------------------------|--------|------|--------|------|
| For Capital Adequacy Purposes | 50,415 | 4.00 | 48,476 | 4.00 |
| To Be Well Capitalized        | 63,019 | 5.00 | 60,595 | 5.00 |

Jersey Shore State Bank's capital ratios as of June 30, 2015 and December 31, 2014 were as follows:

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| (In Thousands)                                         | June 30, 2015 |       | December 31, 2014 |       |   |
|--------------------------------------------------------|---------------|-------|-------------------|-------|---|
|                                                        | Amount        | Ratio | Amount            | Ratio |   |
| Common Equity Tier I Capital (to Risk-weighted Assets) |               |       |                   |       |   |
| Actual                                                 | \$79,595      | 10.71 | % \$—             | —     | % |
| For Capital Adequacy Purposes                          | 33,438        | 4.50  | —                 | —     |   |
| To Be Well Capitalized                                 | 48,300        | 6.50  | —                 | —     |   |
| Tier I Capital (to Risk-weighted Assets)               |               |       |                   |       |   |
| Actual                                                 | \$79,595      | 10.71 | % \$74,730        | 11.05 | % |
| For Capital Adequacy Purposes                          | 44,585        | 6.00  | 27,043            | 4.00  |   |
| To Be Well Capitalized                                 | 59,446        | 8.00  | 40,565            | 6.00  |   |
| Total Capital (to Risk-weighted Assets)                |               |       |                   |       |   |
| Actual                                                 | \$88,522      | 11.91 | % \$83,183        | 12.30 | % |
| For Capital Adequacy Purposes                          | 59,446        | 8.00  | 54,086            | 8.00  |   |
| To Be Well Capitalized                                 | 74,308        | 10.00 | 67,608            | 10.00 |   |
| Tier I Capital (to Average Assets)                     |               |       |                   |       |   |
| Actual                                                 | \$79,595      | 8.62  | % \$74,730        | 8.50  | % |
| For Capital Adequacy Purposes                          | 36,944        | 4.00  | 35,175            | 4.00  |   |
| To Be Well Capitalized                                 | 46,181        | 5.00  | 43,968            | 5.00  |   |

Luzerne Bank's capital ratios as of June 30, 2015 and December 31, 2014 were as follows:

| (In Thousands)                                         | June 30, 2015 |       | December 31, 2014 |       |   |
|--------------------------------------------------------|---------------|-------|-------------------|-------|---|
|                                                        | Amount        | Ratio | Amount            | Ratio |   |
| Common Equity Tier I Capital (to Risk-weighted Assets) |               |       |                   |       |   |
| Actual                                                 | \$30,362      | 9.59  | % \$—             | —     | % |
| For Capital Adequacy Purposes                          | 14,242        | 4.50  | —                 | —     |   |
| To Be Well Capitalized                                 | 20,571        | 6.50  | —                 | —     |   |
| Tier I Capital (to Risk-weighted Assets)               |               |       |                   |       |   |
| Actual                                                 | \$30,362      | 9.59  | % \$112,290       | 11.51 | % |
| For Capital Adequacy Purposes                          | 18,989        | 6.00  | 39,010            | 4.00  |   |
| To Be Well Capitalized                                 | 25,318        | 8.00  | 58,514            | 6.00  |   |
| Total Capital (to Risk-weighted Assets)                |               |       |                   |       |   |
| Actual                                                 | \$32,735      | 10.34 | % \$123,371       | 12.65 | % |
| For Capital Adequacy Purposes                          | 25,318        | 8.00  | 78,019            | 8.00  |   |
| To Be Well Capitalized                                 | 31,648        | 10.00 | 97,524            | 10.00 |   |
| Tier I Capital (to Average Assets)                     |               |       |                   |       |   |
| Actual                                                 | \$30,362      | 9.17  | % \$112,290       | 9.27  | % |
| For Capital Adequacy Purposes                          | 13,246        | 4.00  | 48,476            | 4.00  |   |
| To Be Well Capitalized                                 | 16,558        | 5.00  | 60,595            | 5.00  |   |

In July 2013, the federal bank regulatory agencies adopted revisions to the agencies' capital adequacy guidelines and prompt corrective action rules, which were designed to enhance such requirements and implement the revised standards of the Basel Committee on Banking Supervision, commonly referred to as Basel III. The July 2013 final rules generally implement higher minimum capital requirements, add a new common equity tier 1 capital requirement, and establish criteria that instruments must meet to be considered common equity tier 1 capital, additional tier 1 capital or tier 2 capital. The new minimum capital to risk-adjusted assets requirements are a common equity tier 1 capital ratio of 4.5% (6.5% to be considered "well capitalized") and a tier 1 capital ratio of 6.0%, increased from 4.0% (and increased from 6.0% to 8.0% to be considered "well capitalized"); the total capital ratio remains at 8.0% under the

new rules (10.0% to be considered “well capitalized”). Under the new rules, in order to avoid limitations on capital distributions (including dividend payments and certain discretionary bonus payments to executive officers), a banking organization must hold a capital conservation buffer comprised of common equity tier 1 capital above its minimum risk-based capital requirements in an amount greater than 2.5% of total risk-weighted assets. The new minimum capital requirements were effective beginning on January 1, 2015. The capital contribution buffer requirements phase in over a three-

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year period beginning January 1, 2016. The Company and the Banks will continue to analyze these new rules and their effects on the business, operations and capital levels of the Company and the Banks.

Liquidity; Interest Rate Sensitivity and Market Risk

The asset/liability committee addresses the liquidity needs of the Company to ensure that sufficient funds are available to meet credit demands and deposit withdrawals as well as to the placement of available funds in the investment portfolio. In assessing liquidity requirements, equal consideration is given to the current position as well as the future outlook.

The following liquidity measures are monitored for compliance and were within the limits cited at June 30, 2015:

1. Net Loans to Total Assets, 85% maximum
2. Net Loans to Total Deposits, 100% maximum
3. Cumulative 90 day Maturity GAP %, +/- 20% maximum
4. Cumulative 1 Year Maturity GAP %, +/- 25% maximum

Fundamental objectives of the Company's asset/liability management process are to maintain adequate liquidity while minimizing interest rate risk. The maintenance of adequate liquidity provides the Company with the ability to meet its financial obligations to depositors, loan customers, and shareholders. Additionally, it provides funds for normal operating expenditures and business opportunities as they arise. The objective of interest rate sensitivity management is to increase net interest income by managing interest sensitive assets and liabilities in such a way that they can be repriced in response to changes in market interest rates.

The Banks, like other financial institutions, must have sufficient funds available to meet its liquidity needs for deposit withdrawals, loan commitments and originations, and expenses. In order to control cash flow, the Banks estimate future cash flows from deposits, loan payments, and investment security payments. The primary sources of funds are deposits, principal and interest payments on loans and investment securities, FHLB borrowings, and brokered deposits. Management believes the Banks have adequate resources to meet its normal funding requirements.

Management monitors the Company's liquidity on both a long and short-term basis, thereby providing management necessary information to react to current balance sheet trends. Cash flow needs are assessed and sources of funds are determined. Funding strategies consider both customer needs and economical cost. Both short and long-term funding needs are addressed by maturities and sales of available for sale and trading investment securities, loan repayments and maturities, and liquidating money market investments such as federal funds sold. The use of these resources, in conjunction with access to credit provides core funding to satisfy depositor, borrower, and creditor needs.

Management monitors and determines the desirable level of liquidity. Consideration is given to loan demand, investment opportunities, deposit pricing and growth potential, as well as the current cost of borrowing funds. The Company has a total current maximum borrowing capacity at the FHLB of \$486,018,000. In addition to this credit arrangement, the Company has additional lines of credit with correspondent banks of \$35,510,000. Management believes it has sufficient liquidity to satisfy estimated short-term and long-term funding needs. FHLB borrowings totaled \$117,760,000 as of June 30, 2015.

Interest rate sensitivity, which is closely related to liquidity management, is a function of the repricing characteristics of the Company's portfolio of assets and liabilities. Asset/liability management strives to match maturities and rates between loan and investment security assets with the deposit liabilities and borrowings that fund them. Successful asset/liability management results in a balance sheet structure which can cope effectively with market rate

fluctuations. The matching process by segments both assets and liabilities into future time periods (usually 12 months, or less) based upon when repricing can be effected. Repriceable assets are subtracted from repriceable liabilities, for a specific time period to determine the “gap”, or difference. Once known, the gap is managed based on predictions about future market interest rates. Intentional mismatching, or gapping, can enhance net interest income if market rates move as predicted. However, if market rates behave in a manner contrary to predictions, net interest income will suffer. Gaps, therefore, contain an element of risk and must be prudently managed. In addition to gap management, the Company has an asset/liability management policy which incorporates a market value at risk calculation which is used to determine the effects of interest rate movements on shareholders’ equity and a simulation analysis to monitor the effects of interest rate changes on the Company’s balance sheet.

The Company currently maintains a GAP position of being asset sensitive. The Company has strategically taken this position as it has decreased the duration of the earning asset portfolio by adding quality short and intermediate term loans such as home equity loans and the selling of long-term municipal bonds. Lengthening of the liability portfolio is being undertaken to build protection in a rising rate environment.



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A market value at risk calculation is utilized to monitor the effects of interest rate changes on the Company's balance sheet and more specifically shareholders' equity. The Company does not manage the balance sheet structure in order to maintain compliance with this calculation. The calculation serves as a guideline with greater emphases placed on interest rate sensitivity. Changes to calculation results from period to period are reviewed as changes in results could be a signal of future events. As of the most recent analysis, the results of the market value at risk calculation were within established guidelines due to the strategic direction being taken.

## Interest Rate Sensitivity

In this analysis the Company examines the result of a 100, 200, 300, and 400 basis point change in market interest rates and the effect on net interest income. It is assumed that the change is instantaneous and that all rates move in a parallel manner. Assumptions are also made concerning prepayment speeds on mortgage loans and mortgage securities.

The following is a rate shock forecast for the twelve month period ending June 30, 2016 assuming a static balance sheet as of June 30, 2015.

| (In Thousands)             | Parallel Rate Shock in Basis Points |          |          |          |          |          |          |   |
|----------------------------|-------------------------------------|----------|----------|----------|----------|----------|----------|---|
|                            | -200                                | -100     | Static   | +100     | +200     | +300     | +400     |   |
| Net interest income        | \$36,366                            | \$38,456 | \$40,534 | \$42,015 | \$43,450 | \$44,610 | \$45,487 |   |
| Change from static         | (4,168 )                            | (2,078 ) | —        | 1,481    | 2,916    | 4,076    | 4,953    |   |
| Percent change from static | -10.28                              | % -5.13  | % —      | 3.65     | % 7.19   | % 10.06  | % 12.22  | % |

The model utilized to create the report presented above makes various estimates at each level of interest rate change regarding cash flow from principal repayment on loans and mortgage-backed securities and/or call activity on investment securities. Actual results could differ significantly from these estimates which would result in significant differences in the calculated projected change. In addition, the limits stated above do not necessarily represent the level of change under which management would undertake specific measures to realign its portfolio in order to reduce the projected level of change. Generally, management believes the Company is well positioned to respond expeditiously when the market interest rate outlook changes.

## Inflation

The asset and liability structure of a financial institution is primarily monetary in nature. Therefore, interest rates rather than inflation have a more significant impact on the Company's performance. Interest rates are not always affected in the same direction or magnitude as prices of other goods and services, but are reflective of fiscal policy initiatives or economic factors which are not measured by a price index.

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

Market risk for the Company is comprised primarily of interest rate risk exposure and liquidity risk. Interest rate risk and liquidity risk management is performed at both the level of the Company and the Banks. The Company's interest rate sensitivity is monitored by management through selected interest rate risk measures produced by an independent third party. There have been no substantial changes in the Company's gap analysis or simulation analysis compared to the information provided in the Annual Report on Form 10-K for the period ended December 31, 2014. Additional information and details are provided in the "Liquidity, Interest Rate Sensitivity, and Market Risk" section of "Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations."

Generally, management believes the Company is well positioned to respond in a timely manner when the market interest rate outlook changes.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

An analysis was performed under the supervision and with the participation of the Company's management, including the Chief Executive Officer and the Chief Financial Officer, of the effectiveness of the design and operation of the Company's disclosure controls and procedures. Based on that evaluation, the Company's Chief Executive Officer and Chief Financial Officer concluded that the Company's disclosure controls and procedures were effective as of June 30, 2015.

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Changes in Internal Control over Financial Reporting

There were no changes in the Company's internal control over financial reporting that occurred during the quarter ended June 30, 2015, that materially affected, or are reasonably likely to materially affect, the Company's internal control over financial reporting.

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## Part II. OTHER INFORMATION

## Item 1. Legal Proceedings

None.

## Item 1A. Risk Factors

There are no material changes to the risk factors set forth in Part I, Item 1A, "Risk Factors," of the Company's Annual Report on Form 10-K for the year ended December 31, 2014. Please refer to that section for disclosures regarding the risks and uncertainties related to the Company's business.

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

| Period                              | Total Number of Shares (or Units) Purchased | Average Price Paid per Share (or Units) Purchased | Total Number of Shares (or Units) Purchased as Part of Publicly Announced Plans or Programs | Maximum Number (or Approximate Dollar Value) of Shares (or Units) that May Yet Be Purchased Under the Plans or Programs |
|-------------------------------------|---------------------------------------------|---------------------------------------------------|---------------------------------------------------------------------------------------------|-------------------------------------------------------------------------------------------------------------------------|
| Month #1 (April 1 - April 30, 2015) | 9,836                                       | \$45.04                                           | 9,836                                                                                       | 445,316                                                                                                                 |
| Month #2 (May 1 - May 31, 2015)     | 12,713                                      | 43.17                                             | 12,713                                                                                      | 432,603                                                                                                                 |
| Month #3 (June 1 - June 30, 2015)   | 8,485                                       | 43.08                                             | 8,485                                                                                       | 424,118                                                                                                                 |

On April 16, 2015, the Board of Directors extended the previously approved authorization to repurchase up to 482,000 shares, or approximately 10%, of the outstanding shares of the Company for an additional year to April 30, 2016. As of June 30, 2015 there have been 57,882 shares repurchased under this plan.

## Item 3. Defaults Upon Senior Securities

None.

## Item 4. Mine Safety Disclosures

Not applicable.

## Item 5. Other Information

None.

## Item 6. Exhibits

- 3(i) Articles of Incorporation of the Registrant, as presently in effect (incorporated by reference to Exhibit 3(i) of the Registrant's Quarterly Report on Form 10-Q for the period ended March 31, 2012).
- 3(ii) Bylaws of the Registrant (incorporated by reference to Exhibit 3(ii) of the Registrant's Annual Report on Form 10-K for the year ended December 31, 2011).
- 31(i) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer.
- 31(ii) Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer.
- 32(i) Section 1350 Certification of Chief Executive Officer.

- 32(ii) Section 1350 Certification of Chief Financial Officer.  
Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2015 and December 31, 2014; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2015 and 2014; (iii) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2015 and 2014; (iv) the Consolidated Statement of Shareholders' Equity for the six months ended June 30, 2015 and 2014; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2015 and 2014; and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections.
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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.

PENNS WOODS BANCORP, INC.  
(Registrant)

Date: August 10, 2015

/s/ Richard A. Grafmyre  
Richard A. Grafmyre, President and Chief Executive Officer  
(Principal Executive Officer)

Date: August 10, 2015

/s/ Brian L. Knepp  
Brian L. Knepp, Senior Vice President and Chief Financial Officer  
(Principal Financial Officer and Principal Accounting  
Officer)

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EXHIBIT INDEX

|                |                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                            |
|----------------|--------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Exhibit 31(i)  | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Executive Officer                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| Exhibit 31(ii) | Rule 13a-14(a)/Rule 15d-14(a) Certification of Chief Financial Officer                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                     |
| Exhibit 32(i)  | Section 1350 Certification of Chief Executive Officer                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| Exhibit 32(ii) | Section 1350 Certification of Chief Financial Officer                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                                      |
| Exhibit 101    | Interactive data file containing the following financial statements formatted in XBRL (Extensible Business Reporting Language): (i) the Consolidated Balance Sheet at June 30, 2015 and December 31, 2014; (ii) the Consolidated Statement of Income for the three and six months ended June 30, 2015 and 2014; (iii) Consolidated Statement of Comprehensive Income for the three and six months ended June 30, 2015 and 2014; (iv) the Consolidated Statement of Shareholders' Equity for the six months ended June 30, 2015 and 2014; (v) the Consolidated Statement of Cash Flows for the six months ended June 30, 2015 and 2014; and (vi) the Notes to Consolidated Financial Statements. As provided in Rule 406T of Regulation S-T, this interactive data file shall not be deemed to be "filed" for purposes of Section 18 of the Securities Exchange Act of 1934, and shall not be deemed "filed" or part of any registration statement or prospectus for purposes of Section 11 or 12 under the Securities Act of 1933, or otherwise subject to liability under those sections. |